ESTATE PLANNING AND BUSINESS SUCCESSION PLANNING FOR FARM OWNERS

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PART I

FARM SUCCESSION PLANNING

AND

THE BENEFITS OF LLCS AND SUBCHAPTER S CORPORATIONS FOR FARM OWNERS

PART I
ISSUE 1

WHY MIGHT I PUT MY FARM INTO AN LLC?

Overview of Limited Liability Company ("LLC")

- **Centralized Management:** Provides a mechanism for the centralized management of real estate and rental activities.
- **Privacy:** Provides a certain degree of privacy concerning the ownership of real estate.
- **Separation of Ownership from Control:** Allows for the separation of ownership from control through recapitalizing the LLC into voting and non-voting ownership interests (founder could keep the voting units while transferring away non-voting units and corresponding rights to income). Perhaps 90% non-voting?
- **Facilitates Estate Planning Transfers:** Facilitates estate planning transfers of real estate to descendants and trusts for descendants (easy to transfer units in an LLC holding real estate, while it is difficult to transfer partial undivided interests in the real estate itself).
- **Pass Through Taxation:** Treated like a partnership for income tax purposes. As such, the LLC itself does not pay income tax. Rather, all income and deduction items of the LLC flow through directly to the members.
- **Distributions Not Taxable:** Since the members are directly taxed on the income generated by the LLC, distributions of funds (or with exceptions, assets) from the LLC to the members is generally not a taxable event.

Overview of Limited Liability Company ("LLC")

- **Limited Liability Protection and Insulating LLC Owners from Creditors of the LLC:** An LLC is a separate legal entity that provides liability protection for all owners (owners are referred to as "members") just like a corporation. Only the assets of the LLC (and not the personal assets of the individual members) are subject to the creditors claims of the LLC.
- **Restrictions on Transfers And Insulating LLC Assets from Creditors of Owners:** Helps to restrict transfers (both voluntary and involuntary) of real estate to unrelated third parties (bankruptcy, creditors, divorcing spouses, etc.). Operating Agreement can contain put rights, call rights, restrictions on transfer, and so forth.
- **Valuation Discounts:** Facilitates availability of significant valuation discounts for transfer tax purposes.
  - **Note:** New treasury regulations expected yet this year may impact the availability and size of discounts, especially for LLCs holding only passive marketable investments.
- **Additional Benefits:**
- (1) Avoids Partition,
- (2) Avoids Ancillary Probate and Possibly State Death Taxes in Iowa or Illinois for a non-resident land-owner from Florida, Texas, Arizona, or other state without a death tax, and
- (3) Allows for Smooth Business Succession Planning.

PART I
ISSUE 2

BUSINESS SUCCESSION CONSIDERATIONS

FOR OWNERS OF FARM LLCS AND FARM CORPORATIONS

HOW CAN AN LLC OR CORPORATION HELP WITH FARM SUCCESSION PLANNING?

WHAT TERMS MIGHT A GOOD OPERATING AGREEMENT (OR SHAREHOLDER AGREEMENT) INCLUDE?

Shareholder Agreements

- Shareholder Agreements are essential where ownership of the Corporation is held or will be held by multiple persons.
- Provisions of Shareholder Agreements
  - Permitted transfers (defining the class of permitted transferees)
  - Triggering events (transfer to non-permitted owner, divorce, disability, retirement, death, etc.)
    - Defining Option Holders
    - Option to purchase or mandatory purchase
    - Purchase price and payment terms (cash or promissory note; duration of note & interest rate)
  - Put Options (right of shareholder to have shares purchased – creates exist opportunity)
    - Defining Option Holders
    - Option to purchase or mandatory purchase
    - Purchase price and payment terms (cash or promissory note; duration of note & interest rate)
  - Actions requiring supermajority vote of shareholders (liquidation/dissolution, amending agreement, sale of all or most all corporation assets, etc.)
  - Minimum required distributions (particularly with s-corporations)
  - Asset purchase and lease options (if integrated with terms of a trust owner, perhaps)
  - Tag-along and drag-along rights
  - Provisions related to family groups (classes, voting, directors/managers/officers)
  - Miscellaneous Provisions (dispute resolution, choice of law, etc.)

Shareholder Agreements

- Providing Liquidity to Fund Shareholder Agreement in Event of Death
  - Death of shareholder as a triggering event (often other triggers as well)
  - Option to Purchase vs. Mandatory Purchase
  - Types of Agreements:
    - Entity Purchase (Redemption) – entity is required to purchase the stock from the deceased shareholder.
    - Cross Purchase – other shareholder are required to purchase the stock from the deceased shareholder.
    - Hybrid – other shareholders have the option to purchase the stock from the deceased shareholder, and if option not exercised, the entity is required to purchase the stock from the deceased shareholder.
  - Funding of Purchase by Entity:
    - Life Insurance (BOLI issues)
    - Third Party Financing
    - Cash on Hand
    - Installment Contract
  - Funding of Purchase by Other Shareholders:
    - Life Insurance
    - Third Party Financing
    - Installment Contract
- Life Insurance Proceeds are Generally Not Subject to Income Tax
  - Corporate AMT / Business Owned Life Insurance (IRC Section 101(j))
  - Transfer-For-Value Rules

Shareholder Agreements

- Insurance Partnership/LLC – Addresses many of the negative aspects of Cross-Purchase Agreements
  - Business purpose of partnership/LLC
  - Partnership/LLC is the owner, payor, and beneficiary of the policies (only need one policy per shareholder)
  - Ownership of partnership/LLC would generally mirror that of the operating entity – new shareholders can be added without violating transfer-for-value rules.
  - Protects insurance from creditors of shareholders and operating entity
  - Manager of partnership/LLC has control of policies (responsible for paying premiums and applying the proceeds)
  - Shareholder shall have no "incidents of ownership" (i.e., no control over any decisions related to policy) over the life insurance policy held on his/her life (prevents inclusion of insurance proceeds in shareholder's estate at shareholder's death)
  - Premiums funded from (a) income generated by other assets of the partnership/LLC, (b) from payments made by the operating entity, or (c) from contributions from the shareholders.
  - Upon death of an shareholder:
    - Partnership/LLC uses a portion of the insurance proceeds to redeem the deceased shareholder's interest in the partnership/LLC at a price equal to the deceased shareholder's capital account as of the day preceding death.
    - Specially allocate insurance proceeds (in excess of cash value or unearned premiums) among the capital accounts of the other shareholders on a pro rata basis (determined after redemption of deceased shareholder). Only a portion of the cash value or unearned premiums will be allocated to the deceased shareholder's capital account.
    - Partnership/LLC then makes a special distribution of the remaining insurance proceeds among the remaining shareholder on a pro rata basis (determined after redemption of deceased shareholder), and the remaining shareholder shall be obligated to apply such distribution to the purchase of the deceased shareholder's interest in the operating entity pursuant to the cross-purchase agreement.

One LLC or Two?

- If you have two children, consider two LLCs, each funded with different land.
- This would avoid the need for the children to share ownership going forward.
- Shared inheritances can work, but often they don't.
- I counsel clients to consider leaving different ground to each child.

PART I
ISSUE 3

HOW DO I LEAVE AN INHERITANCE TO EACH OF MY CHILDREN IN A WAY THAT IS FAIR TO EACH AND WON'T CREATE FAMILY PROBLEMS?

