DTN University
Pass It On!
Farm Family Estate and Succession Planning

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Houle is a CPA and certified financial planner specializing in advising small business owners on estate and income taxes, retirement, and business succession plans. He has experience helping families with liquidity to pay taxes and balance treatment of on and off-farm heirs.

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Estate Tax Webinar: Agenda

- 2012 Tax Legislation
  - American Taxpayer Relief Act (ATRA) – General overview on selected items
- The post-cliff Estate Tax System
- Structures for farm transitions
  - Disposition of operating assets
  - Part gift/part sale on direct land transfers
  - Use of entity for land: No heirs
  - Use of entity for land: Farm successor
  - Life insurance trusts and GRATs

2012 ATRA: The Big Picture

- The 2012 Extenders and AMT exemption
- The 2013 Rates: The "cliff"
  - Dividend and capital gain rates
  - Ordinary rates, high income phase-outs
  - Estate and gift system
- Expiring economic recovery incentives
  - 50% bonus depreciation and Sec. 179
  - 2% payroll tax cut

2012 ATRA: 2013 Income Tax Rates

- 2001-2012 six rates made permanent
- New top (7th) rate: 39.6%
- Applies to taxable income over:
  - Joint $450,000
  - Head of H. $425,000
  - Single $400,000
- Bracket threshold inflation-indexed 2014 +
- 35% bracket very narrow in 2013 and after

2012 ATRA: AMT and the Extenders

AMT exemption	2011	2012	2013
Joint	$74,450	$78,750	Indexed
Single	$48,450	$50,600	Indexed

- Extenders renewed:
  - Sales tax in lieu of income tax as itemized deduction
  - The $500 principal residence energy credit
  - Direct IRA to charity transfers up to $ 100,000 for those over age 70 ½
  - Exclusion for principal residence debt relief

2012 ATRA: Phase-out of deductions

- Eff. in 2013, phase-outs if AGI over thresholds of:
  - Joint $300,000
  - Head of H. $275,000
  - Single $250,000
- Itemized deduction offset: 3% of AGI > threshold
  - Limited to offset of 80% of total itemized
  - Excludes medical, inv. interest, casualty, gambling loss
- Personal exemption offset: 2% of deductions for ea. $2,500 of AGI > threshold
  - Zero exemptions if $125K over threshold

Dividend and LTCG Rates

	2012	2013
Low brackets (Ord. 10-15%)	0%	0%
Mid brackets (Ord. 25-35%)	15%	15%
Top bracket (Ord. 39.6%)	-	20%
Net Investment Income tax	-	3.8%

Extended 2% Payroll Tax Cut

- Employee share of OASDI cut from 6.2% to 4.2% for 2011 and 2012
- SE tax rate also cut (12.4% to 10.4%)
- No high income phase-out; 2012 max savings of $2,202 (2% x $110,100)
- Update: 2012 ATRA did not extend for 2013

S Corporation Built-in Gains Tax

2012 ATRA

- Shortens BIG tax period to 5 yrs. (60 mos.) for tax years beginning in 2012 and 2013
- Installment sales originating in tax years beginning 2012 and after: Yr. of sale determines application of BIG tax to all payments

Bonus Depreciation: Bouncing %

Acquired & Placed in Service	Bonus %
1/1/08 – 9/8/10	50%
9/9/10 – 12/31/11	100%
1/1/12 – 12/31/12	50%
1/1/13 – 12/31/13 (2012 ATRA)	50%
2014 and after	0%

- Qualified leasehold improvement
  - Interior improvements, lease arrangement, >3 yrs. in service, no related parties (but $\geq$80% or more def.)
  - Eligible for 50%

Section 179 Amounts

Tax yr. beginning in	Sec. 179 Limit	Asset Addn. Phase-out Range
2009	$250,000	$800K - $1.05M
2010	$500,000	$2M - $2.5M
2011	$500,000	$2M - $2.5M
2012 -prior	$139,000	$560K - $699K
2012 & 2013 -ATRA	$500,000	$2M - $2.5M

2013 Gift and Estate Tax "Cliff"

	2012	2013
Gift & estate exemption	$5.12M	$5.25M
Top rate on excess	35%	40%

Gift & Estate Tax System

Lifetime Gifts

- $14,000 annual exclusion per donee (was $13K)
- Husband-wife gift splitting permitted
- Gifts exceeding annual exclusion: Use $5M unified gift-estate exemption
- Carryover income tax basis on lifetime gifts

Gift & Estate Tax System

Estate Tax

- $5M unified exemption

  + Plus deceased spouse's unused exemption (post-2010 "portability")

  - Prior gifts in excess of annual exclusion

- Increase of $1M for Sec. 2032A farm special use
- Step-up in income tax basis to FMV for heirs

Example: Portability

- H dies in 2012
- H has taxable transfers at death of $3.0 million
- Election is made in his filed estate return to permit W to use H’s unused $2.12 million exemption
- W at death has $7.24 million exemption [$2.12 million from H and $5.12 million (+) of her own]

Gift & Estate Tax System

- Estate Tax Special Use Valuation (Sec. 2032A)
  - ≥ 50% of estate consists of farming assets
  - Actively farmed prior to death or retirement
  - An heir continues to actively farm ≥ 10 yrs. post-death
- Value land at lower 5-year. ave. capitalized rent value
  - Valuation reduction limited to approx. $1M

Lifetime Gifts vs. Estate Transfers

- Carryover tax basis vs. step-up to FMV tax basis
  - Is fresh depreciation important?
  - Is reduced gain on eventual sale important?
- Timing of the transfer
  - Lower value today vs. at estate?
  - Income and cash flow reduction to donor if gift

Specific Farm Estate Planning Objectives - Include

- Maximize use of tax exemption sand exclusions available
- Minimize complexity
- Transfer substantial values to the next generation quickly
- Minimize IRS audit risk/challenge
- Avoid probate – privacy
- Philanthropy?
- Maintain continued financial security for senior family members, their spouses and family
- Family harmony

