

# Estate and Succession Planning for Farm and Forest Landowners

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Cooperative Extension  
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# **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

## **Table of Contents**

Preface

Chapter 1: Overview [John Becker, Matthew Kaplan, Keith Dickinson, and Michael Jacobson]

Chapter 2: Estate and Succession Planning and What it Means to You [John Becker]

Chapter 3: The Dynamics of Family Involvement [Matthew Kaplan]

Chapter 4: Working toward More Effective Family Communication about Succession Issues [Matthew S. Kaplan]

Chapter 5: Building Communication Skills [Matthew Kaplan]

Chapter 6: Understanding Succession Planning [John Becker]

Chapter 7: Establishing Goals for the Family Business [Keith Dickinson]

Chapter 8: Property Transfers After Death [John Becker]

Chapter 9: Tax Aspects of Estate Planning [John Becker]

Chapter 10: Calculating the Federal Estate Tax that an Estate Will Pay [John Becker]

Chapter 11: Using Gifts in Estate Planning [John Becker]

Chapter 12: Conservation Easements: Valuing Property Subject to a Qualified Conservation Contribution [John Becker and Michael Jacobson]

Chapter 13: Lifetime and Testamentary Trusts Commonly Used in Estate and Succession Planning [John Becker]

Chapter 14: Life Insurance in Estate Planning [John Becker]

Chapter 15: Organizing and Operating the Farm or Forest Business Enterprise [John Becker]

Chapter 16: Planning Estates that Involve Farm or Forest Land: Strategies and Application [Michael Jacobson and John Becker]

Chapter 17: The Succession Planning Team [Keith Dickinson]

Chapter 18: Let's Plan Your Farm or Forest Land Estate – Inventory Your Assets [John Becker]

## Preface

*Estate and Succession Planning for  
Farm and Forest Landowners*  
**Handbook and eLearning course**

*John C. Becker, Matthew S. Kaplan, Keith R. Dickinson and Michael G. Jacobson*

Throughout this handbook as well as the eLearning course for which the handbook serves as an ancillary resource, attention has been drawn to the fact that the Federal Estate and Gift Tax was scheduled to expire after December 31, 2012 and Tax law, as it existed in 2001, would be reinstated and applied in 2013 and future years. That did not happen.

On January 2, 2013, Congress passed and the President signed the American Taxpayers' Relief Act of 2013 which has these key Federal Estate and Gift Tax provisions:

- 1) The *sunset provisions* which would have reinstated the 2001 Federal Estate and Gift Tax law were repealed which means that the Federal Estate and Gift tax law in place in 2012 continues and the reinstatement of 2001 law does not occur.
- 2) In addition to removing the *sunset provisions*, the 2012 Act extends a host of earlier income tax provisions that were scheduled to end at the end of 2012.
- 3) For deaths occurring in 2012, the exemption equivalent for federal estate and gift taxes is \$5,125,000. For deaths occurring in 2013, that amount is increased to \$5,250,00 as a result of inflation which will adjust that amount in future years.
- 4) Between spouses the portability of any unused exemption equivalent to the unified credit for estate or gift tax amounts becomes a permanent part of Federal Estate and Gift Tax law. As discussed in this eLearning course and Handbook materials, the portability of an unused exemption requires action when the first spouse dies and this requirement continues.
- 5) Prior to 2013, the maximum federal estate and gift tax was 35%. In regard to deaths or gifts occurring in 2013 and beyond the maximum Federal Estate and Gift tax is raised to 40% from 35%.

Pennsylvania Inheritance Tax changes since the text was written:

In Act 85 of 2012 (effective July 2, 2012), the Legislature added a new inheritance tax exemption for post death transfers of real estate devoted to the business of agriculture between members of the same family. However, the transferred real estate must continue to be devoted to the business of agriculture for a period of seven years beyond the transferor's date of death and the real estate must derive a yearly gross income of at least two thousand dollars (\$2,000).

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

If any tract of land which claims this exemption is no longer devoted to the business of agriculture within seven years after the transferor's date of death, the land will be subject to inheritance tax due the Commonwealth. The tax due is the amount that would have been paid or payable on the basis of its fair market value as of the date of the transferor's death plus interest accruing from the transferor's date of death. If this tax is imposed it will be secured by a lien in favor of the Commonwealth upon the property, and become the personal obligation of the owner of the property at the time of the change of use. The owner of real estate claiming this exemption must certify to the department on an annual basis that the land qualifies for the exemption and must notify the department within thirty days of any transaction or occurrence causing the real estate to fail to qualify for the exemption.

In addition, a transfer of an agricultural commodity, agricultural conservation easement, agricultural reserve, agricultural use property or a forest reserve, as those terms are defined in the inheritance tax law relating to special valuation of agricultural, agricultural reserve and forest reserve lands, which is transferred after death to lineal descendants or siblings is also exempt from inheritance tax.

For the purpose of applying these provisions, the following definitions apply:

“Business of agriculture.” The term shall include the leasing to members of the same family or the leasing to a corporation or association owned by members of the same family of property which is directly and principally used for agricultural purposes. The business of agriculture shall not be deemed to include:

- (1) recreational activities such as, but not limited to, hunting, fishing, camping, skiing, show competition or racing;
- (2) the raising, breeding or training of game animals or game birds, fish, cats, dogs or pets or animals intended for use in sporting or recreational activities;
- (3) fur farming;
- (4) stockyard and slaughterhouse operations; or
- (5) manufacturing or processing operations of any kind.

“Members of the same family” include any individual, such individual's brothers and sisters, the brothers and sisters of such individual's parents and grandparents, the ancestors and lineal descendants of any of the foregoing, a spouse of any of the foregoing and the estate of any of the foregoing. Individuals related by the half blood or legal adoption shall be treated as if they were related by the whole blood.

March 20, 2013

# **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

## **Chapter 1: Overview**

*Estate and Succession Planning and You: the Demographics of Farm owners; the Significance of Individual Private Forest Land Owners*

### **A. How to Use This Handbook Alone or as Part of the Online Course**

This handbook was created to be part of a Penn State Extension online course on estate and succession planning. The handbook could be used independently from the online course or in conjunction with it. Throughout the handbook you will see references to the course. If you are using the handbook independent of the course, then do not allow the course reference to confuse you. You may follow the handbook without using the course.

The handbook and the online course are intended to educate you about the family, tax and property law issues involved in planning the transfer of property and, in particular, the transfer of a farm or forest related business from one generation to another. These transfers could occur during an owner's lifetime or they could occur after an owner's death. Being educational in nature, the handbook and the course will help people who want or need legal advice to understand the questions they must answer, the problems with which they must deal and some of the choices and options that are available to them as they plan their own estates or look for ways to pass an active business from one generation to the next. However, neither the handbook nor the course is intended to be and should not be considered as legal advice to those who read it.

As described in more detail below, the handbook is divided into three major sections and a total of 18 chapters to make the discussion more focused.

### **B. Objective and Purpose**

#### **1. Handbook/Course Purpose**

Estate and Succession Planning Opportunities and Strategies for Farm and Forestland Owners is an outreach education program designed to acquaint you with fundamental issues involving transfer of property during lifetime or following an owner's death. This transfer could be a lifetime event, a process that takes several months or years to complete, or an event or process that is delayed until an owner's death when the property will be transferred to a new set of owners. These post death transfers can be accomplished through one of several means, such as operation of a will or trust, intestate succession law, or joint ownership of property that provides for transfer to surviving joint owners. Many people are aware of these issues as they have experienced their application in their own families or in the lives of their friends and neighbors. Although people are aware of these issues, many people are reluctant to consider them for a variety of reasons, whether the technical nature of the issues, a lack of understanding of what needs to be done or a deep, personal reluctance to tackle the family decisions that are involved in this process. Whatever the reason for choosing not

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

to act, this handbook and course will examine these issues.

In addition to understanding estate and succession planning opportunities and issues, the handbook and course are designed to include a planning strategy component that focuses specifically on the needs and circumstances of private farm and forest landowners. Planning issues are discussed in the context of federal estate and gift tax law and typical inheritance tax issues. Planning strategies will incorporate consideration of these laws in the analysis of various options. There is an expectation that additional changes will occur in the near future.

Planning is a process rather than a single act. It is a subject that may need to be revisited after the initial decisions are made and action is taken to fulfill that plan. A second point to consider is that some of the issues are expected to change in the near future. This is particularly true in regard to federal estate taxes as the later discussion will make clear. Therefore, it is important to remember to always check the accuracy of information dealing with tax law related issues. These provisions change frequently and you must seek current information.

The focus of the handbook and course is on the estate and succession planning situations of private individuals who own farm or forest land and other assets. These individuals are concerned about the future use and ownership of their asset and they fear that without proper planning the investment potential of the assets and the prospect of long awaited returns may be lost. Two of the least understood aspects of forest management by landowners are the role of forests in their estate and the need for coordinated planning to avoid conflicts and compromises that threaten achieving desired goals and objectives. In many respects, their situation is identical to that of other individuals and their families. In some respects, planning choices and opportunities available to forest land owners and their heirs are unique. The handbook and course attempt to address both aspects of the subject, pointing out, where applicable, those provisions that have limited application. Although the title might suggest a narrow discussion, it is intended to be broad.

If you are not a farmer or forest landowner, you will still find interesting and useful information in this publication. If you are a farmer or a forest landowner, you will find information that is likely to be pertinent to your situation.

The handbook and course are intended for an average lay person who is not experienced with estate and succession planning, property transfer or death tax issues, but who has an interest in knowing more about them for personal or professional use. To help you with the transition to the language used in estate and succession planning a glossary that defines common estate and succession planning terms is found at the beginning of the book. Bank trust officers, insurance agents, financial counselors, accountants and others whose interests or employment involve them with these issues will recognize that this course is not as exhaustive a treatment of the topic of estate planning as it would be if it were written for a professional financial or estate planning advisor audience. This decision was intentionally made to limit the scope of the material

# **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

and the level of discussion so it would help property owners understand what estate and succession planning is about.

## **2. Objectives**

The objective of the handbook and course is to help you understand:

- a. how issues arise in these estate and succession planning situations;
- b. what steps can be taken to address them in your own situation; and
- c. how to improve your decision making capability in relation to your property.

Although the handbook and course are intended to increase your knowledge and understanding about this subject, they are not intended to be and should not be interpreted as legal advice or opinion concerning these issues or their application. As will be seen in the discussion of income and estate tax issues, this is a detailed and complex matter. Professional advice and counsel are needed to apply these ideas to actual situations. This advice and counsel can only be given after a thorough review has been made by someone competent to evaluate the situation and offer advice. This handbook/course does not provide this advice and is not intended to replace the need for it.

## **C. Farm and Forest Landowner Demographics**

There is a clear trend that the farm population is aging. In Pennsylvania, for example, the average age of principal farm operators in Pennsylvania is 55 and there are nearly twice as many farm operators over the age of 55 as under the age of 35 (Agricultural Census 2007). Up to 6,000 full time PA farm operations will face the loss through death or retirement of their principal farm operator in the next 15 or 20 years and will transfer the farm operation as a result. The continuation of these farm operations will require that successful transitions plans be developed and carried out in many of these operations.

In Pennsylvania over 500,000 private forest landowners own 12.5 million acres which represents 75 percent of the Commonwealth's forests. The US Forest Service National Woodland Owner Survey of 2006 predicts that one quarter of the private forest acreage will be transferred in the near future. In addition, the study shows that 20% of forest owners are over 75 years old. Forest land owners who have managed their land carefully may realize the importance of transferring their forest land to successors who are capable of seeing their management plans continued as intended. Without such planning and attention, forest land may be divided to such levels that effective management is nearly impossible to achieve and resource conservation goals are not met.

In addition to growing concerns about how to meet the retirement needs of older farmers and forest land owners, there are projections about how it will become increasingly difficult to find young people to continue with family traditions of farming and forest ownership. Another set of factors which has a profound effect on the sustainability of small family-owned and operated farms but has received less attention are problems related to farm and forest land succession planning. Fewer than half of these families have individually designed succession plans with many families not

# Handbook on Estate and Succession Planning for Farm and Forest Landowners

knowing how to develop a plan. The consequences of this are often severe – if the farm is simply “willed” to the succeeding generation of operators, inheritance taxes and other fees may cripple the farm and its new owners. Additionally, inadequate farm succession planning often results in heirs who have an inadequate financial base on which to operate or who are incapable of running the farm or forest business, family conflict, prolonged legal battles, and partition of family-owned and operated farm business assets to satisfy heirs who simply want to “cash in” their share of the business rather than invest in it.

## D. Overview of Content

The handbook and course are divided into an Introduction (Chapters 1-2) and three parts (Chapters 3-18) that are broken down as follows:

- Part One: The Importance of Family Dynamics
- Part Two: A Focus on the Business and Transfer Issues
- Part Three: Getting Started: How Can I Develop My Estate and Succession Plan?

Chapter 2, *Estate and Succession Planning and What it Means to You*, introduces the terms “**estate planning**” and “**succession planning**” to assist you in understanding the scope of the topic, particularly the differences and similarities that exist in these issues and in the responses to each of them. In this discussion, **the tools of estate planning** and the important role that families play in designing effective plans are described. The concept of an **estate planning team** and the composition of that team are discussed. This focus is intended to introduce you to the basic framework within which lifetime planning takes place to influence lifetime and after death matters.

### Part One: The Importance of Family and Family Dynamics begins with Chapter 3

Chapter 3 provides a general overview of the role of **family dynamics** and the goal of collaborative decision making when it comes to estate and succession planning.

Chapter 4 addresses the importance of **communication within and among family members**. Effective communication is a key component in family making processes that evaluate choices and make decisions in effective ways.

Chapter 5 discusses **building communication skills and performance** of family members.

Chapter 6 presents a detailed discussion about the succession planning process. This baseline of understanding provides a context for helping families to frame future discussions and decisions.

Chapter 7 highlights the importance of establishing **goals and objectives** when a family first begins a process aimed at planning for the future of their farm or forest-related business.



# Handbook on Estate and Succession Planning for Farm and Forest Landowners

## Part Two: Focus on the Business and Transfer Issues begins with Chapter 8

Chapter 8 discusses four ways by which property is transferred after the property owner's death. **Transfer by operation of law, through a will, under an intestate distribution statute, and under the terms of a living trust** are described and compared to each other. General information needed to prepare wills and living trusts will be identified. Ownership of property by a single individual or jointly with two or more people is discussed in terms of identifying when **joint interests** exist

and the characteristics of each form. In comparing the forms, consideration is given to the method by which the transfer takes place and costs associated with it.

Chapter 9 introduces the topic of **the tax impacts of property transfer**. The chapter discusses various **state and federal death, inheritance and gift taxes**. In the discussion, consideration is directed to identifying when the tax applies, how it is calculated, when it is due and who is obligated to pay it. Within the last few years, tax laws were frequently amended and the discussion focuses on the inter-relationship between these taxes that must be identified in the planning process. Of particular note in Chapter 9 is discussion of federal estate and gift tax which in 2011 and 2012 is in a state where changes are expected to occur soon.

Chapter 10 addresses how taxes that apply to various **types of estate taxes are calculated**. Included in this discussion are topics that include how property of various types is valued under a series of both general and special rules that apply to various kinds of property.

Chapter 11 discusses the concept of **lifetime gifts of property** as a means to shift property from one owner to another to achieve a particular planning objective. The emphasis of this chapter is to explain what constitutes a gift for property transfer purposes and the tax issues and matters that arise when a gift is made. These tax issues involve income, inheritance, and gift tax considerations.

Chapter 12 discusses the concept of **a conservation easement** and a variety of opportunities available to landowners who sell or donate such interests on their land.

Chapter 13 addresses the estate planning opportunities provided by use of **trusts** created either during lifetime or after death. This chapter will explain the essential elements in the creation of a trust. This discussion will help to explain the various forms that trusts take and the essential requirements they must meet.

Chapter 14 examines the role that **life insurance** plays in a program of estate planning. Life insurance products have many different forms and the chapter describes the most common forms. Life insurance is also subject to particular treatment under state inheritance and federal estate tax law and the chapter describes the treatment and issues associated with it.

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

Chapter 15 addresses various ways in which a **business organization** can be organized and operated in the context of estate and succession plans.

Chapter 16 brings together the various issues and concepts of estate planning and applies them to an estate plan involving a variety of assets, including various quantities of private farm and forest land. Pre-planning information and key decisions are discussed along with strategies to employ the various techniques and opportunities described in other chapters. This chapter also addresses a series of problems and issues that arise in planning estates that include forest land assets of one type or another. This chapter will give you additional **opportunity to evaluate the application of planning strategy.**

### Part Three: Getting Started: “How can I develop my estate and succession plan?”

Chapter 17 introduces you to the concept of an **estate planning team** by explaining their respective roles, their potential contributions and some suggestions for what to look for when selecting team members.

Chapter 18 **outlines the steps you can take to gather the information from which the plan will be developed.** This discussion identifies the information you need to gather to begin the evaluation of your own situation in preparation for identifying the key decisions that are involved in your own situation and should be addressed in the plan. When meeting with planning team members this information will assist them in understanding your situation and in aiding you to make decisions about your plan.

### Performance Objectives - Study Hints

At the end of each chapter, except chapters 1, 3, 4, 5, 16 and 18 you will find a series of **multiple-choice questions** that ask you to evaluate the facts in the situation and address a specific question about it. In addition, many chapters have a series of open ended essay questions that will give you the chance to respond to the question in your own words, using your own understanding of the problem and the solutions available to deal with it.

Each question is intended to evaluate how well you understand the concepts in the chapter and how you apply these concepts to new situations. Multiple-choice questions may ask you to compare several concepts on one point or may test your understanding of the concept and the situations where it applies.

If you have any question about this handbook or about the Penn State Extension programs in the areas of Farm and Forest Business Education, contact: Keith Dickinson, Agricultural Business Management Educator, Penn State Extension at Chester County [farmsuccession@psu.edu](mailto:farmsuccession@psu.edu).

Feel free to raise any questions or problems you have whenever they arise.  
Good luck!

## Chapter 2: Estate and Succession Planning and What it Means to You

### Consider This Situation:

This pattern describes the situation of Harry, Betty and their four children. Harry lives with his wife, Betty and their four children, John, age 29, Jesse, age 27, Mary, age 21 and Leon, age 17. Harry and Betty work together in a farm business for over 35 years. They started by farming the 200 acre main farm and implemented a forestry management plan for the 85 acre wood lot all of which Harry inherited from his parents when they both died in 1979. A few years later, Harry and his brother, Joe, inherited a parcel of land as the sole heirs of their older brother, Dick. Dick's property included an additional tract of 150 acres, 75 acres of which was wooded and located adjacent to a real estate development. All of these wooded acres included mixed hardwood species of an average age of 50 years. The average value of the wood on the wooded acres is \$6,500.00 per acre.

After Dick's death, Harry took over farming operations on Dick's land and began to examine the potential opportunities that the additional wooded acreage presented. Being familiar with managing forest acreage according to a management plan designed to achieve its maximum potential, Harry began to include the added acreage in his current plan.

Joe had no interest in the operations on Dick's property as he was a successful businessman involved with his own business.

Residential development now completely circles the main 200 acre farm and the additional 150 acre parcel. As a result, land values soared. Harry has been approached by several people about selling the farm, but he graciously expresses no interest in selling. Developers are particularly interested in the wooded portion of the tract as it provides an ideal setting for a wooded residential development. Three years ago the combined value of the main farm and woodlot and Harry's interest in the additional parcel was \$8,165,000. The 150 acre parcel alone was worth \$4,100,000.

Harry and Betty believed they owned the main farm and additional properties jointly, although the deeds to the properties list Harry's name alone as owner. The 150 acre parcel was distributed to Harry and Joe after Dick's death and ownership of the land passed to them through Dick's estate. In addition to the farmland, Harry and Betty accumulated over \$900,000 of machinery, livestock and equipment in their farming operation.

Harry prepared a will thirty years ago and this plan transfers all of his property to Betty after his death. Harry also assumed one or more of his children, either John or Jesse, would return to farm and keep the family tradition alive. Family tradition was something that made Harry very proud. He wanted the land to stay in the family but he was uncomfortable being the person who should make decisions about its future.

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

Harry and Betty's son, John, works on the farm after earning a degree in dairy science with a minor in forestry. John has big plans for the future of the farming operation. Jesse travels throughout the country as a public accountant for a national firm. Jesse is not interested in the production side of agriculture, but is very aware of the value of Harry and Betty's holdings. Mary graduated from college this year and is deciding what the next step should be toward some type of a professional career. Leon is a high school senior on the wrestling team and he wants to go to college to earn a degree in hotel management.

Harry and Betty do not spend much time wondering what will happen to their property if either or both of them die. Why should they fill out information about their property and pay fees to lawyers, accountants, financial planners or others who are only interested in selling them something they do not need. At one time Harry considered a partnership with John, but nothing was done about it. Harry didn't think John was ready to enter a partnership, and John knew he wasn't really interested either.

Harry and Betty carefully protect their property because they are concerned about their financial future. Medical care costs are rising and it is difficult to set aside a specific amount of property to feel secure about their future. Giving their property away is not a subject that either want to discuss. Harry and Betty work hard for what they have. Why give property away to someone who could waste it, or squander its value?

Neither Harry nor Betty have an accurate idea of the financial value of what they owned. They considered only their bank accounts and certificates of deposit as available funds. In these accounts they had a total of \$285,000 in a joint account that either spouse can use.

Harry never thought much about insurance or retirement planning and has less than \$20,000 of life insurance protection. His income from farming and timber sales is modest, but Betty and the kids are taken care of to his satisfaction.

Harry and Betty are concerned about the future of the farm, its timber business and the value that the growing trees will bring in the future. The children are concerned about these issues as well, but there has been only one family discussion about the businesses and what Harry and Betty would like to see happen to it when they are gone.

### **A. Overview and Purpose**

The issues presented in the above situation provide important questions that will help you understand what estate and succession planning involves. For example, what happens to the property owned by Harry if he dies suddenly? What are the tax impacts of Harry's death? Which taxes apply? Who pays the tax? When is the payment due? What options do Harry and Betty have to manage these taxes? How can Harry and Betty continue their various businesses after their deaths? How will Betty and the kids get along after Harry's death? What will happen to the kids if Betty dies suddenly? In

# Handbook on Estate and Succession Planning for Farm and Forest Landowners

this chapter we will explore the concept of estate and succession planning and the issues they create.

## B. Lesson Objectives

When you have successfully completed this chapter, you will be able to accomplish these objectives:

1. Define the meaning of the terms, estate planning and succession planning.
2. Make a comparative analysis of each of these activities.
3. Describe the importance of setting family goals and objectives as part of the estate and succession plan.
4. Describe the tools of estate and succession planning.
5. Identify the members of a family's the estate and succession planning team and the role they play as team members.

## C. What is Estate Planning?

**Estate planning** is defined in several ways. In one sense, it means maintaining a continuous inventory of what you own and owe and your plans for disposing of your accumulated property if you die. In another sense, it means the process that you apply in planning for the transfer of property after your death. In a third sense, estate planning also involves important decisions you can make that have lifetime impact or significance. Some other lifetime decisions that don't involve the transfer of property, but are made in the estate planning process include giving someone authority to deal with your property if you become disabled or incapacitated. Long term care will be an important issue for a great many people who live longer lives and find they can no longer live without some type of assistance in their later years. Many of these options are expensive and additional planning must be undertaken to manage these costs and expenses.

Much current interest has been shown to the right of an individual to personally decide whether medical care and services should be provided in the case of a terminable illness, disease or injury. What if the person is incapable of communicating their personal desires concerning the care when the condition is diagnosed? In many states individuals can write their own wishes and instructions concerning medical care in cases of irreversible medical problems. These written instructions are known by several terms, including **advanced directive concerning medical care** or in some states the term **living will**.

A second issue that is related to an individual's disability in matters involving their property is their right to designate someone to have authority over their property. This transfer of authority is known as **a power of attorney**. A power of attorney can address either financial or health care decision making authority. To accomplish this appointment, an individual who is fully competent to manage property makes a written designation of another person to act on their behalf in performing specific duties regarding their property. This authority can arise immediately or at a later date when

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

certain conditions are met. This grant of authority must be accepted by the person who is appointed. The authority should be specifically and clearly described to avoid confusion over its terms and can include ***the power to authorize a person's admission to a medical or nursing facility or authorization of specific medical procedures and treatment.***

Many lifetime decisions, such as the choice of job or profession, where to live, or how to invest your money, are concerned with accumulating assets or establishing a steady stream of income. Estate planning decisions look beyond the accumulation of property to the question of what happens to the property you accumulate after you die.

Among the three definitions of estate planning are several key points. Estate planning is a process rather than an act that ends in a single, final event. Estate planning involves many issues that change over time. The individuals to whom the property will be distributed change as families pass through their cycles of lifetime development. Laws influence choices regarding ownership of property, inheritance and estate tax, business organizations, marital property rights and the status of family members often change. Law changes may present new opportunities for the estate plan. Therefore, it is wise to review the plan from time to time and ask if it still provides for the efficient and effective transfer of property you desire.

### D. What is Succession Planning?

In contrast to estate planning, succession planning looks at developing a plan for a business to continue from the current owner to the next owner. Financial issues such as taxes and the legal mechanisms to transfer property after death are also part of succession planning. Legal issues that address ways in which the transfer from current owner to succeeding owner takes place also apply. Chapter 6 will discuss succession planning in depth, discuss the issues that a succession plan should address and discuss how a succession plan is used with an estate plan.

Throughout this handbook and course, the term “estate and succession planning” is used to refer to more than one type of situation. For example, a person who will not face a considerable inheritance or estate tax problem after death may only be interested in planning for the continuation of a family business either during his lifetime or after his death. Likewise an estate owner whose property does not involve a functioning business or whose business will be sold or liquidated during lifetime may be more interested in the estate and inheritance tax aspects of these transfers and less interested in the succession portion. Successful businesses often make up a large portion of a person’s estate property within the families that own and operate them. In those situations, estate and succession planning go hand in hand. In practice the type of plan or plans selected varies according to the needs of the person doing the planning. Although this handbook and course refer to these plans together, they are easily separable into individual plans tailored to the needs of the property owner.

In other cases that do not involve a business and that will not face federal estate taxes

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

the primary concern may be ownership of land and how a new owner might use it. In this situation questions about who should inherit the land and whether restrictions should be placed on its use are the primary items of discussion.

In later chapters the family decision making process of selecting the successor will be addressed along with discussion of key issues about communication within and among family members.

### E. Estate Planning Advisors and the Tools They Use

In the previous discussion we touched on a number of problems that describe estate and succession planning issues. To whom would a person go to get all of the information needed to deal with these issues? The answer is found in the concept of the **“estate and succession planning team”** and the tools team members use in their work. Chapter 17 of the handbook will explain this concept in more detail and explain the various roles that team members can play.

For matters that involve legal issues such as preparation of a valid **will or trust agreement** to transfer property after death, **ways to organize and operate a farm or woodland business**, **lifetime gift transfers** or advice on property ownership forms that transfer property and save taxes, a person consults an attorney whose practice and experience is in the area of estate and succession planning. The practice of law is complex and many professionals limit their practice to specific kinds of cases. As a result, their knowledge and experience centers on limited subjects. Selecting the right advisor who is experienced in the area you need is an important decision.

Information about **income, estate, or gift tax** questions may come from an accountant or attorney who has the proper background. Since many decisions have lifetime as well as post death impact, the advisor must be able to coordinate matters in order to avoid an unexpected and detrimental result. Tax advisors use the tools of tax planning strategies and opportunities to minimize taxes or lessen their impact.

Other members of the estate and succession planning team include advisors whose expertise and skill is in particular areas, such as insurance, retirement planning, investments or business organization management and operation. The tools insurance and investment advisors use are insurance and investment products applied to estate and succession planning situations. Product choices have grown dramatically over recent years and introduction of new products creates the need to seek out advisors who are aware of and knowledgeable about the range of new products and the functions they serve. Business organization consultants offer advice and recommendations on the organization and operation of alternative business forms such as partnerships, limited partnerships, corporations, tax-option corporations and joint-ventures. As alternatives to evaluate in a particular setting, these structures provide opportunities to plan for business changes.

One part of the estate and succession planning team that does not bring knowledge or

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

expertise to bear on planning choices, but does play an important role is ***the family of the business owner and operator***. As the primary group that benefits from property transfers, family members help to define the goals and objectives of the plan. Certain family members will also play important roles implementing the plan. The strengths and weaknesses they bring to the plan may well influence it in significant ways. Understanding the reasons for plan decisions is another role for family members to play in implementing the plan. Although not the final decision maker, the family should be involved in shaping goals and objectives and supporting the plan that is put in motion. If an impasse occurs a final decision maker should be identified and have the authority to make a decision. If family harmony is an important plan objective, it may be difficult to gain the harmony without family involvement.

### F. Student Exercises

1. The concept of estate and succession planning has several different aspects to it. Which one of the following statements does not describe an aspect of estate and succession planning?
  - a. Planning for the transfer of property after you die.
  - b. Maintaining an inventory of what you own and owe.
  - c. Designating someone to act on your behalf if you become disabled.
  - d. Selecting the investment that offers the highest rate of return on your funds.

**NOTE:** In the following questions you may find more than one correct answer.

2. The estate and succession planning team refers to those individuals who can provide information and assistance to people who are interested in planning their estates or in providing for continued operation of their business. Of the following individuals, who would be part of the estate and succession planning team? Please circle the letter(s) that references those people who would be part of the team.
  - a. Physicians
  - b. Bank Trust Officers
  - c. Bank Loan Officers
  - d. Tax Accountants
3. The tools of estate planning are the devices and techniques that planners use to create plans to achieve the goals of property owners. Which of the following statements describe the tools that could be used in an estate plan? Please circle the letter(s) that corresponds to those items that you consider to be tools.
  - a. Wills
  - b. Trust Agreements
  - c. Insurance policies
  - d. Partnerships and Corporations



## Handbook on Estate and Succession Planning for Farm and Forest Landowners

4. Which of the following events should prompt a person to review their estate plan? Please circle the letter(s) that refers to such an event.
  - a. Birth of a child
  - b. Winning a multi-million dollar lottery
  - c. Changing jobs
  - d. Selling property
  
5. Which of the following statements about estate and succession planning is correct?
  - a. Once a decision is made to transfer specific property, no future events can change that decision to transfer the property.
  - b. Many issues affecting estate and succession planning are based on laws and regulations. As any of these laws or regulations change, or new laws and regulations are adopted, there may be need to revise any plans prepared before the change occurred.
  - c. Wilma planned to transfer her property after her death. She prepared a will that incorporates her plan. With the will in place, Wilma must now recognize the beneficiary's interests in her property.
  - d. None of these statements is a correct statement.

**Part One: The Importance of Family and Family Dynamics**

**Chapter 3: The Dynamics of Family Involvement**

**A. Overview**

To be successful in family estate and succession planning requires a large amount of technical information. Families need to learn about relevant legal and financial issues that must be addressed, and they need information on ways to develop timelines for a sequential transfer of the business that allows the younger generation to gradually build equity in the business, receive managerial training, and assume managerial roles before enacting the formal transfer.

However, obtaining such technical information is just part of the process. Many families find it difficult to begin the process of discussing and making decisions about who will succeed in running the family business and how other heirs who are not involved in the business will be treated. This chapter will focus on issues tied to family communication and relations.

Learning Objectives:

- Identify the role of family dynamics in estate and succession planning.
- Adopt a view of estate and succession planning in which family members recognize that they are “interdependent.”

**B. Family Members as Partners in the Succession Planning Process**

Much of the farm succession planning literature focuses on what the “power-holder” knows and does with regard to making decisions about the family business. Emphasis is placed on how current operators choose and groom their successors and pass on management control.

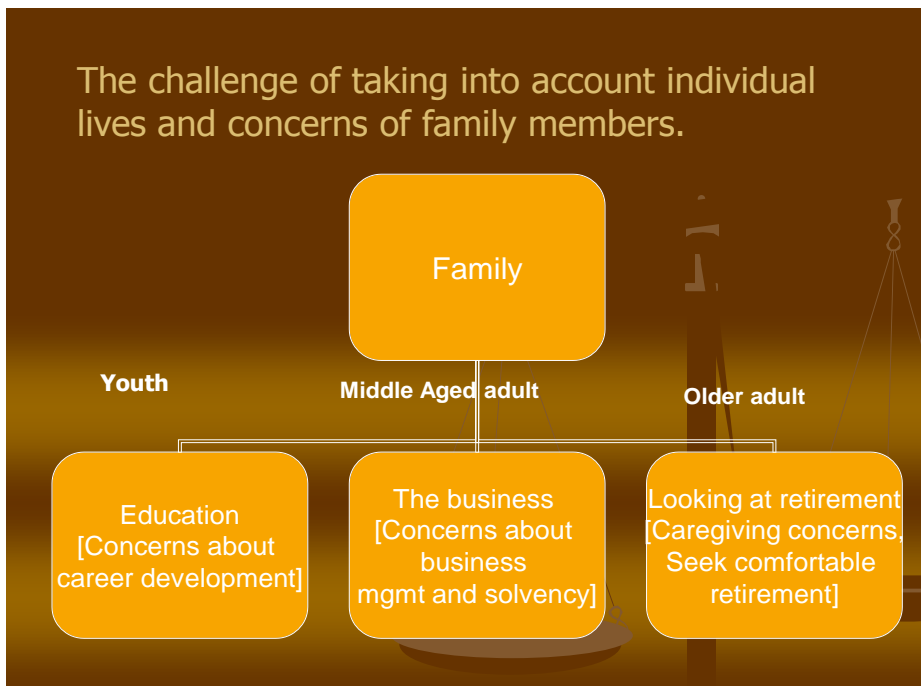
However, as a group of Penn State researchers found out when conducting a study of how farm families talk about farm succession planning issues (Kaplan, Nussbaum, Becker, Fowler, and Pitts, 2009), there are issues in the lives of the younger generation family members, beyond the “control” of older generation members, which can delay or derail the succession planning process. When asked to speak about challenges related to passing on their farm business, respondents were as likely to speak about difficulties associated with family relationships as about economics or any other set of factors. In half of the families in the study, respondents felt unable to make immediate progress with farm succession planning due to unresolved issues or uncertainty tied to the lives of individual family members. In several of the families, heads of household noted obstacles such as waiting for a young adult child to make a decision regarding a job opportunity or to commit more fully to the family farm enterprise.

# Handbook on Estate and Succession Planning for Farm and Forest Landowners

Results from this study suggest that the intergenerational transfer of ownership and management can be helped along by being inclusive of younger generations in key discussions and decisions about the future of the farm. Family members need opportunities to share individually held views, to explore common goals and values, and move forward, together, in establishing shared visions for farm and family. This is consistent with what Errington (1993/94) describes as a “partnership” framework for nurturing potential successors; they develop management skills through guided practice, planned experiences, and gradual increases in decision-making responsibility. It is also consistent with other research that highlights the importance of family relationships and communication in family business succession planning (Fetsch, 1998).

## C. All in the Family: Helping Family Members See How They are *Interdependent*

Many families that own and operate family businesses could use help developing an integrated vision for the future of the family business as well as for relations within the family. Part of the difficulty comes from the fact that individual family members tend to tune into their own sets of concerns and experiences. As the chart below indicates, these concerns often vary along generational lines.



Many people view family farm succession planning as a “zero sum game” which means it is a situation in which a benefit to one party is seen as coming at the expense of another party. However, there is another way to frame the situation. It begins with viewing all family members as being “interdependent” and paying attention to how every decision or action on the part of one family member affects all others. For example, if an older adult family member has his or her financial and health care needs met in

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

retirement, this places that individual in a better position to contribute to the social and emotional development of the grandchildren. Similarly, although sending a young family member to college may add to the family's debt, this individual will be in a better position to make future contributions to the operations and business decisions of the family farm.

In working collaboratively to develop a plan for the future of the family business, it is helpful to consider the needs and contributions that can be made by all individual family members. No one family member will likely get everything they want but everyone should feel that their wishes have been considered and that they have received a fair deal relative to what they put into the family business enterprise and relative to the efforts and rewards afforded all other family members.

With more attention paid to communication and careful planning, farm families are more likely to make decisions based on what is good for the entire family over the long run as opposed to short-term benefits for individuals. This is likely to have implications for the success of the family-owned farm or forest business.

### **D. Using Teamwork to Help Meet Individual Needs**

Young people looking to get started in a family business typically need financial support to get started, while members of the generation passing on the family business often need some help developing retirement plans that will provide enough funds to support them in retirement. Two basic questions that the entire family needs to address for each situation are as follows:

1. How can other family members provide needed help?
2. What are reasonable expectations for "paying back" that help?

When family members work together to support individuals in meeting their personal goals, the entire family has something to gain. The young adult is in a better position to increase the value of the family business. Older adult family members who are financially and socially secure are better able to provide advice and assistance (e.g., childcare) for other members of the family.

### **E. Activity: Conversations that go from *Me* to *We* – Taking into account the needs and perspectives of other family members**

Introduction: When it comes to family conversations about estate and succession planning, it helps when individual family members are oriented toward considering how their own plans and aspirations for the future relate to the plans and aspirations of other family members. This activity is designed to stimulate thinking about how certain needs and concerns of individual family members can be addressed from a family/family business perspective. (Issues related to other communication skills are addressed in the following chapters.)

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

Instructions: Take a look at each of the conversation scenarios provided in the table below. In the middle column is a series of statements that family members might make in conversations about future plans. The focus of each of these statements is on the individual and his or her personal goals and plans. In the column to the right of these statements, we provide some examples and request that you write down additional examples of questions that other family members might ask to encourage that individual to consider how their own plans and aspirations might relate to the family business. The focus of these questions is on how individual family members, whatever the stage they are in their lives, might contribute to, and be supported by, the family business.

*Example: In the first scenario provided below, a teenage girl shares her thinking about her career. She says, “All I know is that I want to go to college and get a job that pays well.” In the column to the right, some examples are provided for questions that other family members might ask her to consider. These questions serve to encourage her to reflect on how her own plans currently fit, and how they could more readily fit, into the future of the family enterprise. Your task is to add to the list of these questions.*

On one hand, this teenager’s original comment is “developmentally appropriate” in its brevity (as those who have teenagers will attest!) and it is not problematic in itself. However, when it comes to family business succession planning, where each family member’s plans can have a dramatic influence on the process and outcome of the family succession planning effort, it helps when family members have the chance to discuss each individual’s personal plans in the context of the family enterprise. You will note that in the example questions that are provided, family members acknowledge the teenager’s goals for going to college while also prompting her to consider ways she might be a part of the family business in the future.

### Conversations that go from ME to WE

Family situation/ context for conversation	Statement by family member:  [Focus is on the individual.]	Questions that family members might ask to prompt the family member to consider how their plans relate to the family/ family business:  [Focus is shifted to how the individual fits into the family/ family business.]
(1) A teenager responds to a parent’s question about her latest thinking about her	“All I know is that I want to go to college and get a job that pays well.”	<ul style="list-style-type: none"> <li>• Do you have an interest in working in the family business? If you do, what aspects of the business interest you the most?</li> <li>• What type of college training do you feel would best prepare you for such work?</li> <li>• What might we (other members of the family) do to help you identify</li> </ul>

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

career.		<p>and pursue such college training opportunities?</p> <ul style="list-style-type: none"><li>• If the family business can generate funds to cover your college expenses, how might you contribute back to the family business after you graduate?</li><li>• _____</li><li>• _____</li><li>• _____</li></ul>
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**Handbook on Estate and Succession Planning for Farm and Forest Landowners**

<p>(2) A 68-year old man who runs a family farm is asked by his young adult son whether he has any plans for retiring in the near future.</p>	<p>“I would like to think more about retiring, but I just don’t see how it is possible that the farm can get by without me in charge. Besides, where would I live?”</p>	<ul style="list-style-type: none"> <li>• If one or a group of us (siblings) is interested in continuing to run the farm, are you open to the idea of passing the farm on to us at some point in the future?</li> <li>• If you are open to passing down the farm at some point, do you have any ideas as to what can be done now to build our business management and operations skills so that we have a better chance of succeeding in the future?</li> <li>• Have you thought of other ways in which you can provide assistance to the family business after you retire (e.g., business advice, child care assistance, etc.)?</li> <li>• If we can build an addition to the house, would you be interested in staying here on the farm?</li> <li>• _____</li> <li>• _____</li> <li>• _____</li> </ul>
<p>(3) A 25-year old man who is one of 4 siblings in a family that has owned and operated a farm for over 50 years shares his views about the future of the family farm.</p>	<p>“If my parents sold our family farm now, my wife and I can buy a better house and a nice car. Why don’t they just sell the farm right now so we (the man and his 3 siblings) can buy such nice things?”</p>	<ul style="list-style-type: none"> <li>• Have you ever considered how keeping the current family business alive might be a way to secure income and security for you and your family in the future?</li> <li>• If the family determines that the family farm business is profitable and there is interest in keeping it going, what role(s) (if any) would you like to take?</li> <li>• _____</li> <li>• _____</li> <li>• _____</li> </ul>

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## Chapter 4: Working Toward More Effective Family Communication about Succession Issues

### A. Overview

We know from communication researchers:

- Families tend to postpone difficult communication.
- Families hesitate to discuss important and serious topics that involve multiple generations of family members (e.g., estate planning, caregiving).

When families avoid discussions on important and serious topics that involve multiple generations of family members, this often leads to poor decision making, especially during times of family crisis. One serious topic that multiple generations of family members need to discuss but often avoid is that of farm (or forest business) transfer.

Delayed communication contributes to delayed or no planning. When an emergency situation comes up (e.g., a family patriarch experiences a severe illness that affects his ability to guide farm operations), this can have significant economic, legal and interpersonal ramifications for the family business.<sup>1</sup> In contrast, by talking through issues related to possible estate and succession planning options in a proactive way (before severe events take place), the family insulates itself from some of the conflicts and tensions that might otherwise occur.

This chapter will explore some of the barriers to effective family communication about succession planning issues.

### Learning Objectives:

- Improve ability to recognize and address potential obstacles to open and effective communication among family members.

### Reading Assignment:

- Kaplan, M., Nussbaum, J., Becker, J., Fowler, C., and Pitts, M. (2009). Communication barriers to family farm succession planning. *Journal of Extension*, 47 (5). October. Available online: <http://www.joe.org/joe/2009october/a8.php>.
- Mishra, A.K., Durst, R.L., and El-Osta, H.S. (2005). How do U.S. farmers plan for retirement? *Amber Waves*, April. Available online: <http://www.ers.usda.gov/AmberWaves/April05/Features/FarmRetirement.htm>.

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<sup>1</sup> As noted throughout this publication, the consequences of a failure to plan can be severe – if the family farm is inherited by multiple heirs, inheritance taxes and other fees may cripple the farm and its new owners. Inadequate farm succession planning may result in heirs becoming owners who are incapable of running the farm business; family conflict among heirs; and partition (which divides property and distributes it to those who are entitled to it) of family-owned and operated farm business assets to satisfy heirs who simply want to “cash in” their share of the business.

## B. Resistance to Talking about Farm Transfer Issues

Many farm families fail to take succession planning actions even when information is available on the tax, business organization, and investment aspects of this process. A growing number of researchers are focusing on the role of family relationship and communication issues in complicating succession planning efforts. Communication is critical to helping farm families develop workable succession plans that result in productive family businesses and harmonious family relationships. When family members receive information, and are involved in goal setting or decision-making, they are more likely to stay in farming because they will feel (and be) more fully invested, involved, or invited to get involved.

In a Pennsylvania study of the role of family communication in succession planning for small farms that are family owned and operated (Kaplan, Nussbaum, Becker, Fowler, and Pitts, 2009; also discussed in Chapter 3), most respondents attributed a high level of importance to the succession planning process, but conceded that they had not done enough planning. Passive communication styles, unresolved issues and uncertainty in their lives were identified as inhibiting factors.

Some individuals who declined to participate in the study, as well as some of the study participants, noted that it was very emotional and difficult for them to speak about the topic of farm transfer. Here is an excerpt of from an e-mail received from a woman who cancelled an appointment to be interviewed for the study mentioned above:

*"I am sorry, but we just cannot agree to participate in your study at this time... This is a very emotional and difficult topic for farm families. We, ourselves don't know how it will happen exactly on our farm. It is also a very personal subject. What we could tell you in 2 hours I can tell you in 4 words: blood, sweat, tears and prayers. That is how things are done."*

It is hard to have effective communication when family members are unwilling to discuss key issues related to the future of the farm or are unaware or intolerant of each other's positions. At a basic level, the relevant parties need to have an interest in learning more about each other's situations and viewpoints.

## C. Addressing Generational Differences

Robert Eisenberger's "Blue Monday: The Loss of the Work Ethic in America" (1989) provides a historical account of how the "Protestant work ethic" (some prefer the phrase "personal work ethic" to accommodate various faiths) was an integral part of America's pioneer past. Many argue that this value system is still at the core of the American psyche. As a society, we "officially" value such qualities as diligence, hard work, pride of accomplishment and a willingness to withstand privations and overcome hardships. However, it is also apparent that many entering today's workforce have different ideas

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

about work than their parents and grandparents.

Differences in work-related attitudes held by different generations can be viewed as symptomatic of larger societal changes. Particularly in rapidly changing societies, the young and the elderly speak different “languages,” dress differently, eat differently and hold different ideas about such issues as sexuality, gender roles, marriage, leisure and technology.

There are times when differing views among family members about how to run the family business can be readily traced back to generational differences in experience and attitudes in terms of *how* to conduct business. Consider, for example, the historic experience of living through severe financial hardship. Previous generations that have experienced economically tough times tend to have a strong sense of thrift – for example, re-using things, stretching resources, and not living beyond one’s means. They also recognize that there is value to being self-reliant such as in growing one’s own food. Although today’s young people might gain an intellectual understanding of what happens during economically tough times from history classes in school, they are not necessarily aware of (or prepared for) the emotional side of dealing with the loss and uncertainty that comes with personal financial hardship. Hence, they might be less cautious about spending and saving than family members from older generations.

In line with changes in the farming enterprise over the past 50 years, it is reasonable to expect that certain perceptions about farming will vary along generational lines. The following quote from a third generation farmer illustrates how family members of different generations are likely to have different views in terms of the role of borrowing money to expand the family farm business.

*We scrimped and saved for years to get this farm off the ground. Our children have never known that. They think you can borrow for everything... To my grandfather, borrowing was immoral; to my father it became a necessity; to me it is normal.*  
[Hutson, 1987, p. 224]

To ensure that intergenerational differences in experience and perspective do not lead to misunderstanding and conflict, it is important for family members to talk and listen to each other in a non-critical, non-judgmental, and non-threatening manner. Further, when each individual feels encouraged to contribute his or her skills and perspectives, there are various benefits to farm and family. Effective family communication can serve to encourage youth to enter the agriculture industry and increase attention paid to pre-retirement planning of older family members. With open, two-way communication, family members are better able to share their individually held views, explore common goals and values, and, ideally, move forward, together, in establishing shared visions for farm and family.

### **D. Enhancing Communication**

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

Families vary in terms of the substance, style, and effectiveness of their efforts to communicate with one another. Here are some of the more common *communication challenges* that hinder families trying to make farm succession planning decisions in an effective and timely manner.

- Avoiding discussion of issues which are uncomfortable to discuss
- Assuming that everyone has the same expectations/understanding about the future
- Resisting change
- Fearing an unknown future
- Desiring to avoid conflict among family members
- Uncertainty about individual family members' plans for the future
- Overly rigid family decision-making patterns
- Avoiding decisions about the distribution of assets

To help families address such obstacles to effective communication, we recommend that family members take part in formal educational programs – workshops, family retreats, and other shared learning experiences – to improve their communication and conflict resolution skills. Such programs help family members to become more effective in voicing their concerns and ideas while working to accommodate the concerns and ideas of other family members.