Balancing Interests of On-Farm/Business and Off-Farm/Business Heirs

- Clients who are business owners or farmers often have few assets outside of the business/farm. These clients will often times have one or more children involved in the business/farm and one or more children who are not. These clients will need to make the following decisions when creating their estate plan:
  - Do you treat children equally or "fair but not equal"
  - Will equipment pass predominately to "on farm" heirs? Land?
  - Do you put your children in business together, or give them different parcels?
  - If you give children different assets, do you equalize with liquid assets or life insurance? If necessary, do you encumber land to allow promissory notes from on-farm heir to equalize inheritances?
  - Do you give those children involved in the business purchase options?
  - Do you give those children not involved in the business put options?
  - How do you value farmland or business assets for purposes of division (some clients want to value farmland at a discount for purposes of effectuating an equal division because they feel current values are inflated and are not sustainable)?
  - Are buy-outs among family members for cash, or on an installment basis?

Balancing Interests of On-Farm/Business and Off-Farm/Business Heirs

- If a closely-held business is to be shared by multiple descendants, an ownership agreement or trust can provide mechanisms that avoid tension between "on-farm/business" and "off-farm/business" heirs.
  - Options for active farming descendants to lease farms (fair market rent; in Iowa, the "ISU extension average"; crop share; some % of market cash rent, etc.).
  -
  - Options to purchase, rights of refusal, and put options (purchase price: appraised value, some % of appraised value, discounted value, payment terms: in cash, on contract, or a combination).

Life Insurance as a Tool to Provide Liquidity to Equalize Inheritance

- Life insurance is often times the simplest answer where the client wants the children to receive roughly equal shares but wants those children involved in the business/farm to receive all of the business/farm assets.
  - Use of augmented share calculation
  - Use of irrevocable life insurance trust to hold insurance
  - Pay attention to beneficiary designation and tax apportionment clause

Each Family is Unique; Consider all the Options

- John has $6,000,000 in farmland and $2,000,000 in other assets ($8,000,000 total). Two children, son who farms and daughter who doesn't.
- Options to consider:
  - 1. Treat them identically?
    - How? Use an LLC or Corporation? Voting and Non-Voting Stock? Give Son Control? Create Deadlock possibility?
    - Give different dirt to different children? Put daughter's land in trust and require her to rent it to her brother for a fair rate until he retires?
    - Direct executor to borrow against farms, Give Farms to Son Subject to $2,000,000 (or lesser amount) of debt, and give borrowed funds to daughter to equalize?
    - Buy $4,000,000 in life insurance to equalize?
  - 2. Give farming son the right/option to purchase farms from estate or sister?
    - FMV or discounted value?
    - Cash or installment basis?
  - 3. Hold all land in Trust, require rental to son at fair market rental rates (county average per ISU extension, or appraised rental value, or 50/50 crop-share), and distribute rent equally to siblings?
    - Give son right to purchase farms from trust?
    - GST exempt trust, to avoid taxation at children's deaths?
    - Fund during life to obtain freeze; use entity to capture valuation discounts?
    - Do you give the children some power to unwind this situation? How many generations do you try to control?
  - 4. Sell farms to Son (or grantor trust for son) on an installment contract during life?
    - Avoids a fight after you die
    - Loses step-up in basis opportunity
    - Obtains a freeze for your son, and you can sell at a discount if desired, but that would entail a taxable gift equal to the difference between appraised value and purchase price.

PART I
ISSUE 4

ADDITIONAL ESTATE PLANNING CONSIDERATIONS

FOR OWNERS OF FARM LLCS AND FARM CORPORATIONS

I JUST PUT MY FARM IN AN LLC
DO I NEED TO CHANGE MY ESTATE PLANNING DOCUMENTS?

DOES MY ESTATE PLANNING ATTORNEY NEED TO KNOW ABOUT MY LLC OR CORPORATION? WHY?

Integrating the Estate Plan

- When doing estate planning for owners of farms or businesses, additional considerations are important:
- **Abide by Buy-Sell Planning / Transfer Restrictions** – Business interests held by the client may be subject to certain transfer restrictions and rights of refusal contained in a shareholder agreement, partnership agreement, operating agreement, or other binding document. Interests in farmland and other real estate held by the client may similarly be subject to transfer restrictions and rights of refusal (which may run with the real estate for a period of time) which may be contained in an instrument signed by the client when inheriting the real estate.
  - Need to consider whether purchase options will be triggered as a result of the persons to whom or the manner in which interests in businesses and/or real estate will pass under the client's will/revocable trust.
  - On the flip side, when a client is attempting to restrict the transfer of business interests or real property interests that he/she leaves to his/her descendants, it is important to ensure that the estate planning documents and transfer restrictions documents created are consistent.

Integrating the Estate Plan

Ensure S corporation stock passes to a qualified shareholder:

- Only Certain Trusts can hold shares in a Subchapter S Corporation:
  - Grantor trusts (such as revocable trusts)
  - Two year grace period following client's death or transfer to testamentary trust during which trust will be a qualified shareholder
  - Qualified Subchapter S Trust (QSST) – only one income beneficiary, all income distributed to beneficiary, principal may only be distributed to that beneficiary, income interest shall terminate at beneficiary's death or termination of the trust, and upon termination during life of beneficiary assets of trust distribute to the beneficiary. Substantially separate and independent shares within a trust can satisfy these requirements. Beneficiary needs to make timely election.
  - Electing Small Business Trust (ESBT) – can have multiple beneficiaries with some limits. Each potential current beneficiary (each beneficiary of the Trust eligible to receive a current distribution of income) is treated as a shareholder of the corporation. Trustee needs to make timely election. Income tax rules for ESBTs are not as favorable as the rules for QSSTs. The ESBT is divided between an S Portion and Non-S Portion for income tax purposes. S Portion is taxed at the highest rates imposed on trusts and estates (39.6% on ordinary income; 20% on capital gains).

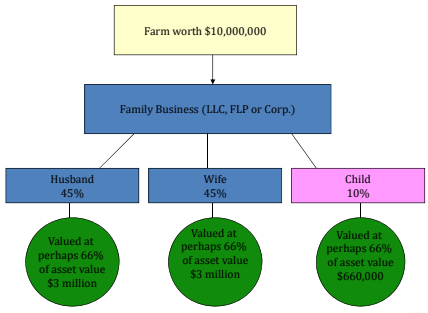
Integrating the Estate Plan

- **Waive the Duty to Diversity**
  - Pursuant to the Prudent Investor Act, Trustees have a duty to diversity assets and to avoid subjecting the trust and its beneficiaries to risk that is not compensated.
  - Often, in situations where the trust will hold real estate or large concentrations of interests in family businesses or other assets, the intent is to preserve those items.
  - In such cases, one must draft around the duty to diversify with respect to such assets. To be cautious, one ought also draft around the duty to invest prudently, and also include limitations of trustee liability sufficient to give the trustee comfort that no liability will attach related to underperformance of non-diversified assets retained under circumstances that would otherwise be deemed "imprudent."
  - Additionally, trust advisors or individual co-trustees can be given the right to direct retention of certain assets or to veto their sale.

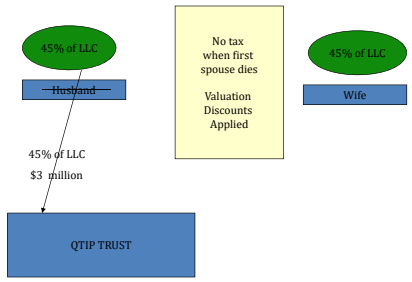
Integrating the Estate Plan

- Facilitate Valuation Discounts if Estate Tax is an Issue – If the availability of valuation discounts on interests in closely-held business is important, then the estate plan that is implemented under the estate planning documents should be designed to facilitate such valuations discounts by having a marital deduction trust and credit shelter trust (i.e., ownership held by the marital deduction trust will not be aggregated with the ownership held by the surviving spouse outright for valuation purposes). It will also be important to have the ownership interests divided between the spouses in a manner that will allow for the application of discounts (50/50) at death, and to have the clients consider making small lifetime gifts of ownership interest to children or trusts for children to get the ownership of each spouse below 50%.