Farm Transition Planning

- Disposing of operating assets (grain, livestock, M&E)
  - Without farming successor
  - With a farming successor
- Transitioning the land to the next generation
  - Gift-sale strategies
  - Use of an entity

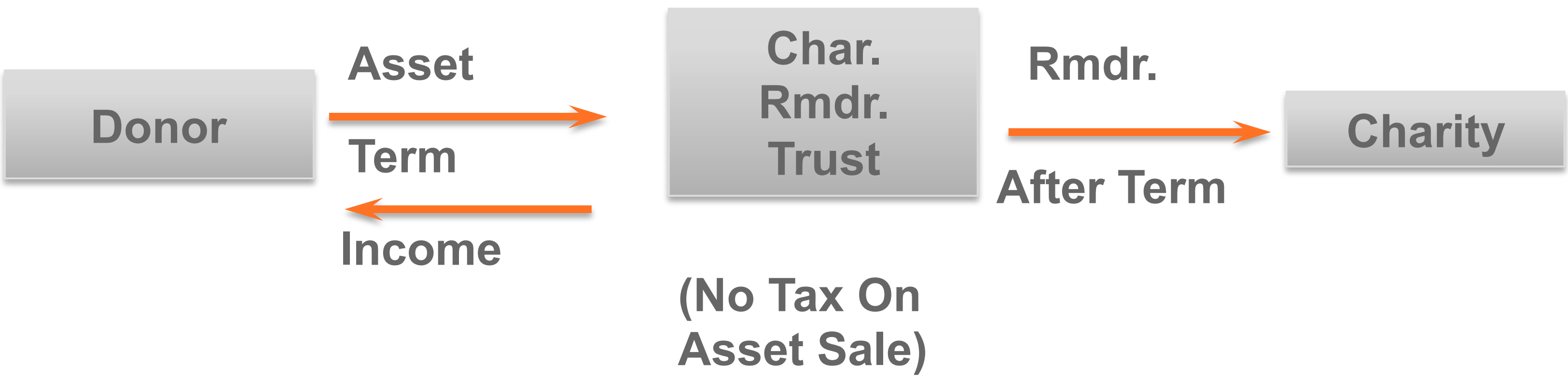
Disposition of Operating Assets

	Ordinary or Cap. Gain?	Installment Method?	SE Tax?
Grain	Ordinary	Yes	Yes
Livestock: Resale	Ordinary	Yes	Yes
Livestock: Breeding-raised	Cap. Gain	Yes	No
Depr. machinery/ breeding stock	Ordinary	No	No
Bins, barns, tiling, irrig.	Ordinary	No	No
Land	Cap. Gain	Yes	No

Disposition of Raised Grain: No Successor

- Spread sales over several tax years
  - Multiple yrs. of lower tier Soc. Sec. tax (15.3% on first $113,700)
  - Miss high grain prices by holding crop?
- Sell early at high price and take installment payments
  - Credit risk?
  - Same Soc. Sec. tax cost

Charitable Remainder Trusts



Charitable Remainder Trusts

Advantages

- Defer income up to a 20-year term
  - Lower federal income tax rates
  - No SE Soc. Sec. Tax
- Commodity can be sold by Trust with no tax
- Less federal tax; trades off with residual to charity
  - 10% minimum net present value to charity

CRT Examples

- 10 yr. term, annual payout
- $500,000 funding
- Annual payout @ yr. end

	IRS Interest Rate	
	2.0%	4.0%
Payout amount	$50,095	$55,400
Charitable remainder	10.01%	10.13%

[Current IRS rate: 1.0%!]

C Corp. with Land Inside: No Successor

- Liquidate grain/livestock inventory and M&E as a C corp.
  - Use C corp. lower tax rates
  - Possible offsetting deductions for past underpaid services to employee-shareholders?
- Convert to S corporate status after disposition of all operating assets
  - S corp. holds land only; becomes landlord entity
  - Net rent income flows through to corp. owners
  - But S corp. must be "active" (crop share rents) <u>or</u> pay out its prior C corp. earnings as a dividend

Transitioning Farm Operations to Successor

- Sell machinery for installment note?
  - Immediate ordinary income “depreciation recapture”
  - Lease alternative (but danger that IRS recharacterizes as a disguised sale)
- Disposition of grain?
  - Ordinary income and SE Social Security tax
- <u>Alternative</u>: Use of an entity

Case Study 1: Active Operations to Successor

Facts:

- Dad, age 65, operates as Schedule F proprietor
  - Owns grain, machinery, and land
  - Objectives: Retire in several years, liquidate grain, and sell machinery to son
  - Est. grain value: $800,000; machinery $500,000
- Jr., age 34, farms with dad, but also files as proprietor
  - Owns his share of grain, some machinery (total value $200K)
  - Buying 160 acres on contract from grandmother