Structured training programs, such as Penn State Cooperative Extension's *Farm Succession Planning – Conversations to Strengthen Farm and Family* (Kaplan, Becker, Nussbaum, & O'Sullivan, 2007) are designed to help family members apply basic principles of effective communication to their farm planning situations. There are also various communication skills training programs offered through organizations such as 4-H. With stronger communication skills, family members will be better able to present their views (about the family and family business) and feel comfortable in doing so.

We also believe that advisors and service providers who work with families should have at least a moderate level of communication skills literacy and be prepared, where possible, to assist families to facilitate and encourage meaningful communication when impediments to it become apparent.

Here are some ways in which estate planning professionals can help families **communicate** more effectively and collaborate on important decisions.

1. **Meet with entire families** (rather than connect only with singular points of contact in each family). In some professions, such as the practice of law (Becker, Kaplan, and Nussbaum, 2007), providing service to multiple parties who have differing interests is considered an ethical problem for the professional. However, it can also be argued that a lack of attention to family relations issues has its own ethically troubling consequences. For example, there are cases in which the exclusion of key family members from important discussions and decision

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

making can breed disagreement and distrust at later crucial points in the business transfer process.

2. **Facilitate dialogue within families.** This might entail *partnering* with professionals who have skills in promoting/ facilitating family communication and cooperation. For example, Extension educators in the farm management area might team up with Extension educators in the family and consumer sciences area. Professionals with family strengthening skills are likely to be better equipped to help family members: recognize how communication problems threaten the transfer process, learn problem-solving and conflict-resolution skills, and practice these communication techniques.
3. **Be flexible in working with families.** There are many ways in which families seek to address the family business succession planning process. For example, some families are more committed to participatory decision-making and open communication than others. Families also have distinct needs in terms of the timing of their succession plans. Here are some distinct ways in which families vary:
  - when family members are ready and able to ask informed questions about transfer planning,
  - when young family members begin contemplating their career path possibilities, and
  - when retirement options for older family members are serious explored.

Professionals who work with families in estate and succession planning should take this variability into account. One size does not fit all.

### E. Activity

Consider the following scenario:

*Noah is the youngest child and only son in a farm family. He has always wanted to be a doctor, but he knows his mother expects him to be a farmer. Noah has not shared his dreams with anyone because he knows what his mother will say and he does not want to anger his father.*

*Noah secretly hopes one of his sisters will decide to stay on the farm so his parents will be satisfied. Meanwhile, his two sisters are pursuing careers in other fields; one is a salesperson of farm equipment and the other is attending a local technical college and plans to become a bookkeeper. Considering the family farm's 6-generation history of being passed from father to son, neither sister has ever seriously considered the possibility of taking a direct role in the ownership and management of the family farm.*

Questions for discussion:

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

- Of the list of 8 communication challenges (see above), which communication challenges does this family face?
- How do these communication challenges hinder the process of creating a succession plan for this family farm?
- What should this family do to begin discussing farm succession planning issues?

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**Chapter 5: Building Communication Skills**

**A. Overview**

A greater understanding of the role of communication in farm succession planning can help farm families develop workable succession plans that result in productive family businesses while maintaining harmonious family relationships. This chapter reviews some principles of effective family communication and introduces some strategies for reaching out to the entire family in a way that promotes more dialogue and cooperation in key discussions and decision-making related to planning for the family farm (or forest business).

**Learning Objectives:**

- Increase knowledge of basic communication principles.
- Enhance efforts within families to communicate and work collaboratively to establish plans that are good for family relations and for the family business.
- Influence family conversations about the future of the family farm (or forest business) so they are easier, more satisfying, and more effective for family members of all ages.

**Reading Assignment:**

- Marlene Stum (2006). Critical conversations about inheritance: Can we talk? Fact sheet. Minneapolis: University of Minnesota Extension. Available online: <http://www.yellowpieplate.umn.edu/fa-04.html>.

**B. Developing — and Getting Clearer on — Your Goals**

Communication doesn't happen in a vacuum. The underlying question is: Communicate about what? In some families, even figuring out what to communicate about can be a communication challenge.

Once you figure out the most important issue or set of issues that your family needs to address as a family, e.g., to eat healthier foods, take part in more physical activity, reduce debt/ increase savings, or develop a succession plan for the family business, you can then set out to clarify exactly what your family is hoping to achieve. For example, a family that is committed to developing a succession plan for its family-owned and operated farm might lay out the following criteria to help frame its succession planning efforts:

- Keep the farm intact at least through the next (1/2/3?) generation(s).<sup>2</sup>
- Maintain good family relationships throughout the development and

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<sup>2</sup> It should be noted however that it may not be known whether a family has such goals/values until they have several family discussions.

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

implementation of the succession plan.

- Develop a written succession plan which is agreeable to all members of the family, consistent with family values and interests and financially viable into the foreseeable future.

Once the overall goal is broken down into specific objectives, it becomes easier to have family conversations geared toward making progress in discussing issues and making decisions.

### C. The Role of Communication in Succession Planning

Family members' situations change over time, as do family communication dynamics and issues which affect the financial viability of family owned and operated farms (or forest businesses). In other words, family business succession planning is a process. It is not a one-time event that is finished when the plan is drafted and begun to be implemented. Therefore, discussions about succession planning should take place on a regular, ongoing basis. This is particularly relevant in families that hope to sustain their family farms (or forest businesses) for future generations.

For succession planning to succeed, there has to be mutual understanding between family members and there has to be a commitment to the communication process. Here are some basic principles of effective communication that families might find useful in regard to launching conversations regarding their farm/ estate planning situations.

Communication among all relevant family members should be:

- **Frequent** — Set aside a specific day/time on a regular basis to discuss issues related to passing on the farm/family business. Document decisions and unresolved issues.
- **Ongoing** — Start as early as possible and keep talking/planning until all issues have been resolved and a written plan has been completed. It may take several meetings to accomplish this. The point is to stay with it until you have a plan.
- **Participatory** — Allow all family members (even as young as 10 years of age) to express their wishes, expectations and opinions. Listen carefully to what others are saying.
- **Explicit** — Don't assume others know what you mean or want. Everyone needs to state their feelings, expectations and opinions clearly and make sure everyone else understands them.
- **Concrete** — Decisions should be put down on paper so everyone can read them and decide whether or not they agree. Wills, estate plans, financial documents, organizational charts, and job descriptions are all good tools for making decisions/arrangements concrete and should be made available to everyone involved.

### D. Family Meetings

A good venue for having discussions about succession planning issues is the family



## Handbook on Estate and Succession Planning for Farm and Forest Landowners

meeting.

Regularly scheduled family meetings provide family members with opportunities to share their respective intentions, expectations, and perceptions (e.g., about what is “fair”) regarding the future of the family business. These meetings, if run in a participatory manner, can also serve to help frame the succession planning process as something that is done *with* rather than *to* family members.

It is also important to note, however, that some families encounter difficulties in planning and conducting family meetings. Here are some common challenges to avoid:

- Skipping or canceling meetings
- Allowing meetings to turn into gripe sessions
- Allowing individuals to be put down (laughed at, ridiculed)
- Allowing one member, child or parent, to dominate the meeting
- Failing to follow through on plans or decisions
- Preaching, scolding, or lecturing

Here are some suggested practices to regularly follow:

- Draw up a schedule of meetings
- Have the person responsible for chairing the meeting and drawing the agenda rotate among interested family members
- List who will be included in meetings
- Note what specific role each person will play
- Create an agenda (at least for the first meeting)
- Establish ground rules to ensure that all participants have the opportunity to express their points of view during family meetings

### E. Activity: Tuning into Family Communication Dynamics

Read the following vignette with one or more members of your own family.

*Nicholas and Alexandria have been married for more than 40 years and operate their farm as a family partnership. Each week the family meets on Monday morning to plan the week’s activities. At each meeting, every member of the family attends, and offers his or her comments about important things to be done in the coming week. Everyone’s views are respected and welcomed. When decisions need to be made, options are discussed and all members are given the chance to share their views. Family members understand that there will be times of conflicting opinions on a topic and that they will not always get their way. Nevertheless, efforts are made to compromise so that decisions are more acceptable to all. They feel the goal of their family conversations is not to start with agreement but to end with it. After decisions are made anyone can ask to discuss the basis for making the decision.*

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

Talk about the situation described above with your family member(s) and share your respective answers to the following questions:

- This family is obviously working hard at communication. Is the effort worth it?
- What do you see as some of the major challenges to successful family meetings?
- How has the family in this example addressed the challenges noted above (in the section on “Family Meetings”)?

In reading about this family’s communication practices, can you glean any clues as to ways in which your family might improve communication about matters that family members feel are important?

## Chapter 6: Understanding Succession Planning

### A. Overview and Purpose

The focus of this chapter is explaining how planning for the succession of ownership and control of a business differs from what is commonly considered to be estate planning. Unlike labor management programs that focus on ways to retain or recover from the loss of key employees, succession planning in this context involves the financial, managerial and operational control of family business. Succession planning has been introduced in earlier chapters, but this chapter will devote the time and attention it deserves. Estate planning and succession planning each recognize the issues and considerations that the other topic addresses, but each also has its unique issues. In this chapter we will explore what succession planning is, what is involved in creating a succession plan, how succession planning differs from estate planning, and how succession planning is used in conjunction with estate planning.

To help set the stage for this closer examination of succession planning, the chapter begins with a discussion of some relevant background factors to consider such as those related to business lifecycle, how business enterprises are structured, and demographic changes that affect family-owned and operated businesses.

A word about examples used in this chapter is necessary. We refer to a family business in a general way without differentiating between family farms or family timber growing businesses. It is our view that in this discussion, the concerns are similar across these two types of businesses and that distinguishing between the two in terms of issues or strategies is unnecessary.

### Lesson Objectives:

As a result of successfully completing this chapter you will be able to accomplish the following:

1. Explain why succession planning is an important issue facing farm and forest business owners and their families.
2. Explain the essential differences between succession planning and estate planning.
3. Describe and discuss the process by which a succession plan is created.
4. Describe and discuss how succession planning is used in conjunction with estate planning.

### B. Business Life Cycle, Organizational Structure, and Demographic Considerations

#### 1. The life cycle of a business

An important part of any business is developing the ability of that business to withstand

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

the competitive pressures that all businesses face. In the first few years of the life of a business, its owners spend much of their time getting the business up and running successfully. At times it might seem to be a struggle to make ends meet in the business and at the home that relies on financial support from the business. These years are likely to be hardest to face. By year 5 many competitive pressures have been successfully faced and managed. The struggles faced in the early years help the owners gain confidence in their ability and educate them about the business they own. The next 10 years might see the business mature as the nature of the product may change or the markets in which they are sold may change. Owners can recognize the “peaks and valleys” of the business cycle they are in. Start-up loans and lines of credit are focused on building from the base established in the first 15 years. Images of what the business could become may also emerge as the owners look to the future. The needs of a successful growing business may require adding new employees to help with the work in the business. Between years 15 to 40 the business can settle into a reliable pattern that enables the owners to have confidence in their ability to produce a product that buyers will want to buy at prices that will allow the owners to make a reasonable profit that supports the lifestyle they want. Some of their dreams may have been recognized while others may have charged or been abandoned for various reasons. Somewhere during this period, age becomes a new consideration. Depending on when this business was created during the life of its owners, physical abilities may be a limiting factor to the business and its future. Families that rely on the business for financial support or employment will be concerned about its future. If planning has been done to transfer the business to new owners then the questions about its future can be answered if the new owners are able to take over the business and continue to it on its profitable track.

### **2. Types of businesses**

Historically, farms were family operated businesses. In today’s world, however, agricultural products, whether crop or livestock, are raised in a variety of settings ranging from individual business owner-operators to small or large partnerships or small or large business corporations which may hire family or non-family employees for their business. Each of these business organizations contributes to production to today’s agricultural economy. Sole proprietorships are the most common form of business organization. Partnerships are used to organize and operate larger scale businesses that find benefits gained from organizing to allow partners to contribute labor and capital to the business. Corporations and limited liability companies (LLC’s) are organizations that have legal existence that is separate from the shareholders, owners and managers who invest in them.

In terms of the distribution of these organization types across today’s agricultural economy, two ways of evaluating the situation can be used. One is to consider how many farming businesses report in each of the three enterprise categories: proprietorship, partnership and corporation/LLC. A second way to evaluate the distribution of business types is to consider the annual sales of agricultural products that each producer category contributes to aggregate annual agricultural production. In this

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

approach the classifications are distinguished by the amount of annual sales of agricultural products. Under this system farms can be as small as an activity that raises few agricultural products or maintains farmland solely for personal use or for limited commercial benefit. There may be a large number of these producers, but their overall contribution may be small. At the other end of the spectrum would be businesses having multi-million dollars in production and sales of agricultural products and that operate at the national and international levels. They may be few in number, but their contribution to overall agricultural production may be great. Businesses with a limited commercial activity are more likely to be operated as proprietorships while large commercial entities are more likely to be operated as corporations or partnerships.

### **3. Aging of America's farm operators**

An important factor to consider when examining patterns of succession planning in families that own and operate farms is the aging of America's farm operators. Based on the 2007 U.S. Census of Agriculture there are twice as many American farm operators above the age of 65 as there are below the age of 35. Based on life expectancy, some operators above age 65 will leave their position as operator in the next 10 years. Whether these farm operators engaged in any type of succession planning in their farm business will determine whether these farms remain part of the agricultural economy or the assets are converted to some other use. Succession planning targets this situation to ask the question, "What can be done before the succession takes place to make it effective once the transfer is actually implemented?"

Growing concerns about the retirement needs of older farmers are affected by projections that it will become increasingly difficult to find young people to continue with family traditions of farming. Fewer than half of farm families have individually designed succession plans (Baker, 2002), with many families not knowing how to develop a plan. The consequences of this are often severe – if the farm is simply "willed" to the succeeding generation of operators, inheritance taxes and other fees may cripple the farm and its new owners. Owners wrestle with the question of giving all heirs an equal share in the estate. While this is an easy decision for parents to reach some heirs who are contributing to the financial success of the business may feel their contribution was overlooked in such a distribution plan. Treating children or heirs fairly rather than equally can be a difficult decision, but is one that must be faced if the succeeding owner's contribution to the business is to be recognized and the owner is to have a chance to make the business run profitably. Inadequate farm succession planning can result in heirs who are incapable of running the farm business, family conflict, prolonged legal battles, and partition of business assets to satisfy heirs who simply want to "cash in" their share of the business rather than invest in it. Partitioning the farm to allow an heir to receive their share of an estate creates expense and hard feelings among other children who may be forced to buy their sibling's share or find the farm sold to others who do not plan to farm it.

## C. What is involved in Creating a Succession Plan?

What motivates farm families to embark on succession planning? Does it depend on having knowledge about the process and consequences associated with taking (or not taking) action? Is succession planning a decision-making process that is simply a matter of giving relevant information to the person with the most power in the situation (i.e., the head(s) of household) with the belief that this person's use of that information will be in the best interest of the family business (e.g., Baker, Duffy, Lamberti, 2001)? When considering the importance of family communication and the complexity of family relationship issues (as noted in Chapters 3-5), it becomes apparent that the succession planning process is multi-faceted and fraught with potential challenges.

Creating a succession plan does not follow a specific outline or format. Rather there are several basic factors that each succession plan should address. These factors may vary from family to family and business to business. The following discussion is intended to highlight these factors.

Succession planning is a process and not an event. The planning process should be initiated early to allow adequate time to gather information needed to make decisions and take action that is necessary to the success of the plan. Appointing a disinterested, impartial person to guide the process may be a valuable decision as most of the interested parties will have other things going on in their lives which could distract them from the succession planning process. This person is not someone who will make decisions for the family, but should be someone who helps families to make decisions on their own. A facilitator can be a family member or it can be someone who has the skills to help families move toward agreement on complex issues. Someone who is familiar with your business, or who has served in this role for another family business are two other attributes to look for in this person.

Aside from the facilitator, the family should agree on the decision making process that will be followed. If there is an impasse in the process and two or more groups within the family believe the ultimate decision should follow a specific path, the family should know how this impasse will be overcome. This may be done through designating someone to break the impasse by making a decision or in some method that all parties recognize and accept for their situation.

Creating a succession plan begins with a critical assessment of the business itself. If the business is not on stable financial ground now, what is the likelihood that it can continue in the future when control is transferred to the succeeding owner? If the succeeding owner is to come into the business to gain needed experience is the income potential of the business able to support the succeeding owner's needs? This should be a critical assessment that addresses the current and projected financial performance of the business.

After determining that there is a future to the business, the next step would be to identify the successor or manager or to establish a process that will result in identifying the

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

successor. Who should pick the successor or have some input into that decision? How should the final decision of naming the successor be made?

The successor may be one person or may be several people who operate under a business structure that allows all owners to participate and share in the rewards. The current owner may have identified the successor from working relationships established over time or from conversations with family members or others. Current owners could assume that certain family members should be in line to succeed the current owner without confirming that the expected successors are interested in taking on the business. Frank, open communication between family members and a decision making process that seeks input from interested parties should assist in determining who has legitimate interest in being part of the business in the future and who does not.

Identifying the successor will also include establishing the personal, technical and managerial requirements a successor must have to be qualified to operate the business. The process of identifying these requirements is similar to writing a job description for the tasks that a manager performs in the daily routine. These requirements may vary from one business to another, but should be drawn from the specific business in question.

Where is the successor currently working? Some people may be working toward succession alongside the current owner or they may be working in some unrelated field that can prepare them to take on management of their own business in the future. If management experience is needed it can be gained in several ways. Working in a business side by side with the current owner is the traditional way to gain the operational knowledge and experience to run that business. Working in a separate segment of the current business making decisions and dealing with the consequences of them is another means. A third approach is to gain experience in a field or business that is completely unrelated to the family business. Opportunities for education or training in today's economy may give a person the chance to do something they always dreamed of doing. Once in that field, the person's interest may change or the situation changes which makes career change a necessary consideration. Taking inventory of the skills and experiences gained in this unrelated activity often point to skills learned in one activity that can be applied to a variety of other activities. Other character traits, such as maturity, judgment, responsibility and integrity gained in military service for example, are universal in their application to any activity

Adequate time must be allowed to find qualified candidates, to give candidates an opportunity to consider the proposal, and to allow for qualified candidates who may choose to turn down the opportunity for their own reasons.

Another step in the plan is to have the current and succeeding owners identify what their own family requirements would be in the succession plan. For example, if the current owner needs a reliable source of retirement income, what will be the source of that income? Will it come from equity in the business, income generated by ongoing operation of the business, or will it come from private financing that the succeeding

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

owner is expected to obtain to purchase a share of the business? In succession plans involving family members already working in the business the succeeding owner's equity interest in the business can be increased by profits that are earned over time or by gifts of assets from the current owners. The current owner may expect to live in a home on the property and some arrangement to provide for that may be necessary. The succeeding owner will also have similar concerns for financial security and living arrangements that must be addressed. A review of the benefits available to current owners and employees will shape the discussion of whether changes to the current benefit plan are needed for either party.

An essential element in the succession plan is a clear timetable for turning over control of the business from the current owner to the succeeding owner. This need not be done at one point in time, but can be done gradually over time as that may assist the current owner in meeting needs for reliable retirement income and the succeeding owner in using current profits to finance the transition, rather than rely solely on commercial financing of a pre-determined purchase price. If the current owner continues to be involved in the business, the succeeding owner gains a knowledgeable employee who can assist the succeeding owner in meeting the challenges that all businesses confront from time to time. The former owner must also recognize the "new" relationships that the plan creates.

Although any plan anticipates a successful outcome, it is not unrealistic to think that the plan may need to be revisited if certain events occur. Therefore, the plan should include an opportunity for the parties to make mutually agreeable changes if the succeeding owner dies or becomes disabled or some other event occurs that affects the business ability to fulfill the promises made in the agreement. The former owner may rely on the success of the business for retirement income or housing arrangements, but a contingency plan would be important. Despite these realities, the agreement should recognize that the transfer will be complete at some point and the succeeding owner will be in the position to face all of the risks and reap all the rewards of the business operation. An open ended promise to "do something for you some day" can lead to frustration when the expected transfer is delayed time and time again.

### **D. Estate Planning Compared with Succession Planning**

An important difference between estate planning and succession planning is the range of issues that each topic addresses. In estate planning the process of moving ownership from current to future owners is a central issue in discussion and decision making. A second issue involves the mechanics of making that transfer by selecting the most appropriate mechanism to accomplish what the current owner selects as the goal he or she wants to accomplish. A third consideration involves the costs associated with making the transfer. These costs involve taxes and expenses, such as income, inheritance, gift, estate or transfer taxes, filing fees and legal fees that must be evaluated as part of the decision to transfer property. Identifying these costs and assessing their impact can lead to planning decisions to minimize their negative impact or avoid these costs entirely.



## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

Succession planning incorporates these issues but adds a series of other issues, such as assessing the income potential of the farm business on which an incoming owner can rely. For the current owner, financial retirement security is a paramount concern for an owner who plans to withdraw from the business. In this area the financial needs of the withdrawing owner to maintain the desired life style must be determined and addressed if the plan is to meet the current owner's needs. In addition to financial considerations, health insurance, living arrangements and possible assisted living arrangements later in life are other topics to be considered.

Another major succession issue is the amount of time needed to fully implement the plan. Estate planning often plans for the transfer of ownership after the current owner's death. This is a process that is expected to be completed as soon as possible. Succession planning, however, encourages the current owner to transfer managerial control of a business during his or her lifetime to allow the successor to transition into control of the business while the current owner can contribute to the business and provide needed assistance. Retaining absolute control over decision making authority until death could leave the successor owners in the position of being unable to manage the business. For example, in a successful plan the management ability of the succeeding owner to "step in" to the operator's role upon achieving control of the business must be addressed. If that expertise does not exist at the time the plan is prepared, then time must be devoted to implementing a management development plan that allows the succeeding owner to gain the management skills and experience needed to operate the business profitably. How that skill will be gained and how much time will be needed to gain it are important elements of a succession plan that faces that concern.

### **How is Succession Planning used in Conjunction with Estate Planning?**

The essential elements of estate planning that are used in conjunction with succession planning are the processes by which control can be transferred from the current owner to the succeeding owner, the mechanics of how the transfer of property takes place, and evaluation of the costs associated with alternative means of transferring control. Each of the chapters of this handbook has some information to bear on these three elements. Specifically chapters 3, 4 and 5 help you with understanding the family communication and decision making dynamics. Chapters 8 through 15 give you insights into the transfer, tax, and business issues to be addressed and the options available to you. Chapter 16 will give you some examples of problems and suggested solutions to them. Chapter 17 helps you recognize the advisors you may need to seek to assist in your effort of designing an estate and succession plan.

### **E. Conclusions**

Succession planning is about the process of transferring ownership and control of a family business from one generation to the next. It involves many of the issues confronted in estate planning as transfer of the business asset is common to both plans.

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

Succession planning goes beyond transferring these assets by including the family in the decision making process, working to improve communication within and between family members, and creating a decision making process that brings people into the process and allows them to contribute to key decisions. Financially viable businesses that are interested in continuing across generations should embrace this process in order to achieve their goal more effectively.

### F. Student Exercises

1. Which of the following topics is NOT an issue that is involved with succession planning situation?
  - a. What does an incoming owner want and need from being involved in the business?
  - b. Will the current owner need to have a place to live?
  - c. Who is the person with the capability to run the business?
  - d. Will the succession plan be approved by the heirs of the current owner?
  
2. When comparing the issues faced in succession planning with the issues faced in estate planning, which of the following issues would NOT be involved in succession planning?
  - a. Completing the plan as soon as possible.
  - b. Evaluating the financial condition of the business when planning begins.
  - c. Evaluating the financial potential of the business to support additional employees.
  - d. The future of social security programs.
  
3. Succession planning is important to American farmers for which of the following reasons?
  - a. To maintain a positive balance of payments with our foreign competitors.
  - b. To provide for the national security of our country.
  - c. To achieve the full potential of a family's investment in the farm business.
  - d. To maintain each state's competitive advantage in the United States.
  
4. Which of the following would NOT be a step taken by a family in a succession planning process?
  - a. Filing an inheritance tax return.
  - b. Naming someone to guide the family through the succession planning process.
  - c. Engaging the family in discussions about succession planning.
  - d. Asking family members for comments and input in development of the plan.

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

5. Which of the following statements describes when a succession plan is successful?
  - a. When the business continues to operate profitably under the control of the new owner.
  - b. When the family relationships between generations continue to be happy and enjoyable.
  - c. When operational problems can be anticipated and successfully addressed.
  - d. All of the above statements describe when a succession plan is successful.
  
6. Assume you and your spouse are the current owners of a farm business. Your current age is 55. You have five children in your family. Some of your children work in the farm business, but others do not. Of your five children, one is in college, one is in high school, and one is in the military. Based on these facts, describe the process you would put in place to complete a succession plan to have your business continue into the next generation. In your response identify the process you would use.
  
7. Use the same fact situation as that found in Question 6. Describe the succession planning questions or issues you think will need to be resolved for your succession plan to be effective. In this response, direct your attention only to the issues you see that need to be resolved, not the process.

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- Penn State Dairy Alliance

## Chapter 7. Establishing Goals for the Family Business

### A. Overview and Purpose

When families begin the process of planning for the future of their farm business through a succession plan, it is critical to think through the goals for the plan and the business as a whole. Far too often, families enter into the process from a single issue frame of mind, such as estate tax avoidance. Such an approach can lead to an incomplete plan, or a plan that fails to recognize the needs and desires of all key members of the business. A formal process of setting and prioritizing goals for the farm succession plan can ensure that the resulting plan best fits the unique needs of the family business.

In this chapter, we will discuss how to use goals for setting the direction of the farm business succession plan. We will outline how to set goals from multiple viewpoints, discuss who should be involved in the process, and how to prioritize goals as a business.

### B. Lesson Objectives

When you have completed this lesson you will be able to accomplish the following objectives:

1. Understand the need for setting goals for the farm succession plan and the farm business.
2. Set goals for your farm business over multiple timeframes.
3. Use the SMART goal criteria for developing effective goals for the business and succession plan.
4. Engage and involve family members in the process of setting goals for the business and succession plan.
5. Prioritize goals from multiple family members and business partners into unified goals for the entire business and succession plan.

### C. Why Worry about Having Goals?

Goals are an integral part of the planning process. Goals provide direction in developing a plan. The process of setting goals can help owners and managers to understand their priorities better. A well-developed set of goals can be the basis for many decisions that are made in a farm succession or business plan.

A good analogy to use when thinking of goals and the planning process is that of planning a long driving trip. When planning a trip, most folks use a map to plan their route. While the modern conveniences of portable GPS devices and internet based mapping programs have certainly simplified the process, most people will still look at a map of some sort when deciding how and where they will travel on a trip. The map can be thought of as the plan. If the trip is to take several days, or there are several sites that the planner wants to

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

visit along the way, there may be several key points that need to be traveled through during the trip. These points can be thought of as the goals in the plan. By connecting these points (or goals) together, the planner can arrive safely and effectively at the final destination, while accomplishing the desired outcomes for the trip along the way.

Just as when planning a road trip you must plan out your trip by connecting a series of points on a map, a farm succession plan must use a route of key decisions and actions to be successful. These decisions and actions must be tied to the goals of the farm business owners, both current and future, in order for the plan to be most successful. If we stick with the roadmap analogy, goals would be those key points along your 'trip' that indicate progress or success with the overall goal, or destination where your plan points. The specific set of goals or objectives of your plan will be unique to your family and your farm business, and will dictate the route that you will need to take in order to accomplish your specific goals.

### D. SMART Goals

An often used acronym for Goals in the planning process is S.M.A.R.T. This stands for:

**S**pecific  
**M**easurable  
**A**chievable  
**R**ealistic  
**T**imely

**Specific:** Goals must be very specific. Identify who, what, when, where, etc. for each goal. In order for the goal to be useful, it needs to specify what needs to happen by when and who is responsible to do it. General or non-specific goals are not very helpful when trying to chart a course or develop a plan. For example, many folks have a general goal to "Be more healthy" or to "Lose Weight". However, personal trainers will tell you that progress is rarely made until you set specific goals such as "Workout with at least 30 minutes of cardio vascular exercise for three days each week" or "Lose 15 pounds by July 1<sup>st</sup>". The same is true for goals when developing your succession plan. Do not write a goal that says simply something such as "Write a will", but rather a goal that says "\_\_\_\_ (person) will write a will by \_\_\_\_ (date)."

**Measurable:** Just as a good goal needs to be clear and specific and also be measurable. Otherwise, it could be argued whether or not a goal was actually met! For example, a goal such as "Keep the farm viable" would be difficult to measure, since "viable" is a pretty broad term. A better version of this goal might be "Maintain a return on assets of at least 5 percent" or "Show a positive growth in farm equity on the balance sheet."

**Achievable:** This is the reality check portion of the goal development process. Is the goal achievable within the time frame specified, or with the resources available? If there are other factors that could interfere with accomplishing a goal or objective, the goal may need to be revised to address those elements that can be accomplished, or the impact of intervening factors should be recognized. Using a previous example of someone who is

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

trying to lose weight, let's say that the specific goal of "Lose 15 pounds by July 1<sup>st</sup>" was developed on June 20<sup>th</sup>. Unless the person is planning to have liposuction performed, it would not be a very achievable goal! However, if the goal was developed on July 1<sup>st</sup> of the previous year, it would certainly be an easily achievable goal. To relate this point to a farm succession situation, think of the goals that you might have already... Are they achievable? Will any modification to the goal be necessary in order to make them achievable?

**Realistic:** This is the second reality check with the goal development process. Is the goal realistic at all? In order for a goal to be realistic, all parties involved must be willing, able AND have the capacity to ensure that the goal is accomplished. If a goal is set that at least one of the key players in the business thinks is "not going to happen" or is even partially skeptical that it will, then chances are it is not realistic because the skepticism indicates uncertainty that the goal is achievable. Time should be spent discussing a goal such as this to adjust it in a way that brings a general agreement about your ability to realistically accomplish it.

**Timely:** The timely feature of the SMART goal is to combat the defeating effects of procrastination and distraction. Managing a farm is a very time consuming affair. It is very easy to put off tasks that are not perceived to be critical to the daily operation of the business. A goal for a farm manager without a set time frame is a dream. However, setting deadlines for achieving goals, and being held accountable to that deadline, is an important key to making those goals successful.

### E. Types of Goals

As you develop goals for your farm succession plan, it can be helpful to break the goals down into several categories. This can help organize the goals, ensure that the goals are on target and relevant, and will help begin the process of prioritizing goals. There are many possible ways to categorize your goals. This section lays out a few ways to frame your goals.

#### 1. Business vs. personal goals

The vast majority of our farm businesses in the U.S. are family owned. In family owned businesses, the lines between work and family time are often blurry, at best. It is important to evaluate goals when having planning discussions to determine if they are goals which are primarily personal in nature versus business in nature. Both types of goals are quite important. However, they should be considered separately when making plans for the business.

For example, a personal goal for a farm owner might be that they would like to retire from the day to day management of the farm business by a specific age. This is most certainly a personal goal for the individual who is planning to retire; however, it has a significant impact on the business as well. A parallel business goal would need to exist that enables a successor to the retiring manager to be in place by the time of the former



manager's retirement.

## 2. Short term vs. intermediate vs. long term

As discussed during the section describing SMART goals, good management and planning goals need to have a defined timeframe. It can be helpful during the planning process to break down goals into groups along similar timeframes such as short term, intermediate term and long term. There are no 'rules' as to what length of time would be appropriate for each category, however, it is important that all parties involved in the planning process agree on what the timeframes should be. A common definition of these timeframes might be:

Short Term – within five years

Intermediate Term – 6-10 years

Long Term – more than 10 years

However, it should be noted again, that there is nothing wrong with a business straying from this example of term lengths, if it makes the goals more relevant to the specific situation or situations being faced by that business. For example, if a farm knows that a major decision on some important aspect of the business will need to be made within three years, the definition of a short term goal might be within three years, and the other timeframes adjusted accordingly.

Grouping goals by common timeframe is a very useful and practical exercise. Through this process, a farm management team can begin to see a timeline for their plan. Steps for accomplishing goals along the desired timeline can then be developed, so that the plan is conducted in an orderly and logical manner. The timeline should be dynamic, however, and changes in circumstances may need to adjust the priority or timing of certain goals.

## 3. Your goals, my goals, "our" goals

A common question that comes up with families that engage in setting goals for the farm business succession planning process is who should be involved in the discussion? While there are no absolute rules to follow in this regard, there are some general guidelines and key points to remember when deciding who to include in the goal setting process. In general, it is very important to, at a minimum; include all adult family members or business partners who have a direct involvement in the farming business, either currently or in the future. It may also be beneficial to include teenage children who have shown an interest in the farm, if for no other reason than to expose them to the process of making important management decisions in the business. In the early stages of a goal setting exercise, participants might want to emphasize who cares most about which goals. However, over time and after intensive discussion, the hope is that a set of integrated goals emerges which incorporates many of the individually held goals laid out earlier in the process.

## F. Additional Considerations in Setting Goals

### 1. Generational differences

The 'generation gap' is a well-known and probably over-used phrase, but it does describe a real phenomenon that exists in our culture. As people age, their attitudes about several issues related to the family business tend to change, both due to their own unique set of life experiences, and their outlook on the future. Family members of different generations often have different views about issues such as debt, new ventures, and opportunities for business expansion. These differences can be sources of disagreements and even conflicts. When evaluating the goals for the family business, it is important to recognize that there may be some distinctly different goals along generational lines.

### 2. In-laws and outlaws

The old phrase "blood is thicker than water" often comes into play in family run businesses. There is often a tendency to pay closer attention to the needs and wishes of the 'blood-relations' in a family business, as opposed to those who are unrelated or related through marriage. However, these parties often do have a role to play in either the management of the business or in helping the various family members to shape their specific goals, on both the personal side and on the business side. It is important to engage these individuals in the goal setting process at some point in the process.

In the case of family members who may have an adversarial approach to the family members involved in the business (i.e. "the Outlaws"), it is important to recognize that their goals are significant, and should be understood, however, if their goals are counterproductive to the success of the business, they do not necessarily need to be included in the overall farm plan. For example, a family member not involved in the business or former spouse may have a goal of owning a significant portion of land outright, with no guarantees that the farm will have continued access to that land. In these cases, their goals could be harmful to the overall success of the succession plan, if one of the central goals of that plan is to keep the farm business viable in the future.

On the other hand, a non-farm sibling might not have any desire to own a piece of the farm and only want to have certain family heirlooms in their inheritance as a memory of their upbringing. If these individuals are not involved in the discussion at some level, the central management or ownership team might 'guess wrong' when making their plans. Therefore, it is very important to involve these individuals in the discussions at some levels, but certainly without any guarantees that their every desire will be met.

## G. Putting Your Goals Together into a Plan

Once all of the members of the farm ownership and management team, as well as any other key individuals have worked through the process of identifying their individual goals for the business, it is time to bring these goals together into the succession and/or

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

business plan for the farm. This would be best accomplished during one or more family meetings. The meetings should include the core management team of the farm business, both current and who may be involved in the future. Everyone should take time to share their individual goals, and listen to each other's goals. It may be surprising to some how many goals that they have in common and/or what areas that they thought they would be in common and are different.

The next step will be to identify those goals that are in common, and those that are significantly different. Some key questions should then be asked:

### **For Common Goals:**

Are they all in the same timeframe? i.e., is one person's short term goal a long term goal for someone else?

Do all members have the same priority for the common goals? How would each person rank them?

Who will be the key person or persons involved in implementing each of the common goals?

### **For Unique Goals or those that are not the subject of common agreement among the family:**

Are any of these unique goals mutually exclusive i.e. can both goals be achieved, or does accomplishing one prevent the other from being accomplished? How important are these goals to the individual who developed them? Which goals could be compromised?

## **H. Prioritizing Goals**

Perhaps the most important task when setting goals for the farm is to prioritize the goals that have been agreed upon by the family. This can be a challenging task, but it is well worth the effort. Prioritizing goals will help to focus the family and the business on the tasks and plans that are the most important to the overall desired outcomes of the plan and the long term vision for the business. The reality of most farm succession and business plans is that not every goal can always be met along the desired timeline.

Prioritization of goals will ensure that the most important goals are focused on first. Listed below are a set of questions that the planning team should ask about each goal to help identify those that should be of highest priority.

- Which goals are most important for immediate family well-being, current business success, and/or retirement success in the future?
- Which short-term goals, if attained, would help you achieve your long-term goals?

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

- Which short-term goals conflict with or impede your long-term goals?
- Which goals are so important that they should be attained even if it prevents you from reaching other goals? For example, do you want to save taxes, provide a secure retirement, provide for long term care if needed, assist the succeeding generation in acquiring the business, maximize use of this resource, or continue a long-standing family tradition?

After working through these questions, each team member should list their top five goals in order of priority, and then compare notes. Are there differences? This is where compromise and discussion will come into play once again.

Hopefully the process of working systematically through individual goals, followed by a discussion of mutual goals will help the team to flesh out what the most important goals are without too much added discussion. However, it is not uncommon to find some disagreements even at this final stage of the process of setting goals for the farm business. Family and team members need to remember to always discuss these issues and seek to find common ground. If there is not a mutual agreement on something as simple as the top five priority goals for the business, the business will face serious challenges in meeting any of its goals, since key team members may not be working together on solving the key issues that their business transition faces. In contrast, a family or closely held business where all team members know and understand the top goals for the business, and are working in unison towards those goals can be a very powerful force.

### I. Student Exercise

#### Multiple Choice Questions

Please read the questions carefully, and then select one of the choices following the question that correctly answers the question asked.

1. True or False: All family members, regardless of level of activity in the farm business, **MUST** have an equal say in the development of goals for the business.
2. A farm business has set the following goal for their business: "All farmland currently owned by John and Joan Hereford will be transferred into Hereford Farms, LLC within 6 years." Is this goal an example of a:
  - a. Short Term Goal
  - b. Intermediate Term Goal
  - c. Long Term Goal
3. Which of the following is an example of a S.M.A.R.T goal?
  - a. Increase farm profitability by 20 percent
  - b. Decrease debt

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

- c. Transfer the farm to our kids
  - d. Mom and Dad will write a will by October 1, 2011.
4. Which of the following statements is correct?
- a. A general goal is better than a more specific goal, because it allows for easier opportunities to achieve the goals.
  - b. Time is not a factor in setting goals. Anytime a goal is achieved is considered to be a success.
  - c. A goal is considered to be realistic if it is one that management consultants propose in the books and seminars held nationally.
  - d. For family businesses, personal goals of the business owner should be considered separate from the business goals that the owner or other family members have for the business.
5. In dealing with family problems, you can consider any one or more of three groups of people to play a part in creating or aggravating problems. These groups are family members, the “in-laws” and the “outlaws”. Which of the following situations is an example of a “family” problem?
- a. Joshua has a poor relationship with his wife’s parents and other family members. Because of this, his wife’s parents involve, only their daughter in discussions about the family business.
  - b. Donald has an outgoing, aggressive, loud and “in your face” attitude about how the family business is run. He offers his opinions and suggestions without being asked to offer them. He always talks, but seldom listens to what people say to him.
  - c. Charles is the last in a long line of Wingnutt family members to own and operate the family farm and forest land business. Everybody in the business knows and understands who is in charge now and who can be involved in operating the business in the future.
  - d. None of these statements describes a “family” problem.

### Short Essay Question

Please read each question carefully and then respond to what is asked for at the end of the question. Your answer need not be long or involved, but it should be as clear and concise as possible. If you want to refer to important facts in your response, please feel free to do so.

1. Ward and Debbie own a dairy farm. They have three children, Chris, Richard and Colleen. Chris has been active on the farm since childhood, and is currently the main full-time employee for the farm. He and his wife, Joanna, live in a tenant house on the farm. Colleen also works on the farm, on a part time basis, helping to milk cows on the weekends and helps with feeding calves during the week when needed. She and her husband, Luke, live a few miles from the farm. Richard does not work on the farm and lives about an hour away, working full

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

time as an engineer. He has mentioned before that he hopes to move back to the farm someday, and likes to give advice to his dad and brother when he visits. Ward and Debbie have decided that they need to start developing their farm succession plan. They would like to have a meeting with family to discuss their goals for the farm and the long term succession plan. Who do you think should be involved in this meeting (or meetings), and at what level should they be involved?

2. Explain why prioritizing goals and objectives must be done in the preparation of an estate and succession plan and describe how you would establish the standards for setting the priorities.

Part Two: Focus on the Business and Transfer Issues

Chapter 8. Property Transfers After Death

A. Overview and Purpose

In rural areas, land is a valuable asset. When land ownership includes forest areas and wood lots, the value attributed to such assets can be misunderstood or overlooked. When the owner of such assets dies, however, the assets transfer to the deceased owner's estate where they await distribution to a new owner or set of owners.

The significance associated with the death of a property owner is illustrated by the basic point that all items of property have an owner at any point in time. When an owner dies, transfer of the owner's property to someone else is a central issue resulting from the owner's death.

In this chapter, we will explore ***four ways in which property is transferred after an owner's death, i.e., by operation of law, by the intestacy law, by a last will and testament, and by a trust created during the owner's lifetime that provides for this transfer after the owner's death.*** As this discussion will describe, a person's death sets in motion specific legal rules that make our basic point, that all items of property have an owner at any point in time, a workable legal proposition.

The chapter starts with a discussion of joint ownership of property in the form of joint tenancy with the right of survivorship, tenancy by the entirety and tenancy in common. In some states, these various types of ownership are known by other names such as joint accounts or multiple-party accounts. Some states also recognize the concept whereby an account is owned by one person during his or her lifetime and the balance that remains at the owner's death is payable on request to someone else after the owner's death. Such an account is known as a P.O.D. account or one that is "payable on death" to another. Following this discussion we turn our attention to the issue of sole ownership of property and its transfer under a last will and testament or the intestate law which applies in cases where a person dies owning property in his or her own name, but without having prepared a will that provides for the transfer of the property. The fourth way in which property can be transferred is under the terms of a trust which is created by a property owner during lifetime and to which the owner's property is transferred under instructions that provide for the transfer to other owners under described conditions. Under the terms of the trust, the owner designates those who are to benefit from the property. During the owner's lifetime, the owner may retain some benefit from the trust property which interest ends at the owner's death. Having created the trust relationship, the owner, through the trust agreement, can designate someone to receive it after the owner's death.

## B. Lesson Objectives

When you have successfully completed this chapter, you will be able to accomplish these objectives:

1. Compare the various forms of joint ownership of property and explain how they are created.
2. Compare property distribution under the terms of a last will and testament to property distribution without a will.
3. Discuss the requirements for creating a trust and compare the operation of trust to the other forms of property ownership.
4. Discuss the general characteristics and concepts of distributing property under the intestate law.
5. Discuss the various kinds of trusts that are used in estate planning situation and discuss the role this vehicle plays in distributing property after an owner's death.
6. Evaluate the various ways you own your own property and consider the advantages and disadvantages of each.

## C. Property Transfers after the Death by Operation of Law

Property transfers that occur by operation of law take place when one joint owner of property dies and the owner's interest passes to other owners who survive the deceased owner. Typically this form of ownership form is referred to as joint ownership with the right of survivorship. In some states this concept is simply referred to as joint ownership. This form of ownership is created when the joint owners make a lifetime decision to share ownership of property, and provide that at the end of any joint owner's life, the surviving owner(s) automatically become the owner(s) of the property. During their lifetime joint owners share the right to use all of the property as their own and they share in the income, rents or profits that the land produces. If the property is sold each joint owner receives a share of the proceeds from the sale. Joint ownership can generally be created in a variety of ways, such as joint sharing of the purchase price, a gift of a one-half interest to the new owner or purchase of a one-half interest in property that is fully owned by a current owner.

Not all forms of ownership involving more than one owner are considered to have this survivorship feature. Another form of joint ownership, tenants in common, does not provide for the transfer to the surviving owner. Therefore distinguishing these two types of joint ownership is important.

How a joint ownership interest with the survivorship feature is created is a matter of state law. Joint ownership with the right of survivorship may require the owners to clearly express their intent to create the survivorship feature as a part of their decision to share ownership with each other. If the owners fail to make this clear expression of their intention a different form of joint ownership, known as tenants in common which is described below, is created. In some states, tenancy in common form of ownership is referred to a multiple-party ownership.



## Handbook on Estate and Succession Planning for Farm and Forest Landowners

In regard to jointly owned personal property, such as a bank account, unless there is clear evidence of intent to include the survivorship feature when it is created, state law, such as The Uniform Probate Code, may give each joint owner access to the account only to the extent of their net contribution to it. This result is based on the assumption that a person who deposits money in a multiple owner account normally does not intend to make a gift of the funds represented by the deposit. Rather this person is presumed to intend the funds in the account should be accessible by those who deposited them there. Any amount remaining on deposit at the death of the original owner belongs to the surviving owner.

*For example: If a single owner decides to add another owner to an account, thereby creating a joint ownership interest, the question is whether the original owner intends to give the new owner a present gift of a one-half interest in the account, or intends for the new owner to receive the property at the original owner's death? In the absence of clear and convincing evidence of the intent to share access to the account during the original owner's life, it will be presumed that the owner intended to delay the transfer until after death. Allowing the new owner to withdraw funds would indicate the intent to make a gift of the funds in the account.*

However, clear and convincing evidence of an intent to create a present gift can give each owner access to an equal share of the account. Each owner is treated as having contributed an equal amount to the account. The person who received the property gift has complete authority and control over the property he or she is given.

*For example, if three people are joint owners with the right of survivorship, at the death of one person, that person's share is divided equally between the surviving owners. Their ownership share increases by one-sixth; their new ownership share would be one-half ( $1/3$  or  $2/6 + 1/6 = 3/6$  or  $1/2$ ). At the death of one of the two owners, the surviving owner becomes the sole owner of the property by receiving the deceased's one-half share and adding it to his or her one-half share. Transfer takes place automatically upon the death of the person who owns property as a joint owner with the right of survivorship. Documents which show ownership must specifically state that it is owned as joint tenants with the right of survivorship.*

Who can be a joint owner of property? The answer is anyone can share ownership of property with another person under this ownership form. There are no restrictions or requirements that limit its availability to family members or other limited groups.

Property acquired by either spouse during the time of the spouse's marriage also creates a question about the rights of a spouse to property that is owned by the other spouse. Married persons can generally acquire property and own it as an individual person, or they can share ownership of the property with their spouses. State laws grant spouses certain specific interests in each other's separately owned property. That

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

discussion is beyond the scope of this book.

In a number of states, property owned by spouses is considered to be owned as community property of the married spouses. Under this concept spouses are considered to share ownership of property that is acquired during their marriage. Property acquired before marriage, as well as property acquired after marriage under a transfer from another's will, by gift, or by inheritance is considered separate property to which the other spouse has no claim. At each spouse's death, essentially one-half of the community property is considered to be owned by the deceased spouse and the other one-half is owned to be owned by the surviving spouse.

In some states property owned jointly by a husband and wife can be held as tenants by the entirety. At the death of the first spouse, the surviving spouse automatically becomes the owner of this property. Documents which show ownership of property must specify joint ownership and that the joint owners are lawfully married to each other.

One situation in which joint ownership creates a problem is the simultaneous death of both owners under circumstances that cannot determine which owner died first. Since surviving the death of the other owner is the key requirement to transfer of ownership, time of death of the first party to die is required to make that determination.