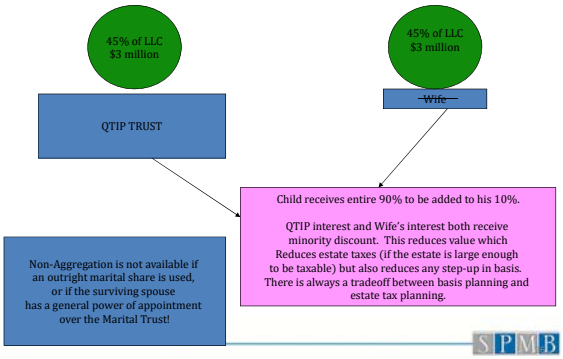
Family Entity in a QTIP: Preserving Discounts



When First Spouse Dies



When Second Spouse Dies



Benefits of dividing a farm LLC and using a QTIP marital trust

- In this example, $10,000,000 worth of farm assets is reduced to $6,000,000 for estate tax purposes.
  - If the family has a taxable estate, the tax savings on that $4,000,000, at 40%, would be $1,600,000.
  - If the family does not have a taxable estate, you have potentially reduced the step-up in basis unnecessarily.
  - New regulations were proposed that, if adopted, would reduce the availability of valuation discounts. The 2016 election seems to have put those proposed regulations on ice.
  - *Tenancy in Common interests in real estate may provide some of the same benefits, when used with a QTIP Trust without a general power of appointment.*

Integrating the Estate Plan

- Placement of Insurance (depends on intended use of insurance) – The placement of life insurance policies ultimately depends on the intended use of the life insurance proceeds. This is particularly important where the insurance proceeds are to be used to fund a buy-sell (or similar) agreement, create liquidity to pay estate tax, or to help equalize the inheritances of children.
- Exercising Powers of Appointment – If the client has been given powers of appointment over assets created by the trust of another, the client should consider exercising those powers in the will/revocable trust to have such assets pass to the client's decedents in the manner that the client wishes.
- Beneficiary Designations
- Tax Payment and Apportionment Clauses

Special Concerns for Blended Families and Second Marriages?



Blended Families

- **Be Aware of Spousal Share Law**
  - Second Marriages are Different: Get a Premarital Agreement!
  - Leaving your children their inheritance in trust protects your farm from their failed marriage.
  - Gifts to Irrevocable Trusts, with spousal waiver, probably avoids inclusion of the gifted assets in a spousal share calculation (at least under current law).
- **Lifetime Irrevocable Grantor Trust** can include Spouse as a beneficiary, if desired. (Alternatively, this can be your kids portion, and other assets can go to spouse).
- **QTIP Trust Solution:** Defers all tax until surviving spouse's death, but also defers children's inheritance until surviving spouse's death, and this can cause disharmony.
- **Alternatives to QTIP**
  - Cash out the spouse (side fund; life insurance; borrow against farm?)
  - Cash out the kids
  - It is Especially Important to Consider Something other than a QTIP Trust if Your Wife is Younger Than Your Kids

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PART I
ISSUE 4

Facilitating "Business Divorces" When Shared Ownership No Longer Makes Sense

Subchapter S Elections & Divisive Reorganizations

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WHAT IF I HAVE AN OLD FARM CORPORATION?

- What might I do to make it easier for the corporation eventually to be liquidated and the farm sold?

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S Election

- S Corporation Election
  - Taxation of S Corporation (certain ownership requirements):
    - S corporations are corporations that elect to pass corporate income, losses, deductions and credit through to their shareholders for federal tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income.
    - If the S corporation was once a C corporation, it may be responsible for tax on certain built-in gains and passive income.
    - S corporations can usually liquidate with lesser tax burden than C Corporations (after waiting 10 years following the conversion, or perhaps in some cases 5 years after the conversion).
  - Issues that Complicate Conversion:
    - C corporations may have a more sophisticated capital structure, such as stock with a preferred rate of return or stock classes with different voting rights. S corporations are limited to one class of stock. Voting and nonvoting stock with the same rights is one class.
    - Corporation converting to an S needs to commit to avoid any sale of highly appreciated assets within 5 years after converting. (The period was 10 years until December of 2015).
    - S Corps generally need to adopt a calendar tax year.
    - S corporations have certain ownership requirements, and all owners must consent to the election.

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S Election

- S Corporation Election
  - Benefits of Conversion:
    - Double tax avoided; pass-through taxation is generally preferable under current rate structure
    - Liquidation or distribution of assets after 10 years (or, in some cases, 5 years) is more beneficial
    - Good Candidates for S Conversions: Corporations with lots of land, especially where owners hope some day to sell the land, especially where ability to avoid corporate income tax has become challenging.
    - Will often times require client to "bleed off" the "hot assets" of the C Corporation over time before converting
  - Passive Income Issues:
    - In cases where a C Corporation has been converted to an S Corporation, if the S Corporation has accumulated E&P from years during which it was taxed as a C Corporation and passive income represents more than 25% of the Corporation's gross receipts in a given tax year, the excess passive income (i.e., the portion of passive income in excess of the 25% threshold) could be subject to a 35% corporate passive income tax rate. If the accumulated E&P and excess passive income persists for three consecutive years, the Corporation could potentially lose its S Corporation status. If the Corporation were able to rid itself of all accumulated E&P (by distributing the accumulated E&P out to the shareholders, which will be taxed as a dividend), there would no longer be passive income issues.

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WHAT IF I HAVE AN OLD FARM CORPORATION AND THE OWNERS HATE EACH OTHER?

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Divisive Reorganization

- **An existing Corporation can be divided, but it is very complicated process and seldom without significant risk.**
- May be beneficial in Farm families at the second or third generation, where there is no longer a unity of interest and where disagreements have begun to arise regarding management of the farm corporation.
- May also be beneficial if different lines of business (trucking vs. farming) will more optimally be operated in separate entities.
- If successful, it is done without generating any tax consequences.
- It cannot be tax-motivated and must have a business purpose, and neither entity should file an S election for at least several years after the division is complete.
- There are numerous requirements that must be followed for a transfer to qualify as a divisive reorganization.
- Three general types of divisive reorganizations:
  1. Spin-off;
  2. Split-off;
  3. Split-up.

Brief Overview of Divisive Reorganization Requirements

Section 355 of the Internal Revenue Code governs divisive reorganizations. Some of its requirements are as follows:

1. Control – The distributing company must be in control of the controlled corporation immediately before the distribution.
2. Device restriction– The transaction must not be principally a device for the distribution of earnings and profits. A device is likely to be found if a business of either resulting company has the principal function of serving the activities of the other company for a significant period of time after the separation, and such business can be sold without adversely affecting the activities of the other company. (It will be assumed that this is a device to bail out the earnings and profits of the entity that can be easily sold after the reorganization). This restriction is important to consider. There are safe harbors, but they don't generally exist where the C Corporation has appreciated property.

Brief Overview of Divisive Reorganization Requirements

3. Active Trade/Business – After the division, both corporations must be engaged in an active trade/business following the distribution. Additionally, the corporation transferring property must also have been engaged in an active trade/business for the five year period prior to the distribution.

   Examples of nonactive trade/business:
   - Holding property (including farm land) for investment purposes;
   - Ownership and operation (including leasing) of real or personal property used in a trade or business is not the active conduct of a trade or business, unless the owner performs significant services with respect to the management of property. It would be difficult in most cases to meet this condition where a corporation cash rents its land.