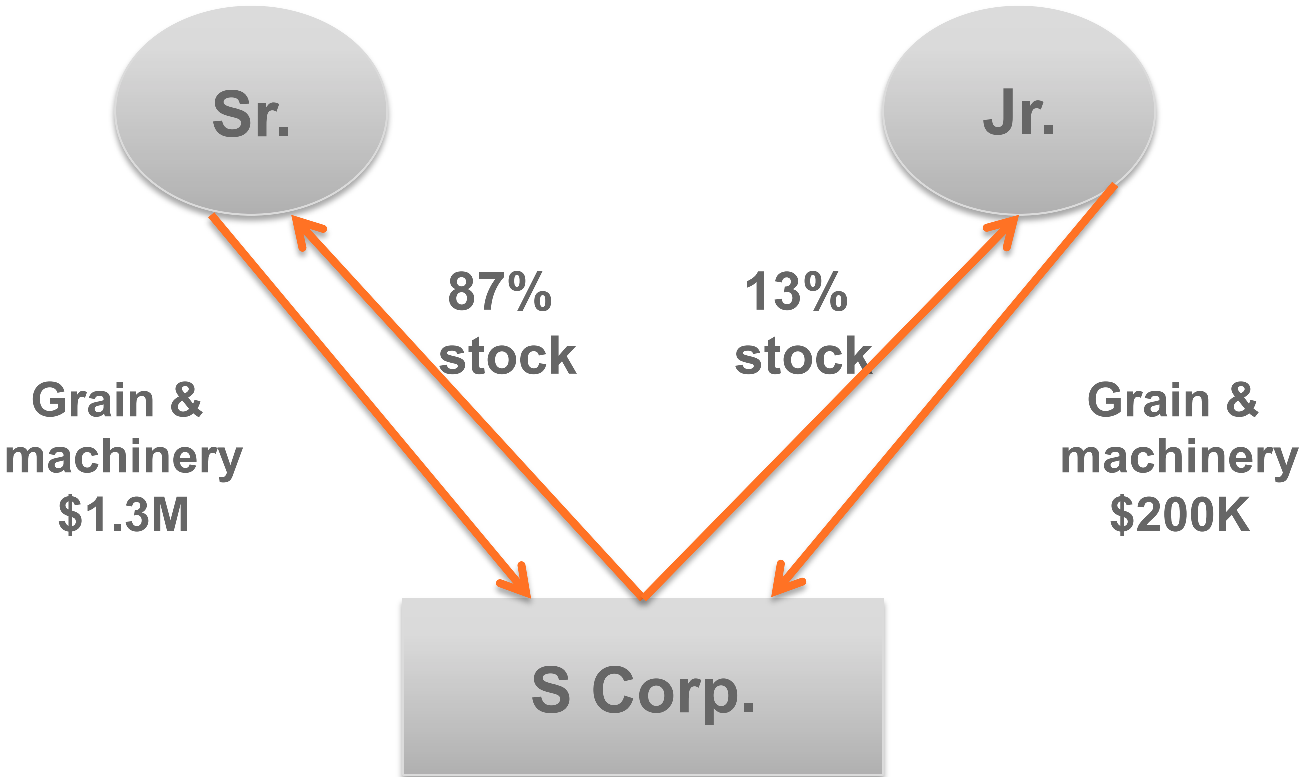
Case Study 1: Active Operations to Successor

Plan A: Liquidate grain/lease & sell machinery to Jr.

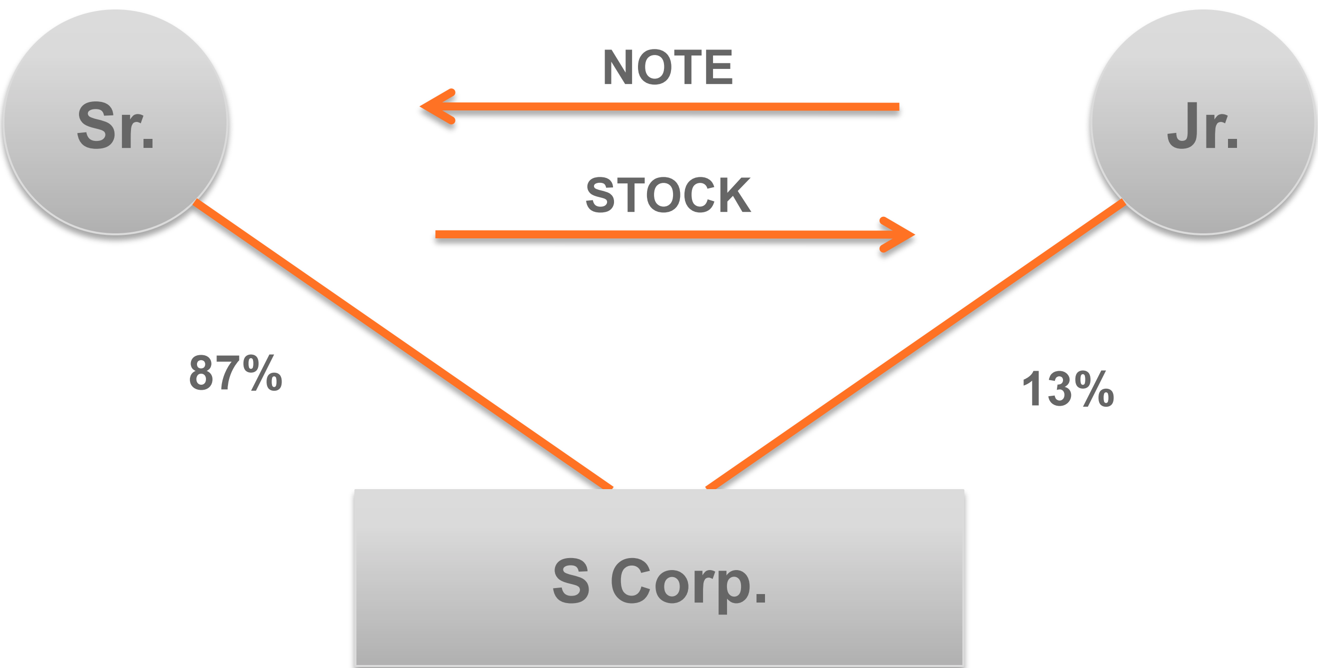
	Federal tax		
Asset	Income tax (29% blended)	Soc. Sec. tax (9% blended)	Total
$800K grain	$232K	$72K	$304K
$500K machinery	$145K	$ -	$145K
$1.3M	$377K	$72K	$449K
			35%

