# TOP ESTATE PLANNING MISTAKES FARMERS (AND OTHERS) MAKE

Nicholas J. Houle CPA/PFS CFP®
Principal
LarsonAllen Financial LLC
Minneapolis, MN
612-376-4760
nhoule@larsonallen.com

DTN/ Progressive Farmer
AG Summit 2011
December, 2011
Chicago, IL

# Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010

| | 2010 - Old Law (Opt-Out) | 2010 New Law | 2011 | 2012 |
|---|---|---|---|---|
| Gift Tax - Exemption | $1 Million | | $5 Million | $5,120,000 Indexed for Inflation |
| Gift Tax - Rate | 35% | | | |
| Estate Tax - Exemption | N/A | $5 Million | | $5,120,000 Indexed for Inflation |
| Estate Tax - Rate | N/A | 35% | | |
| Basis of Inherited Assets | Modified Carryover | Fair Market Value at Date of Death | | |
| Is Exemption "Portable"? | NO | | YES | |
| GST Tax - Exemption | N/A | $5 Million | | $5,120,000 Indexed for Inflation |
| GST Tax - Rate | N/A | Zero Percent | 35% | |

## Mistake #1 - Procrastination

- Lack of or out of date Disposition Document (Will or Revocable Trust)
  - Unsigned or outdated documents
  - State laws of intestacy(dying without a will)
    - Determine who gets your assets
    - How they will get your assets
    - Possibility of paying the highest estate tax
  - No easy approach here – especially farmers
  - Getting right executor or trustee appointed
  - Complex estates
    - Farmland
    - Equipment
    - Non-farm assets
    - Insurance
  - Who do you want to get which assets?

# Mistake #1 – Procrastination (Continued)

- Wills should be updated
  - Birth or death of children
  - Marriage, divorce or separation of anyone named in will
  - Major tax law changes
  - Relocation to new state
  - Significant changes in income or wealth
  - Changes in needs, circumstances or objectives of either farmer or beneficiaries

# Mistake #2 – Property Transfer Rules

- Lack of understanding regarding property ownership and beneficiary designations
  - Improper use of jointly held property
    - Avoids probate – but what does this mean ?
    - Poor man's will
    - Title transfer without control of decedent's will provisions
    - Ability of surviving joint tenant to leave property to anyone regardless of deceased owner's wishes
    - No protection from creditors of surviving joint owners
  - IRA and other pension/beneficiary designations
    - Family members
      - Surviving spouse
      - Children
    - Payable to estate and trusts
      - 5 year payout requirement may apply here

# Mistake #2 – Property Transfer Rules

- Life insurance beneficiary designation
  - Include if life insurance in estate
  - Purpose of life insurance in estate plan
- Use of P.O.D. or T.O.D. terms
  - Does not reduce estate for estate tax
  - Avoids probate
  - Is asset going to correct heir?

# Mistake #3 – “I Love You” Will

- Will says ”leave everything to surviving spouse” – simple will
  - Unlimited marital transfer applies
    - At second spouse’s death, property to children
    - Small estates (perhaps $2.0 million or less) works just fine
  - New law provision “portability” – federal only
    - Not in states
  - Objective to maximize use of each spouse’s federal and state (if any) estate tax exclusion
    - $5,120,000 (2012)
- Larger estates may create unnecessary federal or state estate tax
  - Strategy
    - Will should provide for bypass or credit trust
    - Purpose to use some or all of each spouse’s lifetime estate exemption

# Estate Plan – Use of Exemptions

Dad

$10.0 million estate

Exempt Trust a/k/a Credit Bypass Trust

$5.0 million

Income to surviving spouse

Principal if needed

Spouse share in trust or outright

Amount includable in spouse's estate.

## Example

- Portability vs. Unified Credit Trust
- Facts :
  - H dies in 2011 $10 million estate
  - Choices for executor
    - All assets to W
    - Place $5.0 million to a credit shelter trust
  - W dies in 2019
  - Assume 2% inflation rate annually
  - Assume 5% return on assets annually
  - Assume 35% federal estate tax rate (state estate tax ignored)

# Example continued

- Portability vs. United Credit Trust (cont)
- Combined tax cost

| | Portability | Credit Shelter Trust |
|---|---|---|
| Estate Tax | $1,370,000 | $ 534,000 |
| Capital Gain Tax | $ 0 | $ 477,000 |
| Total Tax | $1,370,000 | $1,012,000 |
| Tax Savings | | $ 358,000 |

Assumptions used:

- 35% estate tax rate
- 20% capital gains rate
- Inflation rate 2%

## Mistake #4 – I am worth less than $5.0 million, so who cares?

- I am worth less than $ 5.0 million, or my wife and I are worth less than $10.0 million, so who cares?
  - How the federal estate exemption works
  - Impact of state estate taxes
    - Reduced exemptions
  - Portability of federal exemption
    - Regular estate tax
    - Not generation skipping tax
    - Not state estate tax
  - Value of estate in future
  - What about in life insurance proceeds?

