Estate Planning for Farmers

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1) **Introduction: What's unique to estate planning for farmers?**
   a) Farmers are in business; farmers generally own or lease significant real estate; farmers usually need a lot of equipment; most farms need a lot of water; farming is usually dependent on the weather; farming can be a real up & down business; farmers often struggle with automation versus need for cheap labor.
   b) While perhaps not unique, a farmer's real estate often suggests use of an entity to hold the real estate; the equipment suggest use of an entity rather than a sole proprietorship for ease of transfer; the transition of the farm to the next generation can be especially problematic because frequently not all of the children wish to continue in the farming business.
   c) What's not so different from planning for other types of family businesses?
      i) The need for wills, trusts, durable powers of attorney, in short, an updated overall estate plan.
      ii) An estate plan in the event of death or disability.
      iii) A revocable living trust is a legal arrangement to hold property/assets for its creator (the "Grantor" or "Settlor"). It is a useful estate planning tool because its administration typically does not require probate.
      iv) The trust is usually managed by its creator until death and then a third party (a "successor trustee") is designated to assume that role. An individual person (a friend or family member), a professional private fiduciary or a corporate trustee can be designated as successor trustee. It is possible for multiple trustees (co-trustees) to act together. In the case of a farm operation (or other business), there may be a division of trustee responsibility: one trustee can be responsible for the farming operation while another trustee may hold and manage the passive investments.

2) **Valid trust requirements in most jurisdictions.**
   a) Grantor or Settlor,
   b) a Trustee,
   c) one or more beneficiaries, and
   d) Trust Property ("trust res")
   e) Historically (under common law) the three "players", i.e., the settlor, the trustee and the beneficiary, needed to be three separate individuals. Today, the settlor can also be the initial trustee[1], and the present beneficiary

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[1] In certain irrevocable, tax sensitive trusts, the settlor should not (or in the case of the ILIT, cannot) be the trustee. But in the case of the revocable living trust, usually the settlor is also the initial trustee.

3) **Basic Categories of Personal Trusts:**
   a) A Revocable Living Trust[2] or an "inter-vivos" trust is set up during the person's lifetime.
      i) Allows the settlor to retain control of all the assets in the trust, and the settlor is thus free to revoke or change the terms of the trust at any time, and
      ii) The trust becomes irrevocable only at the settlor's death.
   b) Irrevocable trusts[3] separate the assets from the settlor.
      i) The assets are no longer the settlor's assets and the settlor is generally precluded from making changes to the trust without the beneficiary's consent (and possibly court approval),
      ii) accordingly, the assets are no longer considered part of the Settlor's estate for estate tax purposes, or creditor access (with some exceptions), and
      iii) some states permit "self-settled" trusts, irrevocable trusts where the settlor retains a beneficial interest in the trust that offers creditor protection to the settlor. A majority of states, however, treat such trusts as accessible by creditors. For estate inclusions purposes, if a creditor can reach the assets, the assets will be considered included in the settlor's estate

4) **Some Common Living Trust Structures:**
   a) The structure of a living trust for a couple is more complicated than for a single individual because there are two settlors. For one thing, as mentioned below, a portion of the couple's trust may become irrevocable after the first death (typically the case, but not always). If a portion of the trust does become irrevocable, then the trust will need to be divided into the appropriate irrevocable and revocable trusts (the trust for the survivor, for example, remains revocable). Joint trusts between husband and wife are much more common in community property states than common law states.
   b) Disclaimer Trust
      i) A married couple shares control and benefits from the trust. At the death of the first spouse, the surviving spouse may choose to:
      ii) Disclaim part or all of the deceased spouse's portion, removing it from the Survivor's estate and placing it into a separate, irrevocable trust; or
      iii) Continue to maintain the same level of access and control in a single

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[2] Technically, living trusts can be either "revocable" or "irrevocable" but in most cases, when people refer to a "living trust" they mean a revocable trust used to hold the bulk of the person's estate to avoid probate (a living trust essentially acts as a Will substitute).