Case Study 1: Active Operations to Successor

Plan B: Use an Entity to Transition Operating Assets



Case Study 1: Active Operations to Successor



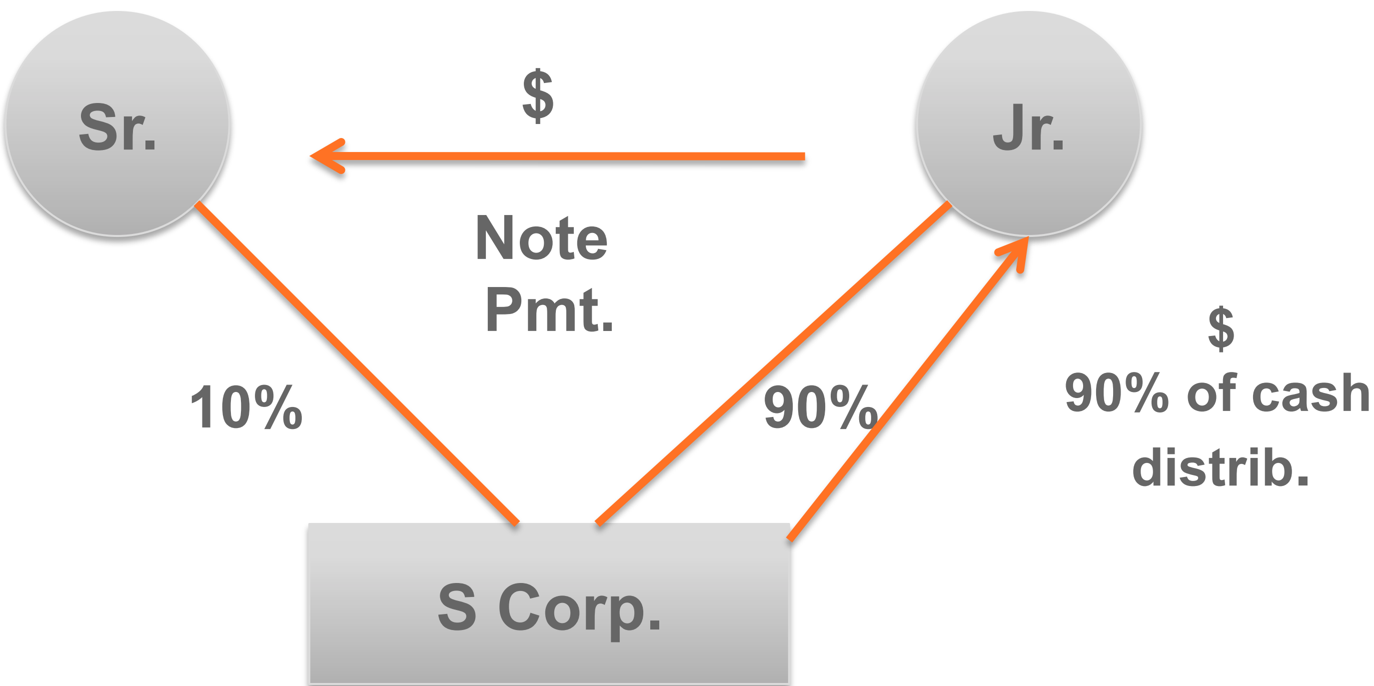
$1.5M grain & machinery

Case Study 1: Active Operations to Successor

<u>Strategies with corporate entity</u>:

- Capital gain & no SE tax to Sr. on stock sale
  - Cuts effective tax rate from 35% to 15%
  - Spread gain over term of note (e.g., 10 yrs.)
- Sell stock in minority increments with discounts
- Consider reorganizing into voting & non-voting shares
  - Sr. can dispose of most stock, but retain control if desired

Case Study 1: Active Operations to Successor



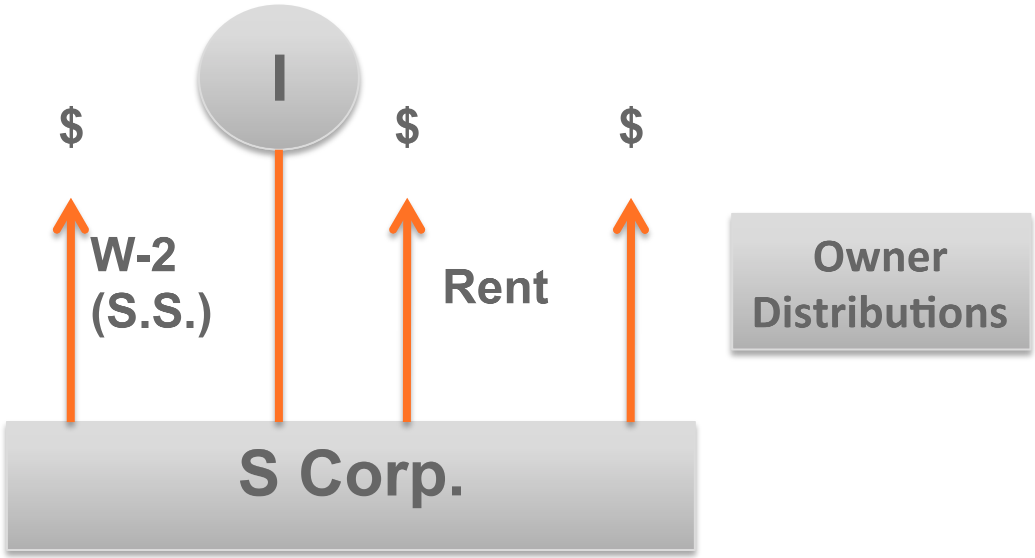
Case Study 1: Active Operations to Successor

	Plan A Sale	Plan B (Entity)
Value of grain/machinery	$1,300K	$1,300K
Less stock discount (25%)		(300K)
Less tax cost: A @ 35%	(449K)	
B @ 15%)		(150K)
Net to Sr. after taxes	$851K	$850K

Cast Study 1: Summary

- Entity sells Sr.'s grain, but offsets income with ongoing farm input expenses & prepaids
- Jr. does not get fresh depreciation on machinery
  - Bought nondeductible stock, but at a discount
  - Jr. gets favorable long-term financing from Sr.
  - Jr. has cash method farm expenses to continue tax deferral
- S corp. distinguishes salaries vs. rent vs. owner distributions

Illustration: S Corporation (Operating Yrs.)