Brief Overview of Divisive Reorganization Requirements

4. Business Purpose – The division has a corporate business purpose that is substantial and germane. A common acceptable purpose is that the shareholders wish to go their separate ways, perhaps because of serious disputes or disagreements, or perhaps because they have different business philosophies. In such situations, different sets of owners should own each of the resulting businesses.
5. Continuity of Interest – The pre-distribution owners of the two resulting companies must maintain a continuing interest in those corporations after the distribution.
6. Continuity of Business Enterprise – The regulations require some continuity of business enterprise.

What happens if a divisive reorganization fails to satisfy the requirements of Section 355?

The consequences of failing to qualify are dramatic:

1. The distributing company will recognize gain to the extent of the appreciation in the assets of the company being spun out.
2. In addition, the full value of the assets in the company being spun out may be taxed to the recipient shareholders as a dividend.

Because the law is so intricate and confusing, and the consequences of failing to meet the test so severe, one should proceed with caution.

PART I
ISSUE 5

MISCELLANEOUS TAX CONCEPTS RELEVANT TO FARMERS AND FARM OWNERS

Special Use Valuation (§ 2032A)

- The Code permits an Executor to "elect" to value certain "qualified" real property on the basis of its actual use value rather than its fair market value as determined by its highest and best use. Allows a farm (or other family business) to be valued based on what it will produce -- not what it would sell for.
- Threshold Requirements for Special Use Valuation.
  - The decedent must have been a U. S. citizen and the land must be located in the United States.
  - The farm must "pass" from the decedent to a "qualified heir" of the decedent (spouse, ancestors, lineal descendant of individual or spouse or parent, or the spouse of lineal descendant).
  - At least fifty percent (50%) of the adjusted value of the gross Estate must consist of the adjusted value of real or personal property that was being used for farming purposes at the date of the decedent's death by the decedent or a member of the decedent's family and which will pass to a qualified family member (i.e., avoid fire sale of equipment and other farm assets immediately following death if such assets are needed to satisfy threshold).
  - At least twenty-five percent (25%) of the adjusted value of the adjusted gross Estate must consist of the adjusted value of farm real estate which is elected for 2032A treatment and which will pass to a qualified heir and with respect to which the five out of eight year test, described below, is satisfied.
  - The real estate must have been owned by the decedent or a member of the decedent's family and have been used as a farm on the date of death and for a total of five (5) of the eight (8) years ending on the date of the decedent's death.
  - Must have been "material participation" by the decedent or a family member for five of the last eight years ending on the date of the decedent's death. (custom farming and most crop share leases will satisfy this requirement.)

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Special Use Valuation (§ 2032A)

- The qualified heirs must agree to pay an additional tax if they fail to continue to use the property for farming purposes.
- The notice of election and the agreement wherein all interested owners consent to such election must be filed with the Federal Estate Tax Return.
- For purposes of special use valuation, a member of decedent's family includes: ancestors of decedent; spouse of descendent; lineal descendants of decedent, decedent's spouse, or decedent's parents; and spouses of lineal descendants.
- Recapture of Estate Tax Upon Early Disposition of Property.
  - Selling the property outside of the family within ten years will trigger an additional Estate Tax. The additional Estate Tax will also be triggered if the property fails to be used for a "qualified use" for ten years following the date of death and if a family member fails to "materially participate" for three of any eight years post-death. Surviving spouse and lineal descendants who are qualified heirs receiving property can satisfy qualified use test by cash renting land to member of family.
  - Additional Estate Tax is determined by a fraction:
    - The numerator is the fair market value on the date of decedent's death of a particular heir's interest in the property disposed of, less the special use valuation of such property.
    - The denominator is the fair market value at the date of decedent's death of all qualified property elected, less the special use valuation of all such property.

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Special Use Valuation (§ 2032A)

- The maximum amount of reduction in real estate value is $1,120,000 for decedents dying in the year 2017. This number is adjusted for inflation annually.
- The special use value of a farm is determined as follows:
  - The excess of the average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm *over* the average annual State and local real estate taxes for such comparable land *shall be divided by* the average annual effective interest rate for all new Federal Land Bank loans (4-6% in recent years). For purpose of this formula, the average annual computation shall be made on the basis of the 5 most recent calendar years ending before the date of the decedent's death.
  - If there is no comparable land from which the average annual gross cash rental may be determined but there is comparable land from which the average net share rental may be determined, the above formula shall be applied by substituting "average annual net share rental" for "average annual gross cash rental".
  - The term "net share rental" means the excess of the value of the produce received by the lessor of the land on which such produce is grown, over the cash operating expenses of growing such produce which, under the lease, are paid by the lessor.
- *Example: Assume for simplicity that the tax-free amount is $5,000,000 and that an unmarried person has total assets of $6,000,000. Of the $6,000,000 in total assets owned by the individual, $4,000,000 represents farmland. The individual owned and actively farmed the land for the last 30 years prior to his death, and has one son (only child) who wishes to continue the farming operation. Although the special use value of the farmland is $2,500,000, the maximum amount of reduction is value is limited to $1,120,000. Thus, for estate tax purposes the farmland could, if applicable, be reduced in value, but not below $2,890,000, which brings the total asset value down to $4,890,000. As a result of the special use valuation of the farmland, the individual's total assets are under the $5,000,000 tax-free amount, so no tax is due.*

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Installment Payment of Estate Tax (§ 6166)

- The Executor of an Estate which qualifies may elect to pay in up to ten (10) annual installments the Estate Tax liability attributable to an interest in a closely-held business. The first installment payment can be made as late as five (5) years, nine (9) months after the date of death.
- Requirements.
  - Decedent must own an interest in a closely-held business (farm) (i.e., entity of which descendant owned 20% or more of the voting interest) at the date of death. Decedent does not have to be personally involved in the business, but must be an active business (cash renting farmland will not qualify).
  - The interest must exceed in value thirty-five percent (35%) of the decedent's "adjusted gross Estate" (adjusted gross Estate means the decedent's gross Estate less allowable deductions for claims against the Estate, administration expenses, funeral expenses, and indebtedness).
  - Interest will be payable on the deferred tax, generally at a special two percent (2%) interest rate on the tax attributable to the first $1,000,000 of taxable business value, which amount is annually adjusted for inflation ($1,490,000 in 2017). Beyond this amount, the interest rate will be 45% of the rate applicable to underpayments of estate tax.
  - Payment of deferred estate tax is accelerated if 50% or more of decedent's interest in the business is distributed, sold, exchanged, or is otherwise disposed of or is withdrawn from the business.
    - Section 303 redemptions, distributions pursuant to decedent's will/revocable trust, and certain other transactions do not count towards this 50% threshold.

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10 Great Charitable Planning Ideas

1. Make gifts during life to capture income tax deductions
2. Fund gifts with appreciated property
3. Make lifetime gifts to public charities (rather than private foundations) whenever possible
4. *For folks with Iowa income:* Qualifying gifts to endowed funds at Iowa-based community foundations (including gifts of land or appreciated stock) create 25% Iowa income tax credits plus federal deductions.
5. *In Iowa*, qualifying gifts of land or easements for permanent conservation generate 50% Iowa income tax credits plus federal deductions. In other states, the federal deduction will apply and state benefits will differ.
6. Fund Charitable Gifts at death with tax-deferred retirement assets.
7. Folks over age 70.5 should consider a direct IRA rollover (up to $100,000). This provision was recently made permanent under the Protecting Americans from Tax Hikes Act of 2015.
8. When selling a business or farm, consider first gifting part of it to a Charitable remainder Trust benefiting your favorite charity, to avoid capital gains tax and obtain a deduction in the year of the sale. (But not an S Corporation)
9. Gifts of appreciated land or stock to a charity in exchange for a charitable gift annuity can be beneficial.
10. Consider a "zero estate tax" plan with the tax-free amount to kids and the rest to a charity or a charitable lead trust.