[3] Note that in most cases, a revocable trust morphs into an irrevocable trust, usually at death of the settlor.

revocable trust.

iv) This choice, to make a portion of the trust irrevocable after the first death, is left solely up to the surviving spouse.

v) When the surviving spouse dies, the trust may provide for the outright distribution of the assets to the beneficiaries without probate or the trust may provide for continuation of the assets in trust for the beneficiaries. In either case, the trust is considered irrevocable upon the surviving spouse's death[4].

c) A-B Trust; a two-part trust

i) This living trust is very similar to the Disclaimer Trust except, instead of waiting for the surviving spouse to disclaim upon the first death, the couple sets out provisions in the A-B Trust while both settlors are alive so that the trust divides into two trusts after the first death:

(1) One trust is for the surviving spouse (and remains revocable);

(a) the surviving spouse may access and control the Survivor's Trust without restrictions and typical benefits from the Bypass Trust (provisions vary but often the surviving spouse can invade the Bypass Trust for HEMS, health, education, support and maintenance), and

(b) at the surviving spouse's death, assets in the Survivor's Trust pass to the beneficiaries according to terms and conditions dictated by the Surviving Spouse (and are open to continual change until the survivor's death).

(2) The Bypass Trust is usually capped at the maximum estate tax-free amount ($11,400,000 for 2019).

(a) In the common law state where each spouse often sets up a separate revocable living trust, when one spouse dies the Bypass Trust is created (typically capped at the estate tax free amount) and the excess over the estate tax free amount passes outright to the surviving spouse.

(b) The Bypass Trust assets will pass to the heirs according to the terms and provisions provided by the deceased spouse.

d) A-B-C Trust; three trusts.

i) If the Bypass Trust is capped at the maximum tax-free amount ($11,400,000 for 2019), the excess of the deceased spouse's share over the tax-free amount can either stay in the revocable Survivor's Trust or pass to another irrevocable trust, the "marital", "QTIP" or "C" Trust.

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4 The Disclaimer Trust, where the assets not disclaimed remain to be taxed in the survivor's estate, has become a more common trust design since Portability (discussed in detail below) was added to the law beginning in 2011.

   ii) The Bypass Trust is estate tax free (estate tax is avoided on both the first and second deaths); whereas the QTIP Trust is estate tax deferred (estate tax delayed until after the surviving spouse's death).
   iii) Unlike the Bypass Trust which *may* provide solely for the surviving spouse (or others), the QTIP Trust *must* designate the surviving spouse as the only beneficiary for the survivor's lifetime. The surviving spouse must receive all net income from the QTIP Trust and the assets must be productive. Upon the surviving spouse's death, the assets of the QTIP Trust may be distributed to the deceased spouse's intended beneficiaries (or continue in trust) and, unlike the Bypass Trust, the QTIP Trust is treated as part of the Surviving Spouse's taxable estate.
   iv) In the common law state where each spouse often sets up a separate revocable living trust, when one spouse dies two trusts, the Bypass Trust and Marital Trusts, are created.

e) A/C Trust; two-part trust.
   i) The "A" Trust is the Survivors Trust, revocable by the survivor and
   ii) the "C" Trust is the marital QTIP trust.

5) **The Law of Portability[5]:** adopted in 2011 to allow surviving spouse to "inherit" deceased spouse estate tax *benefit*, added to the estate planning menu.

a) Prior to "Portability" a "tax free" trust (i.e., Bypass Trust) was always preferred to a "tax deferred" trust (i.e. QTIP Trust)[6]. However, since its adoption in 2011, the law of Portability changed these estate planning considerations because the deceased spouse's estate tax benefit can now be captured without the need to set up a separate irrevocable trust after the deceased spouse's death.
b) For example: spouse A dies in 2019 when the estate tax exclusion is $11.4M per person. Then spouse B dies in the same year. The total exclusion for Spouse B is the sum of both their exclusions, in this case, $22.8M.
c) The above example illustrates how, if the combined estate never exceeds the maximum exclusion amount, then an estate tax deferred trust (QTIP) is likely preferred to the estate tax free trust (Bypass Trust) because the entire estate will pass estate tax free in either case and the QTIP Trust allows for an income tax basis-step up at the surviving spouse's death.