A third form of joint ownership of property is tenancy in common. Under this form two or more people are the owners of undivided fractional shares of a larger piece of property. Unlike joint owners with the right of survivorship, tenants in common need not have equal ownership shares in the property. A tenant in common form of ownership is often recognized by the unequal ownership interests among the joint owners. One owner can own a large share while others own small shares. A second distinguishing factor involves the effect that death of one of the tenants in common has on the surviving owners. Tenants in common who survive the death of any other tenant, do not have a claim to the deceased tenant's share simply because they are surviving joint owners. When a tenant in common dies, that tenant's share of the property becomes an asset of the deceased owner's estate and is transferred to the heirs designated in the deceased owner's will or under the intestate law. This method of transfer may completely disregard the surviving tenants on the property if the owner has decided to do so.

How are the various joint ownership interests created? Simply establishing ownership that is shared by two or more people may not be enough to create the survivorship feature. Words that describe the joint owners as "joint owners with the right of survivorship" are needed to create the ownership form. Under the law of some states, it is presumed that a tenancy in common is created if the document that creates the ownership interest does not contain words that express the intent to apply the survivorship feature.

*For example, John and his brother, Charles, purchase a tract of land in Happy Valley. Each contributes to the purchase of the property and both wish to create a joint tenancy with the right of survivorship. When the deed to the property is*

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

*prepared, the deed should be to "John and Charles of Happy Valley as Joint Tenants with the Right of Survivorship" to create the necessary interest. Other language that conveys the same meaning, but uses different words, will also be effective in creating the desired result if they clearly express the intent to apply the survivorship feature.*

In order to create a tenancy by the entirety, the joint owners must be legally married to each other and reference to the marriage relation may be sufficient under state law to create the interest.

*For example, Mary and her husband, Bob, are purchasing a tract of land near Silver City. Mary and Bob want to create a tenancy by the entirety relationship for their ownership of the property. When the deed to the property is prepared, it should describe the buyers as "Mary and Bob, wife and husband of Silver City."*

Can a joint owner sell his or her share of the joint property?

- In a tenancy by the entirety, both spouses must sell their share for a transfer of title to be effective.
- In a tenancy in common, each tenant is free to sell his or her own share without any involvement from the other tenants.
- In a joint tenancy with the right of survivorship, a sale of one joint tenant's share converts the ownership form from a joint tenancy with the right of survivorship to a tenancy in common.

Can creditors of a joint owner reach the owner's share of the jointly owned property to collect on delinquent debts of that owner?

- In a tenancy by the entirety, creditors of individual spouses cannot reach property owned jointly by the spouses. Individual creditors, however, are able to reach separately owned assets of their debtor spouse.
- Creditors of a tenant in common are able to reach the tenant's share since it is viewed as an individual asset.
- Creditors of a joint tenant with the right of survivorship are also able to reach the tenant's share of the jointly owned property. By attaching such property and executing on it to satisfy an obligation, the joint tenancy is converted to a tenancy in common.

### **D. Transfer by Intestacy**

If a person owns property in his or her name alone, or the property is a tenant in common share of property that is owned jointly with others, the transfer of ownership is made either under a will or trust prepared during the person's lifetime or under the provisions of the intestate law of the state where the owner resides. If a person does not

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

have a will or trust, and there is no joint ownership of property that has a survivorship feature, the intestate law of the state which the deceased considered his or her domicile creates a schedule for the distribution of separately owned property. Within the schedule, the statute decides who is to receive the property, how much they are to receive, and any special conditions that apply to this transfer. The following table describes how the intestate statute distributes property owned by a person who died and who considered this state to be her domicile, the place which the person considered to be her home at the time of her death. This information is based on the Uniform Probate Code (UPC)<sup>3</sup>, a sample law prepared at the national level and available to states to adopt as part of their own state probate law. The UPC offers a typical example of what these laws address:

1. If a *spouse survives the decedent*, the share of the surviving spouse depends on the following circumstances.
  - a. The surviving spouse is entitled to receive all of the decedent's estate if either:
    - 1) No descendants of the deceased survive, or
    - 2) All of the decedent's surviving descendants are also descendants of the surviving spouse. For these purposes the term descendants includes descendants of all generations.
  - b. If one or more of the decedent's surviving descendants is not a descendant of the surviving spouse, then the surviving spouse receives the first \$100,000 of the estate plus one-half of the remaining estate balance.
2. Whatever share is not distributed to the surviving spouse i.e., one-half of the remaining estate balance, or the entire estate if there is no surviving spouse is distributed to the descendants of the deceased by the process of representation. Under the process of representation, a decedent's estate is divided into as many equal shares as there are (i) surviving children of the decedent, if any, and (ii) children of the decedent who failed to survive the decedent but who left descendants who survive the decedent. In this process each surviving child is allocated one share and each deceased child who was survived by descendants also receives one share that is divided among the descendants of the deceased child.
3. *If no descendants of the decedent survive*, then to the parent(s) of the deceased.
  - a. If both survive, they take equally.
  - b. If only one survives, to that person individually.

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<sup>3</sup> The Pennsylvania Intestate Distribution schedule is found in Appendix A of this course.

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

4. *If no descendants and none of the deceased's parents survive*, then to the descendants of the deceased's parents (i.e., the deceased's brothers, sisters, nephews, nieces, grandnephews, or grandnieces) take by the process of representation described above.
5. *If no brothers, sisters, nephews, nieces, grandnephews, or grandnieces of the deceased survive*, then to the deceased's grandparents or descendants of grandparents.
  - a. If one or both of the maternal and paternal grandparents of the deceased survive, one-half of the estate is distributed to the maternal and one-half to the paternal grandparent(s).
  - b. If one of either the maternal or paternal grandparents survive and neither of the other grandparents nor any of their descendants survive (aunts, uncles and cousins of the deceased), the entire estate is distributed to the surviving grandparent.
6. *If neither the maternal nor paternal grandparents of the deceased survive*, nor none of their descendants survive, the estate is considered to have no taker. In the case where there is no taker, the entire estate passes to the state.

In order to receive the share that the intestate law designates, each beneficiary, including a surviving spouse, must survive the decedent by at least 120 hours. This requirement will not be applied, however, if as a result the property passes to the state as described in paragraph F, above.

When property is distributed to more than one heir under the intestate law, the several owners take each of their shares as tenants in common to each other.

The following example describes a distribution of \$170,000 under the Uniform Probate Code. The sum was owned by a person who is survived by a spouse and two children who are children of the marriage. Following the payment of debts, administrative expenses, and a family exemption, the spouse receives all of the estate as the descendants of the deceased are also descendants of the surviving spouse.

If one of the children is not a child of the marriage between the deceased person and the surviving spouse, but was born in a prior marriage, the shares to the spouse and children will change. The spouse is entitled to the first \$100,000 of the estate plus one-half of the remaining amount or \$35,000 (1/2 of \$70,000). Each child's share is one-half of the remaining \$35,000.

If the deceased person and spouse did not have any children from their marriage or a prior marriage, but the deceased person is survived by parents, then the spouse receives the entire estate and the parents receive nothing.

### E. Transfers by A Last Will And Testament

Property owners who want to direct distribution of their property after death can do so by preparing a will. Like the intestate law, a will only provides for the distribution of separately owned property. Unlike the intestate law, which primarily benefits family members, a will can bestow benefits and property on family members, strangers, corporations, charities, churches, and other beneficiaries.

For a transfer to be made according to the will, the document must identify the person to receive property at the owner's death. Therefore, most wills provide for several levels of distribution. The first level is considered to be the primary beneficiaries. If the primary beneficiaries die before the property owner, a will commonly provides for a second level of distribution. In some cases, a will may provide for distributions beyond the second level. If all of the named beneficiaries in the will die before the owner, the owner's property is distributed according to the intestate law even though the owner took steps to avoid this possibility. Under the laws of some states, the children of certain beneficiaries named in a will who die before the person who prepared the will can take the share that their deceased parent would have taken. In such cases, the statutory method of transferring the property can step in to avoid a situation where the intestate law would otherwise apply. Distributing property under the terms of the will can be achieved by assuring that the will always names a beneficiary who will survive the decedent.

Under the Uniform Probate Code, a valid and enforceable will is one prepared by a person eighteen years of age or older, of sound mind, possessing testamentary intent and understanding and acting without force or pressure or under any undue influence. The document must recognize an intent to distribute property after death and be signed at the end by the person making the will. A will can be formally prepared by an attorney experienced in estate planning and administration matters or by a property owner. State laws generally create a list of requirements that must be met for a will to be considered valid. Some states require that people witness the signature of the person who prepared the will. Many states now follow a procedure that allows a will become "self-proving". This means that the person preparing the will follows a detailed procedure and signs a statement in the presence of a person who is authorized to administer oaths. Under many state rules, those who witness the signature also make these statements before a person authorized to administer oaths. State laws are the source of all requirements for the validity of will, and it is advisable to consult a reputable source of current information or someone in the state where you live who is familiar with these requirements to make sure that the outcome of the planning effort is an effective document.

Under the law of many states a surviving spouse may be granted a right to elect not to take the share of property that the will has made for that spouse. Under the Uniform Probate Code, for example, within six months after a person's death, a surviving spouse has a right to elect against what the will provides for the spouse and elect to take what state law has designated as a surviving spouse's share. This election requires the surviving spouse to give up his or her claim to certain property in return for a statutory

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

share of one-third of certain other specifically identified property. In deciding whether to elect against a will, a surviving spouse should calculate what the spouse's share would be with an election and without an election. This will require a detailed examination of the type of property that is subject to the election, or which is not considered to be part of it. Then an actual calculation can be made of what the surviving spouse's share would be with and without the election. At this point the surviving spouse should have detailed information on which a better decision can be made. Timing when the election is made is an important factor. Most of such provisions require the election be made within a specific period. If not made within the period, the election opportunity is lost.

A surviving spouse's right to elect against a will can be forfeited for failure to financially support the deceased spouse, for desertion, and for participation in the willful or unlawful killing of the deceased spouse. In addition, the right to elect can be waived, as in an agreement made by two parties before they marry. Only a surviving spouse has the right to elect against the will. Other family members do not have this right.

Under prevailing state law a will can be challenged after it is presented in probate following the person's death. Some of the people who can challenge the will are determined under state law and can include beneficiaries who are named by the decedent in one will but not in a different will that is presented as the decedent's final will, the intestate heirs of the decedent, and beneficiaries whose share would increase or decrease depending on which will is admitted to probate. Subject to specific provisions in state law, some common grounds for challenging a will are that the decedent was not of sound mind when the will was prepared, that someone unduly influenced the decedent to prepare his or her will with particular terms, fraud practiced on the decedent, the decedent intended to give property away during lifetime rather than at death, and the decedent's failure to properly execute the document makes the document void as a means of transferring the person's property after her death.

In addition to cases where a will is challenged, a will can also be modified by state law as a result of certain events. For example, if a married person prepares a will that provides for his or her spouse, and the marriage is later ended by divorce, the termination of the marriage may void all provisions in the will for the divorced spouse. In a somewhat reverse situation, if a single person prepares a will and then marries after the will is prepared, the surviving spouse may be entitled to an intestate share of the decedent's property if it appears from will or other evidence that the will was made in contemplation of the marriage to the surviving spouse; the will expressed the intention to be effective notwithstanding any subsequent marriage or the person preparing the will provided for the spouse by transfers outside the will and it was intended that these transfers be in lieu of a provision in the will.

If a person prepares a will and a child is born to or adopted by that person's family after the will is prepared and before the person dies, the share of the after-born or adopted child could be either an intestate share comparable to that of all of the children, a share mentioned in the will, or nothing if the person provided for the child by transfers outside the will and the intent of such transfers was that they were in lieu of a provision in the

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

will. If a person participates in the willful and unlawful killing of someone, the slayer may be prevented by state law from receiving any benefit or acquiring any property from the estate of the person who was killed.

Transfers by a will have other advantages that are important to the estate and the heirs. A person with a will can recommend a guardian for the children and thereby save the time and expense needed to obtain a court-ordered appointment. Guardians have legal authority to hold property for a minor child until the child reaches eighteen years of age.

### F. Transfers by a Trust

Ownership of property *in trust* is a special form of ownership that creates a formal legal relationship between the person who holds legal title to the property and the persons or who receive some benefit from it. This relationship involves the person who created the trust (a Grantor) a person who carries out the trust instructions (the Trustee) and the person(s) who benefit from the trust instructions being carried out (the beneficiaries). To create a trust, an owner of property transfers ownership of the property by written agreement to a person or an organization that is designated to act as a trustee. As a trustee, the person who holds the property is subject to a legal obligation to manage, protect and preserve the property for the benefit of a designated beneficiary. The beneficiary is designated by the person who creates the trust. The trustee maintains "legal" ownership or title to the property, and the beneficiary has a "beneficial" ownership interest in the property. Since the trustee holds the property for the benefit of the beneficiary, the trustee's personal creditors must respect the rights of the beneficiary to the property. Therefore, the property is protected from the claims of the trustee's creditors.

A trust created during an owner's lifetime is called a *living trust* in contrast to a *testamentary trust* which is found in a will. Trusts are also known by the terms *revocable and irrevocable*. Each of these terms describes whether the trust agreement can be changed by the person who creates it. The creator is often referred to as the trust grantor. If the grantor retains the right to amend or change the trust after it is created, the trust is considered *revocable* because the grantor can revoke it after it is created. An *irrevocable* trust on the other hand is one that cannot be changed or revised after it is created. Trusts also are named for purposes they serve or the types of assets involved, such as a *charitable* trust or *marital deduction or credit shelter* trust. Each of these terms refers to specific federal estate tax planning opportunities that will be discussed in more detail in later chapters.

In today's estate planning world, transfers of property after death under terms of a living trust reflects the owner's lifetime decision to use the trust vehicle to own, control, and manage property, and to designate those who have a beneficial interest in the property. Commonly the grantor retains a lifetime right as a beneficiary of the trust, as well as the broader right to change or amend the trust or cancel it entirely. Following this trust beneficiary's death, the living trust terms provide for the transfer of ownership to some other beneficiary. Therefore, the trust becomes a vehicle by which the original owner of



## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

the property provides for a lifetime interest and also designates who will receive the property after the owner's death. When the trust is created, the property owner and trustee negotiate an agreement that controls the trustee's ownership of the property and its eventual distribution to a beneficiary. This process allows the grantor to make decisions about who will receive property after the owner's death and to instruct the trustee about uses that can be made of the property while the trustee is its owner.

Holding property in trust may have income tax impacts that should be considered. Also putting property into a trust may not prevent the property from being included in federal estate tax calculations if the terms of the trust yield that result. Later chapters will discuss these issues in more detail.

Chapter 13 deals with trusts in estate planning and discusses this topic in more detail.

### **G. Disclaimers**

Although property is directed to pass to designated or identifiable heirs after a person's death, the heirs are not required to accept it.. Heirs who choose to refuse acceptance of such transfer have disclaimed the transfer to them. In such cases the will or trust considers the beneficiary as having died before the property owner and whoever would inherit the property in that case will then inherit the property. Disclaimers are used in cases where the designated beneficiary has no need for the transfer and the beneficiary who stands next in line is an acceptable substitute for the person who is originally named as beneficiary. In some situations, a disclaimer by a beneficiary may lowering estate and inheritance taxes which makes the decision one that has financial considerations for the parties themselves.

### **H. Comparison of Transfer Methods**

In general, comparison of these transfer methods can be made on three bases; cost to create, time required to complete the transfer and transfer taxes applicable to it. To facilitate the discussion, this comparison is not made on the basis of any specific state law. Reference to such law must eventually be made, however.

On the basis of cost to create the transfer method, transfers under the intestate law are generally the least expensive method since taking no action triggers this method. Transfers by operation of law are generally inexpensive to create, often at little or no expense at all as no planning takes place. Creating joint ownership of bank accounts, certificates of deposit and other property is generally accomplished without cost. Real property that requires a deed or motor vehicles that require certificates of title may have cost or expenses associated with creating the documents.

Preparation of a will or living trust agreement can be the most expensive transfer methods to create as these methods often involve the services of professional advisors to assist in making the needed decisions and in preparing the documents needed to carry out such decisions. When a professional is retained to provide this service, the

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

cost of the professional's service can be reduced by the amount of time and effort put forth by a property owner in gathering information about property ownership, insurance plans, retirement benefits and plans to distribute property after death. Work done by the property owner saves the professional's time in gathering the same information and should lower the final expenses that the property owner pays to complete the process.

In regard to the time required to complete the transfer, transfers by operation of law transfer are made immediately to the surviving owners when one or more joint owners dies. Next, in terms of relative speed of completing the transfer, is the transfer of property under a trust arrangement. The significance of the trust agreement is that title to property is held by a trustee who already has explicit instructions on how to transfer the property if certain events occur. If the owner of the property retains an interest in the trust property, the agreement designates the successor and the trustee completes the transfer according to the agreement's instructions. A potential delaying factor in such situations is a challenge to the validity of the trust agreement or one based on fraud or undue influence of a beneficiary who persuaded an owner to provide for the beneficiary to the exclusion of other potential recipients. Other potential delaying factors involve the potential need to determine the tax consequences involved with the transfer of property under any of the methods described above. These tax consequences involve the application of federal estate tax to property retained in the estate, federal gift tax applied to gifts made before the owner's death and inheritance or other death taxes imposed by states on the transfer of property after the owner's death. In each case time and expenses may be incurred to determine if the estate is subject to the tax, the value of property subject to tax, the party responsible for the payment of the tax imposed, and filing the estate, gift or inheritance tax return that is needed.

Generally, the most time consuming method of transferring property after death is that of either a will or the intestate distribution statute. Both of these methods involve appointing a personal representative for the decedent's estate to take control and responsibility for property owned by the decedent at the time of his or her death. Once appointed, the personal representative gathers the estate assets, collects its debts, pays its bills, and manages the affairs of the estate, including the payment of applicable inheritance and estate taxes. This period is called the estate's administration. While each estate has its own unique problems and opportunities that affect the time needed to complete the transfer under this method, it generally takes 12 months or more to complete it.

The third point of comparison concerns inheritance and estate taxes that apply to the transfer. Transfers of property under a joint tenancy with the right of survivorship may be subject to state inheritance and estate taxes and, potentially, federal estate taxes as well. Under current federal estate tax law, tenant by the entirety property that passes from one spouse to another spouse is included in the gross estate of the deceased spouse, but it is also eligible for a marital deduction from the gross estate. In other words, although the tax statute requires that the property be included in the calculation, it also provides for its deduction from the same calculation.

# Handbook on Estate and Succession Planning for Farm and Forest Landowners

Property that passes under a will, which is separately owned property, is generally subject to state inheritance and tax and potentially subject to federal estate taxes. Property which passes from a trustee to a designated beneficiary may be subject to state inheritance and estate tax and federal estate tax. Factors that influence the question of whether such property is subject to these taxes include the existence of an interest retained by the property owner who created the trust after its creation and the time period between the owner's creation of the trust and the owner's death. Chapter V will discuss these taxes in more detail.

## I. Student Exercises

### Multiple Choice Questions

Please read the following questions carefully, and then select one of the three or four choices following the question that correctly answers the question asked.

1. Charles and his brother, Harold, own a 150 acre farm in Happy Valley. They inherited the farm from their mother who died in 1981. At the time of her death, the property was transferred to Charles and Harold as her sole surviving heirs under the intestate law. What is the tenancy that Charles and Harold enjoy in the 150 acre farm?
  - a. Tenancy by the entirety.
  - b. Joint tenancy with the right of survivorship.
  - c. Tenancy in common.
  - d. None of the above.
  
2. Bill and his wife Betty own all of their property as tenants by the entirety. Neither Bill nor Betty has a will and they have no children. In the event Bill and Betty die under circumstances where it cannot be determined whether Bill or Betty died first, which of the following statements correctly describes how the property will be distributed?
  - a. Bill will be presumed to be the first to die. Betty will then be the sole owner and the property will pass to her heirs.
  - b. Betty will be presumed to be the first to die. Bill will then be the sole owner and the property will pass to his heirs.
  - c. The property will be divided into two shares. One share will pass to Bill's heirs and the other share will pass to Betty's heirs.
  - d. The property will pass to the Commonwealth of Pennsylvania since Bill and Betty have no will and are not survived by children.
  
3. Gerald and Harriet were married in 1990. Gerald owned a dairy farm and several forested tracts in his own name before he married. After the marriage, he transferred some of the forested tracts to himself and Harriet as tenants by the entirety.

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

In 2009, Gerald died in a plane crash. In addition to his jointly owned property he owned \$150,000 of separately owned property and did not have a will or trust agreement. At his death, Gerald was survived by Harriet and Gerald's parents, Ben and Helen. Harriet and Gerald did not have any children from their marriage.

Which of the following statements correctly describes how Gerald's separately owned property will be distributed under the Uniform Probate Code's interstate distribution statute?

- a. Harriet will inherit all of Gerald's separate property as she is his surviving spouse.
  - b. Ben and Helen will inherit all of Gerald's separate property as his surviving parents.
  - c. Harriet will receive one-half of Gerald's separate property and Gerald's parents will inherit the rest.
  - d. Harriet will receive the first \$30,000 of the separate property, plus one-half of the remainder of the property. Gerald's parents will receive the other one-half of the property that remains.
4. Which of the following statements correctly describes the role a trust can play in providing for the transfer of property after death?
- a. By transferring property to a trustee, the property owner can instruct the trustee to transfer the property to a designated beneficiary when specific events occur.
  - b. In creating a trust, the owner makes the trustee a joint owner of the property.
  - c. Under the terms of a trust, the property owner retains legal ownership of the property.
  - d. The creation of a trust does not protect the property from creditors of the trustee.
5. Which of the following events can have the effect of modifying provisions in a person's will?
- a. Divorce of a married person after a will is prepared.
  - b. Marriage of a single person who prepared a will while single.
  - c. Birth of a child after a will is prepared.
  - d. All of the above.

### Short Essay Questions

Please read the following questions carefully and then respond to the question that is asked at the end of the situation. Your answer need not be long or involved, but it should be as clear and concise as is necessary. If you want to refer to important facts in your

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

response, please feel free to do so.

1. Clifford is a retired businessman. Since his wife died last year, he is sad and lonely. Clifford's relationship with his nieces Cindy and Cathy is one of the bright spots in his life. Because of his advancing age and deteriorating health, Clifford wants to do something special for his nieces. At his next stop at the local bank where he maintains several accounts, Clifford instructs the bank to add Cindy's name as an owner of a certificate of deposit and Cathy's name as an owner of another certificate. Neither Cindy nor Cathy knows what Clifford did and neither knows about the certificates Clifford changed. Under the bank's own rules, whenever two or more people are listed as owners of a bank account or certificate of deposit, these owners are considered as joint tenants with the right of survivorship.

Based on our discussion of transfers by operation of law, describe the tenancy relationship between Clifford and his nieces on the various certificates and comment on the rights of Clifford, Cindy and Cathy to use the funds in the certificate during Clifford's lifetime.

2. Walter's wife Martha died in 2003 and he did not re-marry after her death. . Walter died in 20050 He did not have a will. At his death, he was survived by one daughter, Mary and two sons, Bill and Gregory.

After Martha died, Mary worked with her father on the family farm. When Walter died, Mary decided to stay and continue the farm operation. Mary's brothers had no objection since they were not interested in the family farm.

In 2007, Bill died. Under Bill's will he left all of his property to his wife, Wendy and his son James.

In 2009, Gregory died. At his death, Gregory was survived by his sons Allen and Richard. Gregory's will, which was prepared in 1990, left all of his property to his wife, Geraldine, but in 1997, Gregory and Geraldine were divorced. In the event Geraldine died before Gregory, Gregory's will provided that his children inherit his property.

Mary now considers herself to be the sole owner of the property and its prospering farming operation as she is the surviving child of Walter and Martha.

Based on our discussion of the various ways property is transferred after death, comment on whether Mary is the sole owner of the property.

3. John and Mary own and operate a saw mill business in suburban Silver City. Some of the assets are owned as tenants by the entirety while others are owned by John and Mary individually. In addition, John and his brother Charles jointly own a 200 acre tract of land along the Raging River. John and his brother own the land as joint tenants with the right of survivorship.

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

John has several debts owed to local creditors. Each of these debts are John's sole responsibility. Mary is not obligated on these debts.

Based on our discussion of the characteristics of joint ownership, if John fails to pay his debts, describe the rights that John's creditors have to enforce their debts against John's various properties.

## Chapter 9. Tax Aspects of Estate Planning

### A. Overview and Purpose

A common reason for deciding to embark on the estate planning process is to avoid estate and death expenses and taxes that arise when property is transferred after the property owner's death. Succession planning also confronts these issues if gifts or transfers after death are part of the plan. Taxes are by no means the only issues that should be addressed in a thorough estate plan. In most decedent's estates will not face federal estate tax when transferring their property. If that is the case, why are federal estate taxes included in this handbook. The short answer to that is the significance these taxes would have if they apply and the opportunities that are available to avoid or minimize the tax if it does apply. Both of these require an understanding of the problem in order to make good decisions regarding them.

Some of the tax issues are fairly common and well known, such as state and federal income taxes. Others, however, are less well known, such as federal estate and gift tax, state imposed estate taxes and federal generation skipping transfer tax.

This chapter will begin with an explanation of an estate's income tax obligations regarding the decedent's final return and the estate's own fiduciary income tax return. In this discussion the concept of an income tax basis will be discussed. The next topic to be discussed will be federal estate tax for people who died after December 17, 2010. The discussion of federal estate tax will explain key concepts, including the generation skipping transfer tax, the basic exemption equivalent to the unified credit, the unlimited marital deduction, the state death tax deduction and the federal gift tax, including the annual exclusion. The chapter will conclude with a discussion of the general scheme found in state inheritance tax provisions. This chapter will discuss these taxes by emphasizing the nature of the tax, the tax rate, and the situations to which the taxes apply. In addition, it will focus attention on opportunities to minimize or even eliminate the tax.

### An important note about Federal Estate and Gift Taxes

In many parts of the discussion emphasis will be on the planning or tax triggering events that occur. Under current law timing is an important consideration that will become clear as the discussion unfolds.

### B. Lesson Objectives

When you have successfully completed this chapter you will be able to accomplish the following objectives:

1. Describe the state and federal income tax issues and considerations that arise from a person's death and that apply to the person's personal income tax situation and that of his or her estate.

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

2. Describe and compare the provisions of a typical state inheritance tax and the Federal Estate Tax.
3. Describe and compare the typical state inheritance tax provisions relating to gifts of property to the provisions of the Federal Gift Tax.
4. Describe the estate planning opportunities provided by the unified credit against federal estate and gift taxes and the marital deduction.

### **C. Federal Income Tax**

#### **The Decedent's Final Returns**

The first income tax issue that arises when a person dies is the decedent's income tax return for all prior years for which a return was not filed, including a return for the year in which the decedent died. If an individual dies in January or February before filing his or her tax return for the prior year, the person may have two outstanding income tax years to report, the prior year's return which was not filed and the tax return for the year that begins on January 1 and ends on the date of the person's death.

If a decedent has a right to receive income during lifetime, but does not actually receive it or report it as income in the return for the final year, the income, when received, is known as income in respect of a decedent, or IRD.

#### **Income Tax Status of the Estate**

Second income tax issue is creation of a new taxpayer which is the decedent's estate. These provisions are sometimes referred to as the income tax liabilities of a fiduciary, which refers to the personal representative of the estate. Some of the first decisions that a personal representative should make after being appointed is to apply for a federal employer identification number (EIN) for the estate in one of several convenient ways and select the best tax year for the estate.

In addition to income in respect of a decedent, the decedent's estate reports income it receives as interest on invested estate assets, gain or loss on the sale of assets, and income from ongoing business operations. As a separate taxpayer, the estate pays federal income taxes under a tax bracket structure that is different from the tax brackets that apply to individual taxpayers.

The general theory of estate taxation treats an estate as a conduit that passes income and deductions to heirs who then report it on their personal returns. The estate is entitled to deduct all distributions of income, if the estate was required to distribute income currently or it paid, credited or was required to distribute any other amounts to beneficiaries during the tax year.

If an estate sells assets acquired from the decedent during the course of the estate administration it calculates gain or loss on the sale. The basis used to calculate gain or loss is the date of death value of the asset, or the value of the property on the alternate



## Handbook on Estate and Succession Planning for Farm and Forest Landowners

valuation date, if the estate elects to take advantage of the alternate valuation. If an estate distributes assets that appreciate in value during the estate administration to satisfy a bequest of money, the distribution triggers recognition of the excess value of the property over the value as of the date of death.

### Basis of Assets Passing to Heirs from a Decedent

A third income tax concern deals with the tax situation of the heirs who receive property from a decedent.

Under the 2010 Amendments individuals who die after December 17, 2010 will face a potential federal estate tax, but also face return of the “step up” in basis rules which can be used to reduce capitals gains from the sale of capital assets that were inherited from an estate. Individuals who died before that date are subject to a different set of rules that are discussed in a separate appendix for those who are interested in them.

Property that passes to an heir from a decedent receives **a step-up in basis** to its value as of the decedent's date of death. If an estate elects an opportunity to value assets at the value they have in their particular use, such as agriculture, that value, rather than the fair market value as of the date of death, becomes the basis of the assets that are specially valued and passed to other heirs. If estate land assets are subject to a qualified conservation easement transferred by the owner during the owner's lifetime and the estate excludes a portion of the value of the land subject to the conservation easement, when the owner dies the basis of the land will not be adjusted to the extent that the value of the property was excluded from the estate.

In comparison, if an owner gives property to someone during lifetime, the recipient receives the original owner's basis in the property. This is referred to as **a carry-over basis**. A special rule applies in the case of a transfer of property to a recipient who dies within one year of receiving appreciated property and then provides that the property pass back to the original owner after the recipient's death. In this case, the step up in basis does not occur.

In the case of property owned jointly by husbands and wives the step-up rules apply at the death of the first spouse. If the surviving spouse can establish the value of the jointly owned property at the first spouse's death, the surviving spouse can step-up his or her basis in the property.

*For example, John and Mary purchase property for \$300,000 which they own as tenants by the entirety. The funds to purchase the property come from both John and Mary. When Mary dies the property is appraised to be worth \$900,000. As John becomes the owner of Mary's one-half interest as the surviving tenant by the entirety, John's new basis in the property is \$600,000 from his one half of the original purchase price (150,000) plus \$450,000 which represents Mary's one-half interest transferred to John. John's new stepped-up basis is \$600,000 after Mary's death. If John and Mary are joint owners of the*

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

*property, but are not husband and wife, then a similar adjustment to the surviving owner's basis can be made, but it will be necessary to determine the exact proportion of the purchase price that each paid.*

### **D. Federal Estate Tax**

The Federal Estate Tax law has been a part of American tax law since. Throughout this period it has been amended several times and application of this tax is dependent on when death occurred and the law in force at that time. On December 17, 2010 Congress passed the Tax Relief Act of 2010 and created **the 2010 Amendments** that are effective for deaths occurring after December 31, 2009 and before January 1, 2013. These amendments affect Federal estate tax for deaths occurring after December 31, 2009.

After January 1, 2013, the 2010 Amendments provide that the law in place before June 7, 2001 will become effective in 2013 and thereafter.

#### **Estates of people who die after December 17, 2010 and before January 1, 2013.**

Under the Tax Relief Act of 2010, the Federal estate tax applies to taxable transfers that occur after December 31, 2009 and before January 1, 2013. The maximum Federal estate tax rate during that period will be 35% and the amount of the basic exemption equivalent to the unified credit which is explained below will be \$5 million per person. If a decedent's estate is less than \$5 million that estate will not face a federal estate tax obligation and would not be obligated to file a federal estate tax return, but could do so without being required.

#### **Estates of people who die after December 31, 2012**

Congress included the statement that the amendments made in 2001 and 2010 will not apply to estates of decedents dying after December 31, 2012. If those rules apply then a decedent would face a Federal estate tax with a maximum rate of 55%, the maximum rate in effect under the law in place in 2001. The applicable exemption equivalent to the unified credit against either federal estate or gift will be \$1 million per person.

### **E. Generation Skipping Transfer Taxes**

Federal estate tax and Federal gift tax also incorporate another concept known as the generation skipping transfer tax, or "GSTT". GSTT is designed to prevent the tax free transfer of property from one generation to a generation of beneficiaries who are more than one generation below the generation of the person making the gift (i.e. transfers from a grandparent to a grandchild or to someone who is at least two or more generations (or at least 37 and ½ years) younger than the person making the gift. Transfers that are subject to GSTT include direct transfers by gift or inheritance, transfers at the termination of a trust or distributions for the benefit of a grandchild from the income or principal of a trust. In cases where an owner wishes to make a gift to a

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

grandchild whose parent has previously died, the grandchild moves up in generational rank to take the level of their deceased parent and such transfers avoid GSTT. GSTT is a tax that is separate from any estate or gift tax otherwise applicable. Under the 2001 amendments to the estate tax law, the generation skipping transfer tax provisions do not apply to transfers that occur **after December 31, 2009**. The 2010 Tax Relief Act reinstated the generation skipping transfer tax for transfers that occur after 2009. In 2010, transfers that are subject to the Generation Skipping Transfer tax have an exemption of \$5 million that will be adjusted for inflation after 2011. Any unused portion of an individual's generation skipping transfer exemption cannot be passed to anyone else. . Transfers in 2010 that are subject to Generation Skipping Transfer tax are subject to a zero tax rate.

Transfers made after 2010 are subject to a tax rate equal to the highest federal estate or gift tax rate, 35% for 2011 and 2012. In addition to the available exemptions, present interest gifts which qualify for the annual exclusion from federal gift tax and tuition and medical expense exclusions from federal gift tax, which are explained below, are also exempt from GSTT.

Federal estate tax is due within nine months of an owner's death. In the case of estate taxes on active closely held business interests, opportunities are available to pay the estate tax on the business interest in installments first of interest and then principal and interest for up to 14 additional years.

### F. The Basic Exemption Equivalent to the Unified Credit against Federal Estate Tax

An important planning opportunity under federal estate tax law is ***the basic exemption equivalent to the unified credit*** which an owner has and can apply against federal estate tax liability. This exemption equivalent is \$5 million for decedents who die in 2011.

Each resident citizen taxpayer is entitled to this exemption equivalent to the credit.

*For example, if a decedent's estate in 2011 has the full unified credit available, and the decedent's gross estate does not exceed \$5 million, the decedent's estate need not be concerned with federal estate tax. If the unified credit has been reduced through use of the credit to offset gift tax arising from taxable gifts, the total of all adjusted taxable gifts made after December 31, 1976 is deducted from the \$5 million figure.*

In the absence of Congressional action people who die after December 31, 2012 will face a Federal estate and gift tax that has a basic exemption equivalent to the unified credit of \$1 million and no "carryover" opportunity to allow a surviving spouse to use an unused portion of prior deceased spouse's share

The concept of a "gross estate" for federal estate tax purposes which is used to

determine if federal estate taxes apply is explained in chapter 10.

### **G. The Unlimited Marital Deduction**

#### **In general**

For estates that are greater than the exemption equivalent to the unified credit, a second estate planning opportunity is the estate tax marital deduction. One spouse can transfer property to his or her surviving spouse free of federal estate tax if the surviving spouse has the unrestricted or unqualified right to use, possess or enjoy the property.

#### **The Terminable Interest Rule**

If the spouse's right to property can be revoked, the marital deduction may not be allowed for the transfer. Examples of these events include re-marriage or the failure to support a designated family member. A spouse's right to receive property from a deceased spouse that is conditioned on surviving for less than six months, is not considered a terminable interest if the spouse survives for the required period.

#### **Qualified Terminable Interest Property**

Certain transfers involving property in which the spouse is given an interest that is subject to later events, such as an estate that ends at the death of the holder of a life interest, can elect marital deduction treatment as an exception to the rule that ordinarily denies the deduction for such transfers. These transfers are known as "qualified terminable interest property" or "QTIP's". To meet QTIP requirements, the transfer to the surviving spouse must be a qualifying income interest for life. Such an interest provides that the surviving spouse is entitled for life to all of the income from the property, payable at least annually. No person, including the surviving spouse has a power to appoint any part of the transferred property to any person other than the surviving spouse during the surviving spouse's life. Any power over the property transferred that is retained must be exercisable only at or after the spouse's death.

*For example, Harold Wilson and his wife Hattie own several tracts of land in their separate names. In Harold's will he provides that one of his separately owned tracts is to be placed in a trust and Hattie is to receive all of the income from the trust during her lifetime, payable to her quarterly. After Hattie's death, the trustee is directed to distribute the trust property to Harold's children Herbert and Harriet. Hattie's interest in the trust is a qualifying income interest and the trust arrangement qualifies for the marital deduction.*

If the QTIP election is made, the qualified terminable interest property will be included in the surviving spouse's estate at death even though it will pass to the children specified by the first spouse's will. This particular concept allows a person to establish a fund to benefit a surviving spouse for life and gain marital deduction treatment without losing the ability to direct the balance in the fund when the surviving spouse dies.

## Effect of the Marital Deduction

The effect of the unlimited marital deduction for example is to defer federal estate taxes from the estate of the first spouse to die to the estate of the second spouse. The deduction delays payment and collection of the tax to the second spouse's death if the property remains under that spouse's control. . If the property is transferred or disposed of by the surviving spouse before death without incurring federal gift tax, then the transferred property escapes federal estate tax.

To gain the greatest benefit from the unified credit and the marital deduction, coordination should be made between property ownership and post death transfers in order to fully utilize each credit in the estate of each spouse.

## State Death Tax Credit and Credit for Tax on Prior Transfers

For estates of people dying after December 31, 2010, the estate will be given a deduction for the amount of inheritance and estate taxes paid to states.

## H. Federal Gift Tax

In addition to the Federal Estate Tax, the Internal Revenue Code imposes a tax on lifetime transfers of money or property for less than full and adequate consideration in return.

For a gift to exist three things must exist:

1. The person making the transfer must intend the transfer to be a gift rather than a loan or sale.
2. The owner must give up dominion and control of the gift to the recipient. If control of the property is not transferred, or the owner retains authority to change the disposition of the property either for his or her own benefit or for that of others, a gift of the property is not complete and the owner will retain ownership of the item.
3. The recipient of the property must be willing to accept it.

In a gift between spouses a marital deduction is available to the spouses and the transfer is exempt from gift tax. Creation of joint ownership interests between individuals who are not married to each other may create a gift for purposes of the federal gift tax.

To determine if a gift is made several factors are considered:

1. If the joint owners acting alone can sever the joint ownership relationship and withdraw funds from the joint interest, a gift is considered to be made of a fractional share of the joint interest.
2. In the case of a joint bank account in which only one individual has contributed

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

funds, a gift is considered to be made when the recipient of the joint interest withdraws funds from the account for his or her own benefit.

3. When joint interests are terminated during the lifetime of all joint owners and the owners receive their shares of the property, a gift is made to those joint owners who did not contribute a proportional amount to the creation of the joint interest equal to what they receive at the termination.

For taxable gifts made after December 31, 2009 and before January 1, 2013, gift tax rates begin at 18% of the first \$10,000 of taxable gifts and range up to a maximum tax of 35% of gifts over \$500,000.

Transfers of property subject to gift tax also have an exemption equivalent to the unified credit that can be applied to the transfer. Estates of people dying after December 31, 2009 and before January 1, 2013, a federal gift tax exemption equivalent of \$ 5 million is available to federal gift tax transfers.

If an individual made taxable gifts in prior years, the amount of the credit used in those prior years reduces the size of the exemption equivalent to the unified credit available to the taxpayer in the year of the current gift. When the gift tax is calculated, all prior taxable gifts are added to the current taxable gift and a tax based on the current tax rate schedules is calculated on the total gift and gifts in prior years.

### **Annual Exclusion from Gift Tax Liability**

Another gift tax planning opportunity is in the annual exclusion from gift tax liability. Annually, taxpayers are able to give up to \$13,000 to any one person, or any number of people, free of federal gift tax. In other words a gift is not considered "taxable" until it exceeds \$13,000 to a single person in a calendar year. This annual exclusion is subject to an adjustment based on cost of living increases.

To qualify for the annual exclusion, the gift must be a gift of a present interest, which means the recipient must have the right to immediately use, possess or enjoy the gifted property. If restrictions apply and a present interest is not given, the gift is ineligible for the annual exclusion. Individuals who desire to bestow a gift on a minor often face a difficult decision.

How does an owner give a present interest to a minor who cannot fully use, possess or enjoy the property until he or she reaches the age of majority? To be considered a gift of a present interest, the gift must provide that the property will be expended for the benefit of the minor before the minor's 21st birthday. Any balance which is not expended for the benefit of the minor must pass to the minor at the minor's 21st birthday or to the minor's estate if the minor dies before reaching his or her 21st birthday. Transfers in trust for the benefit of the minor that meet these requirements and transfers to custodians for the minor under the Uniform Transfers to Minors Act qualify for the annual exclusion as gifts of present interests.

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

Spouses have the opportunity to increase the amount of their annual exclusion by electing to "split the gift" which enables them to treat one-half of all gifts made in the calendar year as being made by each spouse, even though only one spouse provided the gift property. If spouses choose to split their gifts in a tax year and a gift to a single individual is above the \$13,000 per person per year limit, a gift tax return must be filed. In filing the return the spouses elect the split gift treatment thereby raising the annual exclusion amount to \$26,000 per person per year.

### **Exclusion for Gifts of Tuition or Medical Expenses**

The federal gift tax provides two other opportunities to make tax free gifts which are not limited by the annual exclusion amount. The first of these is a gift of tuition paid directly to an educational institution on behalf of another person for education or training provided to the person. In this context, the exclusion is limited to payments for tuition and cannot be used to offset the cost of books, supplies, residence fees and costs, lodging or similar expenses which do not constitute direct tuition costs.

The second opportunity is the direct payment to a medical care provider for care provided to another person. This exclusion can also be used to pay for medical insurance for another individual. Obligations which will be reimbursed by medical insurance, however, are not eligible for treatment under this unlimited exclusion.

Each of these unlimited exclusions is in addition to the \$13,000 annual exclusion otherwise available and is applied without regard to the relationship between the donor and the recipient.

## **I. A general structure of State Inheritance Tax laws**

### **Tax Rates**

The typical state inheritance tax is imposed at one or more different rates where the rates may vary according to designated factors, such as the dollar value of the property transferred or the family relationship between the deceased person and the person to whom the property is transferred.

Tax-free transfers may include transfers to recognized charities; to federal, state, or local governments; to a surviving spouse; transfers of life insurance proceeds paid to named beneficiaries, social security benefits and veterans benefits.

Transfers taxed at the lowest tax rate imposed include transfers to decedent's grandparents, parents, lineal descendants, and husband or widower of a child. Lineal descendants for inheritance tax purposes include natural children and their descendants, and adopted children and their descendants. Stepchildren and their descendants would be treated as natural children of the natural parent, but may not be treated as being on the same basis as natural children when it comes to determining if these children are lineal descendants of the stepparent.

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

Transfers taxed at one or higher rates include transfers to other persons or entities who are not taxed at either the tax free or the lower percent tax rate, such as transfers to decedent's brother, sister, aunt, uncle, nephew, niece, other family members and all non-family members.

Most states do not impose a tax on gifts and other property given away during lifetime, but such transfers might be considered in the overall calculation of inheritance tax. For example, if property given away to any person is valued at more than \$3,000 at the time of the gift and the person giving property away dies within one year after giving it away, the value of the gift in excess of \$3,000 may be subject to inheritance tax in states, such as Pennsylvania. The \$3,000 figure applies to gifts made to separate individuals without limit as to the number of individuals. For additional details regarding gifts refer to Chapter 11 which will discuss the concept of gift at greater length.

Property jointly owned by husbands and wives may not be subject to state inheritance tax when one spouse dies and the other spouse receives the deceased spouse's share. If joint owners are not husband and wife, the transfer of a fractional share to the surviving joint owner may be subject to inheritance tax at the inheritance tax rate determined by the relationship between the deceased and surviving owner(s).

The amount subject to tax is equal to the fractional share of the property that represents the deceased owner's share passing to the surviving owners. In cases where the joint ownership interest is created, the full value of the property above the limit set by statute may be subject to inheritance tax if the deceased owner who created the joint ownership interest by giving a gift dies within the one-year period that starts with creation of the joint ownership interest.

Property subject to inheritance tax is taxed at its fair market value, which is generally considered to be the value which a willing and able buyer would pay to a willing and able seller of the property. In many instances this value is determined by the market value of the item. Real estate values are determined by real estate appraisals or from sales of the property during the estate administration period where the selling price can generally be used as its value.

Land used in special uses may qualify for special value treatment under some state laws.

Estates whose assets include small business interests may have the opportunity to elect an installment payment arrangement to pay the inheritance tax on the small business interest. This may allow the heir who continues the business to do so without fear of having to sell the business to pay inheritance tax.

### **J. Student Exercises**

#### **Multiple Choice Questions**



## Handbook on Estate and Succession Planning for Farm and Forest Landowners

Please read the questions carefully, and then select one of the four choices following the question that correctly answers the question asked.

1. Which of the following transfers will be subject to federal gift tax?
  - a. The gift of a vehicle worth \$7,000.
  - b. The gift of real property from a husband to his spouse.
  - c. A child's gift of \$30,000 to her parents.
  - d. A parent's gift of \$12,000 to each of her seven children shortly before her death.
  
2. An exemption equivalent of the unified credit allows a property owner to transfer property free of federal estate and gift tax. How much will the exemption equivalent of the unified credit for federal estate tax be for estates of people who die in 2011?
  - a. \$1,000,000
  - b. \$3,500,000
  - c. \$600,000
  - d. None of these answers is correct
  
3. Which of the following tax laws is an issue to be concerned about in making transfers of large amounts of property from a grandparent to a great-grandchild?
  - a. State Gift Tax Law.
  - b. Federal Excise Tax on Excess Accumulations
  - c. Generation Skipping Transfer Tax
  - d. The Abusive Use of Gifted Property Law
  
4. William and Harriet are two happily married people who are concerned about what will happen to their property after they die. Each owns considerable property in his or her own name, as well as other property that is owned by them jointly. The value of their individual holdings is large enough to trigger application of the federal estate tax. Each person wants to have their own property be transferred to the other if one of them dies and the other person survives. Which of the following estate planning opportunities would enable them to transfer all of their property to their spouse after death without federal estate tax being applied?
  - a. The annual exclusion
  - b. The credit for prior transfers
  - c. The marital deduction
  - d. The state death tax deduction
  
5. Which of the following tax concepts is used in calculating income tax gain or loss on the sale of an item that was received as a gift from the prior owner of the property?

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

- a. The tax basis of the property in the hands of the person selling it.
- b. The exemption equivalent of the unified credit.
- c. The generation skipping transfer exemption
- d. Qualified terminable interest property

### Short Essay Questions

Please read the question carefully and then respond to the question that is asked at the end of the situation. Your answer need not be long or involved, but it should be as clear and concise as possible. If you want to refer to important facts in your response, please feel free to do so.

1. Bill and Beth received several gifts of real estate from Bill's mother and inherited other real estate she owned after her death. In order to raise money to fund the cost of a college education for their nine children, Bill and Beth are interested in selling these properties.

When the properties received as gifts are sold how will Beth and Bill's capital gain be calculated? How will the gain be calculated when the inherited properties are sold?

2. The Reddick family has owned a 150 acre tract of farm land in central Pennsylvania for more than 100 years. Presently Ralph and Rita Reddick own the land. Fred and Jayne, their two children are anxious to acquire the land and Ralph and Rita want to give them the chance to do so as they are considering leaving the land to them in their wills. They are also considering giving some or all of the land to their children during their lifetimes, rather than after their deaths.

Based on these facts what federal and state issues do you recognize as Ralph and Rita try to decide what to do with their land? What planning opportunities might be available to them to address some of the problems you've recognized?