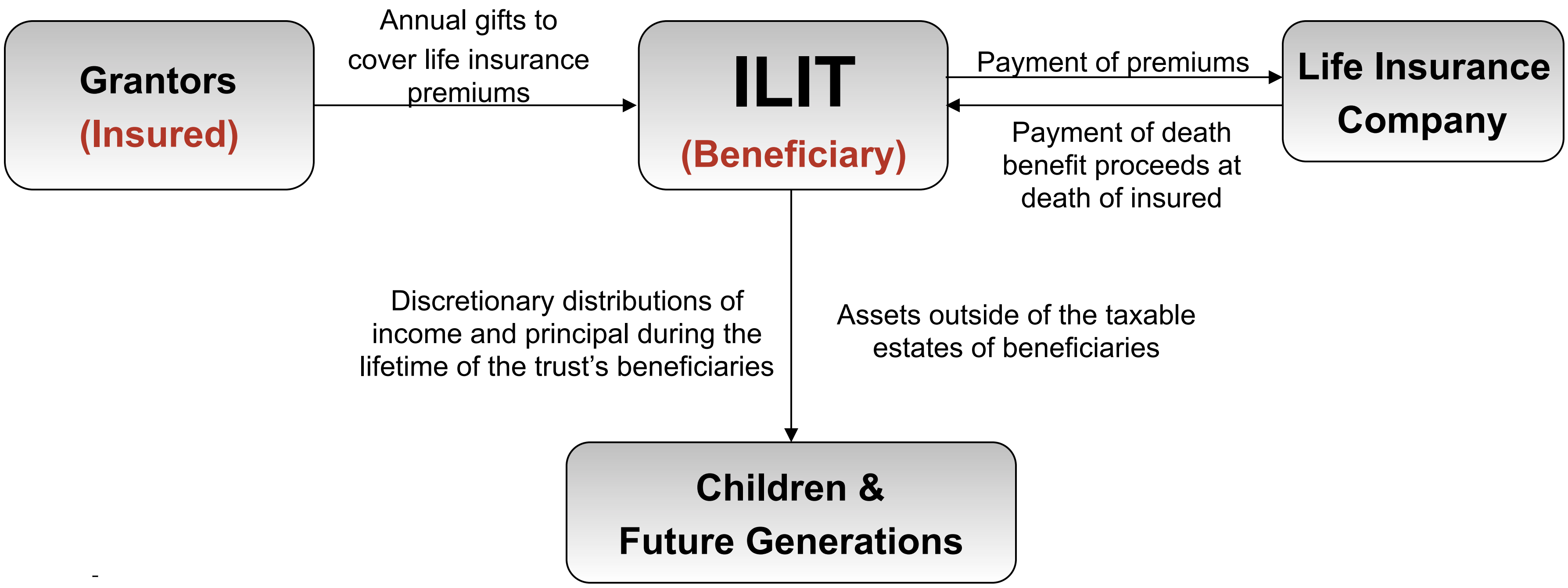
# Mistake #5 – Lack of Liquidity

- What are expenses of estate going to be
  - Legal
  - Maintenance of family members
  - Estate tax liabilities
  - Debt payments
  - Other
- Do you have an idea how much it will cost to settle your estate?
- Where is the money going to come from?
- Will there be a forced sale of estate property to raise cash?
  - Pay estate taxes
    - Due 9 months after death
  - Pay off heirs
  - Funds needed to continue operation
- Do you saddle your children or estate assets with debt?

# Mistake #6 – Proper Ownership of Life Insurance

- Can be a significant part of many estates
  - Why?
    - Immediate liquidity
    - Death benefits – income tax free
- Death benefit are subject to estate tax
  - If insurance is owned by insured at his/her death
  - Estate tax can erode value of death benefit by at least 35%
- Use of life Irrevocable Life Insurance Trust (ILIT)
  - Protects heirs if not ready for death benefit
  - Death benefit not includable in estate tax calculation

# Irrevocable Life Insurance Trust (ILIT)




-

# Mistake #7 – Treat All the Kids the Same

- Family dynamics
  - Business, farm or other income participation
    - Children participating
      - Control
    - Non-participating children
      - Non-business assets
      - Non-voting ownership, if necessary
    - Insurance
      - Can balance inheritance
      - Cash for participating kids who buy out non-participating kids

# Mistake #8 – Gift Away Remainder, Keep Life Estate

- Accomplishes ONE thing
  - Avoids probate
- Used to transfer real property to kids
- Donor retains “Life Tenant Interest”
  - Use property until death
- Children automatically own at your death
- Tax law requires full inclusion of value in estate of donor (subject to estate tax )
  - DOES NOT SAVE ESTATE TAX