- Grain
- Machinery

Taxation of S Corp. Income (2013)

- Salary - Income tax plus:
  - First $113,700 at 15.3% Soc. Sec. tax; excess 2.9%
  - New: 0.9% Medicare tax >$200K single/$250K joint
- Rent - Income tax plus:
  - New: 3.8% Net Inv. Income tax > $200K single/$250K jt. Adjusted Gross Income
- Shareholder Distributions of S Corp. Income
  - Income tax only

Transitioning the Land

- Gift
- Sale
  - Outright
  - Seller-financed (installment sale)
- Combination gift-sale

[Same choices, whether transferring acres or entity shares]

Part Gift – Part Sale Strategy

Example

- Low basis (i.e., tax cost) in land
- Objective: Sell to a family member at a price that can be paid in an installment sale using annual cash rents
- Bargain element (full FMV less sale price) = gift

Part Gift – Part Sale Strategy

Example	Per acre	
Full appraised FMV	$9,500	
		$4,500 gift
Sale price (to family)	$5,000	
		$4,000 cap. gain
Tax basis (cost)	$1,000	

Part Gift – Part Sale Strategy

Planning tips

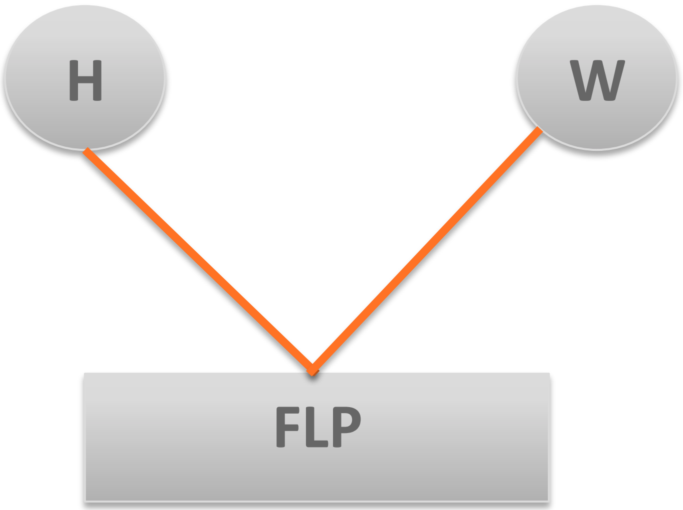
- Importance of a qualified appraisal to prevent IRS attack on amount of gift
- Opportunity: Lock in low interest rate on installment note to family member
  - Based on IRS AFR% for month of sale
  - January 2013 rate: Over 9 yr. term: 2.31%
  - January 2013 rate: Over 3 yr. & ≤ 9yr.: .87%

Case Study 2: No Farming Successor

Facts:

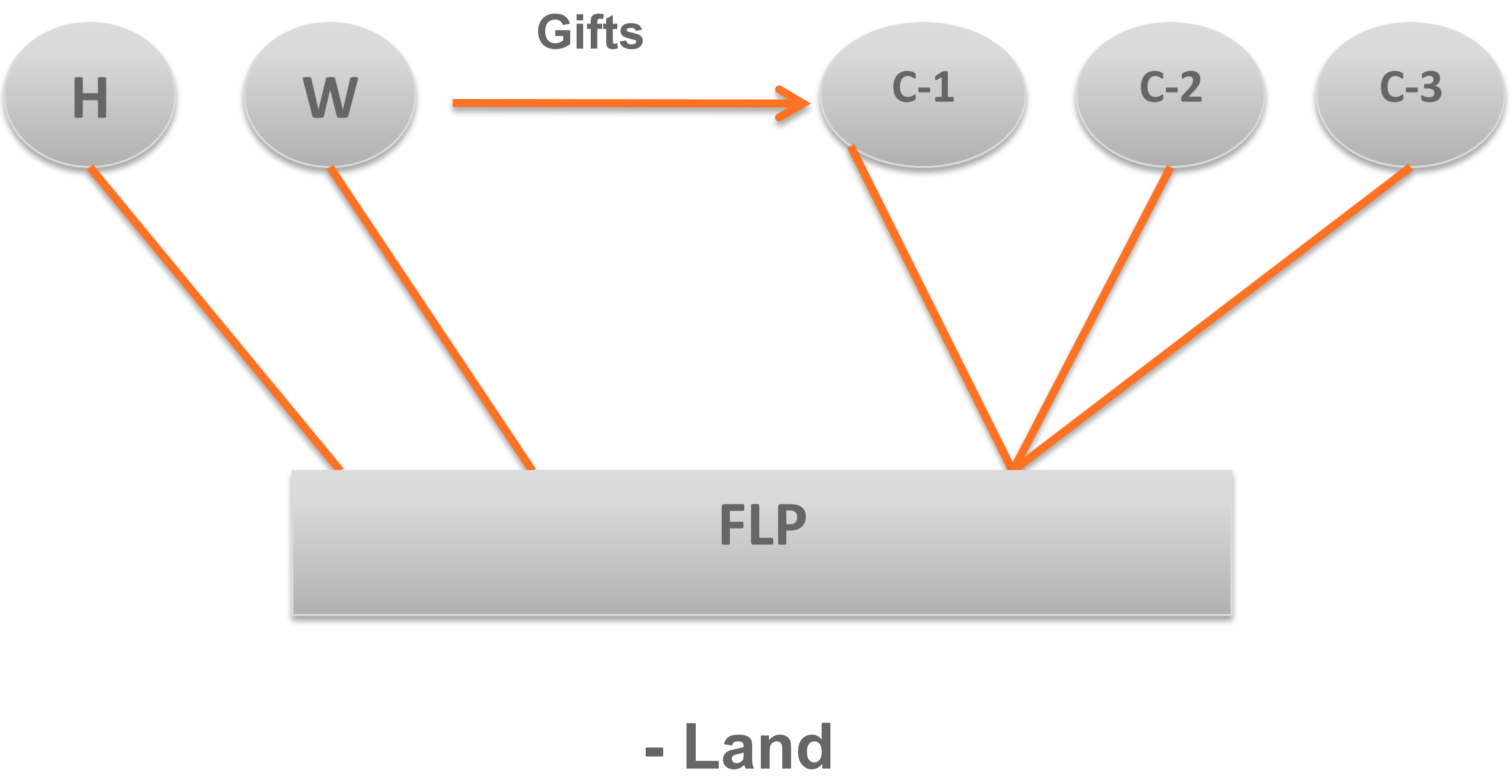
- Dad and Mom ages 74 and 72; 1,260 acres of land
- Net worth about $13.5M ($12M land + $1.5M investments)
- 3 adult children, all married, none farming
- Land has been cash rented to unrelated tenant
- Objectives: Hold land together for children/ grandchildren
  - Concerned about spendthrift lifestyle of Child 3 and husband