3. Sarah Leigh Shashlick is an elderly woman who has accumulated a significant amount of property including substantial bank accounts and land holdings. Her doctors told her recently that her heart condition is worsening and her future is not very bright. Perhaps she will live another year or two.

Based on this assessment of her physical condition Sarah decided to bestow some of her property on her family which includes several children, grandchildren and great-grandchildren.

If Sarah were to make gifts of her property today, what tax considerations would she have to consider before making the gifts?

## **Chapter 10. Calculating the Federal Estate Tax That an Estate Will Pay**

### **A. Overview and Purpose**

Chapter 9 identifies the impact that taxes will have on a person's estate after death. This chapter focuses on calculating the federal estate tax to the estate of a person who died after December 31, 2010 so the impact of that tax is clearly understood.

Deaths occurring after December 17, 2010 will be subject to the rules described by the 2010 Amendments. After January 1, 2013, the 2010 Amendments provide that the law in place in 2001 returns and becomes effective in 2013.

That general discussion addresses most of the typical questions that people will face in calculating federal estate tax that could apply to their estate..

### **B. Lesson Objectives**

When you have successfully completed this chapter, you will be able to accomplish these objectives:

1. Describe what is meant by a "gross estate" under federal estate tax law.
2. Describe the general types of property that are included in the federal gross estate and the general rules for determining how and when these items of property are valued.
3. Describe special valuation rules that apply to land that is subject to conservation easement or that elects special use valuation.
4. Describe the impact that the Family Owned Business Deduction can have on estate plans that involve a family owned business.
5. Describe the valuation opportunity that is available to owners of land that is subject to a qualified conservation easement.

### **C. Calculating the "Federal Gross Estate"**

The **gross estate** includes:

- all property the decedent owned in his or her name alone,
- one-half of all property owned jointly by the decedent and his or her spouse,
- a proportionate share of other jointly owned property equal to the decedent's contribution to the purchase and improvement of the property, and
- proceeds of any life insurance policies which are paid to or for the benefit of the decedent's estate or for which the decedent is considered to hold the incidents of ownership.

**Incidents of ownership of an insurance policy** is a concept that describes the ability of the person, acting alone or in conjunction with any other person, to determine who or what receives the economic benefit of the insurance policy. Authority such as:

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

- the ability to designate a beneficiary,
- to surrender or cancel the policy,
- to assign the policy or revoke an assignment,
- to pledge the policy for a loan or
- to borrow against the cash surrender value of the policy is generally considered to be an incident of ownership.

If the terms of the policy provide for the possibility of the policy or its proceeds returning to the decedent or the decedent's estate or the decedent has a power of disposition over the policy, either of which is valued at more than 5% of the value of the policy immediately before the insured's death, the holder of such power is deemed to have an incident of ownership.

The gross estate also includes the value of property interests over which the decedent held a **general power of appointment** at death.

A power of appointment is the power to determine who will own or enjoy the property subject to the power and when they will own or enjoy it and is created by someone other than the person who holds it. A general power of appointment for estate tax purposes is one in which decedents can appoint the property subject to the power to themselves, their creditors, their estates or creditors of their estates.

A general power includes the unlimited right to use principal, income or principal and income for the decedent's benefit. If a decedent has a power to use or consume that is limited by an ascertainable standard relating to health, education, support or maintenance, the power is not considered a general power. A power to use property for the comfort, welfare, or happiness of the decedent is not an ascertainable standard and therefore is a general power. If a power of appointment is not considered to be a general power it is considered a limited power of appointment.

The federal gross estate includes the value of property transferred during lifetime, but over which the decedent retained a right to use, possess or enjoy the property or the income from it.

Transfers made during lifetime under which the recipient's right to possession and enjoyment is delayed until after the decedent's death or in which the decedent retained a right to reacquire the property which right is valued at more than 5% of the value of the property immediately before the decedent's death result in the entire value of the property being included in the federal gross estate of the deceased former owner.

If the owner of property transfers it during lifetime, but retains the right to alter, amend, revoke or terminate the transfer at the time of death, the value of such property will be included in the deceased owner's estate. Common examples of revocable transfers are "in trust for" savings accounts and custodial accounts in which the person creating the account is the custodian of the account. A revocable living trust in which the person who

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

creates the trust reserves the right to revoke or terminate the trust is another example of a revocable transfer which is included in the gross estate of the deceased owner.

Gifts made by a decedent within three years of his or her death are not included in the gross estate of the decedent, unless the person making the gift retained a lifetime interest, the transfer takes effect at death, retained a right to revoke the transfer or the transfer was of a life insurance policy.

### **D. Valuing Property Subject to Tax - General Rules.**

**Fair market value**, is defined, as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. An example of an arm's length transaction is an auction where the owner of property invites all interested parties to bid on the purchase of the property.

Valuing property subject to federal estate tax and most state inheritance and estate taxes determines the value at the time that the owner of the property dies. If the property is sold close to the date of determining value and the sale is an arm's length sale, the sale price can be considered its fair market value.

If the property is not sold, then value is determined by evaluating information from sales of other comparable properties. Comparing an existing property to another property permits the person making the value determination to estimate its value by evaluating sales of other properties.

### **E. Valuing a Business**

Fractional Ownership shares; discounts for lack of control and lack of market.

Sound valuation decisions regarding business ownership are based upon all relevant facts, as well as on common sense, informed judgment, and reasonableness in weighing the facts and in determining their significance.

Among the factors that are considered are:

- The size of the block of stock being transferred in a corporation or share of a partnership.
- Two recognized discounts that are available are discounts for a minority interest and discounts for lack of marketability.
- The discount for a minority interest recognizes that a minority interest in a company that is not listed on a recognized exchange will be more difficult to sell than a larger interest.
- The lack of marketability discount recognizes that some property may only be of interest to a small group of buyers.

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

Valuing property interests for federal estate and gift tax purposes have allowed reasonable minority and lack of marketability discounts in various situations. What is an appropriate discount amount to be taken in reaching fair market value? Based on reported decisions discounts in the range of 20 to 30% are frequently allowed in cases where all requirements for eligibility are met. Eligibility will depend on the facts and circumstances of each case.

In cases where gifts of property were used to increase the ownership shares of the gift recipients, having the gift qualify as an annual exclusion gift is essential to saving the exemption equivalent to the annual exclusion.

From these decisions the IRS has drawn several conclusions:

- First, if the time period between events affecting the value of assets is short, it is likely that the Service will disregard the creation of a business entity that seeks to qualify for the reduced valuation.
- Second, despite the creation of a family limited partnership, the Internal Revenue Code provides the Service with authority to disregard common types of restrictions or limitations on the transfer of limited partnership interests which are often used to enhance eligibility for lack of marketability and minority control discounts.

Under these provisions when property is valued for federal estate or gift tax purposes the value of the property is determined without regard to any restrictions on the right to sell or use the property unless:

- the restrictions are part of a bona fide business arrangement;
- the restriction is not a device to transfer property to a family member for less than full and adequate consideration in money or money's worth, and
- the terms of the restriction are comparable to similar arrangements entered into by persons in arm's length transactions.

Each of the three elements must be met and it is clear that their focus is one of essential fairness, commercial reasonableness and a significant emphasis on the purpose or motive for carrying out the transaction.

To establish that transfers are annual exclusion gifts for Federal gift tax purposes, the person making the gift must establish that the gifts are present interest gifts. The person receiving the gift will receive property with the immediate right to use, possess and enjoy the property or the income and enjoy a substantial economic benefit from the property. Restrictions or limits placed on the right to transfer property will be closely reviewed in this regard.

### **F. Special Use Valuation of Land and Real Estate Used in a Closely Held Business.**

# Handbook on Estate and Succession Planning for Farm and Forest Landowners

## 1. Valuation Dates

A third estate planning opportunity to lower federal estate taxes is the value assigned to real property for estate tax purposes. The general rule for valuing property is its fair market value as of the date of the decedent's death. An alternate valuation date of six months after the decedent's death can be chosen by the estate if selecting the alternate valuation date lowers the value of the gross estate and lowers federal estate tax liability.

## 2. Valuing Land in a Closely-Held Business at its Use Value Rather Than Fair Market Value

Estates that include land used in a closely held business activity can elect to reduce the value of this land for federal estate tax purposes from its fair market value to the value it has in its particular use, subject to a maximum reduction which is 1,020,000 for decedents who die in 2011.

For purposes of the special use valuation rule, land used for farming purposes is considered to be used in an eligible business activity. Farming purposes includes planting, cultivating, caring for and cutting of trees or the preparation, other than milling, of trees for market. The Internal Revenue Service has ruled that merchantable timber and young growth should be treated as a crop and not as part of the real estate. However, the personal representative of an estate has a statutory opportunity to elect to treat the land as "qualifying woodlands" which results in growing trees being treated as part of the real estate for federal estate tax purposes. To be eligible for this election, the land must be used in timber operations and be an identifiable area of land for which records are normally maintained in conducting timber operations.

## 3. Requirements for Special Use Value Election for Federal Estate Tax:

To qualify for the election to specially value land at its use value rather than its fair market value several pre-death requirements must be met:

- For 5 of the 8 years preceding the property owner's death, retirement or disability, the property owner, or a member of his or her "family", must have "materially participated" in farming or other business in which the real estate to be valued was used. "Family" means an individual's ancestors, spouse, lineal descendants, and lineal descendants of a spouse of the person's parent or spouse of any of the mentioned people. "Material participation" for purpose of this valuation election is determined in the same manner as determining net earnings from self-employment in a trade or business. It generally involves consideration of the labor and effort that the individual directed to the business activity.
- Fifty percent or more of the value of the gross estate, less mortgages and debts applicable to real and personal property included in the decedent's gross estate, must be comprised of the adjusted value of real and personal property used in the business use.

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

- Twenty-five percent or more of the value of the gross estate, less mortgages and debts on real estate included in the gross estate, must be comprised of the adjusted value of the real estate used in the business use.
- If property is held by a partnership or a corporation, the decedent's interest in the partnership or corporation must meet other requirements. For a partnership the decedent's interest must be 20 percent or more of the capital interest in the partnership, or the partnership had 15 or fewer partners. If owned by a corporation, the decedent's interest in the corporation must be 20 percent or more of the value of the voting stock in the corporation, or the corporation had 15 or fewer shareholders.

Post death requirements:

- The specially valued property must pass to a qualified heir who continues the qualified use or faces an obligation to pay a recapture tax based on the tax savings generated by using the tax saving provision. A qualified heir is a member of the decedent's family as that term is described above.
- A qualifying use ends when the qualified heir is no longer financially at risk in the closely held business as to profits because the heir does not have an ownership interest in the farming operation or the heir, or a member of the heir's family does not materially participate in the qualifying use for a period of more than 3 years during the 8 year period that begins with the decedent's death.

### 4. Additional or "Recapture" Tax

If within ten years after the decedent's death and before the qualified heir's death, requirements for continuing eligibility are not met, an additional tax is imposed on the qualified heir which is the difference of what the federal estate tax would have been had the special use value election not been made and the estate tax that was paid as a result of the election.

Events which trigger this recapture tax include:

- The qualifying use ceases during the recapture period,
- The land is sold to someone outside the qualified heir's family, or
- The qualified heir or a member of his or her family ceases to materially participate in the qualifying use.

A surviving spouse who is the qualified heir of qualifying property can lease the property to a member of his or her family without having the lease treated as a termination of the qualifying use of the property.

If a personal representative elects to treat growing timber as "qualified woodland" and the special use valuation election is made, then a qualified heir's decision to dispose of or sever standing timber, or the right to sever the timber, is treated as a sale or



## Handbook on Estate and Succession Planning for Farm and Forest Landowners

disposition of a portion of the qualified heir's interest in the property. This disposition triggers an additional tax. This tax is calculated as the sale of a portion of the qualified heir's interest in the specially valued property. The additional tax imposed in such a situation is the *lesser* of the amount realized on the disposition of the standing timber or the amount of additional estate tax that would be due if the entire interest of the qualified heir in the qualified woodland were disposed of, less any other additional estate taxes imposed. If the qualified heir subsequently disposes of the heir's remaining interest in the specially valued property, the amount of additional tax paid when the standing timber was transferred will be deducted from the amount of additional tax calculated when the second disposition is made.

### 5. Calculating the special use value

By making the election to value the property in this manner, the qualified heir's tax basis in the property becomes the value calculated under the qualifying use. Use value in this context is determined according to one of two formulae. The first formula utilizes the average cash or crop share rental value of comparable land in the same locality minus real estate taxes. The figure obtained by this calculation is then capitalized by an average annual interest rate for federal land bank loans for the land bank district in which the land is located.

*For example, at Helen's death, she owned a 450 acre forest on which a brick farm house and barn were located. The acreage is in woodland consisting of mature northern hardwoods, mixed oak types and 25 acres of black cherry trees and is managed as a business. A fair market value for her farm is \$1,750,000. An adjoining property of comparable size and soil type has been rented on a cash basis for the last 10 years. Over the last five years, the average annual gross cash rent has been \$45,000. The average annual real estate tax has been \$5,500.00. After deducting the average real estate tax, the average rent net of taxes is \$39,500.00. The average rent net of taxes is divided by the average annual effective interest rate charged on federal land bank loans. For the year in which Helen died, this interest rate is 4.0%. The average cash rent net of taxes (39,500.00) divided by the average effective interest rate (4.0%) yields a special use value of \$987,500 ( $39,500 \div 4.0\%$ ).*

In valuing Helen's land for federal estate tax purposes, special use valuation rules will enable Helen's estate to reduce the value of the farm real estate from \$1,750,000 to \$987,500.

A second formula is used when sufficient information on cash or share rental of comparable land cannot be obtained.

Under this alternative method the following five factors are considered in calculating the value of the land:

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

- capitalization of expected income from the activity;
- capitalization of the fair rental value of the land in the closely held business use;
- preferential assessment values for the land;
- comparable sales of other land which are not affected by non-agricultural uses; and
- any other factor which fairly values the closely held business property.

The five-factor method generally results in a higher use value than a calculation based on capitalization of comparable rents, thereby decreasing the benefit to be gained by electing special use valuation in such cases.

### **A. The Qualified Family Owned Business Deduction**

#### **1. In General**

This estate tax opportunity will only apply if the 2001 Federal estate tax law returns and applies provisions that were in place in 2001. In the estates of people dying after 2013, section 2057 offers additional federal estate tax relief for owners of family owned businesses. That provision, known as the “qualified family owned business deduction”

#### **2. Amount of the Deduction**

The amount of the deduction coordinates with the exemption equivalent to the unified credit against federal and estate gift tax. The maximum family owned business deduction and the exemption equivalent to the unified credit is \$1.3 million of business assets in an eligible estate.

For example, an owner of a qualified family owned business interest died in 2013 when the amount protected by the exemption equivalent to the unified credit is \$1,000,000. The value of the qualified business interest is \$1,500,000. Since the value of the business interest is greater than the maximum qualified family owned business deduction, plus the exemption equivalent to the unified credit, the estate will be able to protect \$1.3 million of family owned business estate assets.

#### **3. Eligibility Requirements:**

To be eligible for the deduction, there are four requirements:

- The decedent must be a United States citizen at death;
- The estate executor must make a 2057 election and file a recapture agreement;
- The adjusted value of the qualified family-owned business interest must exceed 50% of the decedent’s adjusted gross estate; and
- The decedent, or members of the decedent’s family, must have materially participated in the operation of the business in an aggregate of at least five

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

years of the eight-year period ending on the decedent's death. Requirement 4) may create some difficulty where business assets may turnover quickly within any five year period.

Qualified family owned trade or business interests can be carried on as sole proprietorships or as other entities.

In regard to other entities, the decedent, or a member of his or her family must own (1) at least 50% of the entity, or (2) at least 30% of an entity in which members of two families own 70%, or (3) at least 30% of an entity in which members of three families own 90%.

For corporations, the family must own the required percentage of the total combined voting power of all classes of stock entitled to vote and the required percentage of the total value of shares of all classes. For partnerships, ownership is determined by the percentage of capital interests of the partnership.

Certain interests **cannot** be qualified as family-owned business interests, such as:

- interests in a business whose principal place of business is outside the United States;
- interests in a business whose stock was readily tradable on an established securities market or secondary market within three years of the decedent's date of death;
- the portion of the interest that is attributable to cash and/or marketable securities in excess of the reasonable expected day-to-day working capital needs of the business or certain passive assets; and
- an interest in a business if more than 35% of the adjusted ordinary gross income of the business for the year of the decedent's death was personal holding company income as defined by section 543 of the Internal Revenue Code.

Certain assets are considered as passive assets and not eligible for the family-owned business deduction. These assets include:

- assets producing interest, dividends, rents, royalties, annuities and personal holding company income;
- assets that are interests in a trust, partnership or real estate mortgage investment conduit that are not in an active business;
- assets producing no income;
- assets giving rise to income from commodity transactions or foreign currency gains;
- assets producing income that is equivalent to interest; and
- assets producing income from "notional principal contracts" or payments in lieu of dividends.

# Handbook on Estate and Succession Planning for Farm and Forest Landowners

## 4. Interest Passes to or is Acquired by a Qualified Heir

The person who acquires the qualified business interest must be a qualified heir, such as a member of the decedent's family, and includes a person's ancestors, spouse, lineal descendants, lineal descendants of a spouse or parent, or the spouse of any of the lineal descendants previously described. In addition, a qualified heir can also be any active employee of the trade or business who has been employed by the trade or business for at least ten years before the decedent's death.

## 5. Additional, or "Recapture" Tax

As is the case of the special valuation opportunity under section 2032A, the estate tax benefit of using the deduction can be recaptured in the form of an additional tax if within 10 years after the decedent's death and before the qualified heir's death certain events occur. This additional tax is imposed on the qualified heir and is based on the value of the qualified business interest that has passed to the qualified heir.

Events that trigger imposing this additional tax include:

- the material participation requirements are not met with respect to interests acquired from the decedent;
- the qualified heir disposes of a portion of the qualified family-owned business interest to other than a member of the qualified heir's family or a qualified conservation organization;
- the qualified heir loses U.S. citizenship or no longer is a U.S. resident; or
- the principal place of business ceases to be located in the United States.

The adjusted tax difference attributable to a qualified family-owned business deduction is fully recaptured as the personal responsibility of the qualified heir to the extent of the heir's interest in the qualified family-owned business if the recapture occurs within six years following the decedent's death. Thereafter the percentage recaptured thereafter is reduced in 20% annual increments, until 20% is recaptured in the tenth year. Interest on the recaptured amount is also due at the rate set for underpayment of taxes for the period beginning on the date the estate tax liability was due under this chapter and ending on the date such additional estate tax is due.

## H. Paying the Tax that is Due - In Full or in Installments

In general, the federal estate tax return and payment of federal estate tax is due within nine months of a decedent's death. However, an estate may have the option to elect an installment payment arrangement that includes interest at the rate of two percent on a portion of the unpaid tax allows the estate to pay the tax due in installments for 14 years beyond the normal tax payment date.

To be eligible for this installment payment option, the decedent must be involved in a closely held business when the decedent died. To qualify for the installment payment

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

option, the business must be considered an active business enterprise rather than simply being the passive owner of business assets.

A qualifying business interest must exceed 35% of the decedent's adjusted gross estate determined immediately prior to the decedent's date of death. Residential buildings and related improvements on land occupied on a regular basis by the owner or lessee of the land or by persons who are employed by the owner or lessee for purposes of operating or maintaining the business are included in the 35% calculation.

The election to pay federal estate tax is made on a timely filed federal estate tax return within the allowed time period for filing. Once the election is made, the installment payment arrangement will be based upon the unpaid tax that is due plus interest at the rate of two percent per year on the first \$1,340,000 of the taxable estate, which allows an estate in 2011 to have a favorable tax rate applied on those taxable assets that exceed the amount excluded by the unified credit.

### I. Student Exercises

1. Which of the following statements correctly describes the meaning of "incidents of ownership" as applied to the treatment of insurance policies under the federal estate tax law?
  - a. The person who has these "incidents of ownership" will receive the proceeds of the policy when the payable.
  - b. If a person has such "incidents" in a policy of insurance at the time of death, the value of the insurance proceeds will be included in the person's gross estate.
  - c. Having an "incident of ownership" will result in no federal estate tax being applied to the policy proceeds.
  - d. Incidents of ownership require that the policy proceeds be shared equally among all of the lineal heirs of the deceased.
  
2. Which of the following statements correctly describes the impact of electing to treat land and growing trees as "qualified woodland" for federal estate tax value purposes?
  - a. Qualified woodland is not subject to federal estate tax.
  - b. Qualified woodland is taxed at the lowest rate of federal estate tax.
  - c. For qualified woodland the value of the land is considered to be zero and the value of the timber is determined according to its fair market value.
  - d. None of the above statements is a correct statement.
  
3. Which of the following statements about the concept of valuing property by its fair market value is a correct statement?
  - a. The value of various things is reported annually in *The Book of Capital*

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

*Values* available in most public libraries.

- b. The value of anything is determined by the average amount of annual income, rent or profit that it generates over a five year period of time.
  - c. The value of anything is determined by what a willing and able buyer would pay to and be accepted by a willing and able seller of the property.
  - d. None of these statements is a correct statement.
4. If a business is owned by several people, which of the following statements correctly describes an important element in determining the value of an individual owner's share of the business?
- a. The value of an owner's share will reflect whether the owner's share is large enough to control action to be taken by the business.
  - b. The value of any share is determined by dividing the assets of the business by the number of owners.
  - c. The value of the owner's share will be determined by the value of the time and effort that the owner puts into the business.
  - d. The value of any share will be determined by the value paid for it when the share is sold in a commercially reasonable way.

### Short essay questions:

1. Briefly describe the impact that each of the following estate planning techniques will have on the amount of property that will be subject to tax: Special Use Valuation, and the Family Owned Business Deduction.
2. George and Laura are the owners of a 750 acre farm business that includes a woodlot of about 100 acres that includes northern hardwoods and mixed oak timber types. The farm business is currently a proprietorship in which George and two of his children, a daughter and a son, are involved. The mix of other assets that George and Laura own includes:
  - a. A collection of gold and silver coins from countries around the world and an extensive collection of American coins and paper money.
  - b. \$700,000 individual IRA's in each of their names.
  - c. A \$500,000 life insurance policy on Laura's life and a \$50,000 policy on George's life. Both George and Laura pay the premiums on the policies from a joint checking account they maintain. Each of them has designated the beneficiaries of the policies.
  - d. U.S. treasury bonds and treasury savings bonds that were issued before 1955.
  - e. Several pieces of machinery and equipment that were used in the farm business.
  - f. A number of Laura's paintings that were done over the last 40 years. Laura was an art major in College and continues to paint from time to time, particularly now that her children are grown and on their own.
  - g. Two complete sets of oak dining room (table, six chairs, and a breakfront

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

in each set) that George built by hand as his hobby. In addition to the furniture that is finished, George also a supply of oak, cherry and walnut boards in his workshop that are part of other projects that are not yet complete.

- h. George's workshop also includes a variety of wood working tools, equipment. Supplies, paints, lacquers and other furniture finishes that George uses in building furniture.

Based on this list of assets develop a plan for determining the value of the property that George and Laura own. All real property is owned by George and Laura, husband and wife. Other assets are owned in a variety of ways, some are considered separately owned, while others are not.

3. Mike and his wife, Sharon, prepared Revocable Living Trusts in January, 2001. When they created the Trusts each of them was named the Trustee of their own Trust and also successor Trustee if one of them died. At that time, their combined wealth was greater than 8 million dollars. In the assessment in 2001, they expected that when both of them died, the estate of the second spouse would pay a federal estate tax before the property was distributed to their designated heirs. Therefore they decided to engage as many of the estate planning opportunities as they could to reduce this tax obligation. One of the measures they chose was to separate their property when the first spouse died into two separate trusts, a decedent's trust and the survivor's trust. The allocation of assets going into each of these trusts was to made by the Trustee or Successor Trustee and the purpose of the allocation was to accomplish two things: First, reduce or eliminate federal estate tax when the first spouse died; and, Second, reduce or eliminate federal estate tax when the surviving spouse died.

In 2010 Sharon died and Mike survived her. At the time of her death, the value of their combined wealth was reduced to 7 million dollars. Today, the estate value is 6.95 million dollars

Based on these facts discuss the impact of federal estate taxes on the estates of Mike and Sharon 2001, in 2010 when Sharon died, and in 2011 as Mike continues to own the property.

**Chapter 11. Using Gifts in Estate Planning**

**A. Overview and Purpose**

To many people, giving property away during lifetime accomplishes several important goals. In this chapter we will examine these goals and the impact they have on estate planning objectives. Some of the items discussed in this chapter will apply the ideas and concepts discussed in chapter 9, the Tax Aspects of Estate Planning.

The opening discussion will examine legal issues that surround the concept of a gift. Understanding the concept will then turn attention to use of gifts in estate planning situations. A popular form of gift is a gift to a charity. The discussion will examine the nature of such transactions by describing common types of charitable gifts. The chapter will review the income, inheritance and estate tax issues to understand before using gifts in estate plans.

**B. Lesson Objectives**

When you have successfully completed this chapter you will be able to accomplish the following objectives:

1. Discuss the legal requirements of lifetime gifts.
2. Discuss the role lifetime gifts can play in solving estate planning problems and describe the situations to which a gifting program can be applied.
3. Describe and compare the various types of charitable gifts commonly used in estate planning today.
4. Discuss the income, estate and gift tax issues to consider before making lifetime gifts part of an estate plan.

**C. What is a Gift?**

A gift is a transfer of property to another person without any consideration or benefit given in return for the property. Gifts can be compared to sales and loans. A gift is distinguished from a sale in which parties exchange something of value with each other. A loan on the other hand has a clear intent to either return the property or repay the funds advanced.

- Gifts can be made to total strangers, close family members, or to institutions whose function is to promote the welfare of mankind and the community.
- A gift can be either total or partial.
- A gift can be either a gift of a present interest or a gift of a future interest.

A total or complete gift is a transfer in which the recipient does not give any consideration or property value to the former owner of the property who transfers the property. A partial gift is one where the recipient of the property transfers some consideration to the former owner, but the value of the consideration is less than the value of the property received by the recipient. A gift of a present interest is a gift that the recipient is able to enjoy now,



## Handbook on Estate and Succession Planning for Farm and Forest Landowners

while a gift of a future interest is one in which enjoyment of the gift property is delayed until some future time or situation.

*For example, if a parent lends money to a child and charges the child a small amount of interest on the loaned funds, the parent has made a gift to the child of the difference between the market rate of interest that lenders normally charge on loans of this type and the rate of interest the child agrees to pay the parent.*

*Likewise, if someone decides to transfer valuable property to another person or entity and the documents that evidence the transfer refer to the fact that the recipient purchased the property for one dollar; the seller of the property makes a gift of the property by transferring it for less than its fair market value.*

If a partial gift is one in which the value of the item given away is greater than the value of what is given in return for the item, how can I distinguish partial gifts from other transactions in which property is transferred but the value of what is given does not equal the value of what is received? Not all situations in which someone transfers something for less than it is worth are considered to be gifts, so it is important to distinguish these transactions. In such cases, three requirements distinguish gift transfers from other transfers.

### D. Distinguishing Gift From Other Transfers

#### 1. Intent to make a gift

The first requirement is that the owner who transfers the property intends to make a gift when the transfer is made. Evidence of such intent may be found in a person's own written or spoken words or by evaluating a variety of typical situations that the person has behaved in the past. The importance of establishing a person's intent is seen in a variety of situations, such as where a person gives away something of great value and receives something of lesser value in return. In general, this situation would not be considered as a gift because the intent to make the gift is lacking. In some situations, a legal presumption arises that a transfer is not a gift.

*For example, if a person creates a joint ownership interest in a bank account in which only his or her funds are deposited, the Uniform Probate Code law presumes that the joint owners intend for each owner to have access during their lifetimes to only that portion of the account which represents their contribution to the account. If only one person contributed funds then only that person would be entitled to withdraw funds from the account while both joint owners are alive. During lifetime, it is presumed that the joint owner who contributes little or nothing to the account is to have access to only that which he or she contributed. At the death of one of the joint owners, however, the rights of survivorship feature of this form of joint ownership transfers ownership of the remaining balance of the account to the surviving joint owners.*

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

To overcome this presumption and create a joint account in which each owner is entitled to access to the full fractional share of each owner, even if no contributions were made, the owner must establish the intent to do so by clear and convincing evidence. An owner who wants to overcome the presumption is able to do so, but the terms on which it is done must be clear and without doubt.

*For example, assume a person creates a joint account with right of survivorship another person. Funds in this account came from only one person, the person who owned the property before the joint account was created. At the time the joint account was created the person who owned the money had a valid will that directed her person property was to be distributed to other people. When the person dies who should receive the funds in the joint account? The people who are named in the will or the surviving joint owner who contributed nothing to the account before it was created? The fact that a person has a will that would give her property to designated people is generally not enough evidence of intent to overturn the effect of the survivorship feature which would give the surviving joint owner control over the funds in the account when the original owner died.*

In another example, suppose the owner created the joint account simply to authorize someone else to have access to the account from time to time. The owner had no intent of making a present or future gift of the account to anyone else. To accomplish that intent, the property owner should designate the other person who has access as their agent under a power of attorney. That action will give the agent authority during the original owner's lifetime, but will not transfer the balance to the agent when the original owner dies. If that is the outcome the owner intends to happen, then a power of attorney and not a joint account should be used to accomplish it.

In addition to state property law presumptions regarding whether a gift is made, the federal gift tax law also impacts on specific transactions when the gift tax law is in place:

- When a joint ownership interest is created in a joint bank account, for federal gift tax purposes, a gift does not occur until money is withdrawn from the account by the recipient of the gift.
- If the recipient of the gift contributed some of the funds in the account, a gift does not occur until the recipient withdraws more money from the account than he or she had contributed to it.
- United States savings bonds are considered gifts when the bond is surrendered by the recipient for his or her own benefit.
- Delivering a check to another person is not treated as a gift until the check is paid or transferred for value to someone else.
- A person who holds a power of appointment over property holds the power to determine who will own or enjoy the property over which the power operates. Powers of appointment are created by someone other than the person who holds the power. The exercise or release of a power of appointment is treated as a gift

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

if the exercise or release was made without adequate consideration.

### **2. Transfer of Dominion and Control**

The second requirement of a gift is that the owner of the property must give up full dominion, ownership and control of the item to the person who receives it. A person who is unwilling to give up control of an item and retains some control over or interest in property does not make a gift of the property.

### **3. Acceptance of the Gift**

The third requirement is that the recipient of the gift actually receives and accepts it. No one can be forced to accept a gift if the person does not intend to do so.

## **E. How Are Lifetime Gifts Used in Estate Planning?**

For estate and succession planning purposes, lifetime gifts are used to shift ownership of assets out of the hands of a person who does not wish to be the owner of the property and into the hands of another who can benefit from ownership. For succession planning purposes, gifts can be used to allow a succeeding owner to build an ownership interest in the business.

The former property owner reduces the size of the assets under his or her ownership and shifts control to the succeeding owner. This in turn reduces the potential size of the former owner's gross estate for federal estate tax purposes and the estate subject to inheritance tax. If the transferred property generates income or enjoys substantial appreciation in the future, the income and future appreciation are also credited to the recipient, rather than the former owner. To those property owners who face the possibility of having estate and inheritance taxes imposed on the transfer of property after their death, lowering the value of their total assets has a direct impact by lowering the taxes they pay.

Gift-giving has often been used to reduce the size of a person's estate that could be subject to inheritance and estate taxes. If the property is given away during a person's lifetime, then it generally cannot be part of the person's estate at their death. Gifts designed to avoid federal estate tax consider the impact of federal gift taxes and in some cases state gift taxes as well. These laws created an additional consideration in deciding to make a gift. In addition to gift tax concerns, state and federal income tax laws create income tax impacts. These issues will be discussed in other places in this handbook.

*For example, a person who owns property valued at \$7,650,000 develops an estate plan that calls for annual gifts of \$13,000 to each of her five children and grandchildren in 2011 and continuing for the next five years. By completing this gift giving program, the owner reduces the size of her estate by \$325,000.*

*If the owner had not made these gifts and died in 2011, the federal estate tax*

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

*on the owner's gross estate of \$7,650,000, less the unified credit of \$1,750,000, would be \$927,500 ( $\$7,650,000 \times .35 - 1,750,000 = \$927,500$ ). By reducing the estate by the \$325,000 that was given away, the owner saves 113,750 in potential estate taxes ( $\$325,000 \times .35 = \$113,750$ )*

For married couples, the ability of one spouse to transfer any unused portion of the exemption equivalent to the unified credit to a surviving spouse is an important tool in the estate plan intended to maximize use of the unified credit in the estate of each spouse.

Transfers between spouses are subject to an unlimited marital deduction for federal gift tax purposes. This enables the couple to rearrange ownership of assets to save federal estate taxes at the death of the spouse and with no lifetime gift tax consequence. If property is jointly owned between spouses, the joint ownership interest can be severed into two, tenant in common interests that enable each spouse to claim an undivided one-half interest in property.

In the case of succession planning for closely held business assets, gifts of assets or shares of stock or partnership interests enable majority owners to shift control of a business to junior owners who are building their ownership share. The principal considerations here are the ease with which the transfer can be made and the estate tax consequence of having made the transfer. Businesses owned in corporate or partnership form also have the advantage of being transferred more easily than those owned as proprietorships.

Transfer of proprietorship assets is generally accomplished on an asset by asset basis or as a "going concern" where all business assets are sold in a single sale. Transferring shares of stock that represent ownership of all business assets is significantly easier to accomplish. In contrast to the ease of transfer of stock or partnership shares, valuation of small business stock and partnership transfers generally requires valuation of the business as a whole in order to determine the relative value of stock shares or partnership interests. Proprietorship assets, in contrast, are valued individually and some may be valued quite easily, such as vehicles, equipment, or livestock.

### **F. Factors involved in Gift-Giving Programs**

In evaluating a gifting program, property owners consider the uncertainty of what tomorrow's financial needs may be. The most significant uncertainty confronting us today is the issue of long term care. How long will each of live and will we be able to afford the care we need when that need arises? What planning options are available and what factors influence a person's choice from among the various options? How expensive are these choices? How will the expenses be paid?

Saving death taxes may seem like a practical way to assure the transfer of a large portion of the estate to intended heirs but it also influences the property owner's current financial picture. At what point does saving future transfer tax affect current financial

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

needs and requirements?

Property owners who decide to embark on a gift giving program have many things to consider. If assets such as farmland, forest land or real estate used in a closely held business are owned, these assets may be able to take advantage of special valuation or installment payment opportunities for federal estate tax purposes. To the extent that these opportunities provide significant tax saving to the estate, retaining the real estate and passing it after death may provide more desirable benefits to a property owner than giving it away during lifetime. Assets that yield significant income to a high income tax bracket taxpayer may be ideal candidates for gifts to those whose income is taxed at lower rates. Transfer of assets that are expected to appreciate in value transfers the property, as well as its future appreciation. Gifts to qualifying charities can yield an income tax benefit through provisions for an income tax charitable deduction as well as estate tax benefits through a charitable deduction for estate and inheritance tax purposes.

When an owner transfers property to another, the owner transfers the owner's income tax basis to the recipient. In the case of a high value, but low income tax basis item, the low basis may affect the recipient's future plans to sell the property by imposing significant tax on the gain from the sale. Individuals who die after December 17, 2010 will face a potential federal estate tax, but also face return of the "step up" in basis rules which can be used to reduce capitals gains from the sale of capital assets that were inherited from an estate. See chapter 9 for a complete discussion of these rules

Gifts to children under the age of majority, which is 18 years in most states, present gift giving considerations. Making the transfer will benefit the adult owner, but the minor child who receives the property may be unable to legally control the property or may lack the maturity to deal with it responsibly. Coupling these concerns with the gift tax annual exclusion requirement of transferring a present interest in the gifted property to the child further complicates the problem.

Gifts to children qualify as present interest gifts if:

- The property and the income it generates may be spent by or for the benefit of the children before their 21st birthday.
- Whatever balance remains is distributed to the children at that birthday.
- If a child dies before reaching age 21, the balance must be payable to the estate of the child or be appointed by the child under a power of appointment to someone else.
- Gifts of property passing to a trustee for the benefit of the minor beneficiary must meet these requirements in order to qualify as a present interest.

Gifts to minor children of a present interest can also be made under the Uniform Transfers to Minor's Act (UTMA).

- Under this act, the donor transfers the property to a custodian who is designated

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

to hold the property for the minor child under the provisions of the Uniform Transfers to Minor's Act.

- By making this transfer and designating the custodian, the property is considered to be the minor child's.
- The custodian's role in this transfer is to facilitate transactions involving the property until the child reaches the age of 21 and to pay over to the minor child the balance of the custodian account when the child reaches age 21.

If a child's parent transfers property under the UTMA, and the parent is the custodian for the minor child, several conflicting issues arise. For purposes of federal estate taxes, the role of a parent as custodian for his or her own child is viewed as the parent retaining ownership and control of the property such that the transferred property is included in the federal gross estate of the parent who dies before the property is transferred to the child at the child's 21st birthday. The UTMA clearly indicates that transfer to a custodian under the act results in an effective transfer to the child. Reconciling this dispute and the accompanying confusion it can create may best be accomplished by naming an unrelated party as custodian for the child.

Another method of designating ownership of bank accounts for minor children is a tentative trust. This type of ownership lists a trustee as owner of the bank account and adds the designation, "in trust for" a minor child. In this situation, unless there is clear and convincing evidence of a contrary intention, this account is considered to be the property of the trustee during the trustee's lifetime. If the parent of the child is the trustee, the parent is considered to be the owner of the property during lifetime. Tentative trusts are not considered gifts of a present interest of the money in the account. After the trustee's death, the balance in the trust account is the property of the beneficiary described in the account title. If more than one beneficiary is named, there is no right of survivorship between the beneficiaries, unless the account specifies this relationship.

### **G. Gifts to Charities and Other Institutions**

In the context of estate planning, transfers to charities, whether during lifetime or at death, are treated in special ways. The tax considerations of such gifts involve income, estate, gift and inheritance taxes. If the lifetime gift of property is eligible for an income tax deduction as a charitable contribution, the property owner may be able to achieve a savings at three levels. Death transfer taxes will be reduced because the size of this owner's estate will be reduced, no gift tax will be imposed because of the gift tax charitable deduction for gifts to charities and income taxes will be reduced as a result of the income tax charitable deduction.

What types of gifts qualify for a charitable deduction?

- Gifts made in a calendar year to or for the use of the federal government or a state or local government body for exclusively public purposes are entitled to a charitable deduction. Certain Indian tribal governments are treated as states and,

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

as such, gifts to these tribal governments qualify as deductible charitable contributions.

- Transfers to a corporation, trust, community chest, fund or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, organizations that foster amateur sports competition and organizations for the prevention of cruelty to children or animals are likewise entitled to a charitable deduction. These organizations qualify for a deduction as long as no part of their net earnings benefit a private individual and no substantial activity is undertaken to carry on lobbying efforts or participation in a political campaign.
- Transfers to other organizations such as fraternal societies, orders or lodges that use property exclusively for religious, charitable, scientific, literary or educational purposes also qualify for a deduction as long as no part of the net earnings of the organization benefit private individuals.
- If a transfer to a charitable organization is contingent on a particular act or occurrence, a deduction is allowed only if it is virtually certain that the transfer will become effective and the contingency can be ignored.

If you have a question about whether a specific organization is considered a charitable organization you can check with the IRS to determine if the gift you are making, the organization that receives it and the use to which the donation will be put qualify for charitable deduction treatment.

Gifts to charities can be of several different types, such as direct gifts, indirect gifts made to a trust, gifts of a full interest and gifts of a partial interest. Direct gifts to charity of a full interest in property are measured by the value of the property at the time the gift is made. In this situation, the owner transfers property directly to the charity which takes over ownership and control of the item from that point forward. Direct gifts to charities of a partial interest in property may be either gifts of a fractional ownership share in the property, a remainder interest in real property, such as a home or land transferred in trust or a gift of a qualified conservation easement to a qualified organization for conservation purposes. Chapter 12 discusses qualified conservation easements in more detail.

A gift can be delayed until a certain event occurs. Suppose a person wants to make a gift, but delay the transfer of the gift until she dies. In such as case the owner would retain a "life interest" in the property and the gift to the charity would be considered a "remainder interest" in the property. If a trust is used, the gift to the charity would be known as a "charitable remainder trust". Once the decision is made to use a charitable remainder trust, the trust can take one of three forms, a remainder **unitrust**, an **annuity trust** or a **pooled income fund**.

A **unitrust** provides for an annual payout from the trust of an amount equal to a fixed percentage, which must be at least 5%, of the net fair market value of the trust assets as valued each year. These annual payments are made to one or more persons who are living at the time the trust is created. At the death of the beneficiaries, or at the end

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

of a term of up to 20 years, the remainder interest is held for the benefit of the designated charity or paid to it.

A charitable remainder **annuity trust** is a trust from which a specified amount is paid at least annually to one or more persons who were living at the time the trust is created. The amount paid to the beneficiaries must be at least 5% of the initial fair market value of the property placed in trust. At the death of the last income beneficiary, or at the end of a fixed term of up to 20 years, the remainder interest must be paid for the benefit of a qualified charitable organization or paid to it.

A **pooled income fund** is a trust maintained by a charity to which donors transfer property by contributing the remainder interest in the property to the charity. In such funds donors can keep an income interest for life or create an income interest in the property for the benefit of another beneficiary who is living at the time the trust is created.

### H. Income, Inheritance, Gift and Estate Tax Issues of Gift Giving

This section reviews the tax issues that are most directly involved with gift giving programs that are part of an estate or succession plan. The following list of questions will review and highlight the issues:

#### 1. Income Tax Issues

- a. Is the recipient of the gift a qualifying organization that permits the donor of the property to receive an income tax charitable deduction for the gift?
- b. What is the value of the gift for income tax deduction purposes?
- c. What is the income tax basis of the property in the hands of the former owner? What is its purchase price? What improvements or other adjustments to basis were made during the donor's period of ownership?
- d. What will the recipient of the property do with the gift after receiving it?
- e. Is the donor of the property eligible to take advantage of the onetime federal income tax exclusion of up to \$250,000 of capital gain from the sale of a personal residence? ). This question is asked to evaluate the option of selling the property rather than gifting it.

#### 2. Estate Tax Issues

- a. Within three years of the decedent's death did the decedent transfer a life insurance policy, transfer property in which the decedent retained a lifetime interest, a transfer taking effect at death, or a transfer in which the decedent retained a right to revoke it?

#### 3. Gift Tax Issues

- a. If a gift is made, will the gift qualify as a gift of a present interest?



## Handbook on Estate and Succession Planning for Farm and Forest Landowners

- b. If a gift is made, will the value of the gift exceed the amount of the gift tax annual exclusion? If the donor is married, is the donor's spouse willing to "split" the gift?
- c. Will the donor make a gift of tuition paid directly to an educational institution on behalf of a student at the institution?
- d. Will the donor make a gift in the form of payment for medical care and services or medical insurance provided to another person?
- e. Will the donor make a gift to his or her spouse that will qualify for the gift tax marital deduction?
- f. Will the donor make a gift to a qualified charity that will it qualify for the gift tax charitable deduction?

### 4. Generation Skipping Transfer Tax Issues

- a. If a gift is made, is the recipient of the gift two or more generations younger than the donor, or is the recipient more than 37 1/2 years younger than the donor? If the gift is made from a grandparent to a grandchild, did the parent of the grandchild die before the gift is made?
- b. If a gift is made will the gift qualify for the gift tax annual exclusion, or the special exclusions for tuition paid directly to an educational institution or for the payment of medical care or service expenses?
- c. If a gift is made to which generation skipping transfer tax can apply, does the donor have all or part of his or her generation skipping transfer tax exemption available to apply to the gift?

### I. Student Exercises

#### Multiple Choice Questions

Please read the questions carefully, and then select one of the four choices following the question that correctly answers the question asked.

1. Which of the following statements does **not** describe one of the requirements of a valid gift for property law purposes?
  - a. The person who receives the property is willing to receive it.
  - b. The person who gives the property intends to transfer the property without receiving something of equal value in return.
  - c. The property given away is less than \$13,000 in value.
  - d. The person giving away property surrenders dominion and control over the property to recipient.
2. Jeffrey wants to transfer his land to his son Jerrold, but he is not ready to turn it over to him completely. Therefore, Jeffrey prepared a deed to the farm that transfers the farm to Jerrold but retains the right to live on the property for the balance of his life. Jeffrey signed the deed, had his signature notarized and put it

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

in his desk drawer without ever giving it to Jerrold or recording it with the Recorder of Deeds. Jerrold has no knowledge of what his father has done.

Based on these facts and our discussions of gifts, which of the following statements about the legal nature of Jeffrey's transfer to Jerrold is correct.

- a. Jeffrey's deed is a valid transfer since he prepared a formal deed.
  - b. Jeffrey's deed is not a valid transfer since the deed was never delivered to Jerrold.
  - c. Since Jeffrey placed the deed in his desk drawer, Jeffrey created a life estate in the farm for the balance of Jeffrey's life.
  - d. Jeffrey's attempt to retain an interest in the property after giving it to Jerrold is ineffective and Jerrold can ignore it.
3. George wants to share some of his good fortune with his neighbors in Happy Valley. After talking with the local high school officials, George decided to sponsor a high school student who wants to attend college, but doesn't have the money to do so. George agreed to pay the tuition for the student to attend George's alma mater. Tuition for undergraduate students at that University is \$27,000 per year.

Based on these facts and our discussion of gifts for federal gift tax purposes, which of the following statements about the federal gift tax is correct?

- a. Each tuition payment that George makes on behalf of the student is a taxable gift on which George is responsible to pay federal gift tax.
  - b. Since the gift is less than \$30,000 in any single year, the gift meets the gift tax annual exclusion.
  - c. If George pays the tuition directly to the University on behalf of the student, George's payment will be exempt from federal gift tax.
  - d. If George dies within three years of making any of these tuition payments, the payments made within that time will be taxable gifts.
4. Which of the following factors is NOT a reason to make gifts of property to qualified charities?
- a. Reduces the potential size of the donor's federal gross estate.
  - b. Obtains an income tax charitable deduction.
  - c. Increase income from private investments.
  - d. Transfer property without having to pay federal gift tax.
5. When a person gives property away to another person, what is the recipient's income tax basis in the property?
- a. The recipient's basis is its fair market value at the time of the gift.
  - b. The recipient's basis is equal to whatever consideration the recipient gave

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

- to receive the property.
- c. The recipient's basis in the property is zero.
- d. The recipient's basis in the property is the same as the basis of the donor of the property.

### Short Essay Questions

Please read each question carefully and then respond to what is asked for at the end of the question. Your answer need not be long or involved, but it should be as clear and concise as possible. If you want to refer to important facts in your response, please feel free to do so.

1. Nicholas and Alexandra want to reduce the potential size of their federal gross estates by making gifts of property during their lifetime. The people they want to benefit by their gifts include their children, their families and several charities, including a church and a university hospital.

Nicholas and Alexandra own 2 parcels of farm land. One was purchased in 1950 for \$50,000 and is now worth \$500,000. The second was inherited from Alexandra's father 30 years ago. Real estate development is surrounding the second farm and its value is increasing rapidly. Some people say it is worth \$8,000,000.

Among their other assets, Nicholas and Alexandra have several joint bank accounts, certificates of deposit, and they own stock in several companies that are traded on the national stock exchanges.

Several years ago Nicholas and Alexandra formed a corporation when the oldest of their children decided to come back to help manage the farm land. Since then the child has been an excellent contributor to the business and she wants to stay and eventually manage the business on her own. Two other children are in the family, but neither child is interested in the business. One aspires to be an astronaut. The other is a software developer.