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5 Portability allows any unused amount of the deceased spouse's $10M+ estate tax benefit to be carried over and used by the survivor. Keep in mind that the $10M (indexed for inflation) is scheduled to drop to $5M (indexed) in the year 2026.

6 Tax-free is always better than tax deferred. For example, tax free proceeds ($250,000 or $500,000) upon sale of a principal residence under IRC Section 121 is always better than tax deferral under the like-kind exchange rules of IRC Section 1031.

d) A step up in basis reduces or avoids capital gain for properties which have increased in value. A residence may have been purchased decades prior to death, for example, and the taxable gain will be calculated not from the date-of-purchase value but from date-of-death value.
e) Another consideration arises from the dynamics of blended families or other situations where beneficiaries differ. As mentioned in the section on A-B-C trusts, the assets of the QTIP Trust will be distributed according to the deceased spouse's wishes while the Survivor's Trust allocates the surviving spouse's assets to his or her intended beneficiaries.

6) **The Basic Estate Plan: the new world order – higher estate tax exclusions, portability of the exclusion, gifting and income tax rates (Federal & State plus possibly the 3.8% surtax), that may exceed the Federal Estate Tax rate of 40%:**
   a) Estate tax exemptions:
      i) As many will remember, there was a flurry of gifting towards the end of 2012 when clients and advisors feared that the $5M Federal exclusion would drop to $1M – that never happened
      ii) In fact, the $5M was extended and indexed so that the tax-free amount for 2016 was $5.45M.
      iii) Then as part of the Tax Cuts and Jobs Act (TCJA) of 2017, the exclusion was doubled (for eight years) resulting in a $11,400,000 Federal exclusion for 2019.
      iv) In addition, Portability, which was a temporary 2-year provision (in 2011 and 2012), was extended indefinitely.
   b) Handling tax basis of assets:
      i) Recall that the income tax basis in assets (other than certain assets {IRD assets} such as IRA's and 401(k) accounts) gets stepped up to date-of-death fair market value when the owner of the assets dies[7]. So, for example, upon the first death, the survivor could sell the real estate or stocks without any capital gains tax. In addition, for assets such as rental real estate, a step-up in basis provides greater depreciation going forward (providing more cash flow to the survivor).
      ii) If the existing trust is an A - B Trust, here is what could happen: upon the survivor's death, the assets in the A trust (assuming they have appreciated from the time of the first death until the time of the second death) receive another basis step-up (saving capital gains and/or reducing taxable income

7 In a community property estate both halves of the community property receive a basis step up (or down if assets have declined in value).

for the child/children/heirs). However, and here is the rub, the assets in the Bypass Trust do not receive a second basis step-up (the basis established at the time of the first death remains).

c) Portability of exclusion: When we thought portability was expiring and the tax-free estate was dropping back to $1M, we needed the B trust to shelter $1M from estate tax. Now that we have $5M ($10M through 2025) and Portability, we may not need the B Trust for estate tax purposes. We can often achieve similar estate tax savings with Portability and can obtain a second basis step up at the survivor's death.
   i) So, for combined estates under two times the Federal exclusion, the trust design often becomes one of control and asset protection.
      (1) Some questions to ponder: Is it a blended family so creating an irrevocable trust upon the first death is desired?
      (2) Is one of the spouses a spendthrift so that an irrevocable trust may be important for protection if the spendthrift ends up being the survivor?
      (3) Do the parties care that the survivor could end up consuming (with extravagancies) the entire estate?
      (4) Is there an existing entity which holds the farm and already provides some liability protection or is an irrevocable trust necessary for such protection?
   ii) For estates expected to be over (but not way over) $20M and for younger estate owners likely to survive past the year 2025 when the exclusion is scheduled to drop, designing the trust is more difficult.
   iii) One of the disadvantages of using portability is that the DSUE (the deceased spouse's unused exclusion…call it $10M for ease of discussion) is capped at the time of the first death. On the other hand, if the $10M were instead applied to the Bypass Trust, the Bypass Trust could grow estate tax free (so the $10M would not be capped).
   iv) Depending on certain factors including size of the estate and growth of the estate between the first and second deaths, sometimes the overall tax savings will be more significant by using a modified B Trust and other times by using an A-C Trust. Estate planning has become more complicated and the CPA and financial advisors are often needed at the trust design and planning stage as well as later. Monitoring the estate value is more critical than ever[8].
   v) You can achieve essentially the same "growth" of the $10M with portability, if the survivor is willing to use the decedent's $10M during the survivor's lifetime