Family Limited Partnership (FLP) Illustration



- Land

Family Limited Partnership (FLP) Illustration



FLP Advantages

- Facilitates gifts
  - Annual exclusion of $14,000
  - Discounts for minority and lack of marketability
- Most units non-voting (to allow management control to selected partners)
  - Centralized management
- Terms for buy-out of a member
  - Discount if early exit (e.g. 80%-90% of appraised value)
  - Specify pmt. terms (long term /low interest rate to preserve entity cash flow)

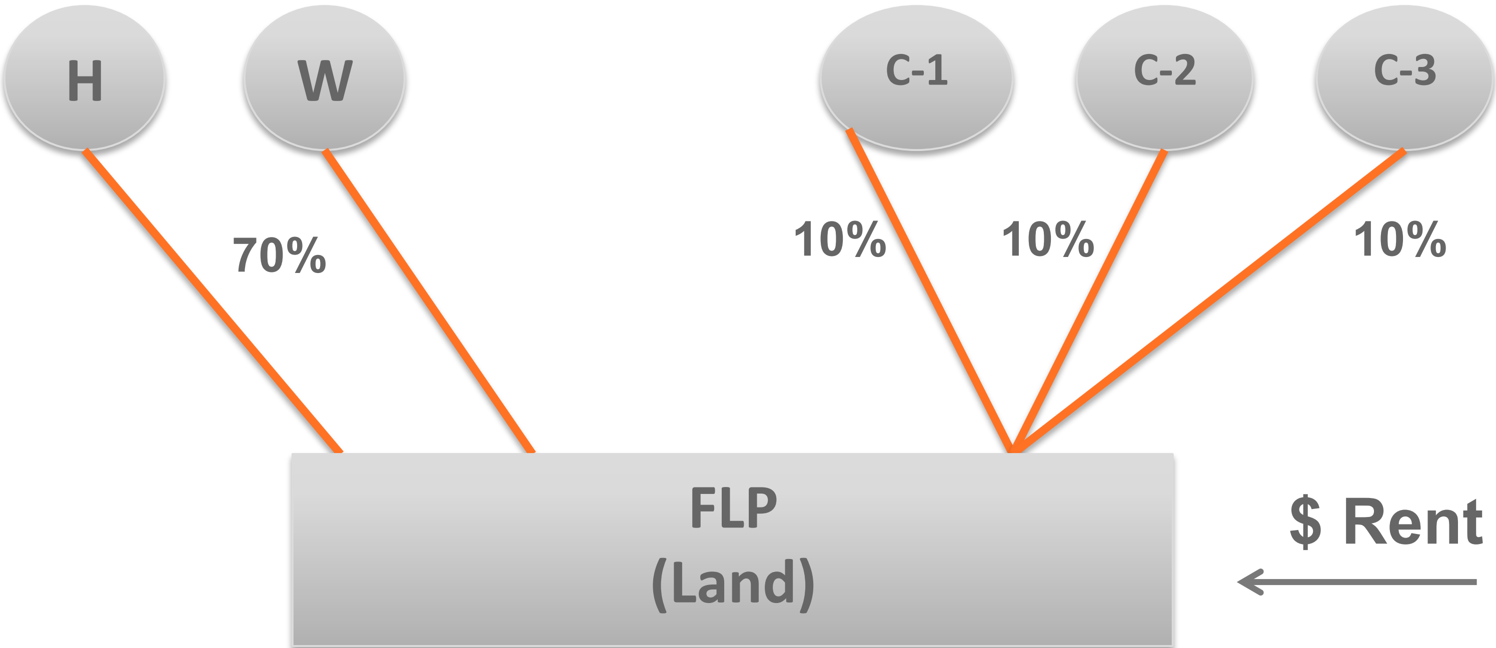
FLP Advantages

- Include binding mediation/arbitration language if disputes arise
- Design of FLP document forces family communication pre-death
  - Require each child to invest cash at formation to force legal and emotional buy-in to the operating agreement
- Require super-majority to liquidate the partnership/distribute land

FLP Disadvantages

- Fees
  - Legal costs of document drafting/planning
  - Appraisal fee for land valuation
  - Appraisal fee for discount valuation
- IRS valuation disputes
- Annual partnership tax return
  - Separate checking account
- Proper allocations of any cash distributions each year