Based on our discussion of the factors that influence gift-giving decisions, evaluate Nicholas and Alexandra's situation and suggest which assets they might give to their children, to the church or to the university hospital.

2. Geraldine decided to open a new bank account after she received proceeds from the sale of her farm. Because she is elderly, she decided to name her daughter joint owner with the right of survivorship, even though her daughter had not contributed any funds to the account. Geraldine chose her daughter to be joint owner because her other two sons live out of the area and Geraldine has a better relationship with her daughter than with her sons.

When the account was opened, Geraldine's daughter signed the bank signature

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

card, but Geraldine maintained the account cards needed to withdraw money. Based on our discussions of gifts, what right does Geraldine's daughter have to withdraw funds from the account during her lifetime and after Geraldine's death?

3. Thomas, an elderly widower, is in failing health. After his wife Martha's sudden death he became lonely and fell ill. Knowing that his health is failing, Thomas asked his oldest son, Ken, to help him distribute some of his property. Thomas asked Ken to draw four checks, each in the amount of \$25,000, from his checking account and pay them to Ken and Thomas's other children. In addition, Thomas asked Ken to issue a check in the amount of \$20,000 to Thomas's neighbors, the Mullin family. Thomas wants to help the family send their oldest son to college next year. Thomas's final instruction was to issue a check in the amount of \$15,000 and pay it to Martha's favorite charity.

Ken carried out all of Thomas's instructions and delivered the checks. Four months later, after a bout with pneumonia, Thomas died in his sleep. Based on our discussions of the tax implications of gift giving, what tax issues do you recognize in this situation?

## Chapter 12: Conservation Easements: Valuing Property Subject to a Qualified Conservation Contribution

### A. Overview and Purpose

When planning their estates, farm and forest landowners may consider selling or donating a conservation easement. Such a decision may allow them to receive income and estate tax relief while maintaining private ownership of the land and ensuring that it remains as farms or forests. A conservation easement is a legally binding agreement that permanently restricts the development and future use of land to achieve a conservation objective. An easement can either impose limitations on an owner or create obligations that a landowner must meet to avoid sanctions or penalties for the violations. Conservation easements are flexible tools and can be created for a variety of purposes, including:

1. Retaining or protecting for the public and economic benefit the natural, scenic, or open space values of real property;
2. Assuring its availability for agricultural, forest, recreational or open-space use;
3. Conserving or managing the use of natural resources;
4. Protecting wildlife;
5. Maintaining or enhancing land, air or water quality, or
6. Preserving the historical, architectural archeological or cultural aspects of real property.

When a landowner grants an easement to an organization or agency, the owner voluntarily gives up some ownership rights, or interests, in the property. The result is shared ownership among the owner of the land and the holder of the conservation easement. Agencies and organizations that hold conservation easements are committed to conservation goals and they acquire development rights through easements in order to eliminate the possibility of future development. As such, a landowner who sells or donates a conservation easement to one of these entities is often said to have “extinguished” the right to develop the land. Easement holders are responsible for enforcing the terms of the easement and they typically conduct annual monitoring to ensure the conservation values protected by the easement are in fact being conserved.

Conservation easements supplement land use and environmental regulation by giving property owners incentives for making decisions that provide the desired outcome of wildlife protection, environmental protection of open space protection from development. The following discussion describes the requirements for making the donation of a conservation easement to a qualified conservation organization. It is one type of action landowners can take in response to these incentives. However, before making the decision to grant a conservation easement, landowners should consider what some believe to be the principle shortcomings associated with these easements.

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

When landowners agree to restrict the use of their land, how will these restrictions be enforced? If the restrictions are not enforced, is the landowner taking the incentive without giving up anything? Landowners who restrict use of their land will want to retain specific rights regarding use of their land after restrictions are in place. The conservation organization that holds the easement may have a different idea of what the landowner should be able to do after the easement is in place. There is a potential for conflict between landowners and organizations concerning use of land that is subject to an easement.

The discussion below discusses requirements for a charitable deduction for the value of the easement donated to the conservation organization. Some people disagree that measuring the decrease in appraised fair market value is the proper method of measuring the value of the easement, or measuring what the landowner gives up as a result of making this transfer. Experience has also shown that the values are often subjective, vary from appraiser to appraiser and present the potential for abusive overvaluation.

The incentives that are provided to landowners are based on the expectation that public benefits will flow from the restriction. People are questioning whether those benefits are real and whether the benefits exceed the cost of the incentives offered to landowners. Some even question whether it has been sufficiently established that the public does benefit from conservation easements.

Conservation easements present land use planning challenges to local communities, particularly those communities which are not equipped to identify where these properties are located and to determine how the easement restrictions comply with land use restrictions already in place. To some degree the incentives to property owners flow from public funds. If public funds are involved, does public access to the restricted land come as a result of public funding for the easement?

These are just some of the questions concerning conservation easements that are being debated at present. Responding to each of these issues is beyond the scope of a publication such as this that highlights techniques and ideas for people who want to proceed with estate and succession plans. But, these problems are important and should not be dismissed without any consideration. Therefore, landowners who consider granting an easement should also consider these questions for they involve the land owner in many aspects and provide some idea of what potential issues may arise after the easement is granted. A decision on granting the easement should be made after considering all of these questions.

The agreement between the landowner and the organization that holds the easement will be embodied in an easement agreement. Elements of this easement agreement should include its purpose, what and how it achieves certain conservation objectives, and all restrictions and obligations placed on the land-uses. Landowners should also recognize the importance of considering what rights they wish to retain in the property after the easement is granted. The nature of the landowner's rights will affect the

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

owner's qualification for income tax and estate benefits. A conservation easement should be individually tailored to the character of each property and the desires of its owner.

An easement has important economic considerations attached to it if it is created for purposes of promoting conservation goals and it is donated to a government body or a charitable corporation or trust that is exempt from taxation under Internal Revenue Code requirements. Such transactions offer the landowner an opportunity for an income tax deduction against current income when the donation is made and additional deductions in calculating federal estate tax.

Landowners should be aware of the numerous legal and economic considerations regarding easements. This chapter discusses how farm or forest land may qualify for a conservation easement and the tax advantages that apply as a result of donating the easement. This chapter does not discuss the tax implications from the sale of a conservation easement.

To receive favorable tax treatment from a **donation** of a conservation easement there must be a qualified real property interest, a qualified organization to receive the easement, and a qualified conservation purpose that yields a significant public benefit. The following discussion will describe basic aspects of conservation easements, the income tax deduction requirements and a discussion of the estate valuation deduction requirements.

### B. Lesson Objectives

When you have successfully completed this chapter you will be able to accomplish the following objectives:

1. Explain what the concept of a conservation easement is and how it affects a property owner.
2. Discuss the income and estate tax benefits arising from donation of a conservation easement.
3. Discuss the requirements for the donation of a conservation easement to qualify for income and estate tax benefits.

### C. Conservation Easements

Conservation easements have become an attractive tool for achieving land conservation objectives. Rising real estate values and resulting higher property taxes threaten sale of forest and farmland for development. Most landowners want to do what is right for their land, but their decisions must also make economic sense. A conservation easement is one tool that can be used to accomplish both objectives. It is a voluntary action of the landowner intended to save various types of taxes, preserve the inherent productivity and character of property, and ensure that the lands remain in their current use *forever*, free from the threat of development. A conservation

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

easement is a legally binding agreement that permanently restricts the development and future use of the land to ensure protection of its conservation values. As described above, conservation purposes are many and varied, so landowners have a wide variety of ways that conservation easements can be used.

The rapidly growing conservation land trust movement was sparked by changes to the Internal Revenue Code that promote tax incentives for the preservation of land. Many conservation easements are held by or acquired by land trusts. A conservation easement is a formal document that is recorded in the same office where documents that prove ownership of land are recorded. Because the transfer of the easement is a transfer of an interest in the land, it continues in effect after the owner who donated the easement transfers the remaining interest to someone else. In other words, a conservation easement stays with land even when ownership of the land changes. Conservation easements are attractive to both land use planners and landowners for a number of reasons, including: 1) it is voluntary (it is not a regulation but is restrictive), 2) each easement is tailored to desires of each property owner and the characteristics of the property involved, 3) it keeps the property in private hands and on the tax rolls, and 4) it costs less than an outright acquisition of full ownership of the land. Tax benefits depend on whether the easement was donated or sold, the income of the landowner, and difference between the land value before and the value after the easement.

In recent years, conservation easements have created significant controversy. The IRS and the media have directed public attention to situations where tax benefits were claimed, but public benefits were not received in return. Examples of this include inflated values for the easement interest that is sold or donated. Also, there are situations in which landowners no longer follow the restrictions imposed by the easement while still retaining the tax benefit they received. No one or no organization stepped in to this situation to enforce the terms of the easement for which the tax benefit was given. This has led some to believe that conservation easements are simply a tax scheme that allows people to evade their otherwise lawful obligations and force honest taxpayers to pick up the burden they avoided. Members of conservation groups will aggressively disagree with these characterizations, but it is important to recognize the controversy associated with conservation easements.

### **D. Tax Aspects for Donation of Conservation Easements**

#### **1. In General - IRC section 170**

Lifetime transfer of a *qualified conservation contribution* is the contribution of a qualified real property interest to a qualified organization exclusively for a conservation purpose. Such transfers qualify the landowner to take an income tax deduction under section 170 of the Internal Revenue Code (IRC) for the value of the contribution. As will be seen below, such transfers also enable the landowner's estate to take an additional deduction under section 2031(c) of the IRC against the value of the remaining property interest retained by the landowner at the owner's death. In order to take advantage of the deduction against the value of the property in the decedent's estate, the transfer must



## Handbook on Estate and Succession Planning for Farm and Forest Landowners

first qualify for the income tax deduction.

*A qualified real property interest* can be one of several different property interests. It can be the landowner's entire interest in the property, other than a qualified mineral interest. A qualified mineral interest is the landowner's interest in subsurface oil, gas, or other minerals and the right of access to them. A qualified real property interest can also be a remainder interest in property, or a perpetual conservation restriction, which specifies permissible property uses. For the most part, the terms *easement*, *conservation restriction*, and *perpetual conservation restriction* have the same meaning.

In order for a *qualified organization* to be eligible to hold the conservation contribution, it must have a commitment to protect the conservation purposes of the donation, and have the resources to enforce the restrictions. Such an organization is a governmental unit, an organization created and operated primarily or substantially for one of the conservation purposes specified in IRC section 170, a charitable organization that meets the public support test of the IRC, or a charitable organization that is controlled by an organization that meets any one of these requirements.

*A qualified conservation purpose* can mean one of several different things: 1) it can mean the preservation of land areas for outdoor recreation by, or for the education of, the general public; 2) it can mean the protection of the natural habitat of fish, wildlife, plant communities or similar ecosystems; 3) it can mean the preservation of open space, including farmland and forest land, where such preservation is for the scenic enjoyment of the general public, or the action is pursuant to a clearly defined and described Federal, state or local government conservation policy, and the action will yield a significant public benefit; and 4) it can mean preservation of a historically important land area or a certified historic structure.

Qualified conservation contributions intended to preserve open space are likely to be the most relevant to private forest owners. In order for this contribution to qualify for the favorable income tax treatment of IRC section 170, it must meet the additional requirements describe in the third item of the preceding paragraph, which include *clearly defined and described conservation-based public policy, scenic enjoyment, and significant public benefit*.

Preservation of land for scenic enjoyment by the general public is meant to prevent any development or use of the property that would impair the scenic character of the local rural or urban landscape or interfere with a scenic panorama that can be enjoyed from a park, nature preserve, road, water body, trail, historic structure or land area is open to or used by the public. Access by the public may be accomplished through visual access to or across the property, rather than by direct physical access. How much visual access is needed in order to satisfy public access requirements will depend upon the nature of the scenic character to be preserved.

A clearly defined and described government conservation policy is one that intends to protect the types of properties identified by representatives of the general public as worthy of preservation or conservation. A general statement of conservation goals by a

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

single official or legislative body is not sufficient, but legislation or ordinances that provide for site-specific conservation projects do meet the requirement. While the acquisition of an easement by a government agency may indicate that the donation is consistent with a clearly delineated government policy, more evidence may be needed to adequately meet the requirement. The more rigorous a government agency's review process, the more likely an easement acquisition alone will satisfy this requirement.

A conservation contribution must also demonstrate that it yields a significant public benefit in order to qualify for the IRC section 170 income tax deduction. This requirement asks whether the primary benefits of the contribution flow to the landowner or to the public. In determining the nature and extent of the benefit, a variety of factors are considered in light of the facts and circumstances associated with the contribution. For example, preservation of an ordinary tract of land would not in and of itself yield a significant public benefit, but the preservation of ordinary land areas in conjunction with other factors that demonstrate such benefit or that preserve a unique land area for public enjoyment that would yield a significant public benefit. Preserving woodland along a public highway pursuant to a government program to preserve the scenic view from the highway would, yield a significant public benefit. In this case the land preservation and the scenic view program would be considered together in determining the benefit.

Although the requirements of a clearly defined and described government policy and significant public benefit are independent of each other, they are related. The more specific the government policy with respect to the particular site to be protected, the more likely the government decision will tend to establish the significant public benefit associated with the contribution. For example, a state statute allowing for preservation of forest reserves is an example of government policy, but additional information would be needed to identify the public benefit to be gained from a conservation contribution on the forest reserve land. In contrast, a statute that names a specific river as a valuable state resource and is accompanied by appropriations to acquire conservation contributions would more easily meet both requirements.

*For example, a particular state contains large tract forests that are desirable recreation and scenic areas for the general public. The forests scenic values attract millions of people to the state each year. However, due to the increasing intensity of land development in the state, the continued existence of forest land parcels in excess of 45 acres is threatened. A property owner grants a perpetual easement on a 100 acre parcel of forest land that is part of one of the State's scenic areas to a qualifying organization. The easement imposes restrictions on the use of the parcel for the purpose of maintaining its scenic values. The restrictions include a requirement that the parcel be maintained forever as open space devoted exclusively to conservation purposes and wildlife protection and that there be no commercial, industrial, residential, or other development use of the parcel. The law in this state recognizes a limited public right to enter private land, particularly for recreational pursuits, unless such land is posted or the landowner objects.*

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

*The easement specifically restricts the landowner from posting the parcel, or from objecting, thereby maintaining public access to the parcel according to the custom of the state. The owner's parcel would provide the public with the opportunity to enjoy the use of the property and appreciate its scenic values. The conservation contribution would qualify for an income tax deduction under IRC section 170.*

A certified appraiser determines the value of the land before and after the easement. Under section 170, if the easement is sold the landowner is liable for capital tax on the value of the easement. If the easement is donated the landowner can deduct the value of the easement against taxable income. This amount of the donation can be deducted up to 50% of the taxpayer's adjusted gross income in the year of the donation and unused deduction amount can be carried forward for up to 15 years. The estate tax benefits come into play since the asset value of the land is reduced.

### **2. IRC Section 2031(c)**

Land that is owned by a decedent and which is subject to a qualified conservation contribution may be entitled to take advantage of a special opportunity to exclude a portion of the value of the land subject to the easement from the gross estate of the deceased property owner who is subject to federal estate taxes.

In order for this section 2031(c) deduction to apply, the conservation contribution must qualify under section 170 described above. However, the reverse is not true. A section 170 qualified conservation contribution need not qualify for section 2031(c) treatment.

In order to be eligible for the section 2031(c) exclusion for the estate of a person who died after December 31, 2000 the land must be: 1) located in the United States or any possession of the United States; 2) be owned by the decedent or a members of the decedent's family during the three year period ending on the decedent's date of death; and 3) be a qualified conservation contribution of a qualified real property interest granted by the decedent or a member of the decedent's family under section 170 described above; and 4) the easement prohibits all but minimal commercial recreational use of the land

The exclusion amount can be up to 40% of the value of the land, but is subject to maximum limits of \$500,000. This benefit is available to each land owner.

*For example, a person owns a tract of forest land that is worth \$1,500,000. In 2008 the owner donates a qualified conservation contribution to a qualifying organization and takes an appropriate income tax deduction. The transfer of the contribution reduces the value of the land to \$900,000. In 2009 the landowner dies. At his death, the land is valued at \$900,000. By electing to take advantage of the exclusion, the executor can exclude \$500,000 of value from the land for purposes of calculating the owner's federal gross estate under the federal estate tax law that applied at that time.*

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

If at the time of the easement contribution the value of the easement is less than 30% of the value of the land without the easement, less the value of any retained development rights, the amount of the exclusion is reduced according to a formula that reduces the exclusion by two percentage points for each point that the percentage falls below 30 percent. For example if the value of the conservation easement is 20% of the original value of the land, less the value of any retained interests, the amount of the maximum exclusion is 20% ( $40\% - 2(30\% - 20\%) = 20\%$ ).

To the extent this deduction reduces the value of the property, the income tax basis of the property is not adjusted after the owner's death.

### **3. Post death easement donation opportunities**

In the event that the land owner had not made a qualified conservation contribution before death, section 2031(c) provides an opportunity for the estate's personal representative and the heirs to make a contribution after the owner's death and still take advantage of the section 2031(c) exclusion in the decedent's estate. An important consideration that must be addressed in this case is whether title the decedent's land passes to the owner's heirs or to his personal representative following the owner's death. This will determine who has authority to grant the desired easement.

A second consideration is whether state law allows the donation of a conservation contribution without specific language authorizing this transfer in the deceased owner's will or other written document that controls the transfer of property after the owner's death. State law may require that such authority be expressly granted which will eliminate this option where an owner fails to plan his estate during lifetime. Owners who are concerned about allowing such post death decisions to be made might be better off making these decisions during lifetime rather than waiting for a post death decision to take advantage of the opportunity.

### **E. The Ongoing Debate about the Role of Conservation Easements**

Entering into a conservation agreement should not be taken lightly. There are serious economic and legal implications. Before making the decision to grant a conservation easement, landowners should consider what some believe to be the principle shortcomings associated with these easements.

When landowners agree to restrict the use of their land, how will these restrictions be enforced? If the restrictions are not enforced, is the landowner taking the incentive without giving up anything? Landowners who restrict use of their land will want to retain specific rights regarding use of their land after restrictions are in place. The conservation organization that holds the easement may have a different idea of what the landowner should be able to do after the easement is in place. There is a potential for conflict between landowners and organizations concerning use of land that is subject to an easement. These issues should be dealt with while the agreement is being

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

negotiated and written.

The discussion addresses requirements for a charitable deduction for the value of the easement donated to the conservation organization. Some people disagree that measuring the decrease in appraised fair market value is the proper method of measuring the value of the easement, or for measuring what the landowner gives up as a result of making this transfer. Experience has also shown that the values are often subjective, vary from appraiser to appraiser and present the potential for abusive overvaluation. It is important to get at least two appraisals performed by certified people.

The incentives that are provided to landowners are based on the expectation that public benefits will flow from the restriction. People are questioning whether those benefits are real and whether the benefits exceed the cost of the incentives offered to landowners. Some even question whether it has been sufficiently established that the public does benefit from conservation easements.

Conservation easements present land use planning challenges to local communities, particularly those communities which are not equipped to identify where these properties are located and to determine how the easement restrictions comply with land use restrictions already in place. To some degree the incentives to property owners flow from public funds. If public funds are involved, does public access to the restricted land come as a result of public funding for the easement?

These are just some of the questions concerning conservation easements that are being debated at present. Responding to each of these issues is beyond the scope of a publication such as this that highlights techniques and ideas for people who want to proceed with estate and succession plans. But, these problems are important and should not be dismissed without any consideration. Therefore, landowners who consider granting an easement should also consider these questions for they involve the land owner in many aspects and provide some idea of what potential issues may arise after the easement is granted. A decision on granting the easement should be made after considering all of these questions.

### F. Student Exercises

1. Which of the following purposes would not be considered as a qualified conservation purpose under section 170 of the Internal Revenue Code?
  - a. Development of natural gas interests
  - b. Preserving critical habitat for a threatened or endangered species
  - c. Enabling the public to enjoy the scenic views from the land
  - d. Preserving land for future farm or forest land use
  
2. Which of the following statements about conservation easements is correct?
  - a. Conservation easements end at the death of the owner who created the

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

- easement.
  - b. Conservation easements require formal action to create the transfer of the interest in the land that is subject to the easement.
  - c. Conservation easements can be used to prevent adjoining landowners from making certain uses of their own property.
  - d. Conservation easements last for not more than 25 years after they are created.
3. Which of the following organizations would not be considered a qualified organization for treating the donation of a conservation easement as a transaction that qualifies for a charitable deduction in calculating the owner's federal income tax?
- a. Patton Township, Centre County, Pennsylvania
  - b. The Western Pennsylvania Land Trust
  - c. The State of Pennsylvania
  - d. A group of land owners who invest in forest land in the hope its value will increase.
4. Which of the following tax planning objectives does Section 2031(c) serve in relation to the donation of a conservation easement?
- a. The donation of the easement qualifies for a marital deduction.
  - b. The donation of the easement is treated as a payment to a state government agency.
  - c. The donation can be used as a way to exclude a portion of the value of the land subject to the easement from the decedent's gross estate.
  - d. The donation allows the estate an additional year to pay federal estate taxes that may arise from the decedent's death.
5. If, during her lifetime, an owner of land does not donate a conservation easement on land she owned, which of the following opportunities is available to her personal representative?
- a. The Department of Revenue can acquire ownership of the land through eminent domain.
  - b. Failure to create the conservation easement allows the public to use the land if there is a recognized need for recreational land in the area where the land is located.
  - c. Ownership of the land reverts to the owner's heirs as determined by state tax law.
  - d. The personal representative can choose to grant a conservation easement on land that is controlled by the estate before it is transferred to heirs or other beneficiaries.

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

### Short Essay Questions:

1. Circleville Farm is a 160 acre tract of rolling farm land that began operation as a farm in the 1800's. It raises corn and soybeans as well as hay and timber is taken from the 30 wooded acres on the farm. As a result of the growth of local industry and other commercial activities Circleville Farm is now surrounded on two sides by residential development. On another side a four land road serves traffic travelling through the community by avoiding the more congested downtown areas. The owner of Circleville Farm is considering the farm's future given its location and the current growth of the community. Despite a recent decline in the rate of growth, there is every indication that growth will resume a steady increase in the coming months and years.

Based on this discussion of conservation easements evaluate how an easement would be applied to Circleville Farm and assess whether the Farm would be suitable for such an interest. Feel free to add factors that you believe to be necessary to support our conclusion.

2. Discuss how the requirements of a "qualified conservation interest" and a "qualified conservation purpose" will affect how a landowner should evaluate the impact a conservation easement will have on the owner and the owner's property.
3. Discuss how the grant of a conservation easement affects the tax and financial interests of the landowner who grants the easement on her land.

## Chapter 13. Lifetime and Testamentary Trusts Commonly Used in Estate and Succession Planning

### A. Overview and Purpose

This chapter examines the legal concept of a trust and explores its use in typical estate planning situations. . The discussion starts with a description of trust terms and concepts. The discussion examines the use of trusts in typical estate planning settings. A brief review of the inheritance, estate and gift tax aspects involving trusts is included in the next discussion. The final topic will look at the application of a trust to woodland estate planning situations specifically.

### B. Lesson Objectives

After successfully completing this chapter you will be able to accomplish the following objectives:

1. Understand the meaning of basic trust terms and terminology.
2. Explain the nature of a trust relationship in comparison to other types of property ownership.
3. Explain the application of trust concepts in estate planning.
4. Review and consider the application of the trust concept to an estate plan in which an active farm is included.

### C. The Concept of a Trust

A trust is a legal relationship that the law describes as a "fiduciary" relationship. A person who undertakes the responsibility to act as trustee is in a fiduciary relationship and accepts the duty to act primarily for the beneficiary's benefit by fulfilling the terms of the trust agreement that creates the relationship. If property is transferred to a person or entity acting as a fiduciary, legal title to the property is held by the trustee, but title is held for the benefit of another and not for the benefit of the fiduciary. The relationship of a trust creates legal ownership in the hands of the trustee and an accompanying obligation on the part of the trustee to maintain ownership of the property for the benefit of another.

Trusts are an important alternative to transferring property by means of its ownership form or under the terms of a will. Having property owned by a revocable or living trust created during the owner's lifetime enables the trust to function when the individual cannot, and eliminates the need for a guardianship of the person or appointment of an agent to operate on behalf of the person. As ownership of trust assets is held by the trustee and the trust agreement describes how these assets are to be held, the trustee has full authority regarding the assets and direction regarding how the assets should be used. Trusts have also been used to garner tax benefits, but there are no separate tax opportunities that are available to a trust. Trusts are a vehicle through which a tax benefit can be obtained, but the benefit is not unique to the trust.



## 1. Elements of a Trust

The elements of a trust are several.

**First**, someone or some entity must be designated to act as the fiduciary. A fiduciary can be either an individual or a corporation that has legal authority to act as a fiduciary built into its charter. In common practice such powers are part of banking company charters, but all financial institutions do not have such powers. The person or entity who acts as the fiduciary is the **trustee** in the trust relationship. The person who creates this relationship and establishes the trustee as a fiduciary is the **grantor or settlor**.

**Second**, for a trust to come into existence, the grantor must transfer property to the trustee with the intention to create a trust.

**Third**, the trust relationship is created for a specific purpose which does not involve committing a crime, violating a person's personal or property rights or violating a rule of conduct supported by a clear public policy.

**Fourth**, the trust must designate the person or persons benefitted by this relationship. **Beneficiaries** can be individuals or organizations, such as corporations or associations.

**Fifth**, the trustee takes title to some item of real property or tangible or intangible personal property under the trust relationship. This property is known as the **trust res or corpus**. Without property to manage, the trust relationship does not exist. Although a trust requires that property be managed for the trust to come into existence, a grantor can describe the trust organization and structure in advance of actually transferring property to the trust. When property is transferred to the trust at some future time, the structure and organization of the trust and the roles of major participants are already identified.

## 2. Trust Compared to Other Forms of Ownership

A trust relationship is fundamentally different from several other common relationships affecting individuals and their property. Unlike a debtor-creditor relationship, a trustee must not combine trust property with the Trustee's personal property. If the trustee combines trust assets with personal assets, the trustee violates the duty owed to beneficiaries and faces personal liability for any loss or damage suffered by them.

Property held in trust, although titled in the name of the trustee, is not subject to the claims of the trustee's creditors or otherwise subject to the trustee's obligations. The position of trustee is one that is subject to numerous requirements that recognize its special relationship to beneficiaries. Acting in ways that are detrimental to beneficiaries, that expose the trustee to conflicts of interest or that reflect the trustee's inability to act

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

are grounds for removal of the trustee, by court order if necessary. If such action is taken, the trustee is personally liable for any loss that occurs as a result of the conduct. Personal liability places the trustee's personal assets at risk to pay claims from beneficiaries. In deciding whether to accept appointment as a trustee, or any other form of fiduciary, the exposure to potential personal liability is an important consideration.

### D. Creation of Trust and Trust Terminology

Under the Uniform Trust Code, a trust is created if:

- The person creating it has the capacity to create it;
- The person has indicated an intention to create the trust;
- The trust has a specific beneficiary or is a charitable trust,
- The trust is a trust for care of an animal or a trust for non-charitable purposes, and
- The trustee has duties to perform.

Creating a trust can be done:

- In a will where property passes from the personal representative of a deceased owner's estate to the trustee for management,
- During lifetime by the execution of a trust agreement under which the grantor transfers property to the trustee,
- By a trustee's written declaration that property held by the trustee is held in trust, or
- By the written exercise of a power of appointment in favor of a trustee which creates the trust.
- Under the Uniform Trust Code, a trust can also be created by the declaration of a property owner that the owner holds a specific item(s) of property as a trustee in trust for another. If there is no written document that evidences creation of the trust, the trust and all of its terms must be established by clear and convincing evidence. A number of states, such as Pennsylvania require that a trust be in written form to be valid and this signifies the importance of considering the law that applies in the state where the settlor (the person creating the trust) lives.

Trust terms and terminology reflect the special characteristics surrounding the creation of the trust.

*For example, a trust created in a will is referred to as a **testamentary trust**. If the terms of the will provide that a transfer of property be made from the estate to the trust, the provisions of the will that describe the transfer are referred to as **pour-over provisions** since they pour-over funds from the estate to the trust. In contrast to a testamentary trust, a trust created during a person's life is referred to as a **living trust** or **inter-vivos trust**.*

*A trust created during lifetime and in which the grantor reserves the right to*

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

cancel the trust is referred to as a **revocable trust**. A common example of such a trust is a **revocable living trust or living trust**. Living refers to the fact that the trust was created during a person's lifetime. Revocable refers to the fact that the person created the trust retained certain interests or rights in the trust, including the right to revoke it. If the grantor wants to create a trust and give up the right to revoke it in the future, the trust is referred to as an **irrevocable trust**. In such situations, the property owner intends to give up ownership and control of the property to avoid the property being included in the owner's estate at his or her death. A common example of such a trust is an irrevocable life insurance trust. In the chapter 14 discussion of how life insurance is treated under federal estate tax, a key issue is who owns the policy or has "incidents of ownership" in the policy. In an irrevocable life insurance trust a policy of insurance is transferred to the trustee who is considered to be the owner of it. The trust agreement designates the trust as the beneficiary of the policy. Once the policy proceeds are paid to the trust the trustee's obligations to the beneficiary will take control to manage and distribute the policy proceeds.

Trusts are also referred to by the purpose they serve, such as a **marital deduction trust** which is a trust created to manage property passing to a surviving spouse who qualifies for the marital deduction under the federal estate tax law. Likewise, a **credit shelter trust** is a trust under which the grantor designates property to pass to the trustee in an amount equivalent to the amount of the grantor's unified credit for federal estate tax. Property which qualifies for marital deduction treatment as qualified terminable interest property (see earlier discussion in chapter 9) , or Q-TIP property, may pass under a **Q-TIP trust**. In making gifts of certain property an owner can separate ownership during lifetime from ownership that follows after the owner's death. This creates a life interest, or life estate, and a follow-on interest, or remainder interest. A transfer in trust of a remainder interest in property to a charity may be made in the form of a **charitable remainder annuity trust or a charitable remainder unitrust** to qualify for the gift tax charitable deduction.

A popular estate planning use of trusts is to invest income producing property in a manner that provides lifetime financial security to the beneficiary without causing an undesired federal estate tax problem for any of the beneficiaries of the trust. This technique is often referred to as an **A-B trust, or a marital trust and a by-pass trust** which is explained below.

In other cases, terms that describe a trust reflect special features of the trust and such terms often become short-hand expressions for these trusts. For example, a **crummy trust** is a trust in which the beneficiary of the trust is given specific powers to withdraw property from the trust in order to qualify the beneficiary's interest in the trust as a present interest for purposes of the gift tax annual exclusion.

**Special needs trusts** are designed to coordinate a beneficiary's need for specific services with the means by which the beneficiary pays for these services. For example,

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

assume that a person is injured in an accident and now has the need for extended hospital and nursing home care, perhaps for life. The cost of such care is considerable and beyond the reach of many people. Therefore, public resources such as medical assistance may be needed to provide the needed care. Before a person is eligible for these resources, the person must spend down practically all of their own resources before becoming eligible. A special needs trust would be used to take funds that would otherwise be paid directly to the injured person, such as insurance proceeds or payments for liability for the injury, hold them in trust and distribute them over time in a way that would supplement, rather than replace, any publicly available resources, such as medical assistance, the injured person may be entitled to receive if the funds in the special needs trust were not considered as assets available to the injured person.

### E. Using Trusts in Estate Planning

#### 1. Managing Property

A trust is useful in planning contexts which involve the management of property. As the essence of a trust relationship is the transfer of property to another to manage the property for the benefit of a third person, a trust is an ideal vehicle for managing property of a minor child, a person who is disabled or incompetent, or someone who wants to be free of the personal obligation to manage property. In all three of these situations, the trustee fills the role of the property owner in collecting income, paying bills and making decisions. Periodically the trustee accounts to the beneficiary to show the results of the trustee's efforts. In keeping with the trustee's instructions, the trustee may make periodic distributions of the principal portion of trust property to the beneficiary. The circumstance under which such a distribution is made is found in the trust agreement defining the trustee's duties and responsibilities.

In these cases, the benefits of trustee management must be greater than the cost of having a trustee manage these affairs.

In the case of a person who is disabled and unable to deal with their property, the property may be frozen until someone has legal authority to act on behalf of the disabled person. Guardianship is a court proceeding that results in appointment of this third person. A trust is an alternative means of providing the same protection and management that a guardianship provides. But, for a trust to be effective as a replacement for a guardianship, a property owner must take steps to influence the situation during lifetime.

*For example, a person who is concerned that advanced age may prevent the person from managing his or her affairs can create a trust during lifetime and transfer property to it. If the person should become disabled at a later date, the owner's property is in the hands of a trustee who should be fully instructed as to the steps to take to protect the owner's interest in his or her property, pay debts and expenses and generally manage the person's affairs. In the case of a property owner who intends to benefit a minor child with property after the*

*property owner dies, the owner may provide in his or her will that property passing to the child be held in a testamentary trust until the time set by the owner for the distribution of the property to the child. As the age of majority in most states is 18 years, some property owners may not feel that 18 is an appropriate age for someone to receive significant property and be free to deal with it as he or she pleases. By placing the property in the hands of a trustee, the owner can direct the trustee to hold the property well past the beneficiary's 18th birthday and be distributed at some later time when the beneficiary is presumably better able to manage property.*

### **2. Speed the Transfer and Continuous Management of Assets after the Grantor's Death**

#### **a. Management Considerations**

The second major use of trusts is to speed the transfer of property after a property owner's death while continuing to manage those assets in the post-death period. In the opinion of some property owners, the process of transferring property after an owner's death is too long, drawn out and expensive in terms of fees paid to personal representatives of estates, accountants, appraisers, auctioneers and attorneys who represent the personal representative and filing fees paid to the Register of Wills to probate a person's will or appoint an administrator for someone who dies without a will. Individuals who own property in several states also face the need to file the deceased person's will in each of the states where real or tangible personal property is located when the decedent died. This further complicates the costs and expenses involved in settling an estate of this kind.

An alternative to the transfer of property under a will or without a will is to create a trust during the owner's lifetime, transfer property to it, add property to it afterward and instruct the trustee to transfer the property held by the trust to designated beneficiaries after the owner's death. In many situations where this technique is used the property owner retains significant rights in the property during his or her lifetime, including the right to income from the property, the right to use the trust principal if necessary, and the right to terminate the trust if the owner changes his or her mind about using this technique. Trusts of this type are *revocable living trusts*. If such a trust is created, at the owner's death, the trustee exercising his or her authority will transfer the property to the designated beneficiary to fulfill the terms of the trust agreement. The trustee is responsible for filing any inheritance or estate tax returns. If all of the decedent's property is transferred under a living trust, the trustee will be responsible for paying the debts and expenses of the decedent. The use of a living trust is particularly helpful in situations where property is located in several states. Transferring out of state property to the trustee and providing for the distribution of the property after the original owner's death, the owner can bypass the probate process in these other states. This may not eliminate the need to file inheritance or death transfer taxes in each of the states where property is located, but it will enable the transfer to be completed in less time. Since the

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

trustee owns the property and has the required instructions regarding the disposition of the property after the original owner's death, the trustee is fully authorized to complete the transfer to a designated person.

In regard to the time needed to transfer property under a will compared to a revocable living trust, most delays in transferring estate property relate to valuing assets, resolving disputes with creditors or debtors of the estate, awaiting acceptance of filed inheritance and estate tax returns and resolving disputes between the estate and unhappy heirs.

A revocable living trust can be challenged on grounds of the grantor's competence at the time of creating the trust or acts that unduly influenced a grantor to create a specific type of living trust. Therefore, many of the same disputes that delay the distribution of an estate can delay the distribution of a trust.

The person who is responsible for filing returns and paying federal estate and state inheritance tax is personally responsible for the proper payment of these taxes. If estate funds are distributed before assurance is received that the tax paid is accepted as the full amount due, and it is later determined that additional tax is due, the personal representative has the choice of either collecting the needed additional money from heirs or paying the tax from his or her own pocket. In most cases the time needed to transfer property under a will and through a living trust will be the same.

### b. Privacy Considerations

When a will or petition is filed in the office of the register of wills or some other local official, the documents are items of public record. In regard to privacy, the living trust agreement is not filed of record in the office of the register of wills in the county where the deceased property owner resided at the time of his death. If the trustee is directed to transfer real estate from the trust after the trust grantor's death, however, it may be necessary to file the trust agreement in the office where land ownership records are retained to establish the trustee's authority to transfer the property. Filing a document in the land records office makes the document an item of public record and available for inspection thereby losing this measure of privacy.

## 3. Tax Planning and Saving

The third major reason for the use of trusts in estate planning is the opportunity it provides for tax planning and saving. In this context, it is not that trusts are eligible for tax benefits that other types of ownership are not entitled to, but rather that the special form of ownership under a trust allows an owner to achieve an intended purpose while still achieving tax benefits. One of the most familiar types of trust used in estate planning is the commonly called **A-B Trust, or marital trust/by-pass trust arrangement**.

The purpose of this technique is to allow an owner to pass a portion of property to a surviving spouse under the marital trust (The A Trust) that qualifies for the marital deduction in the estate of the first spouse to die. Another portion of the owner's property

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

(The B Trust) passes to beneficiaries under the by-pass trust in an amount that is equal to the allowable exemption equivalent for federal estate tax purposes. In this credit shelter trust the surviving spouse may have a limited interest for the spouse's lifetime. The surviving spouse's entitlement under the trust must be such that the trust principal is not considered under the control of the surviving spouse and not part of the surviving spouse's estate at his or her death. Combining the marital trust and the credit shelter trust is intended to trigger no federal estate tax when the first spouse passes away and shelter the exemption equivalent for the next level of beneficiaries, often children.

### **F. Review of Inheritance and Estate Tax Impacts of Trusts**

The tax impacts of using trusts in estate planning relate to the situation in which the trust is employed. If a property owner retains the right to revoke a trust created during lifetime or retains a right to income from the trust property, the property would be subject to state inheritance tax and would be included in the decedent's gross estate for federal estate tax purposes. These impacts refer to the general categories of property that are subject to inheritance and estate taxation.

If an owner wants to avoid having the property included in his or her gross estate for federal estate taxes, the owner can transfer the property and create an irrevocable trust. By doing so the owner makes a gift for federal gift tax purposes of the value of the trust interest which is created for the benefit of other beneficiaries. Through use of the annual exclusion for gifts of present interests and the exemption equivalent of the unified credit, the impact of federal estate and gift taxes can be managed. For state inheritance taxes, an irrevocable gift of property in trust made within one year of the owner's death may be subject to inheritance tax

If a property owner wishes to transfer property in a way that qualifies for the marital deduction, the owner has several choices to design a trust that gives the spouse an interest to such a degree that the property qualifies for it. These choices include a trust with broad authority over the trust principal or a "qualified terminable interest property" trust. Such a trust must provide that the spouse is entitled for life to all of the income from the property, payable at least annually. No person, including the surviving spouse may have the power to appoint any part of the transferred property to any person other than the surviving spouse during the surviving spouse's life. Any power over the property must be exercisable after the spouse's death.

If an owner desires to transfer a remainder interest in property in trust to a qualified charity, the trust can be structured as either a charitable remainder annuity trust or uni-trust. An annuity trust pays designated beneficiaries a specified amount annually, which is at least 5% of the initial fair market value of the property. A uni-trust pays designated beneficiaries a fixed percentage, which is at least 5%, of the net fair market value of trust assets as valued each year.

### **G. Use of Trusts in Farm and Forest Estate Planning**

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

In planning a farm or forest land estate, trusts can fill any of the roles that trusts play in other estates. As in other situations, if an estate planning objective of the property owner can be accomplished through the use of a trust, then a trust should be considered as part of the estate plan. The important question to ask is, "What will be accomplished in my estate plan if I place any of my assets in trust?" If use of a trust does not achieve an objective, or makes it more difficult to achieve the goals and objectives previously set, there should be little or no reason to use it or any other device that does not contribute to the success of the plan.

Unlike other estates the typical farm or woodland estate owned by a private landowner may consist of one large asset in the form of land and several other assets in the form of livestock, crops, machinery and equipment. If the forest activity is part of some other enterprise, then a set of issues and questions regarding these other business assets may arise. The decision to place real estate assets in a trust is an important one. If the purpose of doing so is to improve investment performance and maintain the business for eventual distribution to heirs who want to continue it, accomplishing those goals will depend on whether a trustee can be found with the background and knowledge to understand it and operate the business profitably. Since many investment managers are more adept at managing financial investments that are easily converted to cash, running forest or woodland business to maximize its income potential is often a difficult challenge. Land dedicated to timber production has a considerable period of time before the investment in the growing trees will pay off. Managers of such properties must have considerable skill, excellent sense of timing and considerable business acumen to obtain top market values when the timber is eventually sold.

Institutional trustees, such as banks, managing businesses placed in trust often require that someone familiar with the business operation be named co-trustee with the bank. If a trustee considers the trustee's obligation to be to maximize the income potential of property placed in the trustee's care, the trustee may want to be protected from legal challenges by beneficiaries who could claim that the trustee failed to protect their interest by failing to maximize income. This protection may come in the form of specific instructions to the trustee to maintain a business.

### **H. Revocable Living Trusts**

Although revocable living trusts are discussed in various places throughout this chapter, this section is intended to pull together various comments and considerations regarding use of such trusts. As a popular estate planning device many people consider these trusts as part of their estate plans and this discussion becomes important.

This device is promoted as a simple, inexpensive and private way to avoid the delay and cost of transferring property under a will and, in many cases, it can deliver those benefits. A revocable living trust is also a beneficial way to continue effective asset management if the property owner becomes disabled or incapacitated. Privacy is also an important issue to many people, but the privacy issue may be lost if it is necessary to record the trust agreement in a public office to confirm the authority of the trustee to



## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

sell real estate or to take other action where proof of such authority is required.

In regard to saving expenses by creating a living trust, the principal savings come in two areas, filing fees incurred in the probate system and the need for professional services to complete the transfers. While the need for services may be lower, most trustees will incur some expenses in transferring property after the grantor's death. Certain other steps that will undoubtedly incur some expenses will have to be taken. For example, if inheritance and federal estate tax returns must be filed after the grantor's death, the trustee may incur legal expense for gathering the information needed to prepare and file the returns. Transferring property may also require legal fees to prepare the necessary documents to complete the transfer. If legal fees are based on time and effort spent providing service to either a trustee or a personal representative, the fees charged should be a fair reflection of both cost to the payer of the fee and benefit received from the service.

On the fee question, whatever fees are saved in transferring property under a revocable living trust will be offset by costs incurred to prepare the trust documents, transfer property to it, and to monitor the assets in the trust throughout the owners' lives. Typically the process of drafting a living trust also includes drafting a will and possibly other documents to authorize people to act on behalf of someone else in cases where the person is unable to act on his or her own. This is done to assure that there is some document drafted by the owner that controls the disposition of his or her property after death. In the event that an item of property is purchased but not owned by the trust, the owner's will becomes the vehicle that provides for its transfer, with the beneficiary often being the trustee of the trust.

The fee savings question becomes one of incurring lifetime expenses to save post death expenses. Some people argue that drafting any of these documents does not require professional assistance, and fill-in-the-blank forms are readily available. As you have progressed through this topic to this point you can appreciate the complexity of the issues. Do you feel that the complexity makes it advisable for people to use professional services although not required to do so? Decisions to create revocable living trusts motivated solely by a desire to save fees and expenses in transferring property after death will be more effective if the decisions are made with a full understanding of the fees paid to create the trust that avoids probate fees later.

Some items of property may require special consideration before being transferred to revocable living trusts. Real property subject to a mortgage, or whose equity is needed to finance an activity, may find that the trustee's ownership of the property is objectionable. Since a trustee's representative capacity differs from the trustee's individual capacity, the trustee's only income sources may come from private sources. This will complicate the decision whether to grant the requested loan. Motor vehicles owned by the trust that require liability insurance may require the insurer to question whose driving record is rated for premium purposes, the actual driver or the trustee?

### **I. Student Exercises**

# Handbook on Estate and Succession Planning for Farm and Forest Landowners

## Multiple Choice Questions

Please read the questions carefully; then select one of the four choices following the question that correctly answers the question asked.

1. Which of the following terms describes a trust that **cannot** be canceled after it is created?
  - a. A testamentary trust
  - b. A statutory trust
  - c. An irrevocable trust
  - d. A resulting trust
  
2. In creating a trust several elements are necessary. Which of the following statements is **not** one of these elements?
  - a. The intent of the trust grantor
  - b. Identification of a trustee and/or successor trustee
  - c. Trust property transferred to the trustee
  - d. A taxpayer identification number
  
3. Trusts are used in estate planning to achieve important planning objectives. Which of the following objectives is not an objective which a trust can achieve?
  - a. Obtain an estate tax advantage that is not available to any other form of ownership
  - b. Avoid the need for creating a guardianship if the trust grantor becomes disabled during lifetime
  - c. Provide a vehicle for the transfer of the grantor's property after the grantor's death
  - d. Transfer property for the benefit of a minor child in a way that protects the property until the minor is able to deal with the property
  
4. In comparing the transfer of property after death through an estate to the transfer of property under a revocable living trust, which of the following statements would be a correct statement?
  - a. The role of a personal representative of an estate is similar to the role of a trustee of a trust
  - b. Transfer of all property from a trust is accomplished in one-half of the time it takes for the transfer of property from an estate
  - c. Transfers of property through an estate are subject to legal expenses, while transfers from a trust are not
  - d. Transfers of property from an estate are subject to fees of the personal representative, while trustees are not permitted to charge fees for their services

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

5. Which of the following transfers in trust is subject to a federal gift tax at the time the trust is created?
- Resulting trusts
  - Testamentary trusts
  - Q-tip trusts
  - Irrevocable trusts

### Short Essay Questions

Please read each question carefully and then respond to what is asked for at the end of the question. Your answer need not be long or involved, but it should be as clear and concise as possible. If you want to refer to important facts in your response, please feel free to do so.

1. Evelyn owns approximately \$3,555,000 in separately owned property now being used as an active farm. She is married to Ralph, who is her second husband, and who manages the farm. Evelyn and Ralph have two children from their marriage, Richard and Robert both of whom are involved in the farm business. Evelyn has been sick for a number of years and Ralph is in excellent health. If Evelyn were to pass away before Ralph, Ralph's accumulated retirement funds and a military pension will enable him to live comfortably without using any of Evelyn's money. After they both pass away, Evelyn and Robert would like their estate plan to get as much of Evelyn's separate property to their children as they can without paying a large portion of it in inheritance and estate tax.

Based on our discussions of trusts, what trust techniques might Evelyn and Ralph use to accomplish their goal?

2. Continue with Evelyn and Ralph's situation. Evelyn is considering transferring one half of her property during lifetime to her revocable living trust. The trust will be managed by Evelyn during her lifetime. If she becomes disabled or incapacitated, Ralph is the successor trustee. During her lifetime Evelyn has the right to all income from the trust. At her death, Ralph is entitled to income from the trust for the rest of his life. At his death, Richard becomes the trustee and he is instructed to distribute the remaining portion of property in the trust equally to himself and his brother, Robert.

If Evelyn takes this step rather than have her property pass under her will, what advantages, if any, will she gain by doing so?

3. Geralyn has just been approached by someone in her family to act as trustee under of a testamentary trust that includes an active farm operation that has a considerable stand of timber that consists of northern hardwoods and black

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

cherry. Geralyn grew up on a dairy farm and is a graduate of a College of Agricultural Sciences with a degree in Agricultural Business Management. While in that degree program, Geralyn took several forest management courses that give her a working knowledge of forest management concepts and ideas. If Geralyn asks for your opinion about whether she should accept the appointment, how would you respond to Geralyn as to the legal relationship a trustee has under a trust to the grantor and the beneficiaries and identifies any special problems you feel she may have as trustee of this trust?