8 Obviously, there are small farms that may never be close to $5,000,000 in value and so balancing the estate tax considerations versus the income tax (basis) considerations is not necessary.

by setting up an irrevocable grantor trust. But will the survivor be willing to give away $10M in assets shortly after the first death?

vi) In the case of the really large estate, say $30M or more, often the survivor would be willing to make a $10M gift into an irrevocable trust so the $10M could grow estate-tax free. And if the trust was a "grantor trust", the survivor could pay all income taxes for the grantor trust, thereby allowing the trust to grow estate tax and income tax free. In addition, if the trust was a grantor trust due to a "swap power" under IRC Section 675(4)(C), the survivor might be able to swap trust assets shortly before death to obtain a basis step-up in the appreciated assets.

vii) While permanency of Portability of the estate tax exclusion is a welcome planning tool that provides more flexibility in designing estates and trusts for married couples, another disadvantage of Portability is that the generation-skipping transfer tax exemption (GST exemption) is not portable. In order to be able to fully utilize the decedent's GST exemption, the revocable living trust should include a QTIP Trust and a reverse QTIP election should be made on the deceased spouse's IRS Form 706 (in addition to electing Portability on the Form 706).

7) **Probate**: Probate is a court proceeding to oversee the disposition of an estate that passes under a will or by intestacy.
   a) Probate vs. avoiding probate:
      i) In a state such as California, probate can be costly ($23,000/each for the attorney and executor for the first $1M of probate assets), in addition to being cumbersome and time-consuming.
      ii) In other states, Washington, for example, probate is a streamlined procedure (high inheritance tax in Washington State, however, makes Washington a less than ideal jurisdiction to die in, assuming the person has a choice. If the farm is located in Washington, there may not be much of a choice).
   b) Probate can be avoided by use of a funded revocable living trust.
   c) Probate can also be avoided by using certain types of titling, joint tenancy with right of survivorship, for example.
   d) How property is titled determines how the property passes upon the owner's death.
      i) For example, if the couple owns the brokerage account, real estate, etc., in joint tenancy and a spouse makes out a Will to leave the testator's 50% of the property to the testator's children from a prior marriage, joint tenancy title will, in most cases, control and the property will all go to the surviving joint tenant, the surviving spouse, despite what the Will says.

ii) Other property such as IRAs, life insurance and pay-on-death accounts generally pass according to the beneficiary designation, and thus avoid probate.

8) **Durable Powers of Attorney**: In planning for possible death or disability, in this case disability, the durable power of attorney is an important document.
   a) Note the potential interplay between the revocable living trust and the durable power of attorney (DPA): if the farm is held in an entity (discussed below) and the entity is held in the living trust, then in the event of incapacity of the settlor or trustor, the successor trustee takes over as current trustee (and the DPA may not be necessary for continued operation of the farm) .
      i) Is the trustee equipped to oversee the farming operations as well as the other financial matters of the incapacitated settlor?
      ii) If the farm is not held in trust, then the agent under the Durable Power of Attorney would be responsible for the farming operations in the event of the farmer's incapacity.
   b) Health Directives: While health directives, DNR's (do not resuscitate) and similar documents employed to cover health matters, including but not limited to "pulling the plug" on someone in a persistent vegetative state, do not have a direct impact on the farm, they are generally considered important documents as part of the farmer's contingency plan. Indirectly, of course, the cost of special care for a person in a lengthy persistent vegetative state could cost hundreds of thousands of dollars and possibly put the farm at risk.

