What Now? – Part Two

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Overview

In Part One, I took a look at the possible income tax-related changes that might be on the horizon and the planning implications of such changes. In today's post I turn the spotlight to potential changes that could impact estate and business planning. Will estate and gift tax rates change? What about the level of the federal estate and gift tax exemption? Will the income tax basis rule change when a person dies? Will valuation discounts be available? These are all important questions that bear on how the farming or ranching business should be structured to facilitate an intergenerational transfer. These are all questions that are on the minds of many farm and ranch families.

Potential law changes that could impact farm and ranch estate and business planning – it's the topic of today's post.

Estate and Gift Tax Exemption

When I first started practicing, the federal estate and gift tax exemption sheltered $600,000 of wealth. That seems like a pittance now with the current level set at $11.7 million for deaths in and taxable gifts made in 2021. Indeed, the farm and ranch estate and business planning practice was robust at the time. Even 30 years ago, it was quite easy for a modest-sized farming operation to reach the $600,000 net worth level. That meant that proper structuring of entities, leases, asset ownership and coordinated provisions in wills and trusts were very important. In addition, in situations where it was clear that the family would continue farming after the death(s) of the senior generation, it was necessary to coordinate the planning with an eye toward a possible special use valuation election in the first spouse's (and sometimes also the second spouse's) estate. With the possible reduction of the exemption being discussed those planning techniques and concepts will be back in vogue.

USDA data indicates that the present average U.S. farmland value for all classes of land averaged $3,160 per acre in 2020. Nationwide, the average farm size is 445 acres. Thus, the typical U.S. farming operation has land worth $1,406,200. Add in livestock, farm machinery and equipment, grain inventory, the home and outbuildings, retirement savings, life insurance and other miscellaneous assets, the typical farm estate will routinely have an asset value totaling anywhere from three million to five million dollars. Of course, these are averages and the federal estate tax is based on net worth (asset value less debt), but the point is that a reduction in the exemption to under at or under the $5 million level would be of considerable concern to many farm and ranch families (and other small business owners).

Some proposals that I have seen would lower the exemption anywhere in a range from $3.5 million $5 million. If that happens, a key question is whether it would be indexed for inflation and whether the reduction would apply retroactively to January 1, 2021. Any retroactive change could make some prior tax-free gifts taxable. There is also talk about increasing the top federal estate and gift tax rate to at least 45%.

While no estate plan can accurately anticipate all potential changes in the law, clearly delaying estate planning now increases the potential that a detrimental change in the law would be in effect before the estate/business plan could be finished.

Planning strategies. So, what might be some strategies that could be employed right now? What's the most efficient way to use the current exemption amount?

- **Various types of trusts.** Gifting property to an irrevocable trust containing a disclaimer provision provides needed flexibility to adjust for changes in the exemption level. It can also be used to shift income among beneficiaries. The trust can be carefully drafted to give the grantor limited access to trust assets while simultaneously protecting trust assets from creditor claims and/or and IRS claim that the trust assets should be included in the grantor's estate.

For some assets, a better approach may be to have the owner borrow against them and gift the cash to a trust. This was an approach that was used in prior years when the exemption was much lower. The loaned funds are then gifted to a trust and covered by the exemption so that no gift tax occurs. The leveraged asset remains in the estate but with debt against it. The result is that the taxable value of the decedent's estate is reduced.

- **Valuation discounting.** A common estate/business planning technique when the exemption was much lower than its present level was to utilize various valuation discounting approaches with respect to interests in entities. Such discounts from fairy market value can be achieved to reflect the owner's minority interest in an entity as well as the fact that the interest is in an entity that is not publicly traded and, as a result, lacks marketability. A $10 million interest, therefore, may be able to be valued in the decedent's estate with a discounted value of $8 million, for example, to reflect that the decedent only owned 30% (as an example) of a small, closely-held farming or ranching operation. The IRS has routinely attacked valuation discounting, and the regulations on the matter that were frozen during the Trump Administration now will likely come back. If so, valuation discount planning may become unavailable.

- **GRAT.** One popular estate planning technique for the higher-valued estates has been the use of a grantor-retained annuity trust (GRAT). With this approach, the grantor transfers assets to a trust in return for an annuity. As the trust assets grow in value, any value above the specified annuity amount benefits the grantor's heir(s) without being subject to federal gift tax. Of course, if the exemption is lowered, more estates will be in the "high-value" category and the GRAT technique could be even more widespread in use. Unfortunately, there are discussions that up to 25 percent of the value of assets transferred to a GRAT would be taxed. If that occurs, the GRAT technique would go by the wayside.