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Other Planning Issues For Farmers and Farm Owners

- Maintaining FSA Payment Eligibility
- Like Kind Exchange Opportunities
- Iowa Capital Gains Tax Exclusion Opportunities
- Corporate Farming Acts (i.e., Iowa Code Chapter 9H)
- Title 19 / Medicaid Planning
  - Necessary to Spend Down Assets; 5 Year Look Back Period re gifts, so advance planning required
  - Use of Life Estates in Land
  - State laws vary
- Interstate Issues
  - Florida Homestead Laws – spousal waiver of homestead protection necessary to allow homestead to pass by will/revocable trust.
  - State Gift and Death Taxes
    - May be able to avoid state death taxes if land is in LLC (LLC units treated as personal property), but unlikely to avoid state income tax on income generated from land
    - No longer the case in Minnesota
    - At least one state has a gift tax: *Connecticut. Minnesota* repealed its gift tax.

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PART II
WHAT IS A TRUST AND DO I NEED ONE?

Overview of Trusts – Basis Elements of Trust

1. A Trustor (also called a "settlor" or "grantor")
   - A Person Who Entrusts something to another

2. A Trustee
   - The person to whom something is entrusted by the Trustor
   - Can be a Person, a Committee, or a Bank
   - Can Delegate to Agents
   - Has Duties
     - To invest prudently
       - To diversify investments to avoid uncompensated risk, unless otherwise specified,
       - with certain exceptions for assets with non-economic value, or built in capital-gains liability
       - To invest with an eye to the risk tolerance of the beneficiaries and their need for liquidity and income
     - To account to the beneficiaries
     - To be loyal to the beneficiaries and avoid self-dealing and conflicts of interest
       - Can be paid a reasonable fee
     - To follow the law
       - The Iowa Trust Code (as modified by the terms of the Trust)
       - Filing Income Tax Returns and Paying Required Taxes
     - To follow the terms of the trust
     - To exercise due care and act in the best interests of the beneficiaries
     - To be impartial as among beneficiaries unless otherwise specified
       - Income beneficiary vs. Remainder beneficiary
       - On-farm heir vs. Off-farm heir

Overview of Trusts – Basis Elements of Trust

3. A Beneficiary
   - The person for whose benefit the property is entrusted by the Trustor to the Trustee
   - There can be multiple beneficiaries
   - "Income Beneficiaries"
     - Spouse
     - Spouse and Children
     - A Charity
     - Children and Grandchildren
     - One Child
     - The Trustor
     - The Trustor and the Trustor's Spouse
     - A living pet
   - "Remainder Beneficiaries"
     - A Child or Children
     - Grandchildren
     - A Charity or Charities
   - "Contingent Remainder Beneficiaries"
     - Remote Descendants
     - Descendants of Settlor's Parents, or of Settlor's Spouse's Parents
     - A Charity or Charities

Overview of Trusts – Basis Elements of Trust

4. A "Res"
   - The Thing that is Entrusted
   - "Corpus," or Assets of the Trust.
   - For example:
     - Land
     - Cash
     - A Life Insurance Policy
     - Stocks and Bonds
     - Closely-Held Business
     - LLC or Partnership Interests
     - Oil and Gas Interests
     - Tangible Personal Property
     - Anything

5. Terms
   - *The Trustor's Instructions to the Trustee on what to do with the Res for the benefit of the Beneficiary. Can be almost anything (instructions cannot be illegal or against public policy). For example*:
     1. All income to my spouse, remainder to my kids
     2. Income and Principal to my Spouse in the Discretion of my Trustee, Remainder to my Kids
     3. Income and Principal sprinkled among my Spouse and Kids in the discretion of the trustee, for their health, education, maintenance, and support, considering other sources of support available to each, and with first priority being the needs of my Spouse.
     4. Give $10,000 to Mercy Hospital each year for 10 years, with the remainder to my Children at the end of 10 years.

PART II
ISSUE 1
WHAT IS A REVOCABLE TRUST AND DO I NEED ONE?

Revocable Trusts – What is a Revocable Trust?

- A "Revocable Trust" a/k/a "Living Trust"
  - Usually the Trustor is the initial Trustee and initial Beneficiary
  - The Trustor Can Amend or Revoke (undo) the Trust at any time
  - The Trust is Not a Separate Taxpayer
  - Gifts to the Trust Have No Tax Implication Whatsoever
  - Upon the Trustor's Death, Incompetence, or Resignation, the Trust Continues with a Successor Trustee
  - Upon the Trustor's Death, the Trust Continues With New Beneficiaries, According to the Terms of the Trust, Which at That Point Become a Will Substitute.
  - It is important that every Revocable Trust be Back-stopped with a Valid Will. A "Pour-Over Will" provides that any property owned by the Trustor (and not by the Trustor's Revocable Trust) at Death pours into the Revocable Trust.

Revocable Trusts – Benefits of Revocable Trust

Why Would Somebody Create a Revocable Trust as Opposed to Only Having a Will

- **Probate Avoidance.** If the Trust owns all of the Trustor's property at his death (other than property passing by beneficiary designation or joint tenancy arrangement), then court-supervised probate is avoided. Avoiding court involvement has certain benefits:
  - Reduces Attorney Fees at Death
    - Counterpoint 1: Revocable Trusts involve higher front-end costs and work to establish and fund.
    - Counterpoint 2: Attorney fees are negotiable and court filings are often a small part of the attorney's work.
  - Avoids Executor Fees (your trustee may charge a fee, but trustee fees are often less)
  - Avoids Court Costs (in Iowa, 0.2% of all of the decedent's assets other than life insurance)
  - Enhances Privacy (no "public" court file with copy of will and report and inventory listing the Decedent's assets and their value).
    - Counterpoint 1: Probate creates a public record to memorialize basis of inherited assets
    - Counterpoint 2: Court supervision may deter sneakiness and fiduciary abuses

Revocable Trusts – Benefits of Revocable Trust

- **Better Mechanism for Surrogate Financial Decision-Making During Periods of Incapacity**
  - A Revocable Trust has Certain Advantages if Funded:
    - Revocable Trust Perhaps Less Likely to be Circumvented by Conservatorship Application, Where Families are Dysfunctional
    - Better Succession Mechanisms and More Chance of Avoiding Conservatorships if Agents Die
    - Clearer Accounting Duties Under Trust Rules
    - Less Problem With Out-of-State Transfer Agents (who sometimes will refuse to accept a power of attorney that wasn't recently signed, or that doesn't meet certain requirements)
    - Be Careful not to accidentally give an attorney-in-fact the power of a trustee, or the power to amend a revocable trust. Gifting power in revocable trust should dove-tail with gifting power in the power of attorney, and attorney-in-fact should not have any power to undermine the estate plan.
    - NOTE: EVEN WITH A REVOCABLE TRUST, YOU STILL NEED A WILL AND YOU STILL NEED A DURABLE FINANCIAL POWER OF ATTORNEY.

Revocable Trusts – Benefits of Revocable Trust

When are revocable trusts worth the effort and complexity?

- The older you are, the more beneficial it is
- The wealthier you are, the more beneficial it is
  - Greater savings at death
  - More ability to afford the extra costs now
- The more that privacy matters to you, the more beneficial it is
- If you own property in multiple states or may move between states, it may be worth considering
  - Probate in multiple states can be confusing and expensive
  - LLCs can also be used to address this concern.