# Mistake #9 – Failure to Stabilize and Maximize Values

- Stabilize value in event of death or disability of key person
  - Key person life and disability insurance
  - Buy – Sell Agreements
    - Death of an owner
      - Set values
      - Set terms
      - Funding mechanism
    - Alternative beneficiaries properly named
      - Wills
      - Trusts
      - Retirement plans
      - Life insurance

# Mistake #10 – Lack of Adequate Records

- Drive trustee / executor crazy!
  - Increase costs of administration
- Use of safe deposit box to store key documents
  - Executor can access
- Important documents
  - Wills
  - Trusts
  - Property titles
  - Contracts
  - Deeds for real estate
  - Prior year income tax returns

# Mistake #10 – Lack of Adequate Records (Continued)

- List of advisors
  - Contact information
- Communication of
  - Goals
  - Assets to support survivors
  - Meaningful communication to spouse and children

# Mistake #11 – Lack of a Master Plan for Estate

- "Do it yourself"
  - Would you do surgery on yourself?
- Sources of knowledge
  - Courses and seminars
  - Books
  - Media
- Point of reference to what really needs to be done
  - Do you have one?
- Annually quantify needs, objectives and net worth
  - Prepare accurate net worth statement
  - Sources and uses of cash

# Mistake 11 – Lack of a Master Plan for Estate (Continued)

- Team approach
  - CPA
  - Attorney
  - Banker
  - Insurance professional
  - Financial services professional
- Conduct annual “fire drill”
  - What happens if . . . ?

# Estate Diagram Example

## Assets & Liabilities

- Savings
- Farm Operation
- Land
- Equipment
- Life Insurance
- Debt
    - Equipment
    - Land
    - Operating

| Land (and Debt) | Farm Operation (and Debt) | Equipment (and Debt) | Homestead (not farm buildings) | Other assets<br>-Savings<br>-IRAs<br>-Other | Life Insurance Trust (pay taxes) |
|---|---|---|---|---|---|
| Land Partnership | To Farm Kids Sell or Gift | To Farm Kids Sell or Gift | To Farm or All Kids? | Perhaps Nonfarm Kids | To Farm Kids to Buy Out Nonfarm Kids or To Nonfarm kids To Balance Estate |

# Estate Planning Final Thoughts

- Get qualified professional assistance
- Understand what your exposure is to estate tax today
- Estimate exposure in future to estate tax
- What are your goals for succession of operation and equipment
- What are your goals for land
- Review strategies to reduce potential estate tax exposure and implement if appropriate
- Monitor your plan
  - Don't assume the problem will go away on its own
- Not inexpensive but benefits will far outweigh the upfront costs

# Summary

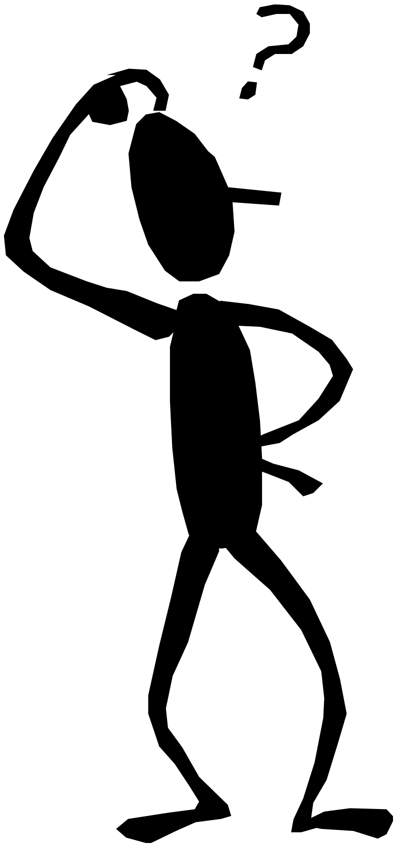
- Have we described you somewhere in this presentation?
- Take the time to learn how your affairs are affected
- “Failure to plan is a plan to fail”

## Famous Quote

The great philosopher, Yogi Berra, once said,

# “If you don’t plan on where you are going, you could wind up somewhere different”

# Questions



# Disclosures

One should not rely on this information for the primary basis of their investment, tax or financial planning. Such general information does not take into account such factors as an individual's own goals and objectives, risk tolerance, tax situation, age, or time frame. We believe the information obtained from third-party sources to be reliable, but neither LarsonAllen Financial, LLC nor its affiliates guarantee its accuracy, timeliness, or completeness. Reference to all tax rules and laws are sourced from the Internal Revenue Code. The views, opinions and estimates herein are as of the date of the material and are subject to change without notice at any time due to changes in the tax law and rules. Examples provided are for illustrative purposes only and not intended to be reflective of results you should expect to attain. This material may not be republished in any format without prior written consent.

This notice is required by IRS Circular 230, which regulates written communication about federal tax matters between tax advisors and their clients. To the extent the preceding material is a written tax advice communication, it is not a full "covered opinion." Accordingly, this advice is not intended and cannot be used for the purpose of avoiding penalties that may be imposed by the IRS.