17. Estate Planning: Important Issues

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Abstract/Summary

Congress finally passed permanent legislation in January 2013 in regards to the Federal Estate Tax Exemption, so farmers finally have direction to complete their estate and transition planning.

This session will review the current estate and gift tax rules and present some example estate plans that a farmer may want to consider.

ESTATE PLANNING IMPORTANT ISSUES

KSU RISK & PROFIT CONFERENCE 2013

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PURPOSE OF THIS SESSION

- REVIEW CURRENT ESTATE TAX RULES
- WHY DO I NEED TO DO ANY ESTATE PLANNING UNDER CURRENT LAW
- CAN A TRUST BE AN IMPORTANT PART OF YOUR ESTATE PLAN?
- PROVIDE AN EXAMPLE ESTATE PLAN TEMPLATE FOR A MULTI-GENERATIONAL FARM

HISTORICAL FEDERAL EXEMPTIONS

- 2002-2003 $ 1 MILLION
- 2004-2005 $ 1.5 MILLION
- 2006-2008 $ 2 MILLION
- 2009 $ 3.5 MILLION
- 2010 – UNLIMITED BUT CHANGED TO $ 5 MILLION

CURRENT ESTATE TAX EXEMPTIONS

- 2011 Federal exemption - $ 5 million per person
- 2012 Federal exemption - $ 5.120 million per person (adjusted for inflation)
- 2013 federal exemption - $ 5.25 million per person (adjusted for inflation hereafter)
- KANSAS – NO INHERITANCE TAX

Current Estate Tax Rates

- 40 percent estate tax rate for any amounts above the $ 5.25 million exemption

KEY TRANSFER TAX CHANGES UNDER ATRA

- Permanence
- Indexing for inflation
- Unification with Gift Tax Rules
- Portability between spouses

Permanency of Transfer Tax Provisions

- There is no effective expiration date of the current estate tax provisions, so the issue does not have to be debated each legislative session.
- However, it is only as permanent as the next legislative bill that changes the rules.

Indexing for Inflation

- Lifetime exemption remains at $ 5 million based on 2011 baseline.
- Exemption is indexed to inflation, so it will continue to rise automatically over time.
- 2013 exemption = $ 5.25 million

Unification with Taxable Gifts

- Taxable gifts during the taxpayer's lifetime are added to the taxpayer's estate value to determine any liability.
- $ 14,000 annual gift tax exclusion per donee for 2013. Must be a gift of a "present interest".
- Consider small dividends from closely held entities to "perfect" present interest.

Gifting Rules for 2013

- Gift and federal inheritance exclusion are tied together, so accumulated taxable gifts up to $ 5,125,000 will owe no gift tax, but the taxable gifts are added to the estate to determine estate tax liability.
- Total taxable gifts during lifetime $ 2 million

Value of Estate	5 million
Total Estate tax exemption	-5.25 mill
Taxable Estate	1.75 mill
Tax Due @ 40%	$ 700,000

Portability

- Surviving spouse can inherit decedent's unused exemption.
- Permanent under ATRA.
- Still have to file Form 706 in first spouse's estate to make election.

PORTABILITY OF EXEMPTION NEW CONCEPT FOR 2011 & AFTER

- In effect, portability lets a married couple double their exemption to $ 10.5 MILLION with no estate planning for 2013.

EXAMPLE OF PORTABILITY

- Joe died in 2013 with a taxable estate of $ 1.25 million and his estate made the portability election.
- Joann, his wife, dies later, with a taxable estate of $ 9 million. She can use up to $ 4 million of Joe's exemption, along with her $ 5.25 million exemption, so she would owe no federal estate tax.

Not in ATRA

- No attack on valuation discounts on closely held entities
- 30-40 % discounts for minority interests and lack of marketability
- Very complicated issue and appraisal process, so get good legal council

Estate Planning Priorities

- Preservation of Stepped-up basis at death of each spouse
- Maintain standard of living for surviving spouse
- Asset Protection Planning
- Medicaid planning
- Keep the family farming

Step-Up in Basis Rules

- IRC Section 1014 – allows a new tax basis equal to fair market value on property which is transferred through a decedent's estate.
- This is a huge benefit to farmers, because of the low basis assets such as raised breeding stock, equipment that has been depreciated out, grain on inventory, and land that has appreciated in value over the past 30 years.