9) **Choice of Entity:**
   a) Often not a choice. Clients frequently have a farming corporation or other entity before setting up the estate plan. However, depending on the situation, number of owners and other factors, the choices can include:
      i) sole proprietorship,
      ii) "C" corporation,
      iii) "S" corporation,
      iv) general partnership,
      v) limited partnership,
      vi) limited liability company (LLC), or
      vii) a combination of these (e.g. limited partnership with corporation as GP or farmland in LLC and operation in corporate form).
      viii) different tax and legal consequences can result, depending on the choice of entity. Each of the choices (plus a couple of other possible choices that arise in unusual circumstances) is outlined below.

b) Sole Proprietorship (Schedule F on IRS Form 1040)
   i) This is the default choice: unless the farmer actually sets up an entity, such as filing with the Secretary of State to form a corporation, or unless the farmer joins together with someone (other than a spouse) in a joint endeavor (in which case the default choice would be a general partnership), the business will be a proprietorship.
      (1) A proprietorship is not a separate legal entity.
      (2) It is really just a farmer as an individual conducting business
      (3) Fictitious business statements must be filed in each county in which the farmer conducts business if the farming operation is not using the legal (entity) name to conduct business.
      (4) In addition to lack of liability protection with the sole proprietorship (other than through insurance), the sole proprietorship frequently also has the disadvantage of lots of equipment and other assets. It is generally preferable to "house" the assets in a separate entity.

c) "C" Corporation (IRS Form 1120)
   i) A corporation is a separate legal entity. A separate legal entity has many of the rights and obligations of a natural person. For instance, a corporation can enter into contracts, can open a bank account, can sue and be sued, can own property; in short, a corporation can do many of the things a natural person can do. Of course, there are some legal rights that only natural persons have; such as the right to vote for political candidates.
   ii) Historically, the corporation has been the standard way to establish a business.
      (1) The corporation offers limited liability (the corporation can be sued, but if the corporation is properly set up and properly run, the individual owners {the shareholders} can avoid personal liability).
      (2) The shareholders appoint a board of directors.
      (3) The board of directors hires a president or CEO and other officers.
      (4) Officers handle the day-to-day affairs running the business with oversight by the board of directors.
      (5) In a small corporation, sometimes the shareholders, directors and officers are the same individuals. In fact, under California law (and most other states) it is possible to have a single shareholder, a single board member and that person acting as the board member and all of the officers.

d) "S" Corporation (IRS Form 1120S)
   i) The only difference between a "C" corporation and an "S" corporation is the tax treatment of each. Both entities are creatures of state law; they both file Articles of Incorporation with the Secretary of State; they both have Bylaws to govern legal operations; they both have shareholders, a board of directors

and two or more officers.

ii) In simple terms, the tax difference between a "C" corporation and an "S" corporation is the "C" corporation pays tax and the "S" corporation does not.[9]

iii) All of the net income earned by the "S" corporation is passed out to the shareholders (whether or not any money is actually distributed to the shareholders). The shareholders are taxed, pro-rata based on percentage ownership of the "S" corporation.[10]

e) General Partnership (IRS Form 1065)

   i) A partnership requires two or more persons. If farmers are going to work together in the farming business, this business may be eligible to form a partnership.

      (1) A partnership is defined as two or more persons joining forces for gain or profit.

      (2) Note, however, that not all persons working together create a partnership. For instance, I could start a business as a proprietorship; later I find I need some help with my computer system, so I hire you (maybe as an employee, maybe as an independent contractor). While you may hope that my business is successful (so I continue to offer you work), we will not be treated as a partnership (principally because you are not at risk).

   ii) Caution should be used before entering a general partnership.