Revocable Trusts – Funding of Revocable Trusts

- Funding of Trust
  - Can't be "kind-of" pregnant or "kind of" in probate.
  - Real Estate – transferred to revocable trust by deed. However, real estate titled as JTWROS passes outside of probate to surviving joint tenant by law, so no need to transfer client's interest to revocable trust.
  - Ownership in Business Entities – stock/units transferred to revocable trust by irrevocable stock/unit power (or signing back of stock/unit certificate)
  - Tangible Personal Property – transferred to revocable trust by bill of sale or general assignment. However, vehicles, boats, and other tangible personal property that can be titled can be re-titled into the name of the revocable trust if desired, but such property should be covered by the bill of sale or general assignment in any event.
  - Assets Passing by Beneficiary Designation (life insurance, IRAs, 401Ks, etc) – do not need to be transferred into the revocable trust, as such assets pass outside of probate to the designated beneficiary by contract. This designations should be reviewed regularly to ensure they are consistent with the rest of the estate plan the client has implemented.
  - Accumulation Accounts (brokerage accounts, investment accounts, CDs, etc) – often recommend that clients place these accounts into the revocable trust of one spouse or the other, equalizing assets between the spouse's revocable trusts to the extent possible absent reasons not to do so. Alternatively, could leave ownership in individual names and add the POD designation discussed below.
  - Transaction Accounts (checking accounts, savings accounts, etc.) – often recommend that clients keep these accounts as joint accounts in the individual names of the spouses, but to add a POD designation directing that upon the death of the surviving spouse the account will be paid to the surviving spouse's revocable trust.

PART II
ISSUE 2
WHAT IS A TESTAMENTARY TRUST AND DO I NEED ONE?

Testamentary Trusts

- "Testamentary" is from the root "Testament," as in "Last Will and Testament"
- Testamentary Trusts Are Those That Become Effective at Death, Created Under a Will
  - (Similar Trusts can be created at death Under a Revocable Trust, which is a will substitute)

Why might somebody want to leave a loved one an inheritance in trust?

- **Minor or Young Beneficiary Not Yet Ready to Handle Inheritance**
  - Pot Trust for Minors
    - Separate Shares After age 18; distributions at 25, 30, 35
  - Grandchildren's Trusts
  - Uniform Transfer to Minors Act (until age 21 in Iowa; possibly 18 in California)
- **Incompetent, Frail, or Financially Unsophisticated Beneficiary**
  - Competence to Handle Investments
  - Disenfranchisement from Public Assistance if No Trust Used, or if Trust is a "Support Trust" or "Discretionary Support Trust" rather than a "Discretionary Trust"
- **To protect the money from creditors ("asset protection planning")**
  - Discretionary Trusts
  - Spendthrift Trusts (in South Dakota, even from your own creditors!)

Why might somebody want to leave a loved one an inheritance in trust?

- **Multiple Beneficiaries----balancing need as it arises from time to time**
  - Surviving Spouse and Children
    - Income to Spouse; Remainder to Children
    - Spray or Sprinkling Power (discretionary or subject to ascertainable standard)
  - Minor Children Being Raised by a Common Guardian
  - On-Farm and Off-Farm Children
    - Allow Farm to Stay in Family With Profits Shared, Perhaps Rented to On-Farm Heir at a Discounted Rental Rate
    - Same concept can work for any business, if family dynamics are carefully taken into account
  - Family Cabin or Retreat
    - Trust could hold "special property" such as a cabin or vacation home, with provisions for shared use. An LLC is another way to structure things like this.

Why might somebody want to leave a loved one an inheritance in trust?

- **Strong feelings about what the money is used for or how quickly it is spent**
  - Don't Create Dependency or Sloth
  - Empower People to Reach Their Potential
    - Incentive Provisions
    - Precatory Language re Money Values and Empowering Initiative Rather Than Coddling Sloth
  - Medical and Educational Needs Paramount
  - Make Sure the Money Doesn't Run Out

Why might somebody want to leave a loved one an inheritance in trust?

- **To protect the money or farm from being lost in the event of the beneficiary's divorce**
- **To prevent the beneficiary from selling the farm or business at least right away, or without assent from some majority or supermajority of the family**
  - A farm
  - A business
- **To allow one person to make investment or farming decisions while the other person benefits from the property**
  - An elderly beneficiary, perhaps, if elder abuse is a concern
  - A beneficiary who isn't used to making financial decisions
  - A beneficiary who may be taken advantage of
  - An off-farm heir

Inter Vivos Irrevocable Trusts – The Estate and Gift Tax in 2016 and Beyond

- No Sunset
  - Permanent until Congress votes to change it
- Rate Unified at 40% (gift, estate, GST)
- Exemptions are Indexed to Inflation
  - $5,000,000 in 2011
  - $5,125,000 in 2012
  - $5,250,000 in 2013
  - $5,340,000 in 2014
  - $5,430,000 in 2015
  - $5,450,000 in 2016
  - $5,490,000 in 2017
  - A married couple gains between $40,000 and $250,000 in exemption each year!
- Estate and Gift Tax Exemptions are Portable (almost $11,000,000 for a married couple)
  - GST Exemption is Not Portable
  - Must File an Estate Tax Return to Elect Portability
    - Must be timely, but relief may be available if a deadline is blown.
  - Allows Most "ordinary folks" to Simplify Their Plans

Testamentary Trusts – Reasons for Leaving Inheritance in Trust for Surviving Spouse

- Tax Reasons for a Married Person to Create an Irrevocable Trust for Surviving Spouse Upon Death:
  - Capture first spouse's estate tax exemption:
    - $5,490,000 plus inflation under current law
    - A "Bypass Trust" or "Credit Shelter Trust" or "Family Trust"
    - Until 2011, the first spouse's exemption was wasted if he didn't leave the "tax free amount" in trust rather than outright to his spouse (now have Portability)
  - Facilitate Generation Skipping Transfer ("GST") Tax Planning
  - Maintain Availability of Valuation Discounts
  - Estate Tax Planning vs Basis Planning (Stepped-Up Basis and Income Taxes)
- Non-Tax Reasons for a Married Person to Create an Irrevocable Trust for Surviving Spouse Upon Death (Especially in Second Marriages):
  - Protect assets from creditor problems of surviving spouse
  - Protect assets from future spouses of surviving spouse
  - Protect assets in event surviving spouse becomes the victim of elder abuse or undue influence.
  - Ensure desired estate plan is carried out following death of surviving spouse (i.e., lock in the remainder beneficiaries).

Types of Marital Planning Included in Estate Plans

- **Disclaimer Plan (Contingent-Tax Plan):**
  - Assets are left to surviving spouse, with surviving spouse having ability to disclaim (within 9 months of deceased spouse's death) assets to the Family (Bypass) Trust created by deceased spouse.
  - Allows Flexibility for Post-Mortem Planning: Disclaim to Fund the Trust and Get an Estate Tax Freeze? Or Spouse to Receive Assets and Get a Second Step-up? Either way, no estate tax exemption is wasted. Assets passing to Family Trust by way of disclaimer by surviving spouse cannot be subject to a spousal second look power over the Family Trust.
  - Optimal Plan for Many or Most "First Marriage" Clients Well Below the $11,000,000 Threshold, as Second Step-Up in Basis will often be Optimal
  - Not Optimal Plan For (a) folks approaching or above the $11,000,000 Threshold, where the estate tax freeze may be more attractive than the possibility of a Second Step-Up (especially with appreciating assets (farms) that are not likely to be sold by heirs but rather retained as legacy assets), (b) folks that have non-tax reasons for utilizing a Trust, or (c) folks who desire to do GST Tax Planning (GST Tax exemption is not portable, so a trust created when the first spouse dies will still be optimal for families interested in dynasty trusts and GST planning).