- **Retroactive change.** A retroactive change in the estate/gift tax exemption would pose special problems. One effect could be that a taxable gift covered by the current $11.7 million exemption would now be taxable to the extent it exceeds the new, lowered exemption level. This effect can be avoided with a special type of marital trust (assuming that the transferor is married) coupled with an election (known as a "QTIP" election). This would involve some guessing as to what the new (lower) exemption level would be. The election ideally would be made on only with respect to the value of enough property such that the balance could remain exempt from estate tax as covered by the new (lower) exemption amount. For large estates where both spouses utilize this technique, the "reciprocal trust doctrine" would need to be avoided.

Another way to potentially combat a retroactive reduction in the exemption is to incorporate formula language in a trust that sets forth the value of property gifted to the trust. Often this approach is used when gifting fractional interests in an entity (such as a limited liability company) to the trust. The formula language must be drafted with precision. For example, in *Wandry v. Comr., T.C. Memo. 2012-88*, formula clause language was upheld as valid because it caused the transfer of percentage interests to the donees equal in value to the amounts set forth in the associated gift documents (i.e., dollar amounts) rather than fixed percentage interests. But, in *Nelson v. Comr., T.C. Memo. 2020-81,* the tax court determined that the formula clause language was ineffective because it resulted in the transfer of fixed dollar amounts resulting in a substantial gift tax deficiency.

Disclaimer language in trust instruments can also be used to allow flexibility to deal with a retroactive change in the exemption level. *I.R.C. §2518*. A disclaimer is a renunciation of rights to property that would otherwise pass to the person if they didn't exercise their right to disclaim receiving the property. There are also ways to create what I would call a "defective" disclaimer to deal with the issue of retroactivity. Again, it's a very complex matter that requires clear and precise drafting.

Other Potential Changes

GSTT. There is additional buzz about imposing the current generation-skipping transfer tax (GSTT) on certain "perpetual" or long-term trusts periodically. For most people, this would be a minor issue.

Present interest gifts. One proposal is to cap the present interest exclusion for gift tax purposes to $20,000 per donor. Presently, a person can give up to $15,000 to a donee annually (on a cumulative basis) and incur no gift tax. There is no limit on the number of donees under current law. Restricting the provision to $20,000 per donor annually would be a substantial restriction on the ability to make non-taxable gifts. This would be a significant change by itself, but when combined with a lower estate tax exemption, such a change would be monumental. Tax-free gifting techniques have long been used as an estate tax minimization strategy. That would change if this provision were to become law.

Income tax basis. This is the "monster" in the room. Currently, an asset that is included in a decedent's estate at death for tax purposes receives an income tax basis in the hands of the heir(s) equal to the fair market value of the asset at the time of death. *I.R.C. §1014*. This is commonly referred to as "stepped-up" basis. Thus, if the heir were to sell the asset capital gains tax for the heir would be computed as the difference between the selling price of the asset and the value at the time of the heir inherited the asset. For an asset that is sold shortly after inheritance, the capital gains tax is likely to be minimal to none. If the stepped-up basis rule were to be eliminated, the heir would receive the decedent's income tax basis. For farmland that the decedent owned for many years, for example, that basis could be much lower than the date-of-death value. That would be particularly the case if the decedent had received the farmland by gift, receiving the donor's income tax basis in the farmland at the time of the gift. The result would be heir's being hit with large capital gains tax, or simply refusing to sell the land (if possible) and creating a "lock-in" effect with respect to certain assets. To make matters worse, there is even talk of imposing a capital gains tax on the appreciated value at the time of death, rather than at the time the heir sells the inherited property that has appreciated in value.

A change in the income tax basis rule would substantially impact estate and business planning. This is particularly true with respect to farm and ranch estates where many assets have a low basis – either from being owned for many years or because of income tax planning strategies that have substantially diminished or eliminated the basis in assets.

Conclusion

Now is certainly the time to engage tax and estate/business planning professionals in discussion about income tax planning, estate planning and entity structuring. The legislation that has been discussed as potentially coming in the near future has important implications for farming and ranching operations (and other small businesses) that desire to continue into the next generation. I will be addressing these issues and providing planning suggestions at my two national event this summer. Shawnee State Park in Ohio on in early June and Missoula, Montana in early August. Registration details will be available soon. Maybe we will have more details by then and can craft plans forward.