      (1) Unlike a corporation (or LLC), each partner in a general partnership is personally liable, not only for the partner's own action but for the actions of all other partners.[11]

      (2) For this reason, intentionally forming a general partnership to conduct active business such as farming is rare.

f) Limited Partnership (IRS Form 1065)

   i) A limited partnership is often used where two or more persons are joining forces for gain or profit, but some of the persons are not active in the business.

   ii) For example, a person decides to buy and run a farm and their brother says he wants to invest $1,000,000 to start the farm. This brother does not intend

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9 This is a slight oversimplification: California imposes a 1.5% tax on "S" corporations. In addition, an "S" corporation that was previously a "C" corporation might also pay tax under certain circumstances.

10 There are a number of restrictions on "S" corporations such as a limit on the number of shareholders (100), a limit on the number of classes of stock (1), and restrictions on who can be shareholders (e.g., no non-resident alien shareholders, only certain trusts can be shareholders).

11 The other partner's action must be related for the business. You are not liable if your partner crashes her car, if she was not driving on business.

to work in the business. In a non-technical sense, he is a "silent partner". The partnership agreement has him classified as a “limited partner”, which means his working in the business is limited, and his liability is also limited. If the partnership is sued, his investment may be lost but he, unlike the farmer, normally would not be personally liable.[12]

iii) The family limited partnership (FLP) has been a popular tool for farmers and other estate owners to transfer the farm, property or assets by gift or at death to younger generations at a discounted value (see discussion in Section 16).

g) LLC (IRS Form 1065; or Single Member: Schedule C/F, Possible Form 1120)

i) The LLC is something of a hybrid between the corporation and the partnership. It can be the most flexible entity.

(1) It limits personal liability like the corporation and most often files a partnership tax return.

(2) In California and all other states, it is now possible to form a "single member LLC". This is what is called a "disregarded entity". It is not treated as a separate entity for tax purposes; rather, the owner files a Schedule C (or Schedule F for a farm business) as if a proprietorship; but the single member LLC is an entity for other purposes (for instance, if the LLC is sued, it provides a shield from personal liability).

ii) LLC's are gaining popularity for good reason. However, there are situations where the LLC may not be the entity of choice.

(1) Start-up and maintenance costs for the LLC may exceed the start-up and maintenance costs of other entities. For instance, like a corporation and limited partnership in California, there is an annual fee for the LLC, the "minimum franchise tax". Currently the fee is $800/year.

(2) Also, the LLC (but not the corporation or limited partnership) has a "gross receipts tax". This tax can go as high as $11,790 for gross income in excess of $5M.

iii) While an LLC for farming is often the vehicle of choice, note that not all businesses can use the LLC. In California, certain businesses and professions required to be licensed or certified under the California Business and Professions Code, such as doctors and lawyers, cannot conduct business as an LLC.

10) What About Using a Trust?

a) There are even more types of trusts than there are different legal entities. As a

12 The brother could lend $100,000 for startup costs, in which case he would be a creditor not a partner.

general rule (certainly in California), trusts cannot be used to conduct active business. In addition, there is a tax risk that a trust conducting an active business could be treated as a "C" corporation (a corporation potentially subject to double tax). Depending on the jurisdiction (but not California), there may be arrangements called "business trusts". The state law where you intend to conduct business should be consulted before using a business trust.

b) Non-tax advantages and disadvantages of partnerships, Limited Liability Companies and corporations: The general partnership is simple to establish (in most states it can be formed orally), but the joint and several liability aspect of the general partnership makes it an unattractive entity for operations with liability risk, e.g., most farms. The limited partnership with a liability limiting entity (such as an LLC) as general partner can divide ownership from management while limiting liability. A corporation with voting and non-voting shares[13] can also limit liability and divide ownership from management.[14]

c) "C" corporation versus "S" corporation is strictly a tax distinction. The corporate form of business is authorized and governed by state law. Filing Articles of Incorporation, adopting Bylaws and memorializing corporate activity with minutes, etc., is governed by the law of the state of incorporation (which may or may not be the state in which the farm is located). Whether a corporation is a "C" corporation or an "S" corporation is a function of Federal (and many states) tax laws. If a corporation meets the requirements (really limitations) to be an "S" corporation then the shareholders can make an "S" election by filing IRS form 2553. In addition to the single class of stock limit discussed above, the inability to have non-resident alien shareholders and the limit on number of shareholders (100)[15], especially important for estate planning: only certain types of trusts can hold "S" corporation stock.[16]

d) Tax advantages and disadvantages of partnerships (including LLCs taxed as partnerships), C and S corporations and sole proprietorships. From an estate tax or gift tax standpoint, all of these entities should, in most cases, qualify for one or more valuation discounts, the two main discounts being discount for lack of