Types of Marital Planning Included in Estate Plans

- **Marital Deduction "Optimal Formula" Plan (Fractional or Pecuniary):**
  - Assets are allocated between a Family (Bypass) Trust and a Marital Trust ("A-B Plan") or between a Family (Bypass) Trust and an Outright Marital Share based on Deceased Spouse's Available Tax-Free Amount (this allocation can be done as a fraction or pecuniary amount).
  - Marital Trust – Surviving Spouse Must Receive All Income for Life and Must be the Only Beneficiary During Life.
  - Family Trust – Flexible with respect to Terms to be Included
  - Optimal Plan For (a) folks approaching or above the $11,000,000 Threshold where availability of valuation discounts will be important, (b) folks that have non-tax reasons for utilizing a Trust, or (c) folks who desire to do GST Tax Planning.

Types of Marital Planning Included in Estate Plans

- **Clayton QTIP:**
  - Assets are allocated between a Family (Bypass) Trust and Marital Trust based on the extent to which the Trustee makes a QTIP election. Portion of assets for which QTIP is elected will be allocated to Marital Trust and remaining portion of assets will be allocated to Family Trust. Marital Trust and Family Trust can provide for different dispositive terms. This type of plan may provide additional post-mortem planning opportunities than traditional Marital Deduction Formula Plan.
  - Optimal Plan For (a) folks approaching or above the $11,000,000 Threshold where availability of valuation discounts will be important, (b) folks that have non-tax reasons for utilizing a Trust, or (c) folks who desire to do GST Tax Planning.

How has portability changed things?

- Example: John and Lisa are married, and neither has made any lifetime gifts. If John dies and leaves everything to his wife Lisa, and if John's Executor files a timely federal estate tax for John (within nine months) and elects portability, John's $5,490,000 estate tax exemption is added to Lisa's. At least if Lisa doesn't remarry, she now has $10,980,000 in estate tax exemption to apply to assets that pass at her death.
- At Lisa's death, her heirs will get a new stepped-up basis on the entire $10,980,000, which is good if the assets will one day be sold and if they are appreciating.
- If Lisa's assets have grown beyond $10,980,000 prior to her death, then estate tax will be due. In that case, a freeze might be more valuable

How has Portability Impacted How We Draft for Married Couples?

- For most married couples whose assets are well below $11,000,000, we are recommending either (1) outright marital shares with disclaimer-based "contingent tax planning" (where there are no non-tax reasons for a trust), or else (2) fractional or Clayton QTIP plans (where there are non-tax reasons for Trusts).
- Generation-Skipping Transfer Tax Exemption is not portable, so if a "dynasty" trust is desired, then the first spouse must create a trust upon his death, perhaps for the first $5,490,000 plus inflation.
- For couples whose assets may exceed $11,000,000, it is still wise, in many cases, to put as much as possible in a credit shelter trust when the first spouse dies, to keep future appreciation out of the survivor's estate, and capture valuation discounts.
- Each case is unique. There are no hard and fast rules. It depends in part on whether assets will be sold at death or kept in the family, and how much they are likely to appreciate. It depends on whether there are non-tax reasons for trusts that factor into the balance.
- Portability is Great for Married Persons with Large IRAs and Qualified Plans: with qualified plans and IRAs, outright bequests to spouse to allow a spousal roll-over is more optimal than ever, as it no longer wastes exemption.

Testamentary Trusts – Maintaining Flexibility

- Trustee's Power to "Sprinkle" or "Spray" income and/or principal of Trust among a specified class of beneficiaries – provides flexibility for Trustee to manage taxes and direct funds to persons who need them
- Surviving Spouse's Second Look Power (Limited Power of Appointment) – provides surviving spouse with flexibility to change the distribution of trust assets that will occur after death of surviving spouse (can be narrow or broad).
- Independent Trustee's Power to Amend Trust (for tax reasons, to carry out grantor's intent, to corrects errors, etc.) or to terminate the Trust early.

PART II
ISSUE 3
WHAT IS AN IRREVOCABLE TRUST AND DO I NEED ONE?

(ADVANCED ESTATE TAX PLANNING)

Lifetime Gifting Involves a Trade-Off: Estate Tax Avoidance v. Basis Step-Up at Death

- Section 1014 of the Code – basis of property passing to beneficiary at the death of the transferor will be stepped-up to fair market value
- Section 1015 of the Code – basis of property passing to beneficiary during the life of the transferor will be the same basis that the transferor had in the property ("carryover basis"), increased by any gift tax paid by the transferor. Lower of basis or FMV rule applies for determining loss in the hands of the beneficiary.
- Lifetime gifting accelerate use of exemption amounts to obtain freezes: keep future income and appreciation on such gifted assets out of your estate.
- Lifetime Gifting Strategies:
  - Outright gifts (large gifts or annual exclusion gifts)
  - Outright part gift / part sale transactions ("bargain sales") – for cash or on installment contract
  - Outright sales for fair market value – for cash or on installment contract
  - **Use of inter vivos irrevocable trusts (GRATS and IDGTS)**
    - **Effectuate freeze without giving control over gifted assets to beneficiary (at least not all at once)**
    - **Concerns about beneficiaries**
    - **Balancing inheritance off-farm and on-farm heirs**
    - **GST Tax Planning**
    - **Additional planning opportunities provided by using "grantor trusts" (income tax payments and sales)**

Consider State Taxes as Well: For Example, Lifetime Gifting may Avoid Iowa Inheritance Tax

- No inheritance tax due on assets passing to surviving spouse, lineal descendants (including step-children and as of 2015, the children of step-children), or lineal ascendants
- Assets passing to siblings, son-in-law, or daughter-in-law subject to inheritance tax of 5% (assets under $12,500) up to 10% (assets over $150,000).
- Assets passing to all other persons (including uncles, aunts, cousins, nieces, nephews, brother-in-laws, sister-in-laws, step grandchild, etc.) subject to inheritance tax of 5% (assets under $50,000), 10% (assets between $50,000 and $100,000), and 15% (assets over $100,000).
- 3 Year Look Back Period (gifts made within 3 years of death subject to tax).
- Beneficiary is liable for tax, unless estate planning documents provide otherwise.
- Life insurance proceeds and deferred retirement benefits (not Roth benefits) payable to such persons are generally exempt from inheritance tax.

Will I pay state death taxes?

- California has no state death tax
- Arizona has no state death tax
- Florida has no state death tax
- Even if you are not an Iowa resident, Iowa will charge a state death tax on your Iowa real estate, unless it is in an LLC or corporation, but only if it goes to someone other than your spouse or descendants.
- Illinois has a state death tax. Even if you are not an Illinois resident, Illinois may charge a state death tax on your Illinois real estate, if your estate exceeds $4,000,000 in value.

USING IRREVOCABLE LIFETIME TRUSTS TO REDUCE OR AVOID ESTATE TAXES AT DEATH:

ADVANCED ESTATE PLANNING STRATEGIES FOR WEALTHY FARM CLIENTS

10 Powerful Estate Tax Strategies for Families Who Face Estate Taxes (singles above $5,490,000; couples above $10,980,000).

1. Defer any taxes until the second spouse dies
2. Accelerate gifts of exemption amounts to obtain freezes: Keep Future Income and Appreciation on such Gifted Assets Out of Your Estate
   a. Outright Gifts to Descendants
   b. Bargain Sales to Descendants – i.e., sale of farmland equal to basis to avoid capital gain
   c. Gift (and possible sale) to inter vivos irrevocable trust
3. Put Life Insurance in Irrevocable Life Insurance Trust (or LLC, or Children's names) to Avoid Subjecting Death Benefit to Estate Tax.
4. Use Grantor Trusts: Pay Taxes on Income That Benefits Your Children and Grandchildren So They Don't Have To
5. Take Full Advantage of Valuation Discounts (pay attention to ownership percentages and language of shareholder agreement/operating agreement concerning restrictions on transfer and valuations methods)
6. Use Interest Rate Arbitrage & Cherry-Picking Assets to Beat IRS Assumptions on Trust Total Return
7. Lock in Low Interest Rate Assumptions for 9 Years or Longer
8. Consider Multi-Generational Trusts: Use GST Exemption to Avoid Taxes When Your Children and Grandchildren Die As Well
9. Consider use of Wandry Clause when making large gifts to Reduce Valuation Risk.
10. Keep Plan and Trusts Flexible in case the law or family dynamics change.