Step-Up in Basis Rules - Continued

- Since men have a shorter life expectancy than women, utilize a strategy that leaves low cost basis assets in the husbands name (i.e. cows, equipment, grain) and put the land in the wife's name.
- If Trusts are utilized, give spouse a testamentary "power of appointment" to allow basis adjustment on surviving spouse's death.

Special Use Valuation
IRC Code Section 2032A

- Applies to real estate only, livestock and equipment are not eligible
- Qualifying property must be at least 25% of total real property
- Property is valued by dividing net cash rental rate on similar property by the FCS cap rate = $ 70 net income divided by 5.15 rate = $ 1359 per acre

Special Use Valuation

- Decrease in value limited to $ 1,070,000 for 2013
- 10 year recapture period, whereby the property must be held by qualified heirs and actively managed. This is a very technical IRS code section and legal council is advised

Installment Payment of Estate Tax
IRC Section 6166

- 4 years interest only, then 10 year installment contract is available
- 2% interest rate on the first $ 572,000 of estate tax due, then 45% of the regular IRS underpayment of tax rate on the balance due(1.35% for 2013)
- Closely held business assets must equal 35% of total estate value

Estate Planners Are Still Needed

- Asset protection through entities, trusts, pre-nups, and post-nups
- Planning for long-term health care
- Powers of Attorney
- Reviewing beneficiary designations and coordinating them with estate plan
- Business Succession

TRUST PLANNING

- Why should you consider a trust when there is no estate tax benefit?

TRUST ADMINISTRATION

- Avoid Probate
- No probate fees, but this is offset by the cost of the initial trust set-up
- Assets are not public information
- No conservator needed if a person become incapacitated
- Very easy to name successor trustee

ESTABLISH A FAMILY TRUST UPON FIRST SPOUSES DEATH THAT IS IRREVOCABLE AND FREEZES THIS PART OF ESTATE

- Divide ½ of marital assets and fund a family trust upon the first spouses death.
- Leave assets in trust for the next generation, with the surviving spouse receiving all income during their lifetime.
- Could also “spray” or divide income between the surviving spouse and children.

BENEFITS OF A FAMILY TRUST

- Assures that children will receive at least ½ of assets if surviving spouse remarries.
- Keeps ½ of assets out of the surviving spouses taxable estate if the exemption is lowered. Congress could take action to lower the federal exemption.
- Could keep these assets out of surviving spouse’s name if extended nursing home care is needed.
- Keeps ½ of inflation out of survivors estate.

BENEFITS OF LEAVING ASSETS IN TRUST FOR YOUR CHILDREN INSTEAD OF TERMINATING

- Protects against a judgment against your child/potential litigation
- Protects against a divorce settlement
- Is not included in your child’s taxable estate if they already have a high net worth

Example Estate Plan

- Establish two revocable trusts, one for each spouse, with ½ net worth in each.
- Establish two LLC’s, one with the operating assets such as grain, cattle, and equipment; second LLC with farmland in it.
- If each LLC is of equal value, let husband’s trust own the operating LLC, and wife’s trust own the farmland LLC. This takes advantage of the step-up in basis at death.

Example Plan - Continued

- Each trust becomes irrevocable at death. Assets are left in trust for children with the surviving spouse entitled to the income. This keeps the assets of the first spouse to die out of the second spouse’s estate.
- Could “spray” income between spouse and the children at discretion of trustee.
- Could let trustee “appoint” or distribute assets out to children if desired.

Example Plan #2

- Put all assets into a joint trust between husband and wife
- Upon the death of the first spouse, assets equal to the federal estate tax exemption are transferred to a “Family Trust”, which becomes irrevocable.
- Surviving spouse gets the income from the Family Trust and can invade the principle for his/her health/education/living expense.

Example Plan – Buy/Sell Agreements

- Each LLC could have a buy-sell agreement that allows a non-farm heir to sell their units at FMV, but will receive their money over a 15 year contract at the minimum IRS interest rates.
- This gives non-farm heirs some liquidity to get assets out of the LLC's, but does not require on-farm heirs to go borrow a lot of money at high interest rates to buy others out.

Example Plan – Buy/Sell Agreements

- The Trusts could transfer more operating LLC units to the on-farm heirs to leave them in control.
- A long term lease could tie up the use of the farmland in the "Land" LLC for the benefit of the "Operating" LLC.

Joe Biden Quote

- Do not let "perfect" get in the way of "good".
- Apply this concept to your family estate plan.
- Getting a plan in place is very important.

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