Case Study 2: Family Ltd. Partnership



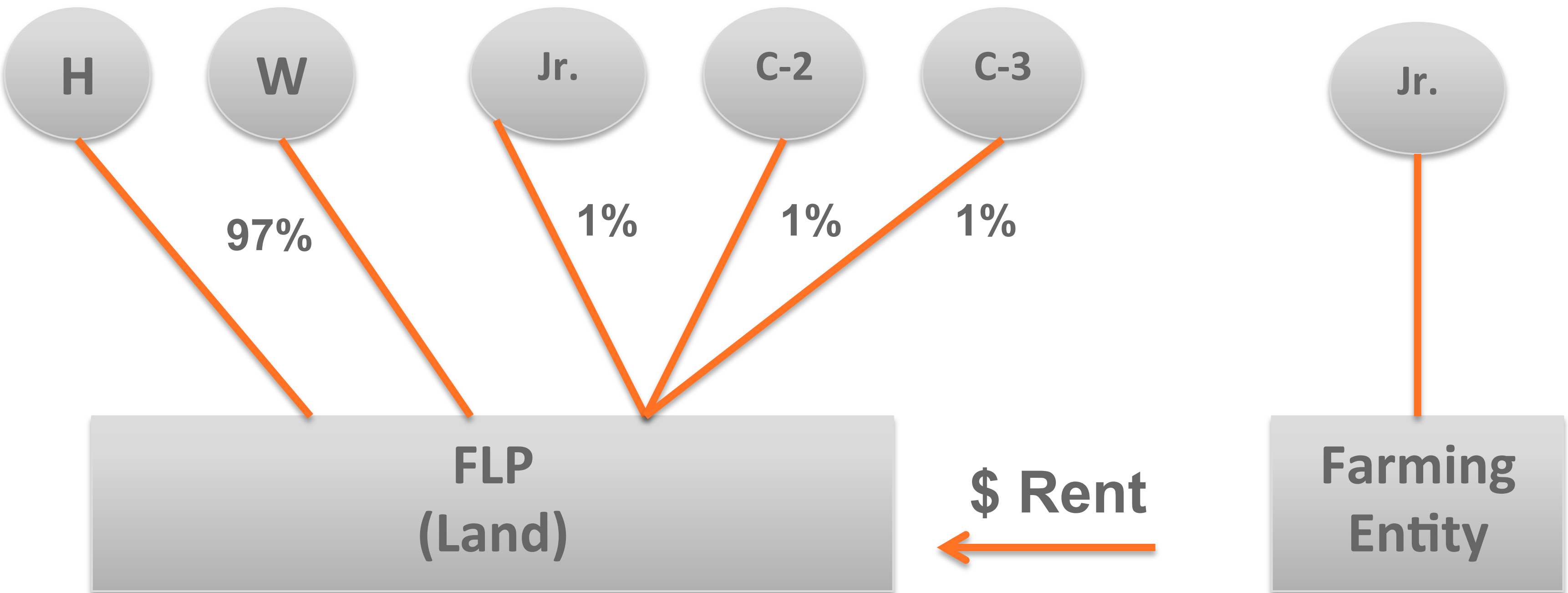
Cash distributions out of FLP allocated 70-10-10-10

Case Study 3: Farming Successor

Facts:

- Same as Case Study 2, except Child 1 (Jr.) is a farmer who leases land from Dad and Mom
- Active farm assets (inventory & machinery) owned by Jr.; Dad and Mom are retired landlords
- Objectives: Hold land together and assure Jr. has access to lease and buy land

Case Study 3: Family Ltd. Partnership



Case Study 3: Family Ltd. Partnership

Additional FLP document issues if tenant-successor:

- Define Jr. as having first right to lease and define terms
  - Example: 95% of county extension lease rates
- Define right of Jr. to purchase land parcels from partnership (e.g., appraisal mechanism; seller-financed terms)
- Consider specific designation of voting units
  - Example: 3 voting units: Dad, Mom and Jr.
  - At second parent’s death, 1 unit to Jr. & 1 to non-farm child
  - Jr. has control, but one child to monitor compliance with FLP document

Family Ltd. Partnership

Avoiding family conflict:

- Thorough communication at formation about Dad & Mom's objectives
- Emotional and financial buy-in by each child
- Consider use of consultant to sort out conflicting objectives of children/misconceptions/hidden heartburn
    - Private interviews; feedback to Dad & Mom

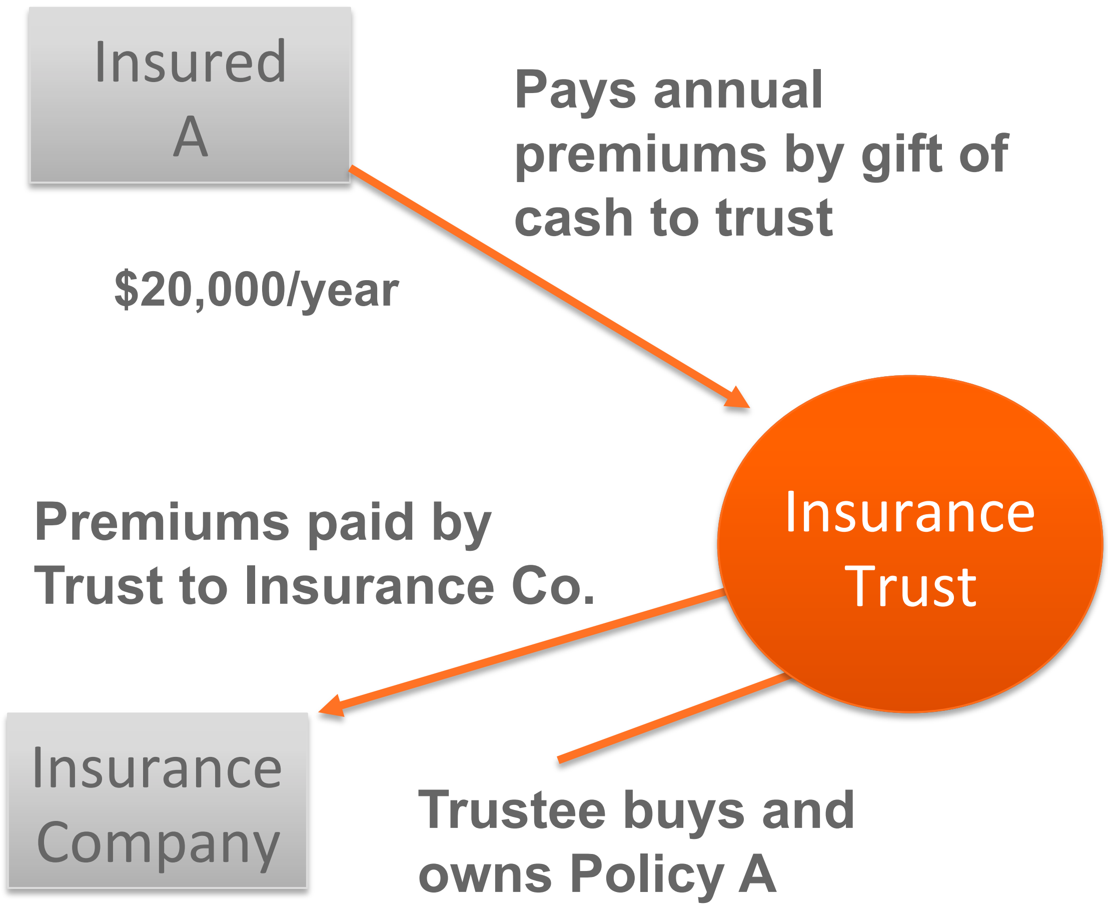
Life Insurance and Estate Planning

- Proper amount of insurance (risk protection)
- Proper ownership of policy to avoid estate inclusion
  - Who pays premiums?
  - Keeping insurance out of estate