**Chapter 14. Life Insurance in Estate Planning**

**A. Overview and Purpose**

In this chapter we will examine the role played by insurance in a typical estate plan. We will begin our discussion by referring to key insurance terms in order to understand the differences in insurance products and roles the products can play. From that point, we will examine the various types of insurance products that are available in today's market place. After identifying the products, we will examine how these products can be used in an estate plan. Before deciding on their use, we will examine the tax impacts of using the product in estate planning. Our final topic will address the question of how much insurance to buy and several factors insurance buyers can use in deciding the amount of insurance coverage to purchase.

There are many useful references in books and on the internet for people who want to know more about life insurance policies and purchase decisions. The following website was consulted in preparing this chapter: "and "Financial Guide: Life Insurance: How Much and What Kind to Buy" found at [www.gofso.com/Premium/LE/08\\_le\\_bi/fg/fg-life\\_ins.html](http://www.gofso.com/Premium/LE/08_le_bi/fg/fg-life_ins.html).

**B. Lesson Objectives**

When you have successfully completed this chapter you will be able to accomplish the following objectives:

1. Distinguish between the various types of life insurance policies generally available to consumers today and the terminology that relates to these policies.
2. Discuss the role that life insurance can play in an estate plan.
3. Consider the state inheritance and federal estate, gift and generation skipping transfer tax treatment afforded life insurance proceeds paid to a named beneficiary and to an insured's estate.
4. Distinguish between situations in which a person has incidents of ownership in an insurance policy from those in which a person has no incidents of ownership.
5. Describe the process consumers can follow and the factors they can apply in deciding how much insurance to purchase for their personal situation.

**C. Insurance Terms and Definitions**

Insurance is one of the most common financial assets that people acquire during their lives, but it is unlike any other purchase that people generally make. When you pay the premiums, you're buying the future financial security for your family that only life insurance can provide. As a common financial asset, many people are familiar with basic policy types and insurance terminology. While many people feel they are knowledgeable about insurance, they often overlook the new types of insurance products and techniques developed over the last 20 years to serve a variety of financial planning needs and situations. Policy choices are much wider than simply deciding

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

between whole life policies and term policies. To begin the discussion let's turn to some basic insurance terms and definitions.

**Accidental Death Benefit** - A provision added to a life insurance policy for payment of an additional benefit in case of death as a result of accidental means. It is often called "double indemnity".

**Annuity** - A contract in which a person pays an amount to an annuity company in return for payment of income and principal either for a specified period of time or for a person's lifetime. Although annuities are financed by life insurance companies, annuities are the direct opposites of life insurance policies. Life insurance policies are payable at a person's death. Annuities are payable during lifetime. In some annuity situations, the payment stream ends with the death of the person whose receives the annuity benefit. In other cases the benefits can continue for a second person, or some amount may be payable to another beneficiary after the initial person's death. Annuity policies require careful review to be certain its terms are understood. In addition, the financial condition of the company paying the annuity is also a concern. If the company that is obligated to pay the annuity is no longer financially viable, the expected annuity payment may be lost.

**Beneficiary** - The person or entity, such as a trust fund, named in the policy as the recipient of the insurance proceeds in the event of the death of the insured person named in the policy.

**Cash Surrender Value** - The amount available in cash upon surrender of a policy before it becomes payable by death or maturity.

**Convertible Term Insurance** - Term insurance that offers a policyholder the option of exchanging it for a permanent plan of insurance without evidence of insurability.

**Cost Index** - A way to compare the costs of similar plans of life insurance and help you shop for a policy. One index is called a *net payment index* and it gauges the cost of carrying your policy for the next ten or twenty years. The lower the number the less expensive the policy will be. The other type of index is a *surrender cost index*. This index measures cash value of a policy. This index may be a negative number and again the lower the number; the less expensive is the policy. These two indexes apply to term and whole life insurance policies

**Face Amount** - The amount stated on the face of the policy that will be paid in case of death or at maturity. It does not include dividend additions or additional amounts payable under accidental death or other specified conditions.

**Grace Period** - A period (usually 31 days) following each premium due date, other than the first, during which an overdue premium may be paid. All provisions of the

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

policy remain in force throughout this period.

**Guaranteed Interest Rate** - The minimum interest rate that can be credited to a policy. On whole life and universal life policies, the guaranteed minimum is usually from 4% - 5.5%.

**Guaranteed Insurability** - An option that permits the policyholder to buy additional stated amounts of life insurance at stated times in the future without evidence of insurability.

**Insured** - The person on whose life an insurance policy is issued. The owner of the policy need not be the insured person on the policy.

**Lapsed Policy** - A policy terminated at the end of the grace period because of non-payment of premiums.

**Level Premium Insurance** - Insurance for which the cost is distributed evenly over the premium payment period. The premium remains the same from year to year, and is more than the actual cost of protection in the earlier years of the policy and less than the actual cost in the later years. The excess paid in the early years builds up a reserve to cover the higher costs in the later years.

**Mutual Life Insurance Company** - A life insurance company whose board of directors is elected by its policyholders. Generally, these companies issue participating policies that entitle policyholders to share in surplus earnings through dividends reflecting the difference between premiums charged and the cost to the company of providing the insurance.

**Non-Forfeiture Values** - The value, if any, either in cash or in another form of insurance, available upon failure to make the required premium payments.

**Nonparticipating Policies** - Insurance on which no dividends are paid.

**Optional Benefits** - Benefits which are in addition to basic life insurance protection. Waiver of premium upon disability or some other event. Accidental death benefits are optional benefits.

**Paid-up Additions** - A dividend option which allows dividends on a participating policy each year to purchase small amounts of single premium life insurance on which no further premiums will be necessary.

**Paid-up Insurance** - Insurance on which all required premiums have been paid. Paid-up policies may be confused with vanishing premium option policies described below.

**Participating Policy** - Insurance on which the policyholder is entitled to share in

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

the surplus earnings of the company through dividends that reflect the difference between the premium charged and the cost to the company of providing the insurance.

**Policy Dividend** - A return of part of the premium on participating insurance resulting from actual mortality, interest and expenses that were more favorable than the corresponding assumptions used in determining the premiums.

**Policy Loan** - The amount that can be borrowed at a specified rate of interest from the issuing company by the policyholder using the value of the policy as collateral. If the insured dies with the debt partially or fully unpaid, the amount borrowed, plus any accrued interest, is deducted from the amount payable.

**Renewable Term Insurance** - Term insurance providing the right to renew at the end of the term for another term or terms, without evidence of insurability. The premium increases at each renewal as the age of the insured increases.

**Rider** - An amendment to an insurance policy that modifies the policy by expanding or restricting its benefits or excluding certain conditions from coverage.

**Settlement Option** - One of the several ways, other than immediate payment in a lump sum, in which the insured or beneficiary may choose to have the policy proceeds paid.

**Stock Life Insurance Company** - A life insurance company owned and controlled by stockholders who share in the company's surplus earnings. Generally, the company issues nonparticipating life insurance policies.

**Term Insurance** - A plan of insurance that covers the insured for only a certain period of time (the term), not for his or her entire life. It pays death benefits only if the insured dies during the term of the policy.

**Term Rider** - Term insurance that is added to a whole life policy at the time of purchase or that may be added in the future.

**Underwriting (or Risk Classification)** - The process of classifying applicants for insurance by identifying characteristics as age, sex, health, occupation and hobbies. People with similar characteristics are grouped together and are charged a premium based on the group's level of risk. The process includes rejection of unacceptable risks.

**Universal Life Insurance** - A flexible premium life insurance policy under which a policyholder may change the death benefit from time to time (with satisfactory evidence of insurability for increases) and vary the amount or timing of premium payments. Premiums (less expense charges) are credited to a policy account from which mortality charges are deducted and to which interest is credited at rates that



## Handbook on Estate and Succession Planning for Farm and Forest Landowners

may change from time to time.

**Variable Life Insurance** - Life insurance under which the benefits relate to the value of assets behind the contract at the time the benefit is paid. The assets fluctuate according to the investment experience of a separate account managed by the life insurance company

**Waiver of Premium** - A policy provision that sets certain conditions under which an insurance policy is kept in full force and effect by the company without the payment of premiums. It is used most frequently for those policyholders who become totally and permanently disabled, but may be available in other cases.

**Whole Life Insurance (or Straight Life or Permanent Life)** - A plan of insurance for the whole of life, with premiums payable for life.

### D. Types of Insurance Policies and Products

Life insurance is acquired by purchasing a policy, which is a contract between the insurance company and the policy owner. As a contract, its terms have special significance in defining the rights and responsibilities of the parties. When a policy is purchased the owner joins a risk-sharing group or life insurance company. The company agrees to pay the designated beneficiaries at the time of the insured's death an amount specified in the policy. This promise is made in return for the owner's promise to pay the agreed premium over the period specified by the policy.

Insurers gather information about applicants. such as age, gender, health, occupation and hobbies, so they can group together people with similar characteristics and calculate a premium based on the group's level of risk. Those with similar risks pay the same premium. This process is known as risk classification, and by providing equal treatment for equal risks, it allows insurers to treat policyholders fairly.

There are two basic types of life insurance, term and whole life insurance, and several variations of each type.

Term insurance is protection that insures a person for a specified period of time, usually one, five, 10 or 20 years, or up to certain age, such as 70. It is a policy that provides pure protection against an insured event occurring during the policy term. A term policy pays proceeds to the designated beneficiary if the insured person dies during the period the policy is in force. At the end of the term, the policy terminates, unless the policy has a "renewable" provision included in it. Under a renewable term policy, the insured need not provide evidence of insurability to renew it. Each time it is renewed, however, premiums can be adjusted higher.

Term insurance that is convertible can be exchanged for a whole life policy without providing proof of insurability, but at a higher insurance premium. Term insurance is initially cheaper than whole life insurance for the same amount of insurance coverage. It

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

gives the largest amount of immediate coverage per dollar of premium spent. Term insurance is frequently used by consumers who need large amounts of coverage for known periods of time, such as home buyers or parents of young children.

Whole life insurance is protection that can be kept in force as long as the insured lives and the owner pays the premiums. By choosing to pay premiums that remain the same throughout the policy period, the owner averages out the cost of the policy over the insured's lifetime.

An important feature of whole life insurance is its cash value. Cash value continues to grow on a tax deferred basis. If the policy is canceled and cash value is paid to the owner on a lump sum basis, the owner reports as income the amount by which the cash value, plus any dividends received exceed policy premiums paid. Insurance policies include tables that describe exactly how much cash value is in the policy. Cash value of whole life insurance policies can be used many ways.

*For example, using the policy as collateral, the owner can borrow the cash value from the insurance company.*

*If a premium payment is missed, the company, with the owner's authorization can draw from the cash value to keep the policy in force. Cash value can be used to purchase a paid-up policy that may lower the level of protection, but also remove the obligation to pay further premiums. Cash value can also be used to purchase an annuity that provides monthly income during lifetime. If a policy owner no longer wishes to continue the policy, the owner can surrender the policy to the company and receive its cash value remaining after surrender fees or charges are deducted.*

There are several variations of whole life insurance plans. One is modified life, which is a policy with a premium that is relatively low in the first several years of a policy, but goes up in the later years. This policy is attractive to people who want whole life insurance, but who want to pay lower premiums in the early portion of the contract.

Limited-payment whole life insurance policies provide protection for the life of the insured, but premiums are payable over a shorter time period - such as 20 years - or until the death of the insured. Since premiums are paid over a shorter period of time than for regular whole life policies, premiums are generally higher in such cases.

Single-payment whole life insurance provides protection for the life of the insured in exchange for the payment of the total premium in one lump sum amount. Under recent amendments to the Internal Revenue Code, policies which are paid-up in fewer than seven years are classified as "modified endowment contracts" and are subject to adverse income tax consequences if loans against the cash value or withdrawals are made by the owner.

Combination term and whole life plans combine both types of insurance coverage in

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

one policy. Through the life of the policy coverage can be influenced by the rising cost of term coverage or a gradual conversion of term coverage to whole life coverage. In this context, the policy owner and insurance agent can plan to achieve their desired goal.

In recent years a number of new insurance products have been developed to take advantage of consumer interest and financial opportunities available to insurance companies. These products are known as universal life insurance, variable life insurance and adjustable life insurance.

Universal life is a policy that includes an investment program and a term insurance contract. These policies allow policy owners to pay premiums in virtually any amount, subject to certain minimums. The policyholder can also change the amount of insurance more easily than under traditional policies. In a universal life policy, the amount of the cash value reflects the interest earned at the prevailing interest rates. The level of cash value is "interest sensitive" which means that the amount accumulated varies according to the general financial climate. Rates are usually guaranteed for one year, and then a new rate is determined. Rates can go no lower than a guaranteed rate specified in the policy.

Variable life allows death benefits and cash values to fluctuate according to the investment experience of a separate account managed by the life insurance company. Policy holders have the opportunity to obtain higher cash values and death benefits than with policies calculating benefits based on a fixed rate of return. On the other hand however, policy holders also assume the risk of negative investment performance.

Two types of variable life policies exist: scheduled premium variable life and flexible premium variable life. Premium payments under a scheduled premium policy are fixed as to the timing and amount. Policy holders who own a flexible premium policy may change the timing or amount or both of their premium payments.

Adjustable life policies allow the policy holder to change the policy as his or her needs change. For example, if the owner wants to increase or decrease coverage, the owner can change the premium payment or change the length of time that the policy is in force. If the death benefit or amount of insurance is increased, the insured may have to provide evidence of insurability.

Other forms of insurance that are widely available include second to die policies and split-dollar policies. In a second to die policy, the insurance company's obligation to pay the policy proceeds is conditioned on the death of two people. Therefore, the obligation to pay does not arise until the second of the named insured dies. Second to die policies can be either term or whole life policies or any of the whole life variations, such as universal life. In addition such policies can have other policy options. An advantage of second to die coverage is that the premium cost of such coverage is generally lower than the premium cost for single life policies. With two lives being underwritten, the poor health of one insured can be offset by the good health and life expectancy of the second

insured.

Split-dollar life insurance policies are used to provide insurance coverage for major shareholder-employees of closely held or family owned business corporations. In such plans, the business advances a portion of the insurance premiums to the shareholder-employee. This amount may be the portion of the premium that reflects the increase in the cash value of the insurance policy during the period represented by the premium paid. At the insured's death, the corporation receives a portion of the insurance proceeds, such as the amount of the cash surrender value of the policy for the year in which the shareholder-employee dies, and the balance is paid to beneficiaries designated by the shareholder-employee.

### **E. How Is Insurance Used In Estate and Succession Planning?**

As the variety of insurance products indicates, insurance can play a very versatile role in an estate plan that addresses lifetime needs and opportunities and provides for the transfer of property after a person's death. First and foremost insurance can provide significant funds at a time when they are needed most. Insurance proceeds may be the source of substantial wealth that is passed on to designated beneficiaries, whether family, non-family or charitable. Second, insurance can be used to create a fund that pays taxes, debts or expenses generated during lifetime or created by the death of the insured. An insurance fund can also provide financial security for a surviving spouse or other person who is financially dependent on others or whose special needs require significant financial resources to deal with problems they present. Third, in the context of a closely held or family-owned business, policies of insurance may provide the funds that younger generation owners need to acquire a business interest from a deceased parent or other family member and continue the business. In the context of family owned businesses, not all children may have the interest or ability to successfully continue the business. Insurance proceeds can also be used to equalize the treatment of children who inherit a share in the business with children who are not involved in the business, but to whom the deceased owner wants to bestow a significant benefit.

### **F. Inheritance, Estate, and Gift Tax Impacts of Using Insurance**

For state inheritance tax purposes, receipt of life insurance proceeds following an insured's death, whether from a separate insurance policy that is part of a retirement plan, may not be subject to state inheritance tax. A different result could apply if the proceeds are paid to the deceased person's estate rather than a named beneficiary. Therefore it is important to check on the treatment that applies in a specific state. In Pennsylvania, for example, insurance proceeds whether paid to a person who is named as a beneficiary of the policy proceeds or if paid to a person's estate as the default beneficiary is not subject to state inheritance tax.

For federal estate tax purposes, proceeds of life insurance policies paid to or for the benefit of the decedent's estate or over which the decedent is considered to hold the incidents of ownership are included in the decedent's gross estate for estate tax

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

purposes.

Proceeds payable directly to the personal representative of the decedent's estate or payable to a person who is subject to a legally binding obligation to pay taxes, debts, or other charges enforceable against the estate are considered payable to or for the benefit of the estate. The concept of incidents of ownership of a policy looks to the deceased owner's ability, acting either alone or in conjunction with another, to determine who or what receives the economic benefit of the policy. Authority such as designating a beneficiary, surrendering or canceling the policy, assigning the policy or revoking an assignment, pledging the policy for a loan or borrowing against the cash surrender value of the policy is generally considered to be an incident of ownership. If the policy provides it or its proceeds can return to the decedent or the decedent's estate, or the decedent's estate has a power of disposition over the policy, the holder of such power is considered to have an incident of ownership if either of these powers is valued at more than 5% of the value of the policy immediately before the decedent's death. These powers are referred to as reversionary interests. A person who has incidents of ownership can assign the policy to another to avoid the inclusion of policy proceeds in a gross estate.

In chapter 13, the concept of an *irrevocable life insurance trust* was introduced. The objective of this approach is to make the trustee the owner of a life insurance policy which will eventually fund the trust when the insured person dies. By having the trustee be considered the policy owner, the individual who sets up the arrangement avoids having the proceeds of the policy being included in his or her gross estate for federal estate tax purposes while still having some control over the ultimate destination of the policy proceeds when the trust agreement is prepared. Once the policy proceeds are received, the trustee manages the proceeds for the benefit of the persons named in the trust agreement and distributes the funds according to those terms. If a surviving spouse is given an interest in the benefits of the trust care should be taken to avoid the trust proceeds from being considered as part of the spouse's estate where it may create a significant tax. The earlier discussion in Chapter 13 of a by-pass trust is relevant to this discussion as well. Under the terms of the trust agreement the trustee can be given authority to purchase assets from the estate and provide cash to the estate. Drafting the irrevocable life insurance trust agreement is an important component in making this plan a success. Care must be taken to draft the plan to achieve the desired goals while avoiding the pitfalls that could create unintended and undesirable results.

A second estate tax consideration involves gifts of insurance policies within three years of the decedent's death. Under current estate tax law, such gifts, as well as several others, are included in the gross estate despite the transfer of the property before death. Policy proceeds will generally be included in the gross estate of the decedent who dies within three years of transferring the policy even though the recipient of the policy pays the insurance premiums during the three year period. Therefore, if a policy owner assigns or transfers the policy to another person to avoid having the policy proceeds included in his or her estate, the three year rule becomes an important consideration.

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

For gift tax purposes, the lifetime transfer of life insurance policies is a potentially taxable transfer if the value of the gift exceeds the gift tax annual exclusion. Gifts of insurance policies can be either direct or indirect. A transfer from a policy owner, who is also the insured, to another is an example of a direct transfer. Similarly, if a person purchases a policy of insurance on his or her life and names another as the beneficiary, a gift occurs regardless of whether the beneficiary is named directly, or as the beneficiary of a trust. Examples of indirect transfers are payment of another's insurance premium, transfer of employer provided group term coverage from the employee to another, split-dollar insurance coverage arrangements between a corporation and another who is not an employee of the corporation, such as the spouse of an employee. In these gift situations, a central concern is the value of the gift in relation to the annual exclusion amount that determines if a taxable gift is made.

For gift tax purposes, insurance policies are valued at their fair market value which is its actual cost or replacement cost. The value of a particular type of policy is determined by establishing the cost of comparable policies issued by other companies. If the policy is a whole life policy in force for some time, however, it may be necessary to determine the terminal reserve value of the policy and then adjust that amount by adding unearned premiums and dividend accumulations and deducting policy loans from the total. The value of certain types of policies may also reflect their unique character. Since term insurance policies have no terminal reserve value, their fair market value is the value of their unearned premium at the date of the gift. Newly issued single premium policies are valued at the amount of the premium paid. If a policy has been in force for some time and is paid-up, its value is the single premium or charge that would be charged by the issuing company, at the date of the gift, for a policy with the same face amount and based on the insured's age at the time of the gift. Employer provided group term insurance coverage is valued at the amount of the unearned premium on the date of the gift. Whole life insurance subject to a split-dollar arrangement is valued as other whole life policies, but the amount of the employer's interest in the policy is deducted.

A second gift tax consideration is that the recipient of the gift must have a present interest in the gift property for the annual exclusion to apply. Outright gifts of insurance policies to recipients qualify as present interests if the recipients have the unrestricted right to the use, possession and enjoyment of the policy, even though the death proceeds may not be payable to a later time. Transfers of life insurance policies in trust must also meet the present interest requirement to qualify for the annual exclusion. To create the present interest, gifts in trust can provide for the beneficiary's right to withdraw an annual amount (Crummey powers") which is small enough to avoid being treated as a taxable gift or a general power of appointment over the trust if the failure to exercise the right to withdraw is treated as the lapse of a general power of appointment.

For generation skipping transfer tax (GSTT) purposes when that tax applied, a trust includes any arrangement (other than an estate) which, although not a trust, has substantially the same effect as a trust. Insurance is specifically subject to this treatment. Therefore, life insurance policies that are not held in trust, but which have substantially the same effect as a trust (income to a person for life, with principal paid to

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

others at the person's death) may be subject to GSTT.

In considering the impact of generation skipping transfer tax on insurance several issues arise. The first involves the effective date of GSTT provisions. GSTT does not apply to a trust that was irrevocable on or before September 25, 1985 and which had no additions to the trust after that date. Additions after September 25, 1985 may result in a portion of the trust being subject to GSTT. Constructive additions to an exempt trust occur where release, exercise or lapse of a power over a portion of the trust is treated as a taxable transfer. This may result in the portion of the trust subject to the power being treated as an addition to the trust.

Gifts of property below the annual exclusion amount for gift tax purposes are also exempt from GSTT provided they are treated as direct skips. Direct skip gifts can be gifts made directly to a skip person or to a trust for the benefit of one or more skip persons and in which no non-skip persons have an interest. Direct skip gifts below the \$13,000 annual exclusion amount made to a trust may also be exempt if the trust is structured so that during the life of the individual beneficiary no portion of the principal or income of the trust may be distributed to or for the benefit of any person other than the beneficiary. If the beneficiary dies before the trust is completely distributed, the trust must provide that the remaining trust assets are to be distributed to the beneficiary's gross estate and potentially subject to estate tax at that time.

Therefore, a gift by a grandparent to a trust established for a grandchild who qualifies for the annual exclusion by reason of the grandchild's present interest in the trust may also qualify for the GSTT exemption. If the trustee chooses to purchase life insurance with the trust principal, the funds used to pay insurance premiums will avoid GSTT. Since the funds are received by the trust as nontaxable gifts, the policy proceeds will likewise be nontaxable for GSTT purposes.

Nontaxable gift situations may benefit from considering second to die life insurance policies that take advantage of the lower premium costs which such policies often offer. As such policies pay proceeds only at the second death; the financial circumstances of intended beneficiaries must be able to deal with that fact. Similar results may be obtained by using split-dollar arrangements between the insured's employer-corporation and an irrevocable life insurance trust. In an appropriate situation, combining both techniques may drive premium costs down even further.

### **G. How Much Life Insurance Should I Buy?**

Buying life insurance, like many other financial purchases, is an individual decision, based on particular circumstances and needs. For example, term insurance is useful on a temporary basis if a person is young and wants to provide for a spouse and young children should he or she die unexpectedly. For young, healthy people, it is relatively inexpensive. For older, more established people, the cash value and fixed premiums of a whole life policy might be more attractive. The flexibility afforded by universal and variable life policies may respond to individual needs more effectively. For older

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

persons, insurance may be very difficult to get, especially in the case of someone who suffers significant illness or injury which makes insurance very expensive, or even impossible to buy. The *Financial Guide's* "Life Insurance: How Much and What Kind to Buy" website considers five typical situations in which life insurance might be considered and how the situation might impact on the amount of insurance to purchase. These five situations include:

1. Families or single parents with young children or other dependents.
2. Adults with no children or other dependents
3. Single adults with no dependents
4. Children
5. Retirees

Without considering other factors, of these five groups the group with the greatest need for life insurance is the first group. This is especially true for parents of young children. People in the second group may view insurance as an important tool to replace the income support lost by a spouse's death or as a means to provide a supplement to a surviving spouse's retirement plan. Children have perhaps the lowest need for life insurance. Retirees may have less need for life insurance unless they view it as a source of funds for a variety of estate, planning or retirement purposes, such as funding payment of death taxes, purchase shares of stock or partnership shares in a business, creating the instant estate, or making special gifts to special people. This classification process simply helps someone to consider how their individual circumstances and situations impact on their need for life insurance.

In deciding how much insurance to buy, the first step should be to determine your insurance needs. What purpose or role do you expect the insurance to serve in your overall estate or financial plan? Up to this point we've discussed several roles that insurance can play, such as creating the estate that will pass to the beneficiaries, providing financial security for a financially dependent spouse or beneficiary, providing a fund from which major bills such as a mortgage or a deceased owner's share of a business can be paid, or payment of an anticipated expense, such as a college education. Life insurance also plays a role in retirement planning by allowing individuals to maximize their existing retirement benefit plans.

After deciding the role insurance is to play, the next step is to review your present resources to determine your financial situation. Completing the estate summary and estimate of annual income and expense found in chapter 18 is an excellent way to organize and analyze your personal financial situation. Once you have the information organized, look for key points in the summaries.

*For example, if your assets exceed your liabilities by a significant amount, your financial situation may be pretty good. How will the death of the sole property owner, or one spouse, affect that situation? What taxes will be imposed on the transfer of property from the deceased owner to whoever is intended to receive it? How will taxes be paid? Will it be necessary to sell valuable assets to pay the*



## Handbook on Estate and Succession Planning for Farm and Forest Landowners

*tax? Will the sale of these assets affect the surviving spouse's income level? If the income level is reduced, will it be sufficient to maintain the life style enjoyed while both spouses were alive?*

In considering these questions, the annual income and expense estimates in chapter (check) are convenient and helpful guides to determining the present situation and estimating the affect that the loss of one spouse's income will have on the survivor's financial situation. If additional resources must be found to cover expenses or maintain income levels, a review of alternatives will identify the potential sources of additional resources.

After examining the role that insurance can play and examining the present asset and anticipated income and expense situations, the next area to consider is the amount of personal or family resources that can be devoted to purchasing insurance. Without considering the ability to pay factor, a purchase decision can quickly become a financial mistake that leads to canceling the insurance and significant loss of premium and insurance protection. If ability to pay is limited, it may mean that the purchase decision should be to purchase the best available insurance product that provides the desired level of protection and financial benefit. Insurance products can be expanded or modified in the future, and it is generally better to accomplish part of a goal than to leave it completely unaccomplished.

The decision to purchase insurance should be made only after a thorough consideration of these three factors: the role insurance is to play, the financial situation at present and as anticipated in the future, your ability to pay.

Once the decision is made to purchase insurance, the buyer's attention should focus on purchasing the best policy from the best company with available premium dollars. This consideration looks at two factors, the policy that is being offered and the company that is offering it. To help buyers compare insurance policies a cost index has been developed and an insurance company can calculate an index for a particular policy. This allows buyers to compare the cost index from one policy to the index of similar policies from other companies. In making the comparison, a policy with a lower index is generally a better buy than a policy with a higher index. Additional information about the cost index method of comparison can be obtained from an insurance agent, an insurance company or a state insurance department or office. In making comparisons between policies remember the following rules:

- Cost comparisons can only be made between similar life insurance policies.
- Index number comparisons should only be made for the insured's age, for the kind of policy you intend to buy and for the amount of insurance you plan to purchase.
- Small variations in index numbers might be offset by other policy features or differences in the quality of service you get from the company or the agent.

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

- Base a decision not only on a low index number, but also on whether the policy meets your needs; whether you can afford the premium; whether you understand its cash values, if any, its dividends, if any, and its death benefits.
- The cost index cannot be used to compare existing policies to newly issued policies. Therefore, it cannot be used to determine whether a current policy should be replaced by a new policy.

After obtaining the cost index information from the companies in which you are interested, a buyer should also examine the strength of the company issuing the policy. An essential assumption in using life insurance is that the company is financially sound and will be available to pay the policy when the time comes to do so. This company analysis can be done by consulting one or more of the insurance rating services that analyze and rate life insurance companies in the United States. These services include Best's Ratings, Moody's Investors Service and Standard and Poor's. Best's Ratings are prepared by A.M. Best for over 1400 life insurance companies and their ratings range from its highest rating of A+ to the lowest rating of C. Generally, over 200 companies receive the A+ rating. Moody's Investor Service rates fewer life insurance companies than A.M. Best and its ratings range from a high rating of Aaa to a low of C. Standard and Poor's ratings of life insurance companies range from a high of AAA+ to a low of D. It is important to remember that the rating scales vary from one company to another. An A+ is the highest rating issued by A.M. Best, but third from the highest in the Standards and Poor's rating system.

Before deciding on the policy and company that best accomplishes your goals and fits your budget, it would be useful to read the insurance contract carefully. At this point in reading through this chapter and at this point in the book you are probably saying to yourself, "Why would someone ever want to read an insurance contract if I am not going to understand what it says"? While it is certainly true that insurance contracts are complex and difficult to understand the fact remains that much valuable information can be learned from reading over them. As a contract, the terms and conditions set forth in the policy are very important in defining the rights and responsibilities of both the company and the policy owner. If policy terms and conditions are unclear, important elements of an informed purchase decision may be missing from the decision making process. Reading through the contract will help to highlight key questions that must be resolved before a final decision can be made.

To summarize the many factors and issues, before purchasing policy buyers should follow these 10 rules developed by the American Council of Life Insurance:

1. Understand and know what your life insurance needs are before purchasing any policy. Choose the company that offers policies that address those needs.
2. Buy life insurance from a company that is authorized to do business in your state.
3. Select a competent, knowledgeable and trustworthy insurance agent.
4. Shop around and compare the cost of insurance policies.
5. Buy only the amount of life insurance that you need and can afford

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

6. Be certain to inquire about lower rates for special groups, such as non-smokers.
7. Read and understand your insurance policy.
8. Inform your beneficiaries about the kinds and amounts of life insurance that you own.
9. Keep insurance policies, a separate list of the companies that issued the policies and a list of policy numbers in a safe place.
10. Check insurance coverage and designated beneficiaries periodically, to be sure that coverage is proper and the beneficiaries are people you want to benefit.

### H. Student Exercises

#### Multiple Choice Questions

Please read the following questions carefully, and then select one of the four choices following the question that best answers the question asked.

1. Which of the following statements is incorrect?
  - a. The beneficiary of a life insurance policy is the person who receives the proceeds of the policy after the owner's death.
  - b. Cash surrender value of a life insurance policy is the amount payable by the insurance company to the beneficiary after the insured dies.
  - c. Term insurance does not have cash value.
  - d. Annuities are contracts that pay income to someone during their lifetime and are unlike insurance policies that pay proceeds after a person's death.
2. Which of the following terms describes a life insurance policy that accumulates cash value?
  - a. A convertible term policy
  - b. A permanent life insurance policy
  - c. A renewable term policy
  - d. A participating policy
3. Which of the following terms describes an insurance policy which covers the lives of two people and which is payable only after both people have died?
  - a. A variable life insurance policy
  - b. A universal life insurance policy
  - c. A split-dollar life insurance arrangement
  - d. A second to die life insurance policy
4. If a deceased person is considered to have the "incidents of ownership" of an insurance policy at the time of his or her death, the policy proceeds will be included in the decedent's gross estate for federal estate tax purposes. In which of the following cases would the decedent not have incidents of ownership?

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

- a. The decedent is authorized to designate beneficiaries of the insurance.
  - b. The decedent pledged the policy as security for a loan.
  - c. The decedent is authorized to cancel the policy at any time during his lifetime.
  - d. The decedent paid none of the policy premiums and had no authority to deal with the policy in question.
5. Gifts of life insurance policies valued for less than \$13,000 may qualify for the annual exclusion from federal gift tax. Which of the following statements correctly describes a requirement for the annual exclusion to apply?
- a. The gift must be made within three years of the owner's death.
  - b. The recipient must live for three years after the gift is made for the annual exclusion to apply.
  - c. The recipient must have the unrestricted right to use, possess or enjoy the insurance policy after the gift is received.
  - d. The donor may make only three such gifts in a calendar year.

### Short-Essay Questions

Please read the following questions carefully and then respond to the question that is asked at the end of the situation. Your answer need not be long or involved, but it should be clear and concise as is necessary. If you want to refer to important facts in your response, please feel free to do so.

1. John and Mary operate a farm and woodlot with the help of their daughter, Marcia, and their son, Michael. John and Mary have two other children, Martin and Martha. Neither of these other children is interested in working in the business. They are financially independent and involved in their own careers.

If John and Mary intend to transfer the land, business assets and equipment to Marcia and Michael, almost the entire estate will be transferred to these two children. If John and Mary don't want to ignore their other children, discuss the role that life insurance can play in enabling John and Mary to provide for post death transfers to Martin and Martha.

2. In 1996, Harold Humphries purchased a \$100,000 whole life insurance policy on his life and named his wife, Harriet, as beneficiary. At the time, Harold was not aware that Harriet secretly desired to end their marriage of five years. Harriet's heart belonged to another, but Harold didn't know this.

When he purchased the policy, Harold retained the right to name the beneficiary and to borrow against the cash value of the policy. Harold considered the cash value a valuable investment that also provided insurance protection in the event of his death.

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

In 2006, Harriet confronted Harold and told him of her desire to end their marriage. Harold was heartbroken, but he knew he could not change Harriet's mind. The divorce became final on December 1, 2007 and Harriet married the man she secretly loved.

In March of 2009, while traveling to town to pick up parts for his machinery, Harold was involved in an accident and suffered fatal injuries. At Harold's death he was survived by his brother, Hank, and his sister, Hildie. No children were born to Harold and Harriet during their marriage. Harriet now married to her new husband, Herb, also survived.

After Harold's death, Hank and Hildie went through Harold's papers and found the insurance policy. Hank notified the company of Harold's death. The insurance company then notified Harriet that she was the beneficiary of the policy and made arrangements to pay the proceeds to her.

Based on our discussion of state inheritance tax and federal estate tax, discuss the impact of these taxes on Harold's estate and on Harriet.

3. Over the years, Jerome Jaxsenn and his wife Jennine have often considered the need to purchase additional insurance. The needs they want to cover include the cost of inheritance and estate taxes and providing significant gifts to their two children, both of whom owe considerable amounts in student loans for their professional educations. If either Jerome or Jennine were to die, the survivor would be financially able to manage on their own.

The difficult questions concerning insurance coverage have always been, "How much insurance should we buy, and from which company should it be purchased?" Based on our discussion of the types of insurance policies, comment on the types of policies that would fit the Jaxsenn's needs. Briefly outline the steps they should take as they evaluate their purchase of a new insurance policy.

# Handbook on Estate and Succession Planning for Farm and Forest Landowners

## Chapter 15. Organizing and Operating the Farm or Forest Business Enterprise

### A. Overview and Purpose

This chapter focuses attention on the farm or forest enterprise. In the opening portion it examines various ways a business can be organized as a proprietorship, partnership, limited liability company or corporation. Within each business form the common variations, such as regular and limited partnerships; regular, close or professional corporations, cooperative agricultural associations and limited liability companies are discussed.

After discussing the general characteristics of each organization form, the chapter will compare each form on its organization, management and operation considerations.

The next section of the chapter will introduce a number of state and federal income tax considerations in organizing the business. Although this discussion of tax considerations will not cover the tax consequences of operating the business, it will highlight factors that business owners and operators need to consider in the organizational stage, before the decision is made to form the enterprise.

The final issue to be addressed is the role that the organization form plays in passing a business interest from one generation to the next.

### Lesson Objectives:

After successfully completing this material, you should be able to accomplish the following objectives:

- To identify the organizational and operational aspects of a proprietorship.
- To distinguish between the operational and organizational aspects of regular partnerships and limited partnerships.
- To distinguish between the organizational and operational aspects of regular corporations, close corporations, professional corporations, cooperative agricultural associations and limited liability companies.
- To compare the management structure and process of proprietorships, partnerships, corporations and limited liability companies.
- To list several factors that affect a business owner's choice of a business organization form.
- To explain how assets held in a proprietorship, partnership, corporation or limited liability company can be transferred by an owner to another owner either during lifetime or after death.

### B. Choice of Farm or Forest Business Organization

The four general ways in which a farm or forest business enterprise can be organized are a proprietorship, a partnership, a corporation or a limited liability company.

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

Proprietorships are the most common type of organization. Corporations are the least common type among farm operators. Partnerships are more frequent than corporations, but significantly less frequent than proprietorships. Limited Liability companies are a hybrid that include characteristics of partnerships and corporations.

### **Proprietorships**

The reason that many farm or forest small businesses use the proprietorship form is the simple nature of the organization. In a proprietorship, every aspect of the business revolves around the owner. All of the assets, debts, profits and responsibility fall on the owner's shoulders. The owner decides when the business is formed, how it operates and when it chooses to end its existence. Between its formation and its closing, all business decisions are made by the owner.

### **Partnerships**

A partnership is an association of two or more persons to carry on a profit making business as co-owners. In this type of organization, partners share capital and labor in the operation of the business and make decisions that benefit the business. By combining these resources, the partners hope to gain the advantage of a larger operation that lowers costs, increases efficiencies and enables the partners to increase business volume through their combined efforts.

In contrast to hiring an employee to provide additional labor, a partner provides more than just additional labor. A partner is an owner who applies management expertise and skill to business decisions. Co-ownership of assets, such as joint tenancy with the right of survivorship and tenancy in common, does not rise to the level of a partnership since ownership alone does not constitute the operation of a business for profit. Sharing profits is an indication of a partnership relationship, but there are many situations where gross profits are shared that are not partnerships. These include wages paid to an employee; rent paid to a landlord, payments on a debt and annuity payments to the heirs of a deceased partner. In determining the nature of the relationship between multiple owners, the intention of the parties at the time the organization is formed is an important point to consider.

### **General Partnerships and Limited Partnerships**

Partnerships are of two types, general partnerships and limited partnerships. In a general partnership each of the partners is involved in the operation and decision making of the partnership. Each general partner is personally responsible for the payment of partnership debts and obligations, even to the extent of personal assets. A limited partnership differs in that there are two types of partners, general and limited. General partners of a limited partnership are much like general partners in a general partnership. They make decisions regarding the operation of the partnership business and are personally liable for the debts and obligations incurred by the partnership business.

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Limited partners, however, have only a limited role to play in the operation and decision making of the limited partnership. Their role is similar to that of an investor rather than a general partner. As a consequence of their limited involvement in the partnership business, they have no responsibility for the payment of partnership debts and obligations beyond the amount of their investment in the partnership. Limited partners, who exceed their role of limited involvement in the partnership, by participating in the control of the business, run the risk of having their responsibility expanded to that of a general partner. A limited partner who participates in the control of the partnership business faces broader responsibility for debts and obligations incurred when dealing with others who reasonably believe the partner is a general partner and not a limited partner.

### **Registered Limited Liability Partnerships**

Registered Limited Liability Partnerships are a third type of partnership. In a general partnership, all partners are jointly and severally liable for all losses chargeable to the partnership because of a partner's wrongful acts or omissions, or because of a partner's breach of trust, and jointly responsible for all other debts and obligations of the partnership. In a registered limited liability partnership, however, partners are not liable for debts and obligations of, or chargeable to, the partnership arising from any negligent, wrongful acts or acts of misconduct committed by another partner or other representative of the partnership. In a registered limited liability partnership, a partner cannot be forced to contribute to payment of the debt or obligation, or to indemnify anyone else who makes such a payment.

An important condition for this result to apply is that the partnership must carry minimum liability insurance coverage or other form of financial security equal to \$100,000 times the number of partners in the partnership in excess of one. In no event will this minimum coverage or financial security exceed \$1,000,000. This coverage protection is for liability arising from negligent or wrongful acts or misconduct committed by a partner.

This limitation on liability does not extend to liability of a partner arising from his own acts of negligence or wrongful acts or misconduct, or those acts of others who are under the partner's direct supervision or control. Debts or other obligations of the partnership which arise from some other source continue to be the responsibility of all partners as well as those debts or obligations for which any partner has agreed in writing to be responsible for or which are expressly undertaken by the partnership.

Once registered as a limited liability partnership, the partnership remains liable for all debts and obligations and its entire assets can be used to satisfy these debts and obligations.

### **Corporations**

The third type of business organization is a corporation. A corporation is a legal entity



## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

that has a life of its own that is separate and apart from the lives of people who own or operate the corporation. This separate existence is unique among the business organizations. As an entity that has legal existence, a corporation is tied to the statute that gives it this existence. Laws in Pennsylvania and other states provide for the creation and operation of corporations that can be organized for business and non-business purposes. As a business organization form it has particular appeal and advantage to medium and large businesses, but less advantage to small businesses.

In most states, corporations include several different types, such as business, non-profit, close, professional or cooperative corporations. The differences between these organizations are relatively few. Business corporations are the traditional or common example of a business organization formed to conduct a commercial activity. Non-profit corporations are those charitable, educational or community service activities conducted on a non-profit basis that wish to take advantage of the separate existence of a corporation to conduct their activities. Close corporations, or closely held corporations, are business corporations owned by not more than 30 shareholders that wish to simplify management of the corporation and restrict future ownership of shares of stock in the corporation to only a defined class of people, such as family members of present shareholders.

Professional corporations are business corporations created for the purpose of providing professional services that require a license, admission to practice or other legal authorization, such as medical, dental, and funeral director, legal, accounting and professional engineering services. Ownership of stock in a professional corporation is limited to members of the licensed profession. Professional corporations are authorized to engage in only those professional activities for which the corporation is formed. Professional services rendered by the corporation must be provided by its officers, directors, employees and agents who are licensed members of the profession. Unlicensed employees may not provide such services.

Cooperatives are business organizations that are organized on the principle that members working in cooperation with each other can achieve a greater advantage than individuals working alone. Cooperative agricultural associations have been in existence for many years operating for the mutual benefit of its members, shareholders, patrons and producers. In terms of their organization and operation, cooperative agricultural associations are generally treated as business corporations organized with shareholders or as business corporations organized without shareholders.

### **Limited Liability Companies**

Limited Liability Companies are designed to allow business owners to gain the advantage of limited liability for debts and expenses which corporations provide, while being treated as a partnership for most other operational purposes. In this way, business owners can combine some of the distinct advantages that apply to partnerships and corporations in a single entity. Property transferred to such a company belongs to the company and individual members or managers of the company have no

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

claim to it. Real estate acquired by the company is owned by it and not its individual members.

In general, a limited liability company can be organized and treated as either a partnership or a corporation for federal tax purposes. As the partnership tax status avoids separate taxation of the business which would be the case for a corporation, most limited liability companies are organized with the intent of being taxed at the federal level as partnerships rather than corporations. Each state in which a limited liability company is organized will determine how this business entity will be treated for tax purposes.

*For example, Pennsylvania's limited liability company law provides that for purposes of state taxes, licenses or fees, domestic limited liability companies are recognized to be corporations and its members are treated as shareholders of the corporation. Although this corporate status is granted, the company may elect to be treated as a Pennsylvania S corporation and its members treated as shareholders of the corporation if the company meets the requirements of such an election. As income tax consequences are generally an important ingredient in the organizational decision, great care must be taken to assure that the entity is properly organized to achieve desired goals and consequences.*

Under Pennsylvania's limited liability company law, neither members of such a company nor its managers will be liable, solely by reason of being a member or a manager, for any debt, obligation or liability of the company of any kind or for the acts or omissions of any other member, manager, agent or employee of the company.

### **C. Organization of Farm and Forest Business Enterprises**

#### **Proprietorships**

To organize a proprietorship little need be done. A simple statement by the business owner that the business is active and the owner is exercising control is sufficient. If the owner chooses to do business in a name other than the owner's own name, the proprietor may need to register the business name as required by laws dealing with doing business under a fictitious name.

#### **Partnerships**

Two important questions must be answered before deciding to organize a partnership or a corporation. The first asks, "Is the business financially strong enough to generate sufficient income to support two owners and their families?" The second is equally important; "Can I get along and work well with the person I want to bring in to the business?"

Organization of a partnership can be relatively simple or quite complex depending upon the type of partnership being formed. General partnerships are formed when two or more

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

persons form their association to co-own and carry on the business for profit. For purposes of forming a partnership, a person can be an individual, a corporation or another partnership. From there, creation of the entity can be formalized in a written partnership agreement that details the rights and duties of the partners to each other and to the partnership business. If the partners do not take advantage of the opportunity to formalize their agreement, most states follow the provisions of the Uniform Partnership Act (UPA). Under the UPA, if the partners have not entered into an agreement that defines their relationship to the partnership, the act fills in the blanks and provides rules that control the relationship of the parties to the business and to each other.

*For example, if the partners have not prepared a written partnership agreement, the UPA provides that partners will share equally in the following items:*

- *Profits*
- *Losses*
- *Management of the partnership*
- *Access to partnership books*
- *Possession of partnership property*
- *Capital and profits of the partnership that remain at dissolution after creditors and debts to partners are paid.*

Given the significance of these important matters, most partnerships take the time to reduce their agreement to writing. In the written document, the partners detail who, what, when, where, and how the partnership business will be operated. Its terms provide for the amount of capital to be contributed to the partnership, capital additions by the partners, distribution of profits, accounting responsibility, managerial duties of the partners, limitations on the authority of partners to act on behalf of the partnership, dissolution rights of the partners and a blueprint for handling the death or withdrawal of a partner. Although the partnership agreement covers many issues, its value to the partners is most apparent when it is used to resolve disputes between the partners. In this context, it provides guidance for resolving problems under the framework designed by the partners in a more cooperative spirit.

Formation of a limited partnership is more complex since a limited partnership cannot exist without formal certificate of limited partnership and the partnership agreement. In the certificate of limited partnership, the partnership describes its name, address of its registered office, name and address of each general partner and any other matter of importance that the partners decide to include in the certificate. In addition to the certificate, the partners prepare a detailed partnership agreement similar to that of a general partnership, with provisions for sharing of profits and losses and distributions to the partners. The agreement should also include provisions that detail the special relationship which limited partners have to the partnership and the importance of the limited partners remaining out of the operation of the partnership business. When the certificate of limited partnership is prepared by the general partners of a Pennsylvania limited partnership, it is filed with the Department of State of the Commonwealth of Pennsylvania. Upon filing the partnership comes into existence, although the certificate

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

can request its existence be delayed until some other time. After filing the certificate, the general partners deliver copies of the filed certificates to the limited partners, unless the partnership agreement provides otherwise.

Organizing a partnership as a limited liability partnership requires filing a statement of registration with the Department of State. In the statement, the partnership expresses its intent to be a limited partnership under the law. This statement must be signed by a general partner.

### **Corporations**

Formation of a business corporation, whether it is a regular, close, professional or cooperative agricultural association, also requires filing documents to create the organization. The central document that leads to the creation of a corporation is the Articles of Incorporation which is prepared by the incorporators of the business. One or more natural persons 18 years old or older or another business or non-profit corporation may be an incorporator of a business corporation.

In the Articles, the corporation describes the name which it has selected and is eligible to use in conducting its business, the address of its initial registered office, a statement of its intent to be organized as a business corporation, a statement that the corporation is to be organized on a stock or non-stock basis, the name and address of each incorporator, the term of the corporation's existence and any other provision that the incorporators choose to place in the Articles. All business corporations organized in Pennsylvania are organized with the power to engage in all lawful business activities, unless the Articles limit the corporation's authority in some express way. Professional corporations and cooperative agricultural associations by their nature have special provisions in their articles that reflect their unique status.