Tax Reasons for Creating an Inter Vivos Irrevocable Trust?

- **Get Life Insurance Death Benefit Out of the Taxable Estate**
  - An "Irrevocable Life Insurance Trust"
  - Trustor Must have no "incidents of ownership" over the policy
  - Funding of Annual Premiums:
    - Annual Exclusion of $14,000 per beneficiary can be used to fund annual premiums ("Crummey Trust")
    - Large cash gift to Trust
    - Gift of assets (interests in closely-held business or real estate) that can generate income sufficient to fund the annual premiums
    - Annual transfer of funds from another irrevocable trust created by Trustor that holds income producing assets
    - Loan from Trustor
    - Split-Dollar Arrangement
  - For new policies bought by the trust initially, the death benefit is not included in the Trustor's taxable estate.
  - For policies gifted by the Trustor to the life insurance trust, the Trustor must survive 3 years before the death benefit is out of his taxable estate.

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Tax Reasons for Creating an Inter Vivos Irrevocable Trust?

- **Get An Estate Tax Freeze**
  - Making a gift now to get an asset out of your taxable estate, without giving control to the beneficiary, at least all at once
  - Must be an "Irrevocable Trust"
  - Trustor Generally must part with control and any right to enjoyment
  - Up to $5,490,000 under current law; double that for married folks who gift-split (but spouse generally cannot have a beneficial interest if you gift-split).
  - Example: Trustor gifts stock in a closely-held business to an irrevocable trust for his wife and children, valued at $5,490,000. He files a gift tax return and reports that gift.
    - Wife and children get the income every year
    - When Trustor dies 20 years later, the stock in the trust is worth $20,000,000.
    - None of that $20,000,000 is taxed in his estate, or in his Spouse's estate.

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Tax Reasons for Creating an Inter Vivos Irrevocable Trust?

Lock in Valuation Discounts

- Non-voting units in LLCs and non-voting shares in Corporations generate significant valuation discounts
  - Discounting opportunity may go away in the future, as discounts are on the chopping block
  - Not wise to fund with voting units, 2036 issues
  - Recapitalization may be necessary
  - Units retained may also qualify for a discount with proper QTIP/Family Trust planning

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Tax Reasons for Creating an Inter Vivos Irrevocable Trust?

- **Take Advantage of Grantor Trust Status and Benefits**
  - Grantor Trusts allow a wealthier person (a parent) to pay income taxes on income that benefits a less wealthy person (a child)
  - A "Grantor Trust" or "Intentionally Defective Trust"
  - Often done by having the Trustor retain a "substitution power" or "swap power"
    - Example: Trustor gifts stock in a closely-held business to an irrevocable grantor trust for his children, valued at $5,490,000. He files a gift tax return and reports that gift, allocating his GST tax exemption to it.
    - Because it is a grantor trust, when son gets income from the Trust, the Trustor pays the income taxes on that income. Trustor's payment of the income taxes on that income is a tax-free transfer of value to Trustor's son.
    - Because it is a grantor trust, the Trustor can sell assets to the trust without triggering capital gains tax, which can be beneficial.

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Why are Grantor Trusts Powerful Estate Tax Planning Tools?

- Grantor Trusts may be good candidates for purchasing additional assets in the future once exemptions have been fully utilized
  - Must be a separate decision, preferably in a different year.
  - Fair market value must be paid (get qualified appraisals, especially where discounts applied)
  - No capital gain should be recognized on sale (but no step-up in basis at death of Grantor)
  - Interest on promissory note should not be taxable income. And since AFRs are so low (1.75% for 9-year notes), it is not hard to outperform IRS assumptions.
  - If substitution power is used, Grantor has a right to buy back the assets transferred
  - The sale leverages not only the gift tax exemption, but also the Generation-Skipping Transfer Tax Exemption, saving estate taxes at each generation, and insulating the farm from creditor claims and divorcing spouses at each generation.
- If desired, spouse can be a beneficiary of the trust, creating a safety valve as long as Grantor's spouse is alive and couple is married.
  - Backstop with life insurance on spouse, in an ILIT?
  - "Leaky freeze" may reduce tax planning benefits, but helps make gifts affordable in some cases
  - Beware "reciprocal trust doctrine"

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Using GRATs to fund Trusts

- A Grantor Trust (or Life Insurance Trust) can also be the beneficiary of GRATs.
- GRATs can be zeroed out to eliminate using any of the Grantor's gift tax exemption, and essentially shift appreciation between the 7520 Rate (2.2% in January 2016) to the beneficiary.
- GRATs are a no-risk strategy.

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Tax Reasons for Creating an Inter Vivos Irrevocable Trust?

- **Avoid Estate Taxes at Each Generation (Don't Waste GST Tax Exemption)**
  - A "Generation-Skipping Transfer Tax Exempt Trust" or "Dynasty Trust"
  - $5,490,000 exemption plus inflation
  - Example: Trustor gifts stock in a closely-held business to an irrevocable trust for his wife and children, valued at $5,490,000. He files a gift tax return and reports that gift, allocating his GST tax exemption to it.
    - Wife gets income for life; then son gets income for life, then the trust passes to grandchildren or great-grandchildren
    - When Trustor dies 20 years later, the stock in the trust is worth $20,000,000. When Trustor's wife dies 5 years after that, it is worth $24,000,000. When Trustor' s child dies 25 years after that (50 years from now), the stock is valued at $50,000,000.
    - None of that stock is subject to estate tax at Trustor's death, at Trustor's Spouse's death, or at Trustor's Child's death.

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Building Flexibility into Long-Term Trusts

- Trustee Discretion regarding distributions
- Powers to change Trustees
- Powers of appointment
  - In spouse
  - In descendants
- Disclaimer Powers
- Partial Elections
- Options/Rights of Refusal
- Limited Powers of Amendment/Reformation
- Decanting Powers
- Substitution (Swap) Powers

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Preparing the Federal Gift Tax return– Triggering the Statute of Limitations and Other Considerations

- GST Exemption Election Statements – opting in and opting out of automatic allocation rules
- Gift-Splitting, Even For Annual Exclusion Gifts
- Disclosure of Non-Gift Transactions to Family Members, to Trigger Statute of Limitations on Valuation Questions
- Full and Adequate Disclosure Statements – trigger 3 years statute of limitations
  - Description of property transferred and consideration received
  - Identity of and relationship between transferor and transferee
  - If property transferred in trust, trust's tax ID and description of trust terms (or copy of trust)
  - Statement of any position taken to contrary of regulation or ruling
  - Value of property (Revenue Ruling 59-60)
    - Qualified Appraisal (we strongly recommend this route)
      - Qualification of appraiser
      - Date of transfer and date of appraisal
      - Purpose of appraisal
      - Description of property
      - Description of assumptions, hypothetical conditions, and any limiting conditions or restrictions on the property affecting conclusions of value
      - Info considered in determining value
      - Appraisal procedures followed and reasoning that supports conclusions
      - Valuation method used and rationale for its use
      - Basis for valuation
    - If no appraisal – detailed description and analysis of method used to determine value

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"Mr. Osborne, may I be excused? My brain is full."

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Questions?



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