Life Insurance: Estate Tax on Death Benefit

- Total Estate – Assume $ 10.0 million
  - Life Insurance
    - Husband has $2.0 million death benefit with wife as beneficiary
    - Assume husband dies and wife collects death benefit
  - Total Estate now $ 12.0 million
    - $2.0 million exposed to Federal Estate Tax
    - Estate tax cost estimated $700,000
  - Net death benefit after estate tax erosion is $1.3 million

Irrevocable Life Insurance Trust (ILIT)



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The Progressive Farmer

Insurance Trust At Death

Pays death benefit to Trust

Insurance Company

Insurance Trust
$1,000,000

Trustee

•Pays out benefit to beneficiaries

•Lends money to estate for expenses

•Buys assets from estate

•Pays income to surviving spouse

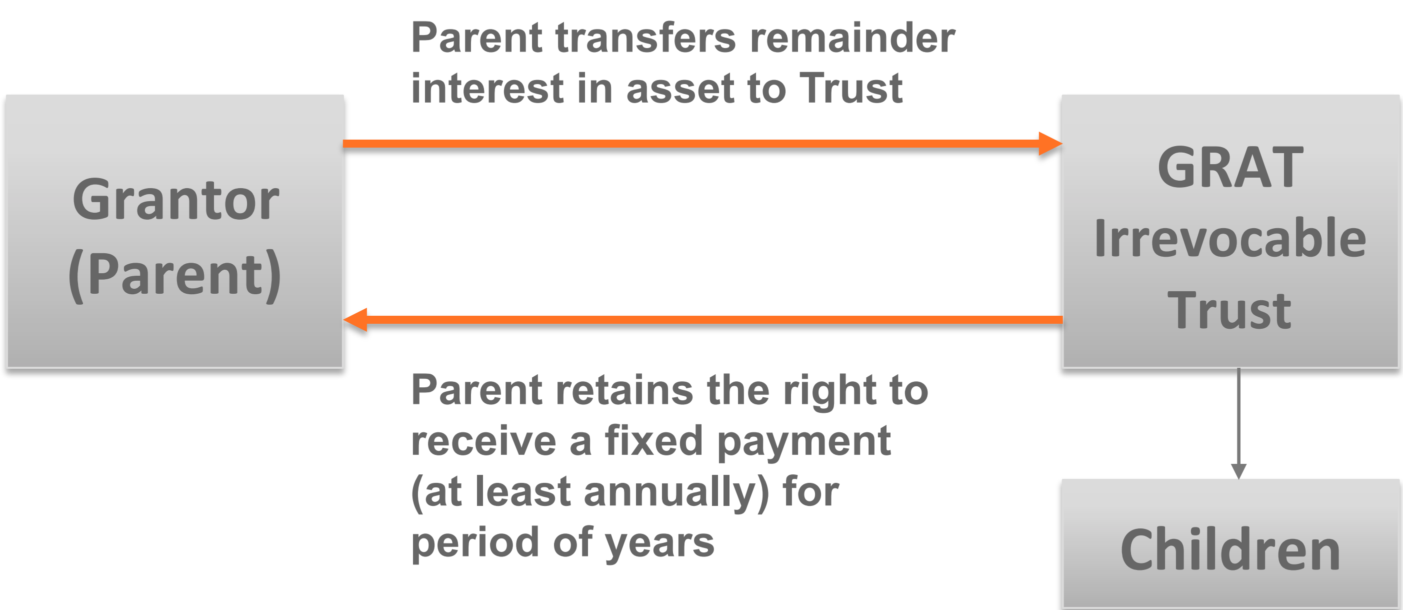
Insurance Issues to Consider

- Transfer of existing policies to insurance trust
  - Gift value
  - Three year rule
- Payment of premiums
  - Annual gift exclusion
  - GST exemption allocation

Grantor Trained Annuity Trust (GRAT)

Possible solution for Farm Stock

GRAT may be used by farmer to transfer assets and future appreciation to his or her children



Grantor Trained Annuity Trust (GRAT)

- Technique to make deferred gift of property
- Utilizes a discounting of value technique which divides the value of property into two portions:
  - Income portion
  - Remainder portion
- GRATS are best used when a property is expected to appreciate/ produce income at a rate higher than government prescribed rate (currently 1.0%)

Grantor Retained Annuity Trust

- Example:
  - Assume Farmer has farm entity with a FMV of $3M
  - Farmer expects a 3% income stream and 5% appreciation of the farm entity over the next several years
  - Wants to gift entity to his farm kids with the lowest gift tax cost possible
- Alternatives:
  - Outright gift
  - Contribution to a 5 yr GRAT

Grantor Retained Annuity Trust

- Example (cont):
  - Farmer has not made any prior gifts
  - GRAT annuity is 21.835% annually

    **2012 Gift Tax Rate = 35%

Alternative	Amount to Children	Lifetime Exemption Used	Amount Subject to Gift Tax**
Contribution of entity worth $3M to 5 Yr GRAT	$575,000 (estimated)	$0	$0
Outright gift of entity worth $3M	$3,000,000	$3,000,000	$0
Outright gift of securities worth $575,000	$575,000	$575,000	$0

For more help

- Download a hard copy of this presentation at http://bit.ly/dtn_passiton
- Read DTN's prize-winning *"Senior Partners"* series on the financial and emotional issues of passing on a farm at http://www.dtn.com/ag/indepth/senior-partners-package.cfm
- E-mail Marcia.Taylor@telventdtn.com
- Contact Andy or Nick at CliftonLarsonAllen LLC at 612-376-4500