When the Articles are prepared, they are filed with the Corporation Bureau of the Department of State. Upon filing the Articles of Incorporation with the Department of State, the corporation comes into existence as a separate legal entity, unless a later date is requested in the Articles. Either prior to or following the filing of the Articles, the corporation places an ad in a local newspaper announcing the filing or expected filing of the Articles.

After the Articles are filed, the incorporators or the initial directors of the corporation call an organizational meeting for the purpose of establishing the corporation. At the meeting, the by-laws of the corporation can be adopted to guide the operation of the corporation.

By-laws deal with four important aspects of any corporation:

- Its organization;
- Its officers, and directors,
- Its shareholders, and
- Its membership and its future.

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

The corporation is now operating as a body that is independent of its owners. Maintaining a separate operating identity and following the formalities of corporate existence are important to retaining the advantages of separate corporate existence.

### **Limited Liability Companies**

To organize a limited liability company, one or more persons must act to initiate the organization process. If a single member company is organized it will be taxed as a corporation rather than as a partnership. Action will need to be taken to avoid unexpected taxes in this situation. As the first step in the organization process a certificate of organization must be filed with the Department of State. In this document the organizers decide if the company is to be operated a single manager or several managers. In the absence of this decision, management authority vests in the members of the company.

Members of a limited liability company should enter into a written operating agreement which describes the affairs of the company and the conduct of its business. This agreement will contain provisions for regulating the internal affairs of the company with which members agree. The limited liability company law provides certain general rules for the treatment of specific situations which could apply to a business if the business has not exercised its opportunity to determine how that the situation should otherwise be treated. Therefore, if the organizers of the business do not take advantage of this opportunity the general rules apply.

## **D. Management of a Farm or Forest Business Enterprise**

### **Proprietorships**

If the organization has chosen to operate as a proprietorship, management authority is vested in the proprietor. Decision making authority and responsibility for decisions rests on his or her shoulders. If the proprietor dies, the business ends.

### **Partnerships**

In a general partnership, the partners are the chief decision makers in the business. Unless otherwise specified in the partnership agreement, each partner has authority to make decisions on behalf of the partnership. General partners act as agents of the partnership in carrying out the partnership business. Their acts bind the partnership unless the partner has no authority and the person with whom the partner transacts business is aware of this absence of authority. Every partner must account to the partnership for any benefit and hold as a trustee any profits that arise out of any partnership business transaction and which are obtained without the consent of the other partners. Partners also have the right to use all partnership property for any partnership purpose, but they have no right to use the property for any other purpose, without the consent of the partners.

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

Management authority in a limited partnership is vested in the general partners who operate under the terms of the partnership agreement and the law relating to general partners. To retain their limited liability status, limited partners must avoid participating in control of the partnership business.

*For example, the Revised Uniform Limited Partnership Act provides that limited partners can be involved in the following activities and still maintain their status as limited partners:*

- *Act as agent or employee of the limited partnership or of the general partner.*
- *Act as officer, director, trustee, partner or shareholder of a general partner.*
- *Consult with or advise a general partner with respect to any matter including the business of the limited partnership.*
- *Borrow money from the limited partnership or the general partner.*
- *Lend money to the limited partnership or the general partner.*
- *Provide collateral for the limited partnership or the general partner request or attend a meeting of partners.*
- *Propose or vote on issues that involve the partnership, such as the sale of partnership assets, change in business activity, admission of new general or limited partners, merger of the partnership or its dissolution and winding up.*
- *Other matters that relate to the business of the limited partnership described in the partnership agreement as subject to the approval or disapproval of the limited partners.*

### Corporations

Management of a corporation involves officers, directors and shareholders. Corporations are owned by shareholders, the investors who purchased shares which give them the right to vote on important corporate issues and share in the profits of the business through the issuance of corporate dividends. One of the matters on which shareholders vote is election of the Board of Directors of the corporation.

This Board constitutes the long range planning and decision making body within a corporation. Directors stand in a position of trust to the corporation. They are obligated to perform their duties in good faith, in a manner which the director reasonably believes to be in the best interest of the corporation. In making decisions, directors exercise care, including reasonable inquiry, skill and diligence as a person of ordinary prudence would use under similar circumstances. The Board of Directors appoints the officers of the corporation. Officers serve as the day-to-day decision makers of the business in matters of sales, production, personnel management, marketing and so forth. Officers are obligated to perform their duties in good faith and in a manner which the officer reasonably believes to be in the best interests of the corporation. Officers exercise their authority with care, including such reasonable inquiry, skill and diligence, as a person of

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

ordinary prudence would use under similar circumstances.

In a small corporation, all of the stock may be held by one person who serves as shareholder, director and officer of the business. In larger corporations, a seat on the Board of Directors or appointment as an officer of the corporation may be given to other shareholders who are active in the business and want to remain so.

In close corporations, management can be simplified by eliminating the role of the Board of Directors and giving its authority to the shareholders. As the status of shareholder can be limited in close corporations, the potential number of people who can achieve this powerful position is likewise controlled.

In professional corporations, the status of shareholder is restricted to licensed members of the profession involved in providing the professional services. Following the death of a shareholder in such corporations, the deceased shareholder's estate can continue to own the shares for a reasonable period of time until the shares can be transferred to another eligible person.

### **Limited Liability Companies**

In the management and operation of a limited liability company, the principal players are the members and managers. A member is a person who is admitted to membership in the company. Generally, membership is acquired by either purchase of an interest in the business or by assignment or transfer of an existing interest from another member. The operating agreement of a company may provide for classes of members at the time of organization as well as in later years. An owner's membership interest may be recognized by a certificate of membership, but such a certificate is not a required item.

Unless a company's certificate of organization provides for management by a manager or managers, management of a limited liability company vests in the members of the company. The members operate the company with the same power which general partners have in a general partnership. If a company is managed by its members, every member of the company must account to the company for any benefit that he or she derives from any transaction with the company which has not been the subject of consent from other members of the company.

Another key player is the manager(s) of the company who is designated in the company's certificate of organization as having the authority to manage the business of the company in accordance with a description of authority in the certificate. Managers serve for a term of one year and until a successor has been elected and qualified, or until the manager's earlier death, resignation or removal. Replacement managers may be selected according to procedures described in the company's operating agreement. Managers of limited liability companies have authority of general partners in a general partnership and the same duties as corporate officers and directors. Members of a limited liability company which has designated managers are treated as limited partners in a limited partnership. A manager need not be a member of the company and may be

another entity, such as a corporation or a partnership.

### E. General Tax Considerations Involved with Business Organizations

The first tax point to consider is that neither a proprietorship nor a partnership involves the creation of a new taxpaying entity. In a proprietorship, the taxpayer is the person who owns and operates the business. Reporting business income and expense deductions involves filing IRS schedule F or schedule C plus supporting schedules and forms as required. As assets are already owned by the business owner/operator, few tax consequences occur when the decision is made to devote personally owned assets to a business activity.

#### Partnerships

In a partnership, partners are the responsible taxpayers and the partnership passes income and deductions back to the partners who file this information on their personal or corporate tax returns. Reporting is accomplished by filing IRS forms and other supporting schedules and forms as required. When assets are transferred by an incoming partner to the partnership, two important tax events occur. The first is that the fair market value of what is transferred to the partnership becomes the partner's contribution to the partnership, and is then used to determine the partner's share in the overall capital of the business. The second event is that when the partner's share of the capital is determined, the individual partner acquires a tax basis in the partnership capital he or she contributed.

*For example, two partners contribute property to a partnership when it is formed. Partner A contributes purchased dairy cows that have a fair market value of \$10,000 and an adjusted basis for income tax of only \$4,500. Partner B contributes milking equipment that has a fair market value of \$10,000 and an adjusted basis of \$8,000 for tax purposes.*

If we consider only these items as the property of the partnership, the value of the partnership property is \$20,000. Each partner contributed one-half of that amount so they are equal partners in terms of their contribution to the partnership.

In regard to the partners, each will have a different tax basis in his or her share of the partnership. Partner A's tax basis is \$4,500 and Partner B's tax basis is \$8,000. In terms of the partnership, its basis in these assets is the same as that of the partners. If the assets were of the same type, whether breeding cattle or milking equipment, the partnership's tax basis would be a combination of the basis of each partner.

Tax basis becomes important when the partner's interest in the partnership is transferred or the partnership distributes funds to the partners. In addition to the contribution of property to a partnership, cash can be contributed in which case the value of the cash is its basis and its value. A partnership interest transferred as a gift has an ownership interest equal to the fair market value of the gift at the time it is made.



## Handbook on Estate and Succession Planning for Farm and Forest Landowners

The tax basis of the gifted interest is the adjusted basis of the gifted interest in the hands of the person who made the gift.

When property that is not subject to a debt or other liability is transferred to a partnership, there is no recognition of gain or loss as a result of the transfer. When property subject to a debt or liability is transferred to a partnership in exchange for a partnership interest, the debt can be involved in the calculation of the contributing partner's tax basis in the partnership.

*For example, a new partner contributes property with a fair market value of \$40,000 and an adjusted basis of \$20,000 to a partnership that consists of three other partners. The property is subject to a mortgage of \$16,000 which the partnership will assume.*

In calculating the contributing partner's basis in the partnership, the three-quarter interest in the mortgage assumed by the three original partners will be deducted from the contributing partner's original adjusted basis. This results in a tax basis of \$8,000 (\$20,000-\$12,000) for the contributing partner.

If an incoming partner assumes a liability of the partnership, his or her assumption will increase the partner's tax basis in the partnership.

Throughout the operation of a partnership, a partner's tax basis is an important piece of information. As income is generated by the partnership, a partner's tax basis can be increased by the amount of undistributed income. Partnership operating losses have the effect of reducing a partner's tax basis in the partnership. If a partnership chooses to distribute partnership property to the partners during the lifetime of the partnership, tax basis is also important. When distributions are made, the partnership's basis in the item is carried over to the receiving partner who reduces his or her tax basis in the partnership by the amount of the partnership's basis. If the amount of this distribution exceeds the partner's tax basis in the partnership interest, gain is recognized by the receiving partner. If at the time of liquidation a partnership distributes cash, unrealized receivables or inventory, of which the aggregate bases to the partnership are less than the partner's tax basis in the partnership, the partner may report as a loss the difference between the taxpayer's basis and the aggregate bases of the distribution. During the operation of the partnership, a partner may choose to transfer some of his or her partnership interest to another person. In such transactions, the transferring partner's tax basis in the partnership is an important element in the calculation of gain or loss arising out of the transfer.

### Corporations

Corporations by virtue of their separate legal existence have a separate existence for income tax purposes. Therefore, they are subject to separate corporate income tax at the federal and often at the state level as well. Under such tax statutes rates of taxation vary from individual tax rates. States may also tax other corporation attributes. For

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

example Pennsylvania imposes a tax on corporation Capital Stock.

As a separate taxpayer, the corporation calculates its income and loss at its own level. To the extent income exceeds expenses, corporations may choose to retain a portion of the earnings or pay them out to shareholders as dividends on their investment in the business. Before the dividends are paid, the corporation calculates its own taxable income and pays the appropriate tax. Shareholders who receive dividend distributions report them on their individual returns. In this situation the amount passed to shareholders is subject to tax twice. The first tax is imposed at the corporate level when the corporation calculates its own taxable income for tax purposes. The second tax is imposed when the shareholder reports the dividend as income on the shareholder's individual tax return.

Corporations that seek to avoid this result by retaining earnings rather than distributing them to shareholders must contend with the excess retained earnings rules which impose a separate tax on substantial amounts of retained earnings held without a reasonable business need to do so. Many small businesses that are operated in the corporate form avoid the problem of excess retained earnings and dividend taxation by paying out much of their income for deductible items such as reasonable salaries and bonuses. These amounts are not limitless as a corporation loses its ability to take a deduction for salary payments that are later found to be unreasonably high.

The solution to the dilemma of corporate and shareholder taxation in a relatively small corporation is election of S-corporation status. An S corporation is a regularly organized small business corporation that elected to be taxed on corporate earnings and losses directly, similar to the pass through treatment of partners in a partnership. S corporations lose their elected status as S corporations if for more than three consecutive years the corporation receives more than 25% of its receipts from rents, royalties, dividends, interests, annuities, and sales or exchanges of stock or securities.

To be eligible to elect this status for federal income tax purposes, a corporation must not have more than 100 shareholders, with husbands and wives treated as one shareholder. None of the shareholders can be non-resident aliens. The capital structure of eligible corporations must permit only a single class of stock, but distinctions in voting rights within the single class are allowed without such differences being considered a second class of stock.

In the case of either a regular corporation or an S corporation, certain rules allow the transfer of property to the corporation to be a tax free event. These rules are based on the assumption that the transfer of property to a corporation controlled by the persons who transfer the property is merely a change in the form of entity, from direct ownership of property by individuals to indirect ownership through ownership of a corporation that owns the property. If the tax free organization rules apply, recognition of gain and recapture of depreciation arising from the transfer of assets to the corporation are avoided.

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

Three requirements must be satisfied for the tax free incorporation rules to apply:

1. There must be a transfer of property by one or more persons to the corporation.

Stock that is issued in exchange for services rendered in the past or to be rendered in the future is not considered property for these purposes, even though the corporation law of the state where the business is organized permits stock to be issued for services.

2. The transfer of property must be solely in exchange for stock of the corporation.

In situations where the transfer of property to a corporation is made in exchange for stock and other types of property, the receipt of other property will trigger the recognition of gain to the extent of the money or fair market value of the other property received.

3. Immediately after the exchange, the transferring parties must be in control of the corporation.

The transferring parties must be in control of the corporation immediately after the exchange. Control is defined to mean ownership of at least 80% of each class of voting and non-voting shares of stock in the corporation. Individuals who provide services to the corporation in exchange for issuance of stock are not counted in the 80% test. If their shares exceed 20% of any one class, the test cannot be met.

The basis of stock issued in the incorporation equals the transferor's basis in the property transferred to the corporation in return for the issuance of stock. If the transfer includes assets that are subject to a debt or liability that the corporation assumes, the transferor's basis in the stock is reduced by the amount of the debt assumed by the corporation. Where the liabilities assumed by the corporation exceed the transferor's basis in the property, the transferor recognizes gain equal to the excess amount.

This discussion of state and federal taxes covers only a small portion of the tax issues that a business faces in deciding to organize, acquire property and start operations. Before making a decision, persons who seek to organize a new business or convert an existing business to a new form must take adequate time to explore these other tax issues with knowledgeable professionals.

### **F. Operational Considerations in Business Organizations**

#### **Proprietorships**

The relative simplicity which surrounds the organization and management of a proprietorship is obtained at a price which is the liability of the owner for all debts and obligations of the business that either the owner or the owner's employees create. This

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

liability extends well beyond the value of assets that are part of the business and includes the owner's non-business assets.

### **Partnerships**

In a general partnership, all general partners are jointly and severally liable for the payment of partnership obligations, except those that arise from the partnership's failure to perform a contract, in which case the partners are jointly liable with each other. Joint and several liability can be enforced against any one or all of the partners, while joint liability can only be imposed on all partners. In fulfilling this liability, a partner's personal assets, above and beyond those employed in the partnership, can be called upon to respond to the liability.

A limited partnership with its protected status of limited partners and a registered limited liability partnership which has more sweeping changes to the general rules which determine a partner's liability for obligations created by other partners are opportunities to avoid some of the undesirable results which the general partnership liability rules create.

### **Corporations**

A general business corporation, as a separate entity, may limit its liability to its own assets without threatening the assets of its shareholders. Corporate employees who create liability while performing within the scope of their duties and responsibilities for the corporation are jointly and severally liable with their employer for injuries and property damage caused by their acts. Although shareholders are generally not responsible for liabilities incurred by the corporation or their employees, shareholders who participate in the act or event that gives rise to liability may lose that protection through their participation. This protection can also be waived by a shareholder who assumes responsibility to pay a corporate debt or who guarantees performance of a corporate obligation. In situations involving newly formed corporations, it is not uncommon to see major creditors require the principal shareholders of the corporation to assume personal responsibility for the payment of corporate debts. In such situations, the shareholder's protected position is lost.

A second operational consideration involves the lifetime of the business. Proprietorships and partnerships are tied to the lives of their owners or partners. The death of an owner ends the business existence. In a partnership, the deceased partner's share may be transferred to someone else, but the original partnership must come to an end when one of its partners dies. A corporation's existence, however, is not affected by the death of its owner or owners. Corporate existence can be perpetual, thereby allowing for continued future existence if the business is profitable.

### **G. Using the Business Organization Form to Pass a Business on to the Next Generation.**

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

One of the most useful ways to achieve a transfer of a family business from one generation to the next is through a business organization that allows for a sharing of ownership and control during lifetime and a gradual transfer of it from one owner to another. In this context, the partnership and corporation are useful devices to achieve lifetime sharing and a vehicle for transferring control during lifetime. As a proprietorship involves a single owner, a business owned in this organizational form will only pass to another by lifetime gift or a transfer following the owner's death. In either of these situations, death or transfer taxes may significantly decrease the value of the asset passed to the next generation.

Partnerships and corporations play an important role in succession planning as they provide an opportunity for the succeeding generation to gain valuable management and operational experience and accumulate assets to acquire a share of the business over time. Gifts of partnership interests or shares of stock in a corporation permit the senior person to gradually shift ownership to the younger person. Coordinating gift giving programs with the annual exclusion for federal gift tax purposes allows a property owner to transfer significant amounts of property free of gift taxes over a period of years. This permits a greater amount of property to be transferred to a younger generation without a loss of value to taxes.

In the situation of a large family with several children involved on the farm and several children off the farm, providing for the transfer of an active business in a way that treats all children fairly is a difficult problem. The children who are involved with the farm business may have given up significant opportunities with the expectation of taking over the operation someday. Off farm children may someday expect to receive an equal share of the business assets even though they are not involved with this business. Reconciling these two very different expectations can lead to confrontation and dispute.

A possible solution to the dilemma facing the business owner is organization of the business into an entity that allows each interest to be served. Limited partnerships that have on-farm heirs as general partners and off farm heirs as limited partners allow each interest to be treated as an owner. Corporations likewise allow business owners to spread shares of stock throughout a family thereby reducing assets and giving an ownership stake to the recipients. Retaining a controlling interest in stock ownership enables the business owner to protect his or her interests through retirement. Through stock purchase agreements or detailed partnership agreements, the right of partners or shareholders wishing to withdraw their ownership shares can be addressed in an effective and equitable way.

### **H. Student Exercises**

#### **Multiple Choice Questions:**

1. In which of the following situations would the person described below be personally responsible for the debts and obligations of a business enterprise because of the relationship the person has to the business?

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

- a. An officer of a corporation.
  - b. A shareholder of a corporation
  - c. A limited partner in a limited partnership.
  - d. A proprietor of a proprietorship
2. The purpose for creating a business organization that is separate from and independent of the interests of its owners is to:
  - a. Allow creditors to gain access to the individual owners' assets for debt collection purposes.
  - b. Allow the business to limit its existence to less than 50 years.
  - c. Allow the business to operate across state lines.
  - d. Shelter the personal assets from creditors whose claim arose from a business transaction or situation.
3. Which of the following statements is an important point to consider in regard to partnerships?
  - a. Partnerships are taxed as corporations for federal and state income tax purposes.
  - b. Shares of a partnership are traded in the same way stock in a corporation is traded.
  - c. Only the majority partner of a general partnership is responsible for business income taxes.
  - d. If the partners of a general partnership fail to create a partnership agreement, the Uniform Partnership Act would control the relationship between the partners.
4. Which of the following statements is an advantage that a partnership has over a proprietorship?
  - a. The income tax rate that a partner pays on partnership income distributed to the partner is lower than the rate that a proprietor would pay on the same amount of income.
  - b. Creating the partnership allows the partners to pool their labor and capital in the business to expand the business and lower costs.
  - c. Partnerships have a separate legal existence that does not depend on the lives of its partners.
  - d. Partnership shares are freely tradable to people who are in or out of the partnership business which allows new ideas and new investors to become part of the business.
5. Limited Liability Companies, or LLC's, differ from Corporations in which of the following ways?

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

- a. LLC's are formed in the same way as proprietorships and partnerships. Corporations are formed in a more formal way.
- b. LLC's exist and operate only during the lifetime of the LLC manager, up to a maximum of 40 years.
- c. LLC's operate as partnerships and thereby are freed from the formalities under which corporations operate.
- d. Members of an LLC are responsible for the debts and obligations of the LLC while shareholders of a Corporation are responsible for only certain debts.

Please read the following questions carefully and then consider the question that is asked at the end of the situation. Your response need not be long or involved, but it should be clear and concise as necessary. If you want to refer to important facts in your response, please feel free to do so.

### Question 1

Brian has been an employee on his father's dairy farm since he graduated from high school 10 years ago. Brian's father operates the farm as a sole proprietorship and he would like to retire within the next 10 years. Brian's father inherited the farm from his father 25 years ago.

Brian is married and has a family. Brian wants to increase his income to provide the things that he wants his family to have. He has several ideas to improve the operation of the dairy farm and expand its income sources. Brian and his wife own several dairy animals and have been saving some of their income to invest in the future. Brian and his father get along well together as they both share a strong desire to be farmers.

Based on our discussion of partnerships, how would reorganizing the business into a partnership help Brian and his father achieve their goals?

### Question 2

Windy Ridge Farm in eastern Happy Valley raises feeder pigs and cash grains for the local and regional grain markets. The farm is currently organized as a partnership consisting of Billy Rouff and his brother Bobby Rouff. Each of the brothers has an equal ownership share of the partnership. Both of the brothers maintain their homes on the farm. This farm has been in the Rouff family for more than five generations. The family is proud of that and wants to continue to own and operate the farm.

Billy and his wife, Sue, are the parents of two adult children, one of whom is interested in working on the farm. Bobby and his wife, Rebecca, are the parents of three adult children and one child who is in school. Two of the adult children are interested in working on the farm. Some of the children who want to work on the farm live at home and others live nearby.

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

Billy recently suffered a heart attack and he has to cut down on his work on the farm. He is interested in seeing that his share of the partnership passes to Sue and their children. Bobby is the older of the Rouff brothers and he wants to enjoy his retirement with Rebecca. After seeing what happened to his brother, he wants to enjoy his life before sickness or illness prevent him from doing so. Bobby also wants to see that his share in the partnership passes to Rebecca and their children. Both Billy and Bobby want each of their children to receive an equal share of their property if they and their spouses both die.

Based on our discussion of corporations how would a corporation be used to help Billy and Bobby achieve their present and future goals?

### **Question 3**

A farm operator who transports her grain to a local elevator is concerned about the liability she would face if one of her employees causes an accident while driving one of her trucks. Her farm business is currently operated as a proprietorship.

A neighbor who also transports his grain to the elevator recently approached the operator to suggest a partnership to expand their individual trucking businesses by adding work for other farmers and general hauling services for the public.

Based on our discussion of the operational aspects of business organizations, compare the liability position the concerned farm operator would be in if her business remained as a proprietorship, if she became a partner with her neighbor or if she formed a limited liability company for the trucking business and operated it as a business that is independent of her farm. Discuss each situation separately.



## Chapter 16. Planning Estates that Involve Farm or Forest Land: Strategies and Application

### A. Overview and Purpose

This chapter is intended to bring together many of the concepts and ideas discussed in other chapters and identify their application to a farm or forest land situation. In the course, frequent reference is made to particular ideas and aspects of estate and succession planning for these interests. This chapter will put the pieces of the puzzle together.

The discussion opens with a review of the important background information that property owners and their families should gather before beginning the planning process. This discussion will build on the broader treatment of issues that precedes it and will identify several key decisions that are involved in the plan. Each decision should be made in the early stages of plan preparation. The next portion will address application of planning strategies, concepts and techniques that are most appropriate to estates with farm or forest land assets.

In this chapter planning strategies and ideas are discussed in the context of being applied to a particular situation. The purpose of this approach is to give you more exposure to a wide variety of situations, the problems they create and the potential solutions that can be fashioned to address them. This discussion will give you the chance to explore a variety of solutions. Unlike earlier chapters that included a set of problems at the end of the chapter, this chapter consists of problems themselves for you to read, review and then carefully consider. Refer to the earlier chapters for valuable information that can help you evaluate the situations and understand the strategies being discussed.

### B. Lesson Objectives

After having successfully completed this chapter, the student will be able to accomplish the following objectives:

1. Discuss and identify the important initial decisions that a property owner must make before initiating the estate planning process.
2. Discuss the application of property transfer, estate, and inheritance tax, gift tax and income tax considerations to estate and succession planning situations that involve farm or forest lands.
3. Identify the practical problems that arise in estate and succession planning and the techniques that are available to deal with them.
4. Review the situation of a farm or forest land owner and identify basic and business planning strategies available to the property owner.
5. Identify and evaluate the estate and succession planning goals and objectives that are presented in a wide variety of situations.
6. Based on your evaluation of the impacts these situation have on potential goals

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

of estate and succession planning, you will be able to fashion a list of considerations that will aid in deciding which goals should be given priority and which strategies have the greatest likelihood of accomplishing them.

### C. Initial Decisions

Planning is the crucial ingredient to the success of an effort to manage the transfer of property or business assets. Planning is done at several levels and should be done in a way that coordinates with other decisions, such as retirement planning, financial counseling and succession planning. Without this type of planning, decisions on property ownership, transfer methods, tax avoidance and tax payment can be haphazard and may be ineffective. Such decisions often fail to achieve important plan goals and objectives and may be costly to the property owner and the owner's family. If reviewing earlier chapters that discuss the importance of planning will be helpful to you (particularly chapters 2 through 8 and 17), feel free to return to those chapters before proceeding with this chapter.

We should also remember that family communication is a value and a way of valuing the input of others. It is not a series of steps in the same way as processing tax related information and recommendations. Family communication implies a different set of assumptions and considerations about family business decision making than traditional power centered approaches of making decisions for the family. Family decision making engages family members and increases their participation in discussions that lead to decisions.

In the pre-planning phase a property owner's first step, taken in conjunction with family members, is to gather information about estate assets that planners need to evaluate present situations and recommend actions. The second step involves preliminary discussions of the family's goals and objectives in the estate plan. Typical objectives involve a combination of personal or family decisions, property decisions and financial or tax decisions.

In the personal or family decision category, important issues involve:

- Do some family members have special needs that must be addressed in the plan?
- Who will benefit from the plan and how will they benefit?
- Forest land owners also face key decisions about the forest land assets and future plans for it.
- Is a forest management plan in place?
- For farm land the issues might involve continuation of the farm business and the willingness and capability of someone to continue the enterprise.
- Does the plan describe a clear, direct and attainable goal in regard to the assets that are owned?
- Does the plan allow for changed circumstances or situations in the future?

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

- Are people who are likely to take over a business or inherit the property familiar with the plan? What responsibilities do they have in the plan?
- Does the designated successor of the business want to continue it?
- Is the designated successor capable of taking over the business successfully? If not, what is needed to achieve success?
- Is the designated successor familiar with advisors who can assist in making effective decisions?

In the category of property decisions, the property owner must consider the available transfer methods to get the property to the intended beneficiary. This decision evaluates the owner's present situation and considers changes to the current arrangement that will contribute to accomplishing plan goals and objectives. Several choices are available, such as:

- Lifetime sales,
- Lifetime gifts of a whole or partial interest,
- Transfers to a living trust, or
- Transfers by will.

Some choices may be more efficient and less costly than others. Recognizing the choices, how they work and what they involve are important considerations in this phase of the discussion.

A third set of decisions involves financial or tax considerations affecting the property owner. Most planners focus on an analysis of the owner's present situation in order to identify the tax implications that arise from taking no action to plan the transfer of property. The reason for doing this is simple. Most people who have substantial assets and have not taken any steps to plan their estate will be at risk to see their property go to unintended heirs or to pay substantial estate or inheritance taxes. By pointing out these risks planning efforts can focus on addressing these problems and avoiding them wherever possible.

Timing the planning decisions and revisiting those decisions afterward is one of the most important parts of any planning process.

Let's summarize some of the key elements of the 2010 amendments that apply over the next two-year period:

1. The basic exemption equivalent of the unified credit is \$5 million through 2012. Estates of people who die after 2012 could be entitled to an exemption equivalent of only \$1 million if the 2001 estate tax rules are restored as provided in current law.
2. In 2011 and 2012, unused spousal exemption equivalent can be transferred to a surviving spouse to assure that each spouse has the chance to use their own exemption equivalent fully. Note this transfer of the unused amount applies only

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

to estate and gift tax situations and does not apply to generation skipping transfer tax situations. The transfer of unused exemption equivalent requires action when the first spouse dies and is not automatic.

3. In estates of people dying after December 31, 2001, installment payment of estate taxes will be available to businesses having up to 45 partners in a partnership or shareholders in a corporation
4. Gifts made after December 31, 2010 and before January 1, 2013 are subject to a lifetime gift exemption of \$5 million. Gifts made after December 31, 2012 could be entitled to a gift tax exemption equal to only \$1 million if the 2001 gift tax rules are restored as provided in current law.
5. The maximum rate of federal estate and gift tax is reduced to 35% of assets for decedents dying in 2010 through 2012. If the 2001 federal estate and gift tax rates are restored as provided in current law, these rates could rise to 55%.
6. The Family Owned Business Deduction could apply to estates of people dying after December 31, 2012 if the Federal estate and Gift tax reverts to its pre 2001 Amendment provisions.
7. Property passing through an estate of a decedent who died in 2010 continues to receive a step up in its income tax basis to its date of death values if the estate elects to have the 2010 Tax Relief Act amendments apply. Estates of decedents who die in 2010 but who elect to apply the 2001 Amendments will have a basis increase of \$1.3 million for any property and \$3 million of qualified spousal property passing through that estate, but will not have any federal estate tax liability.

Whether Congress acts before the Federal estate tax reverts to its 2001 form is uncertain. Therefore, planning decisions made now will need to keep eyes and ears open to action taken by Congress before 2013. Planning is a process that is subject to many variables which need to be considered for their potential impact on the plan.

Taxes are not the only reason why people are interested in these issues and take action regarding them. All of the non-tax reasons for acting, particularly succession planning, remain as important when federal estate taxes do not apply as when they do apply.

### **D. Key Decisions in Any Plan That Involves Farm or Forest Land**

As background information is gathered, the owner's attention should be drawn to several key decisions that must be made in the plan. The first decision deals with the potential taxes and potential distribution that could be applied to the estate. In 2011 and 2012 the number of estates that are subject to federal estate taxes will decline. State inheritance taxes vary by state. In Pennsylvania for example, most estates that involve separately owned property that passes to someone other than the deceased's spouse will pay some inheritance tax. In Tennessee, however, the first \$1 million dollars of property in a similar situation is free of inheritance tax. Maximum state inheritance tax rates are often much less than federal estate and gift tax rates. In addition, some state laws do not impose taxes on some types of property, such as insurance proceeds, even if the decedent's estate is the beneficiary or the decedent was the owner of the policy.

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

In regard to federal estate taxes what will happen to estates of people dying after December 31, 2012 remains to be seen.

The future of the farm or forest land and any business activity associated with the land is another key decision. As chapter 6 described, these key questions include:

- What does the owner intend to happen to the business?
- Will the farm or forest land continue to be an important component of the business?
- Should the business be maintained at all, or even some, cost to the heirs who inherit it?
- Can those interested in continuing the business afford to pay fair market value for the assets it contains?
- Should the people who inherit the business be given the chance to decide what to do with it?
- Will taxes imposed on property transferred during lifetime, or after death, affect the business's ability to succeed?

Business owners who feel strongly enough about continuation of the business to make it a central feature of their estate plan may have several opportunities under both state and federal law to lessen the financial impacts of inheritance and estate taxes on meeting their goals such as:

- Valuing land at its use value rather than fair market value is an opportunity to save federal estate tax. Small estates can use to save inheritance taxes as some state inheritance tax laws recognize the ability of a business to value its assets at use value rather than fair market value.
- For those estates that qualify and elect to take advantage of this opportunity, several provisions require that use of the land remain in a qualifying use or face the loss of the tax saving gained by using the provision.
- Special use valuation of farm or forest land for federal estate tax purposes requires that the land being valued be transferred to or purchased by certain qualified heirs who are found in a defined class of people.
- Failing to find a member in that class of people who is willing or able to acquire the property and continue the use results in losing the opportunity to use this provision.
- Once the qualified heir inherits or acquires the property, that heir must continue to be at risk financially and materially participate in the qualifying use on the property for the recapture period or face the loss of the savings gained through use of this valuation provision.

The Family Owned Business Deduction can be an effective tool if the pre-2001 Amendment Federal estate tax law returns after December 31, 2012. For those who take advantage of it, however, key aspects need to be understood:

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

- Eligibility requirements for the Family Owned Business Deduction are similar to the requirements for special use valuation, but there are key differences.
- Both require that the decedent or a member of the decedent's family must materially participate in the family-owned business for five or more of the eight years before the decedent's date of death, retirement, or disability.
- Both provisions require that a qualified heir continue the qualifying use or family-owned business or face having a "recapture tax" imposed on the qualified heir who triggers a recapture event during the ten-year "recapture tax period" that will continue often the tax is repealed.
- An important difference between the two provisions is that a qualified heir can include an "active employee" under the family owned business deduction rules, an opportunity that is not available under the special use valuation provisions.

If use of these opportunities reduces the amount of tax due, but does not eliminate it, there are other opportunities under some state inheritance tax and federal estate tax laws that allow payment of the tax in installments over time. Under the federal provision this installment period can be up to 14 years and 9 months from the decedent's date of death. These approaches are intended to ease the burden of inheritance and estate taxes imposed on the business assets and lessen the need to sell business assets to pay inheritance taxes in a timely manner.

Who is to receive the property after the owner's death and the most efficient and effective way to accomplish the transfer? Lifetime decisions concerning ownership forms impact on the transfer of property after an owner's death, such as: Joint ownership with the right of survivorship and living trusts. A final consideration involving the transfer of property is that the failure to develop an estate or succession plan during lifetime is also a decision to allow the transfer of separately owned property under the intestate law of the state where the property is located. In effect, each of us already has an estate plan in place. The plan can be either one that is specifically prepared for our personal situation, or one that others have prepared for us on the assumption that this is what we would have wanted to do.

### **E. Strategies to Employ in Planning Farm or Forest Land Estates**

The following discussion of planning strategies is divided into two parts, the first being those strategies to apply in as many cases as it is practical to do so. This will be referred to as the "basic strategies." The second part refers to those strategies to employ where use of the farm or forest land can meet the requirements for being considered a trade or business. This part will be referred to as the "business strategies."

Each of these strategy discussions will focus on the objective of reducing federal estate taxes that are determined to be a threat to this estate.

#### **Basic Strategies**

## The Basic Exemption Equivalent of the Unified Credit

**Objective:** Shelter as much property as the law will allow each property owner to shelter. Evaluate the opportunity to transfer any unused basic exemption equivalent to a surviving spouse for use in his or her estate.

Perhaps the most important strategy to employ in planning farm and forest land estates that are subject to federal estate tax is to take full advantage of every opportunity to use the exclusion equivalents and available credits in the estate of each spouse. Once a taxable estate exhausts the exclusion equivalent to the unified credit, state death tax deduction, and allowable deductions, the estate will be subject to tax. If both spouses take full advantage of their exclusion equivalents, federal estate tax savings will be significant. Full use of the exemption equivalents in the estates of two spouses will protect up to \$10,000,000 of estate assets for decedents who die during 2011 or 2012. If land qualifies for special use valuation than more than \$1 million in additional value can be sheltered from tax if the estate qualifies and recapture tax is avoided.

## Taking/Keeping Property Out of a Gross Estate

**Objective:** Consistent with plan goals and objectives, keep property out of the calculation of the gross estate for federal estate taxes.

A technique that should be considered by any estate that is close to or above the amount of the exemption equivalent is to carefully examine those property ownership situations in which property can provide benefits to an intended beneficiary, but that will not be included in the current owner's estate when that arises. For example, gifts of appreciating property or creating ownership of a life insurance policy in an irrevocable trust allows the policy proceeds to benefit those intended without having to include the policy proceeds in the estate of the person whose life is insured. Transfers made in 2011 or 2012 when the basic exemption equivalent for federal estate and gift tax and the exemption equivalent to the generation skipping transfer tax are high can take advantage of these provisions.

## Conservation Easements

**Objective:** Reduce the size of the federal gross estate and serve a conservation purpose through the transfer of a conservation easement on property that will become part of a future estate.

Another example of other action that impacts on estate transfer and tax issues is the role that a conservation easement or transfer of qualified conservation contributions may have in an estate plan. Such transfers can be sold, gifted, or a combination of sale and gift (sometimes referred to as a "bargain" sale).

Transfer of a conservation easement may have the double benefit of reducing the size of the estate at the time of the transfer and later when the interest subject to the

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

conservation easement is valued for estate and inheritance tax purposes. When valuing property that is subject to such an easement, limits on the property's use will be an important factor in determining the fair market value of the property at the owner's death. In areas where land is subject to pressure from development, these restrictions can be expected to reduce the fair market value of restricted land compared to unrestricted land. Lowering the fair market value will lower the value of the estate subject to inheritance tax and the inheritance and estate tax as well. The sale of an easement, however, will have current income tax impacts for the landowner that must be evaluated before a decision is made.

Owners who sell conservation easements must consider the income tax impact of the sale and the best use of the funds received from the sale. If the funds are invested or used to purchase additional land, the size of the owner's estate may not be dramatically reduced, or may even be increased. One estate planning opportunity that involves the use of these funds is to distribute the funds among children who will not inherit the land at the owner's death. A second opportunity is to use the sale proceeds to purchase insurance on the life of the property owner and name the children as beneficiaries. This provides an opportunity to leverage the sale proceeds for the benefit of the children. For this second technique to be successful, however, the incidents of ownership of the insurance policy on the property owner's life must be held by someone other than the property owner. This will avoid the insurance proceeds being included in the deceased owner's estate that would defeat the tax savings purpose of the plan. If a property owner is in ill health, such that he or she cannot purchase life insurance at normal rates, any attempt to buy life insurance may be impossible or uneconomical.

Qualified conservation organizations that meet Internal Revenue Service requirements offer an income tax charitable deduction to those who donate qualified conservation contributions from their property to the organization. This enables owners of valuable land to follow a path to preserve the use of land while gaining a measure of current income tax saving resulting from donations to charitable organizations that qualify for income, estate and gift tax purposes.

Before reaching a decision, it is important to thoroughly and carefully evaluate choices and the advantages and disadvantages they offer to the owner's specific situation. The advisability of selling or donating a conservation easement must be fully considered and evaluated before a decision is made or action taken to complete it. Conservation easements have been the subject of attention by the IRS in recent years as concern has been raised whether the value of the easements donated have been overstated and whether benefits from the donation have actually occurred. Landowners have also raised concern that granting an easement in perpetuity (meaning forever) is practical in light of our rapidly changing world. Easement holders and property owners have also had conflicting perspectives about how the restrictions apply to land and the landowners' right to conduct other activities on the property. These and other issues should be addressed before the decision is made to grant the easement.



## General Gift-Giving Considerations

**Objective:** Using the basic exemption equivalent to the unified credit and reduce the size of the federal gross estate by fulfilling the personal desire to support a deserving person or charitable institution.

A technique to consider in estates is to lower the size of the federal gross estate by gift-giving programs. Such programs are intended to transfer property during lifetime to heirs or others who would eventually receive the property after the owner's death. To implement a gift-giving program several considerations must be addressed:

- To be considered a gift the owner must give up dominion and control of the property. Understandably, some people will be unwilling to do that. Therefore, those who are reluctant to part with control of their property are not good candidates for gift-giving programs.
- The \$13,000 annual exclusion amount per person, per year for federal gift tax purposes and the basic exemption equivalent applicable to federal gift tax can reduce an estate significantly.
- In order for the annual exclusion to apply, a gift must be a gift of a present interest. To satisfy this requirement, special care must be taken to make gifts to minors or certain gifts in which the beneficiaries have “Crummey” withdrawal powers. Failing to meet the guidelines may result in loss of the exclusion as the gifts lack the required “present interest” feature.
- State inheritance tax law may provide for treatment of gifts that is coordinated with the federal gift tax annual exclusion.
- Gifts to charities provide opportunities to people who are interested in reducing the size of their estate and obtaining tax benefits. Gifts to charities can take many different forms and be made during lifetime or after death, and can be made in a full or partial interest.
- A gift of property transfers the current owner's income tax basis in the property to the recipient. A recipient who intends to sell the gifted property may face substantial income taxes on gain recognized from this sale.
- For federal gift tax purposes, there is no special use valuation opportunity similar to that which exists in the federal estate tax law. Gift taxes are calculated on the date of gift fair market value of the property given away.

## Strategies Available to Farm or Forest Land Involved in a Trade or Business

A number of strategies can be employed to assist in continuation of a recognized business activity that involves farm or forest land.

### Business Organization

**Objective:** Facilitate the transfer of an active trade or business at lower transfer costs that are manageable to the recipient.

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

If there is someone who is interested in and capable of continuing the business, the first strategy is for the owner to consider restructuring the way the business is owned to allow other people who will inherit the property to share in its value today and build an ownership interest for the future. Separating ownership transfers assets out of the original owner's estate and sets up the opportunity to take lack of marketability and minority interest discounts that will further reduce the size of the estate and lower taxes. Whether the choice is one of the partnership forms, one of the corporation forms or the hybrid limited liability company, organizing the business provides important opportunities to shift ownership of assets from senior owners to younger generation owners and reduce the size of the senior owner's estate at his or her death.

### Special Use Valuation

**Objective:** Reduce the size of the federal gross estate through valuing the property at use value rather than fair market value; assist qualified heirs in obtaining ownership of real estate used in a closely held trade or business.

Another strategy to employ is to consider opportunities to value property for inheritance and estate tax purposes at use value rather than fair market value levels. Reducing the value of an estate reduces the amount of estate and inheritance tax that could eventually be paid. In considering how this opportunity will be used, an important question to ask is, will the qualifying requirements be met? Is it realistic to think that the qualifying use will continue long enough to avoid losing the tax benefit gained by use of the provision? If there is some doubt about this, the next question to ask is whether the qualified heir is aware of the obligation to pay the recapture tax if it is triggered

### Family Owned Business Deduction

**Objective:** Lower the size of the federal gross estate; assist a qualified employee to acquire assets and continue the business. Remember that this opportunity will return only if the Federal Estate tax is allowed to revert to its pre-2001 Amendment form where the basic exemption equivalent for federal estate tax is only \$1 million.

The family owned-business deduction has several opportunities. First, it supplements the unified credit and shelters a combined maximum amount of \$1,300,000 from federal estate tax. Second, it provides an alternative means of reducing the value of the real and personal property business assets in the estate. Third, it also provides an additional opportunity in those cases where requirements for special use valuation and family owned business deduction can be met. If the requirements for special use valuation can be met, it is likely that the requirements of the family owned business deduction can also be met. The reverse situation is not true, however, if the only available qualified heir is a non-family member employee. Fourth, in many cases, estates can seek opportunities to combine these deduction amounts to achieve even greater reductions in the amount of property subject to tax. This strategy also has a limited lifespan that will likely lead to decreasing interest in it.

# Handbook on Estate and Succession Planning for Farm and Forest Landowners

## Installment Payment of Federal Estate Tax

**Objective:** Lessen the burden of the federal estate tax by stretching out its payment over time while taking advantage of favorable interest rates on the unpaid tax balance.

If planning does not eliminate taxes completely, the portion of the tax due that is attributable to the business interest can be deferred under installment payment arrangements that are available under the federal estate tax law and some state inheritance tax laws. Although the obligation to pay the tax may not be pleasing, a long term payment plan at attractive interest rates may lessen the impact of the payment obligation.

## F. Practical Problems in Farm or Forest Land Estate Plans

The most common problem associated with planning farm and forest land estates is the potential complexity of the issues and the techniques that are involved:

- The inheritance, estate, gift, and income tax considerations are often independent of each other such that steps to save taxes at one level may not save taxes at another level.
- The income tax treatment of proceeds from the sale of a conservation easement and the lack of coordination between the annual exclusion for federal gift tax purposes and the treatment of gifts for state inheritance tax are very good examples of this problem.
- Being a complex issue with many facets and implications, some people are turned away thinking they could not possibly understand it. In addition, they do not feel comfortable with many of the advisors who offer their services to business owners and operators.
- A common complaint is that advisors do not understand farm or forest management problems and, therefore, their advice cannot be valuable.

A second problem that relates to estate planning in general is the fact that most people are apathetic when it comes to something that is perceived to be a future issue. Opportunities can be lost through a failure to act while there is still time to do so. Another aspect of this problem is the psychological barrier that discussions of death and dying create for some people.

Getting started is the most difficult part, but once started completing the plan is easier to achieve.

## G. Case Studies

In this section several case studies are provided to illustrate the tools and strategies discussed in previous sections of the handbook. These case studies will help you understand more about estate and succession planning tools and how they work. Because many of the tax issues that are discussed in these problems will vary over

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

time, unless the fact situation otherwise directs you to consider the situation in a different time period, consider 2011 to be the time when the planning decisions are made in these cases. In 2011 and 2012 the exemption equivalent to the unified is \$5 million and in 2013 could return to the \$1million level it was under the 2001 Federal estate tax law.

We will generally use the situation of Jeff and Clare Yoder for our discussion. They have \$6 million in assets which they own as tenants by the entirety . They have three adult married children. They own a farm with 1,500 acres of woodland located in a growing residential area, which was recently assessed at an average value of \$2,000 per acre. (FMV =\$3 million). The other \$3 million is in prime residential land, a farm business, buildings, equipment, and their bank accounts.

### 1. Simple wills all property owned as tenants by the entirety

In this case each spouse executes a will that gives all of the assets to the other spouse. Since the property is owned as tenants by the entirety it passes to the surviving spouse when the first spouse dies. No federal estate tax is due at the first death since the entire amount qualifies as a marital deduction. This plan defers inheritance and estate tax from the first death to the death of the second spouse. It gives the surviving spouse full access to the assets with opportunities to consume the funds or to plan for their eventual use and distribution. At the second spouse's death in 2012, however, there could be a tax of approximately **\$350,000** on the \$6 million estate since there is no marital deduction available and the tax credit that was unused in the estate of the first spouse could be wasted if it was not transported to the surviving spouse when the first person died. The estate tax when the second spouse dies could cause liquidity problems for the children. This strategy provides greater financial security for the surviving spouse, but has the potential for greater tax cost to the second spouse.

Simple will using the same facts as above, all property owned by only one spouse. In this case there is no federal estate tax due as the surviving spouse is the heir under the will and all property passing to that spouse qualifies for the marital deduction. Since no portion of the first spouse's unified credit would be used in this first estate, that estate should consider doing what is necessary to allow the unused portion to be transported to the surviving spouse to be used when that spouse dies. If Clare dies in 2012, only \$5 million is sheltered from estate taxes by the exemption equivalent to the unified credit that Clare is entitled to. If she could use some of Jeff's unused exemption equivalent, Clare could shelter a greater portion of her estate and possibly avoid federal estate tax in her estate. If Clare is limited to only her exemption equivalent to the unified credit, then her children could pay federal estate taxes on a gross estate worth more than \$5 million and any appreciation on that property occurring between deaths. An unfortunate result would be if the family had to sell assets (the woodlot or liquidate the timber) to pay the taxes. If death occurred after 2012, the federal estate tax rate could be as high as 55% of net taxable estate.

### 2. No will

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

Jeff and Clare discussed the need to plan their estates many times, but they simply did not make it a priority item in order to get it done. If one spouse dies without a will (unplanned estate), the surviving owner will become the sole owner of their property as a result of being the surviving tenant of all property that is owned as tenants by the entirety or some other form of joint ownership between spouses. As an alternative in the no will situation let's consider that all of the property is owned by Jeff or Clare and now the owner dies. Without a will the intestate law governs the actual distribution of the assets, but applies a generic solution for this case under which the first \$100,000 and one-half of the remainder is transferred to the surviving spouse and whatever remains is transferred to children. Without considering the impact of estate and inheritances taxes which will reduce what is inherited, the surviving spouse will inherit **\$3,050,000**. The amount inherited by the spouse qualifies for the marital deduction and the remaining \$2,950,000 goes to the children but the estate is not liable for Federal estate taxes because it is under the \$5 million exemption in 2011. If the spouse died in 2013 and the exemption level reverted to \$1 million, the children would have an estate tax liability. State inheritance taxes may also be imposed.

If Jeff and Claire each own only a portion of their assets as separate assets and not jointly with each other, then the transfer of property owned by either of them will still be handled under the intestate law at either person's death.

### **3. Marital deduction and unified credit in trust**

If the value of Jeff and Clare's property increases in value to the point where it exceeds the amount of the exemption equivalent available to both of them, they should consider other strategies to save potential federal estate taxes. This could involve both Jeff and Clare protecting each other's interest after the first one of them passes away but avoiding tax consequences when the second spouse dies. With a little bit of planning, trusts of various types can be used to increase the amount owners leave to their children free of estate taxes after the second spouse dies. Assume the same scenario in case 1 but in the will direct that the exemption equivalent to the unified credit be placed in trust for the benefit of the surviving spouse with the remainder to pass to the children after that spouse's death. By limiting the surviving spouse's authority over the fund so that it does not become included in the surviving spouse's estate the surviving spouse will have financial protection and the assets remaining at the second spouse's death will benefit the children. Additional planning opportunities could permit the survivor to explore special use valuation, a program of gifting and other means for reducing the taxable estate below the amount that is sheltered by the exemption equivalent.

### **4. Annual exclusion gifts.**

While still alive, Jeff as the property owner (donor) can give each child \$13,000 in value each year tax-free. After obtaining real estate appraisals to verify the value of the land, he can give each child either acreage outright (not including potential subdivision,

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

engineering, survey costs) or a fractional undivided interest in the property worth \$13,000. A real estate appraisal by a competent professional should be ordered as a means of certifying the value of the property. He can also give each child's spouse a similar acreage or a \$13,000 undivided interest annually for a total of \$26,000.

### **5. Split gifts**

Assume the same facts as in case five, except now Clare agrees to make a split gift of Jeff's woodland property to the children. Each child could receive a gift of up to \$26,000 under the gift tax annual exclusion. A similar amount can be given by Jeff and Clare to the spouses of their children.

### **6. Irrevocable life insurance trust**

In addition to the estate assets, consider that Jeff has a \$5 million life insurance policy. At present Jeff controls the economic benefit of the policy because he retains the right to name the beneficiary of the policy and the right to cancel it if he wishes. If he were to die under this set of circumstances, the insurance policy will be included in Jeff's gross estate for federal estate tax purposes. In planning Jeff's estate, he chose to keep assets such as this one out of the calculation of his gross estate. Jeff could accomplish that goal by transferring ownership of the policy to someone else or to another entity, such as a trust. If he does that Jeff will face a three-year period within which the policy proceeds could still be brought in to the calculation of his "gross estate" if Jeff dies within that three year period that begins on the date he transfers the policy to the trust. In contrast, if Jeff decided to create an irrevocable life insurance trust for the express purpose of making the trust the owner of the policy, then each new policy the trust purchases is not subject to the three year period during which the policy proceeds could be brought back into the calculation. This policy could benefit either Jeff and Clare's children or anyone else they chose to benefit.

How can Jeff fund payment of the policy premiums? Jeff can make annual exclusion eligible gifts to the trust, provided that the beneficiaries of the trust have a present interest in the trust. Jeff can accomplish this by structuring the trust with Crummey withdrawal powers. Giving the beneficiaries "Crummey withdrawal powers" allows the exclusion to apply to gifts of a present interest made to the trust. If beneficiaries do not exercise their withdrawal or demand rights then the trustee can use the funds to pay the policy premiums. By creating an irrevocable life insurance trust, Jeff has met two of his estate planning objectives: 1) structure his life insurance in ways that result in the trust being the owner of the policy, and 2) provide that distribution and use of the proceeds will be subject to controls he put in place.

### **7. Split purchases**

Jeff and Clare and one of their daughters agreed to make a split purchase of a personal residence. Assets purchased by multiple purchasers involve transactions in which one purchaser (Jeff and Clare, in this case) purchases a life interest in property and their

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

daughter acquires a remainder interest. The life estate expires at the death of both Jeff and Clare. The determination of the purchase price to be paid by each party is made on the basis of actuarial based life expectancy tables for Jeff and Clare. In this case, assume the purchase price was \$500,000 and Jeff and Clare 64 and 62 years old respectively. According to the Section 7520 valuation tables, the life estate factor is .81254 and the remainder factor is .18746. Assuming a rate of appreciation of 3% annually over the parent's 21 year joint and survivor life expectancy, the residence could be worth \$ 1.23 million on the death of the surviving parent.

### **8. Sales of a remainder interest**

This is a variation of case 8, where Jeff and Clare sell a remainder interest in their property to a child while keeping a life interest in the property. The objectives of this sale are to avoid creating a taxable gift when the property is acquired and to eliminate estate tax liability when the life estate ends and the remainder interest **vests**. When Jeff and Clare's life estate ends, the value of their life interest has been fully realized and nothing remains to be transferred from Jeff and Clare's estate after death.

### **9. Appreciating property**

For This situation assumes Jeff and Clare Yoder's estate is currently worth \$3 million and they are a 45-year-old couple who think their net worth leaves no estate taxation to worry about. Should Jeff die his holdings can be passed along tax-free to Clare under the unlimited marital deduction rule. When she dies, their assets currently are well within the maximum \$5 million allowed to pass tax-free to the next generation. But what about increasing values? If either Jeff or Clare lives to age 75, the estate will have zoomed to almost \$7.4 million based on 3 percent inflation rate. Also bear in mind these projections do not take into consideration other assets the Yoder's will probably accumulate during their lifetime. There is also no guarantee that property value will always rise as the 2008 property bubble burst painfully establishes.

### **10. Charitable remainder trusts (CRT)**

In this case assume Jeff Yoder is 65 years old and is about to retire. With nearly \$6 million in total assets (\$3 million in timberlands), Jeff and his wife Clare are considering a number of planning strategies. Beyond providing a comfortable retirement income for themselves, they have two main objectives: provide for their three daughters and make a generous contribution to their local church, of which they have been members for nearly 40 years.

The Yoder's children are not members of the church that Jeff and Clare plan to benefit and they do not share their parents' passion for making this gift. Instead, the daughters are heavily involved in some other local organizations such as an environmental education center and the county 4-H program, and the daughters would prefer to focus family donations to these organizations. At a family meeting, Jeff, Clare, and their three daughters discuss their respective community interests and organizational contribution

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

preferences and negotiate a family philanthropy plan for distributing a portion of the proceeds from the family estate to all three organizations – the church, the environmental education center and the 4-H program.

After consultation with the family, their financial advisors and a forestry consultant, the Yoder's decide to harvest a portion (a stand) of their mature, high-quality hardwood that has a current market value of \$200,000 net of all fees associated with the sale. Let's assume that the Yoder's purchased their woodlot in 1965 and that the value of the timber, at that time, was negligible so their basis in the timber is zero. Therefore, if the Yoder's sell the timber outright, they'll lose 15% (\$30,000) to capital gains taxes, realizing only \$170,000 from the sale. If the \$160,000 is invested at 3% interest per year, they will receive \$4,800 in interest income on which they will pay income tax. Instead, of this scenario, they could place the timber in a charitable remainder trust (CRT), naming their church as beneficiary. The value of the charity's remainder interest is considered a charitable gift for income tax purposes. The creation of the charitable remainder trust with the timber in it constitutes a "constructive severance" for purposes of title to the trees. Later, the trustee sells the timber for its full market value of \$200,000 with no capital gains tax due. The Yoder's chose the unitrust option the structure the trust.<sup>4</sup> If the Yoder's choose the payout to continue during Jeff's lifetime only, the value of the charity's remainder interest is 35% of the gift. This figure is taken from IRS valuation tables. If the Yoder's choose a payout that continues until the death of both of them, the value of the charity's remainder interest drops to 21% of the gift. The Church earns interest on the amount in the trust and through prudent investment can enjoy an increase in asset value. In the first year of the trust, the payout to the Yoder's is approximately \$10,000 plus a portion of the interest income and capital appreciation that the trust enjoys. This amount will also be subject to income tax. In this arrangement, the Yoder's are receiving greater income than they would have received had they invested the money from the timber sale themselves. Since a unitrust pays a fluctuating annual income based on the value of the assets in trust as the trust assets increase/decrease in value, the Yoder's receive a higher/lower income. What is the net result of using the CRT? The Yoder's have a higher income and realize the full value of their hard-earned assets, enabling them to enjoy a more comfortable retirement. They are also able to leave more to their children. Because they made a charitable contribution of only the timber to be harvested, the children also inherit the family woodlands and the other estate assets.

### 11. Wealth replacement trust

Using the scenario in case 11, to keep their daughter's happy, the Yoder's gift a portion of their charitable remainder trust (CRT) payout to a "wealth replacement" trust, with their daughters as beneficiaries. Jeff's younger brother, Pete, is trustee of this separate and distinct trust. Pete, as the trustee then uses the gifted cash to purchase life insurance on the lives of Jeff and Clare. As we saw in case 7, the children are the

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<sup>4</sup> A unitrust option requires the trust will pay out a fixed percentage of at least 5% of the net fair market value of the assets in the trust valued each year. The alternative is an annuity trust option which pays out a fixed dollar amount each year.



## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

beneficiaries of the trust, and will eventually receive the insurance proceeds. This arrangement keeps the life insurance out of Jeff and Clare's estate so that it will not be subject to estate taxes at their death.

### **12. Planning to make gifts while the basic exemption equivalent is known**

Jeff and Clare have been approached by gas companies interested in a gas lease on their property. Realizing that the gas will be around for a while they are thinking of transferring their gas interests to their children. Gifts made in 2011-2012 will take advantage of the \$5 million exemption equivalent and can shelter significant property from these taxes in future years. This is especially true if the property that is given has the potential to appreciate over time. There are several strategies to consider such as family limited partnership that will share the royalty income with their son and grandchild. Valuing the amount of the gift they make is an important part of this transaction. Transferring the interest before a well is drilled should result in the lower values than the value of a well after it is drilled and its production potential is known. After an oil and gas lease is signed and a well is drilled on the land or a pool is created which includes the land, the value of the landowner's royalty interest will consider the income produced by the well in determining the value of the lease.

### **13. Planning for an estate that is above the basic exemption equivalent to the unified credit amount**

Jeff and Clare's children have expressed interest in continuing their parent's farm. The family met to consider how they can plan for their future in the business and they recognize that without special planning their future in the Farm will be affected by the estate and inheritance taxes. To reduce taxes they consider several options. First, create some type of business arrangement that will allow the children to begin to build up an equity interest in the Farm. This could involve a corporation, a partnership or a limited liability company. The objective is to transfer assets to the children during Jeff's lifetime through a series of annual gifts and to allow them to receive the largest amount of the business property at discounted tax cost when Jeff dies. The children are also thinking of taking advantage of the special use valuation opportunity to specially value the qualified forest land and also the family owned business deduction if it becomes available.

### **14. Planning with qualified conservation contributions**

Jeff and Clare's property is not only in a growing residential area, but has frontage along an important stream and the land supports several species of wildlife. Their dwelling, parts of which were built in the mid-19<sup>th</sup> century, and related out buildings is the only structures located on the property. The dwelling was included in a survey of historic properties conducted by the local county government. Their property was identified by a local land trust to have important historical and ecological significance. State law provides that preservation of these types of land is in the public interest and should be encouraged. Statutes authorize the use of easements to maintain the character of open

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

space lands and authorize qualified organizations to accept gifts, such as easements if the gift is consistent with the state's objectives. Jeff and Clare are concerned about the future use of their land. They want to preserve its rural character and prohibit industrial or commercial activities except those that can be conducted from the existing or permitted buildings. They also want to prohibit exploration for or extraction of subsurface materials as well as the alteration of the property's surface topography. They asked their children to be part of the discussion and decision making process and to offer for discussion what they see as their values,

dreams and plans for the property. They want to engage the family in the discussion that leads to the decision the family makes.

After these discussions the family decided that Jeff and Clare should divide the property into two parcels, the smallest of which is to be no less than 100 acres. One single-family home and associated out buildings and roads may be constructed on each parcel. The existing home will be one of the homes as long as it remains standing. No structure can be built closer within 1,000 feet of the Lazy River. Management of the timber would be required to be conducted in accordance with sound forestry management practices, subject to the approval of the state. Conservation and management of the property would also include a natural habitat for wildlife. Jeff and Clare are interested in making a qualified conservation contribution on their land. The requirements of section 170 of the IRC will apply to this situation, what benefit will section 2031(c) offer Jeff and Clare if their planned contribution qualifies for it? Assuming that the organization to which the easement will be transferred meets the requirements of the Internal Revenue Code, the landowners will get an income tax deduction for the value of their contribution as determined by an appraisal by a qualified professional. Restricting the use of their land will also affect the property value of federal estate and state inheritance tax value. In the estate of the decedent, the section 2031(c) opportunity to reduce the value of the restricted land may also be available.

### **Evaluating Alternatives**

Consider the following new situation. Woody is 65 years old and his wife, Mary, is 62. They have two children and four grandchildren. Their combined net worth is \$12 million, \$8 million consists of timberland owned by Woody and Mary as tenants by the entireties. Of the remaining assets, Woody owns \$600,000 in his name alone and Mary owns \$400,000. Woody and Mary have jointly decided their goal is to minimize the impact of federal estate and gift taxes on their estates. Neither of their children is interested in managing the timberland, but several of the grandchildren are interest in it. Two grandchildren are enrolled in Forestry degree programs at State University. All grandchildren are under the age of 21 at this point. Woody and Mary will separate their joint ownership interest into two tenants in common interests which they will then transfer in any way that they care to, including to individual living trusts. What are some things that Woody and Mary can do to accomplish their objectives?

### Alternative 1: Using living trusts and coordinating their provisions

- a. Each living trust provides that at the death of Woody (or Mary) assets that remain after the payment of all debts, expenses, taxes, fees and costs will be divided among 2 trusts. Woody and Mary's children are the beneficiaries of the income from the first trust. The amount going into the trust will be the amount that can be sheltered by the exemption equivalent to the unified credit. Following the death of both Woody and Mary, this trust is to be divided among both of children if they survive at that time. However, if one or both of the children die before Woody and Mary pass away, any children or grandchildren of the deceased child that survive Woody and Mary will share among themselves the share that their deceased parent/grandparent would have received if they survived Woody and Mary
- b. The remaining property will go into a second trust and will be structured as a qualified terminal interest property trust (QTIP) for the benefit of Mary (or Woody in the case of Mary's trust). As a qualified terminable interest property trust, all of the income from this trust is to be paid to Mary (or Woody) quarterly for all long as they live. Upon the trustee exercising his discretion to act, the trust principal is available to Mary (or Woody) if it is needed to satisfy reasonable support and comfort during their lives. After the death of Mary (or Woody) the remaining principal in this trust will be divided equally among their children who survive them, or among the children and grandchildren of any of their children who predecease them. Under this plan, both unified credits have been sheltered, but considerable tax could remain if the exemption amount that is equivalent to the unified credit falls to the pre 2001 Amendment level.

Could that result be improved? Without someone, other than Mary or Woody, who is interested and able to carry on the forest management business, special use valuation, the family owned business deduction and the installment payment arrangement are not available and would not offer an opportunity to lower the size of the taxable estate. Gifts to charities and gifts of conservation easements would offer an opportunity to lower the size of the taxable estate of either Mary or Woody. Transferring the timber to a charity and retaining a lifetime annuity for Mary and Woody would allow both of them to gain additional income they can use to fund the purchase of insurance for the benefit of their children.

### Alternative 2: Direct gifts to grandchildren; dealing with the generation skipping transfer tax

Should Woody and Mary consider directly distributing property to their grandchildren as some of them are interested in managing the forestland? An important consequence of doing this would be the generation skipping transfer tax (GSTT). But there are planning opportunities available to them there also. One important feature is the GSTT exemption of \$5,000,000 available to each of them. Another technique is known as a "Reverse QTIP." In this situation the original grantor of the trust transfers property to a trust that provides that all income is to be paid to the grantor's spouse during the

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

spouse's lifetime. At the spouse's death the property is to be transferred to the grantor's grandchildren and great grandchildren. The grantor can elect to have the transfer qualify for marital deduction treatment as a Q-TIP trust, but also can elect to treat it as a "reverse QTIP" which will enable the grantor to consider the property as his own for purposes of the GSTT, particularly the authority to designate the property to which the grantor's \$5 million GSTT exemption applies. An effective strategy to follow in regard to gifts to grandchildren and beyond is to take full advantage of this exemption and apply it to property that can be expected to appreciate in value.

### Alternative 3: Charitable giving

Gifts to charities can also be applied in the situation that applies to Woody and Mary. This type of gift allows Woody and Mary to save several different types of tax, including income, estate and gift taxes. Gifts to charities come in many different forms, i.e. charitable remainder trusts (interest of a designated beneficiary precedes the gift to the charity), or charitable lead trusts where interest of the charity precedes the interest of another designated beneficiary). Charitable remainder trusts can be one of three types: a remainder annuity trust (income from property is paid to designated beneficiary, remainder to the charity), a remainder unitrust (a fixed portion of the trust principal is paid to designated beneficiaries, remainder to charity) or a pooled income fund. A pooled income fund is an arrangement by which the donor contributes an irrevocable remainder interest in property to a public charity, retaining for himself an income interest for life. In such a fund, the property contributed is commingled by the charity with property transferred by other donors.

Gifts to charities can also be considered as charitable gift annuities. In such cases, a property owner transfers the property to a charity that agrees to pay the owner an annuity for life based on the value of the gift. This arrangement is designed to provide a benefit to the charity in the amount in excess of the value of the lifetime payments reserved for the beneficiary. Another variation is a qualified terminable interest property (QTIP) trust with a charitable remainder. This vehicle blends the benefits of the marital deduction with a charitable gift of the property after the surviving spouse passes on.

What is the best type of property to give to a charity? Since a gift to a charity will not be burdened with fears about the income tax consequences of selling "high value and low basis" property, gifting should consider highly appreciated property where part of the benefit is to save the capital gain tax. This helps to motivate owners to make these gifts to charities where avoiding the capital gain tax is significant. Is forest land a good candidate for a gift to a charity? Since a charity will sell the asset to raise cash to pay the retained benefit to the grantor, any attempt to maximize the timberland value could be lost. Would that matter to someone who has spent considerable time and effort managing the value of the forest land to gain its full potential?

# Handbook on Estate and Succession Planning for Farm and Forest Landowners

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**Part Three: Getting Started: “How can I develop my estate and succession plan?”**

**Chapter 17. The Succession Planning Team**

**A. Overview and Purpose**

Professional advisors are a critical component of the farm succession planning process. The farm business owners and family members will need the advice of qualified professionals with specialized training and certification in key legal, financial and risk management areas of expertise. Using a team approach to coordinate the advice and discussions with professional advisors can save the farm business owners significant time and financial resources in the long run. This chapter will provide an overview of why and how a farm succession advisory team can and should be assembled. Suggestions on what types of advisors should be included as well as methods for selecting these professionals will also be discussed.

**B. Lesson Objectives**

When you have completed this lesson you will be able to:

1. Understand the need for using a team approach for using professional advisors for completing the farm estate and succession plan.
2. Itemize the types of advisors that your farm business will need in completing your estate and succession plan.
3. Develop a list of interview questions for interviewing potential advisors for your farm business.
4. Identify and recruit a facilitator for your farm estate and succession advisory team.
5. Prepare an agenda for the first team meeting of our professional advisory team.

**C. Content**

**Introduction**

The issues and processes for developing a farm business succession plan and a personal estate plan are very complex. Tax laws , as discussed in chapter 9 , often change and could involve complex sets of considerations and requirements. Planning for financial retirement from the farm and developing plans that ensure a stable future for the farm financially can be complicated. It is difficult, if not impossible for business owners to successfully manage their business and keep on top of all of the legal, financial and other issues necessary to implement a successful business succession plan. This is why it is very important for business and landowners to seek the advice and services of trained professionals with specialized expertise in these important

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

areas.

Not only is it important for farm business and landowners to seek the counsel of trained professionals, but it is quite advantageous to bring these professionals together from time to time to introduce them to the people who are planning and to introduce them to each other as they will be working together to address a common problem. These professionals should be thought of as

your advisory team, and they should be working together as a team, rather than as a group of rugged individuals.

It can be quite frustrating and even counter-productive for families planning the future of their farm business to receive conflicting suggestions from their advisors when these advisors have not taken the time to coordinate their advice with the family and their other advisors. Time and money is often wasted going back and forth between advisors. In the worst cases, families just simply give up after being discouraged by the process and fail to fully develop their plans. Having all advisors work together using the team approach reduces the incidences of conflicting advice that happens when people do not know what other advisors are suggesting and the basis on which they offer their advice. When these advisors can discuss their ideas together, the resulting advice will be much more relevant and powerful than as if they had worked independently of one another.

### Who should be on the Team?

The exact composition of a farm business' estate and succession planning team will vary by the individual needs of the business and family members. However, there are a few categories of professional advisors that would likely have a role on nearly every team. These professionals would include:

**Attorney:** Provides legal advice, prepares key legal documents such as power of attorney, wills, business organization documents (LLC, S-Corp, Partnership, etc.), and provides insight into tax management strategies.

**Certified Public Accountant:** Provides key financial documentation of business performance and financial status, provides advice for organizational changes in the business and for tax management strategies.

**Certified Financial Planner:** Provides advice and implements retirement investments and strategies for estate planning and tax management strategies.

Other likely candidates for membership on a farm succession and estate planning advisory team would include:

**Insurance Agent:** Provides advice on insurance products and helps to implement the life and business insurance and risk management strategies.

**Lender:** Provides input into the appropriate debt structure the farm. Also needs to be

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

kept aware of plans for changes to the business relative to current farm debt.

**Other Key Farm Advisors, including: extension educators, management consultants, and respected peers in the industry:** These advisors can help to provide input on impacts on the overall business or key business segments might be realized by certain decisions or strategies as they are discussed. These individuals might also be candidates for a role of facilitator or the ‘quarterback’ of the overall team.

### **Selecting the Team Members**

There should be an organized process for selecting the members of the team. A business should treat the process as if the advisors were employees being hired for the business. Once the specific types of professionals that the business will need for their succession planning team have been identified (Attorney, CPA, Certified Financial Planner, etc.), a ‘job description’ for each can be developed. Family members can then seek out professionals that meet the criteria that they have established for meeting the needs of their farm. If the farm business and/or individual family members already have existing relationships with certain professionals, these might be logical places to start. However, it may also be a good time to look for new professionals who can provide a fresh look or needed expertise. When likely candidates have been identified for the key member positions of the planning team, the interviewing and selection process can begin.

Professional advisors should be interviewed by members of the family, just as if they were being hired as an employee. Members of the business should ask the potential team members about their past experience with similar situations.. The potential team members should be asked for references for farms and comparable business for which they have performed similar work. Some professional s may raise the point that the identity of people they represent must remain confidential until the client agrees to share that information with someone else.

Professionals should be asked how long they have been working in their fields, and what professional credentials they hold. They should be asked if they have any sample plans, or examples of plans that have been worked out for other clientele that would be available for review. However, many professionals will not provide sample documents before the professional is engaged by the client.

Sample documents may or may not be relevant to the needs of the client, so the benefit of providing one is arguable. Using a form document also raises the question of the cost for obtaining a service. If a professional uses form documents, how should the cost of using that form be decided? Living Trust packages are a good example. Once you have the package together, the goal is to duplicate that as often as possible to maximize income from the effort that went in to creating the form. So, how do you price the first use of the package and then every other use as it goes forward? As the package is used more often there is less and less time that goes into to delivering the service, or the final product. Clients might seek to lower the cost while professionals may prefer to



## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

keep the cost high as a way to recover their investment.

Finally, the professional advisors should be asked for a clear breakdown of their fee structure, including an estimated cost for each step in the process. Some professionals are obligated to discuss the way their fees are calculated when the representation starts. The agreement between the professional and client is then written as a letter of representation to memorialize what has been agreed.

Where there are multiple family members or business partners involved in the business, it would be a good idea for a small group or no more than three members of the family or business ownership to conduct the initial interviews with the candidates to narrow down the field to a set of likely team members, and then conduct a meeting between the candidates and the rest of the farm ownership and family members to ensure that all are comfortable with each team member before a final commitment is made.

There may also be circumstances in some family situations when more than one professional advisor in a given field of expertise might be warranted, to provide advice and to represent individual family members, in addition to those advisors who work for the group as a whole. For example, in situations where there are both farm and non-farm heirs, it would not be unreasonable for a non-farm heir to seek the advice and secure representation from a different attorney than the attorney who is working on behalf of the interests of the farm, particularly when there is disagreement over how assets should be divided. The conflict of interest rules that regulate how attorneys approach representation of multiple parties are an example of how the profession dictates the way that professionals operate. . If these rules prevent a professional from representing all parties, who does the professional consider the client to be? This will enable people to understand whose interests are being considered when advice is given.

A final important task related to selecting members of the team is to determine who will be the facilitator or 'leader' of the team. This person can be someone in the family or someone from outside of it. The person will be responsible for 'running' the team meetings, keeping discussion moving and on track, while ensuring that all parties have a voice during those meetings. The facilitator should be an unbiased member of the team. The facilitator could be one of the professional advisors for the team, or could be an independent member whose sole role is to be the facilitator of the team, thus helping to ensure their lack of bias.

### **Team Meetings**

Once the team members have been selected, an initial team meeting should be scheduled. This should be a short meeting, no more than one hour in length, with the sole intention of letting all team members get to meet and know one another. The management team of the farm business should also give the members of the team an overview of their expectations for the outcome of the planning process and subsequent team meetings.

## **Handbook on Estate and Succession Planning for Farm and Forest Landowners**

At the end of the first 'get to know you' meeting, subsequent team meetings should be scheduled. An agenda for each meeting should be developed by the meeting facilitator, with input from the family members and business partners. For meetings to be productive, they should be focused on specific points of discussion or tasks and kept to a defined timeframe, preferably not longer than two hours in length. All team members, including family members and business partners, should come to each meeting fully prepared to listen and to contribute.

### **Mediation**

In some family or business partner relationships there may be a need for mediation, in addition to the planning team. If there are conflicts between family members or business partners over issues related or unrelated to the development of the farm succession plan that cause meetings to be unproductive, an outside mediator may be able to help. The role of an outside mediator is NOT to settle a dispute between two or more family members or business partners. In contrast, their role is to help the disputing parties to communicate more effectively and work through their differences. They are there to help find a compromise or solution to the issue that is acceptable to all parties. Mediators can be found through a variety of sources, such as the family's local church, the chamber of commerce, or via referral from one of the farm's professional advisors.

### **Summary**

In summary, any family or business that is engaged in the process of preparing a plan for the successful transition of a farm business from one owner to the next MUST have the assistance of trained professional advisors to work through the complex issues they may confront in this planning process.. The coordinated team approach to planning is the best way to ensure that all professional advisors are working together towards the common goals of the business and family members. The use of a professional advisory team who meet with each other regularly will save the business and family members both time and financial resources in the long run.

### **D. Student Exercise**

#### **Multiple Choice Questions**

1. Which of the following professionals should be included on a farm succession advisory team, at a minimum?
  - a. Attorney
  - b. Certified Public Accountant
  - c. Certified Financial Planner
  - d. All of the above
  
2. Which of the following types of advisors was NOT mentioned as a potential

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

member of the farm succession advisory team?

- a. Extension Educator
  - b. Investment Broker
  - c. Crop Consultant
  - d. Lender
3. How long should the first meeting of the Succession Advisory Team be?
- a. A half hour
  - b. Three Hours
  - c. Not more than one hour
  - d. The advisory team will never actually 'meet', it is just the name for the group of advisors.
4. Which of the following statements correctly describes the importance of coordinating the advice of outside advisors who assist in the succession planning process?
- a. Coordination is required to deduct the cost of using these advisors for federal and state income tax purposes.
  - b. Coordination enhances advice given as each advisors recognizes the perspective taken by the other advisors and uses that to formulate her own advice and recommendations.
  - c. Without coordination the impact of taxes would be missed in the planning process.
  - d. Coordination is an effective means to solve disputes and disagreements among family members and others involved in the planning process.
5. Which of the following factors should be used in selecting an advisor to work with a family that intends to develop a succession plan?
- a. A prior or current business relationship with one or more of the family members.
  - b. The advisor takes credit cards in payment of charges for their services.
  - c. The advisor is available on evening and weekend hours to consult with individual family members involved with the planning process.
  - d. Whether the advisor's fees and charges are the lowest available.

### Short Essay Question

In your own words, please describe the role of a facilitator on the Farm Succession Advisory Team, and who would be a likely candidate to fill this role in your community?

**Chapter 18. Let's Plan Your Farm or Forest Land Estate – Inventory Your Assets**

**A. Overview and Purpose**

Congratulations on reaching this final chapter of this handbook.

After studying the previous lessons, you realize that estate planning is not a matter of just having a simple will prepared, although this may be all that is needed in some situations. To develop an estate and succession plan, a complete analysis of family objectives, net worth, and income needs is necessary; after completing such an analysis, the estate planning tools discussed in this handbook can be chosen. Information also needs to be available to assist the executor in administering the estate.

A will may be the heart of the estate plan, but many things must be studied to determine what goes in the will. How large is the estate? How is property owned and who provided the major monetary consideration? How many children are in the family? Are there minor, physically handicapped, or retarded children? How much insurance is there and who owns it? Is there a business involved? Does the owner intend for family members to take it over? What will be incurred and what taxes will be imposed in settling the estate? Are there antiques or family heirlooms the owner wants specific family members to receive? This chapter will walk through the process of gathering information needed to evaluate the present situation and begin the planning process. Before doing the actual planning an owner needs to know more about personal objectives and assets. This chapter will pull together this information. There are no student exercises at the end of this chapter, but students are strongly encouraged to fill in the schedules and forms described in the chapter.

**B. Lesson Objectives**

When you have successfully completed this chapter you will be able to accomplish the following objectives:

1. Determine your personal and family objectives for an estate plan.
2. Inventory all of your assets and evaluate your ownership interest in them.
3. Evaluate the financial size of your estate.
4. Estimate the federal estate and Pennsylvania inheritance tax that would be applicable to your current estate.
5. Evaluate the income needs of your present family and potential survivors if one spouse should die and identify income sources to meet these income needs.

**C. Determining Objectives**

The first and most important step is to determine family objectives. The following is a partial listing of objectives. Check those that apply to your situation and add others that may not be listed. Make some notes that provide added details to each objective.

**Handbook on Estate and Succession Planning for Farm and Forest Landowners**

\_\_\_\_ Retirement security for parents during their lifetime.

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\_\_\_\_ Guardianship for minor, physically handicapped, and retarded children.  
(Name person to be guardian, plus other details.)

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\_\_\_\_ Family heirlooms and antiques for the children.  
(Detail what and to whom.)

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\_\_\_\_ Turn business over to family members and have it continue into the future.  
(Name individuals.)

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\_\_\_\_ Provide for some gifts to children.

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\_\_\_\_ Provide for some gifts to church or charity.

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\_\_\_\_ Minimize estate expenses and taxes.

**Handbook on Estate and Succession Planning for Farm and Forest Landowners**

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\_\_\_ Desire that each child be treated equally in the estate.

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\_\_\_ Desire that each child be treated fairly, but not necessarily equal.

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\_\_\_ Education for all children.

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\_\_\_ Achieve a conservation objective by limiting the future use or development of my land.

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\_\_\_ Other

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## D. Taking the Inventory

The second step in estate and succession planning is to make a complete inventory of all property that will be subject to the plan. Do not forget antiques and heirlooms, insurance policies with named beneficiaries, personal property, and stocks and bonds. Ownership of property is an extremely important issue and should be carefully evaluated. Identify who has the incidents of ownership of any policies.

Some people have very complicated estates, while others have simple ones. The forms provided in this lesson are organized to permit a simplified analysis or a very detailed analysis of a family situation. The forms in this chapter are designed to give you an orderly way to gather information about yourself and your assets. Form 1, the Family Information sheet is about you and your family. This form is a must for an attorney who works with you to design the plan. It briefly outlines the family status and identifies key family members.

Form 2 is a summary of the family assets and liabilities so the attorney or estate counselor knows the assets in your estate. Complete Form 5 (six pages) first to aid in summarizing assets and liabilities.

Form number 3 provides income and expense estimates. These are necessary to determine whether insurance or other assets are needed to meet the financial goals and objectives in your plan. It will also influence whether and how trusts should be used in your plan.

Form 4 summarizes where you keep your important papers. Families need to know where you keep important papers as there may be a need to find them quickly.

Form 6 is a way to summarize the tax impacts that may affect your estate. Information from your assets, your plan and the lessons on taxes will help you complete this portion of Chapter 18.

Once you have completed Chapter 18 you will be on your way to taking the next steps toward developing an estate and succession plan in your own situation. Taking the first step is the hardest to take.

Good luck with developing an estate and succession plan tailored to your needs.

Form number 4 is designed to help the executor or heirs administer the estate. On this form list the location of important papers and the names of your professional advisors. If your attorney comes from a large city, he may be difficult to locate if your family does not know who you retained. If you used several banks, your money may lie there for years, if your executors are not aware of it.

Form number 5 entitled "estate evaluation" consists of six pages. These pages provide

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

details on your assets and liabilities. You may or may not use all of these pages depending on how complicated your estate is and how much information your estate counselor or attorney needs. You should keep a completed set for your own information. It will be helpful in completing form number 2.

Keep in mind that your attorney or estate planning counselor needs complete details of your family situation to do an effective job of planning your estate. In addition, the forms are designed to assist you and your executor in managing your estate more effectively, thereby saving you time and money. Too often, a surviving spouse or family member named as an executor must spend hours searching for information needed to settle an estate. Does your family know what insurance you have or how many properties you own? What attorney do you want to handle your affairs? What stocks, bonds, or savings do you own? The inventory is your way of providing an accessible source of information that answers these important questions.

### Contact information for people who helped me to develop my plan:

Name

Address

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**E. Family Information - Form 1**

Husband's Name	_____	Wife's Name	_____
Social Security Number	_____		_____
Date of Birth	_____		_____
Health Status	_____		_____
Home Address	_____		_____
Business Address	_____		_____
Occupation	_____		_____
Phone Number	Home_____Office_____		Home_____Office_____
Prior Marriage	Yes____No_____		Yes____No_____

Children's Names	Address	Occupation	Marital Birth Date	No. Children	
				Status	Male
1.					
2.					
3.					
4.					
5.					
6.					
7.					
8.					
9.					

Other Dependents Name	Address	Occupation	Birth Date	Relationship
1.				
2.				
3.				

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### F. Estate Summary - Form 2

#### Gross Estate Values

<b>Assets - Personal</b>	<b>Husband</b>	<b>Wife</b>	<b>Joint</b>
<b><u>Other</u></b>			
Bank Accounts	_____	_____	_____
Stocks and Mutual Funds	_____	_____	_____
Bonds	_____	_____	_____
Life Insurance	_____	_____	_____
Real Estate	_____	_____	_____
Automobiles	_____	_____	_____
Personal Property	_____	_____	_____
Retirement Account	_____	_____	_____
Other	_____	_____	_____
<b><u>Business</u></b>	<b>Husband</b>	<b>Wife</b>	<b>Joint</b>
<b><u>Other</u></b>			
Real Estate	_____	_____	_____
Personal Property (machinery, livestock, etc.)	_____	_____	_____
Bank Account	_____	_____	_____
Receivables, Notes, Contracts, etc.	_____	_____	_____
Other	_____	_____	_____
<b>Grand Total Assets</b>	_____	_____	_____
<b><u>Liabilities</u></b>	<b>Husband</b>	<b>Wife</b>	<b>Joint</b>
<b><u>Other</u></b>			
Mortgages and Contracts	_____	_____	_____
Chattels and Notes	_____	_____	_____
Insurance Loans	_____	_____	_____

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

Consumer Loans	
Accounts Payable	
Other	
<b>Grand Total Liabilities</b>	
<b>Gross Estate</b>	

**Note:** Form no. 5 (6 pages) is designed to provide more specific detail on your assets and liabilities. If you are having trouble completing this form, you may wish to complete form 5 first. There is some detail on form 5 that your attorney will need. This will apply especially to real estate on page 3 of form 5.

### G. Estimated Federal Estate and State Inheritance Tax

	<u>First Death</u>	<u>Second Death</u>
Gross Estate	\$ _____	\$ _____
Expenses	\$ _____	\$ _____
Net Estate	\$ _____	\$ _____
Marital Deduction	\$ _____	\$ _____
Taxable Estate	\$ _____	\$ _____
Federal Tax	\$ _____	\$ _____
Federal Tax Credit	\$ _____	\$ _____
State Tax Credit	\$ _____	\$ _____
Federal Tax Due	\$ _____	\$ _____
State Tax Due	\$ _____	\$ _____
Total Tax Due	\$ _____	\$ _____
<b>Total Tax After Both Deaths</b>	\$ _____	\$ _____

Handbook on Estate and Succession Planning for Farm and Forest Landowners

H. Income Information - Form 3

Estimated Spendable Income

	<u>Current Husband &amp; Wife</u>	<u>Future Surviving Spouse</u>
<b><u>Source</u></b>		
Salaries	\$ _____	\$ _____
Rentals	\$ _____	\$ _____
Retirement	\$ _____	\$ _____
Social Security	\$ _____	\$ _____
Business Net Income	\$ _____	\$ _____
<b><u>Investments</u></b>		
Savings	\$ _____	\$ _____
Stocks and Mutual Funds	\$ _____	\$ _____
Bonds	\$ _____	\$ _____
Other	\$ _____	\$ _____
Annuities	\$ _____	\$ _____
Other	\$ _____	\$ _____
<b>Total Annual Spendable Income</b>	<b>\$ _____</b>	<b>\$ _____</b>

## Handbook on Estate and Succession Planning for Farm and Forest Landowners

### Estimated Annual Expenditures

	<u>Current Husband &amp; Wife</u>	<u>Future Surviving Spouse</u>
<b><u>Housing</u></b>		
Mortgage or Rent	\$ _____	\$ _____
Taxes	\$ _____	\$ _____
Insurance	\$ _____	\$ _____
Repairs	\$ _____	\$ _____
Utilities	\$ _____	\$ _____
Other - Furnishings, etc.	\$ _____	\$ _____
Food	\$ _____	\$ _____
Clothing	\$ _____	\$ _____
Taxes	\$ _____	\$ _____
Medical (doctor, dental, drugs, hospital)	\$ _____	\$ _____
Transportation & Travel (tips, boats, campers, golf, auto, plane, etc.)	\$ _____	\$ _____
Insurance	\$ _____	\$ _____
Gifts and Contributions	\$ _____	\$ _____
Personal	\$ _____	\$ _____
<b>Total Estimated Expense</b>	<b>\$ _____</b>	<b>\$ _____</b>

**Handbook on Estate and Succession Planning for Farm and Forest Landowners**

**I. Miscellaneous Information for Estate Administration - Form 4**

**A. Paper, Documents, etc.                      Check                      Where Kept                      Addresses (if applicable)**

- Birth Certificate
- Marriage Certificate
- Property Titles
- Home
- Business
- Cemetery Lot
- Bank(s)
- Safe Deposit Box (No. \_\_\_\_\_)
- Insurance Policies
- Vehicle Titles
- Wills
- Trust Agreements

**B. Advisors                                      Name                                      Address                                      Phone                                      Attorney**

- Bank or Banker
- Accountant
- Insurance Representative
- Broker
- Trustees
- Guardians
- Other

**C. Record of Prior Gifts**

**Name of Recipient                      Date of Gift                      Amount or Value of Gift                      Comments**

**Handbook on Estate and Succession Planning for Farm and Forest Landowners**

**J. Estate Valuation - Form 5 (Page 1)**

**A. Assets - Family Non-Business**

**Bank Accounts**

<b>Type</b>	<b>Name of Bank</b>	<b>Address</b>	<b>Average Balance</b>			
			<b>Husband</b>	<b>Wife</b>	<b>Joint</b>	<b>Other</b>
Checking			\$	\$	\$	\$
Savings			\$	\$	\$	\$
<b>Total</b>			<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>

**Stocks and Mutual Funds**

<b>Name</b>	<b>NO.</b>	<b>Year Purchased</b>	<b>Purchase Value</b>	<b>Current Value</b>			
				<b>Husband</b>	<b>Wife</b>	<b>Joint</b>	<b>Other</b>
<b>Totals</b>							



**Handbook on Estate and Succession Planning for Farm and Forest Landowners**

**J. Estate Valuation - Form 5 (Page 2)**

<u>Bonds</u> Type and Serial Number	NO.	Year Purchased	Purchase Price	Maturity Date	Current Value			
					Husband	Wife	Joint	Other

<u>Life Insurance</u>							
Company	Policy No.	Insured	Owner	Beneficiary	Cash Value	Face Value	

Total - Husband	XXXXXXXXXX	XXXXXXXX	XXXXXXXX	XXXXXXXXXXXXXXXXXX	\$	\$	
Total - Wife	XXXXXXXXXX	XXXXXXXX	XXXXXXXX	XXXXXXXXXXXXXXXXXX	\$	\$	

**Real Property (Not including business)**

Description	Address	Date Acquired	Purchase Price	Improvements	Depreciation	Current Value			
						Husband	Wife	Joint	Other

**Retirement Accounts (Keogh, IRA, Annuity, etc.)**

Type	Company or Bank	Ownership	Value in Account			
			Husband	Wife	Joint	Other

Total					\$	\$	\$	\$
-------	--	--	--	--	----	----	----	----

**Handbook on Estate and Succession Planning for Farm and Forest Landowners**

**J. Estate Valuation - Form 5 (Page 3)**

**Personal Property (not including business)**

<b>Item</b>	<b>Description</b>	<b>Cost</b>		<b>Depreciation If Any</b>	<b>Current Value</b>		
					<b>Husband</b>	<b>Wife</b>	<b>Joint</b>
<b>Other</b>							
Automobiles		\$	\$	\$	\$	\$	\$
Home Furnishings		\$	\$	\$	\$	\$	\$
Jewelry		\$	\$	\$	\$	\$	\$
Collections		\$	\$	\$	\$	\$	\$
Cash on Hand		\$	\$	\$	\$	\$	\$
Other		\$	\$	\$	\$	\$	\$
<b>Total</b>		<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>

**B. Assets – Business**

**Real Estate**

<b>Tract 1 - Location</b>	<b>Total</b>	<b>Forested</b>	<b>Cost Basis at Acquisition</b>		<b>Value of</b>
	<b>Acres</b>	<b>Acres</b>	<b>Land</b>	<b>Timber</b>	<b>Improvements</b>

<b>Tract 1 - Ownership</b>	<b>Date Acquired</b>	<b>How Acquired</b>			<b>How Owned</b>			<b>Current Value</b>
		<b>Purch.</b>	<b>Gift</b>	<b>Inheri.</b>	<b>Sole Prop.</b>	<b>Tenants in Corp. Common</b>		

<b>Tract 2 - Location</b>	<b>Total</b>	<b>Forested</b>	<b>Cost Basis at Acquisition</b>		<b>Value of</b>
	<b>Acres</b>	<b>Acres</b>	<b>Land</b>	<b>Timber</b>	<b>Improvements</b>

**Handbook on Estate and Succession Planning for Farm and Forest Landowners**

<u>Tract 2 - Ownership</u>	<u>Date Acquired</u>	<u>How Acquired</u>			<u>Sole Prop.</u>	<u>How Owned</u>		<u>Current Value</u>
		<u>Purch.</u>	<u>Gift</u>	<u>Inheri.</u>		<u>Tenants in</u>	<u>Corp. Common</u>	

**J. Estate Valuation - Form 5 (Page 4)**

**B. Assets – Business (Cont.)**

<u>Tract 3 - Location</u>	<u>Total Acres</u>	<u>Forested Acres</u>	<u>Cost Basis at Acquisition</u>		<u>Value of Improvements</u>
			<u>Land</u>	<u>Timber</u>	

<u>Tract 3 - Ownership</u>	<u>Date Acquired</u>	<u>How Acquired</u>			<u>Sole Prop.</u>	<u>How Owned</u>		<u>Current Value</u>
		<u>Purch.</u>	<u>Gift</u>	<u>Inheri.</u>		<u>Tenants in</u>	<u>Corp. Common</u>	

**Business Personal Property**

<u>Type</u>	<u>Owner(s) (Specify Corp. or Partnership)</u>	<u>Original Cost</u>	<u>Undepreciated Depreciation Value</u>	<u>Current Market Value</u>
Machinery & Equip.		\$	\$	\$
Trucks		\$	\$	\$
Livestock		\$	\$	\$
Inventories		\$	\$	\$
Other		\$	\$	\$

**Business Bank Accounts**

<u>Type</u>	<u>Name of Bank</u>	<u>Address</u>	<u>Sole Prop.</u>	<u>Partnership</u>	<u>Corporation</u>	<u>Other</u>
Checking						
Saving						
<b>Total</b>						

**Handbook on Estate and Succession Planning for Farm and Forest Landowners**

**J. Estate Valuation - Form 5 (Page 5)**

**C. Debts Owed You: Contracts, Mortgages, Notes, Accounts Receivable**

<u>Name</u> Type and Security	Debtor	Date Acquired	Original Value	Maturity	<u>Unpaid Balance in Whose</u>			
				Date	Husband	Wife	Joint	Other
					\$	\$	\$	\$
<b>Total</b>					\$	\$	\$	\$

**D. Liabilities**

**Mortgages & Contracts**

Real Estate

<u>Due</u> Property mortgaged	Name of Creditor	Date Due	<u>Amount</u>			
			Husband	Wife	Joint	Other
			\$	\$	\$	\$
<b>Total</b>			\$	\$	\$	\$

**Chattel Mortgages & Notes**

Personal Property

<b>Total</b>						
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**Handbook on Estate and Succession Planning for Farm and Forest Landowners**

**J. Estate Valuation - Form 5 (Page 6)**

**Insurance Loans**

**Total**

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**Consumer Loans**

**Total**

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**Accounts Payable**

<u>Due</u> <u>Items</u> <u>Other</u>	<u>Name of Creditor</u>	<u>Date Due</u>	<u>Amount</u>		
			<u>Husband</u>	<u>Wife</u>	<u>Joint</u>
Taxes, Real Estate			\$	\$	\$
Taxes, Income\$			\$	\$	\$
Taxes, Estate\$			\$	\$	\$
Unsettled Claims\$			\$	\$	\$
<b>TOTAL</b>			<b>\$</b>	<b>\$</b>	<b>\$</b>

Armed with these forms and your understanding of the issues involved in estate planning, you are now better equipped to make the important decisions that lie ahead of you as you plan. Good luck to you as you proceed!

**Readings and Resources:**

Chap. XIII Let's Plan Your Estate—Jacobson & Becker, Page 156

Chap. VIII Let's Plan Your Estate—Jacobson & Becker, Page 155

Estate Planning Opportunities & Strategies—Jacobson & Becker, Page 140

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