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13 While the S corporation is limited to one class of stock, that class can be voting and non-voting common stock without violating the one class of stock rule.

14 See discussion under Family Dynamics, below. Consider the case where some of the children are active in the farm and may have a management role while other children are not (but the parents want active and inactive children to have the same percentage ownership in the farm).

15 Spouses and other family members may be combined and treated as a single shareholder unit, so the 100-shareholder limit is rarely an issue for farming families.

16 The Qualified Subchapter S Trust or QSST, the Electing Small Business Trust or ESBT and the Grantor Trust. The most common Grantor Trust is the revocable living trust.

marketability and discount for minority ownership. But in the age of higher estate tax exemptions (Federal $11,400,000 for 2019), discounts can be a bad thing, reducing basis step up at death. The flow-through nature (generally single level income tax) of the LLC taxed as a partnership and the flow through nature of the "S" corporation can be attractive and will usually carry the day, especially if the entity will own appreciated real estate. The IRC 754 election to allow the basis of the entity assets (not just the interest in the entity) to be stepped up often tips the scale towards the partnership and LLC taxed as a partnership.[17] There may be a temptation with the lowering of the Federal "C" corporation tax rate to 21% to think the "C" corporation may now be preferred. In almost all cases using a pass-through entity and taking an IRC Section 199A deduction will produce more "net" to the owners. It is true that 199A is set to sunset at the end of 2025, but the 21% rate could change sooner than that, at least if the Democrats sweep in 2020.

11) **Transfer Tax and Tax Basis Considerations Under current law:** Capital gain property acquires a new fair-market-value basis when the property passes to an heir or beneficiary at the property owner's death. Thus, capital gains often can be completely avoided after death. The IRC Section 1014 basis step-up rule can be especially advantageous for community property. If husband and wife hold the farm property as community property, there is a 100% basis step-up; so, the surviving spouse could sell the property without capital gains tax. However, if the property was instead held by husband and wife as joint tenants, only a 50% basis step up is allowed; possibly resulting in a significant capital gain upon sale of the property by the surviving spouse. This significant community property advantage has other states, in addition to the existing nine community property states, seeking ways to capture this advantage. Tennessee, for example, has adopted an elective community property regime.

12) **Using Portability:** While portability has been part of the law for over eight years, it is still relatively "new law".[18] The number of pre-portability estate plans, at least based on the author's limited sampling, is quite significant.
   a) History of portability: the ability for the surviving spouse to use the deceased

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17 An in-depth discussion of entity income taxation is beyond the scope of this outline but the new IRC Section 199A (up to) 20% deduction for pass-through entities which was part of TCJA is an important consideration, even though, like the doubling of the Federal estate exclusion, is scheduled to sunset at the end of 2025.

18 A relative newbie compared to Chapter 14 (1990) or the unlimited marital deduction (1981).

spouse's estate tax exclusion, had been an idea kicking around Washington, D.C., for some time [19]

i) However, it was a surprise inclusion in the Tax Relief, Unemployment Insurance Reauthorization, and Jobs Creation Act of 2010 (the "2010 Tax Act").
ii) While the 2010 Tax Act increased the exclusion (to $5M[20]) and reduced the estate, gift and GST tax rates (to 35%, later increased to 40% with the American Taxpayer Relief Act of 2012), those changes can fairly be characterized as "tweaking" prior law.
iii) Portability, on the other hand, introduced a new concept: the use of the estate tax exclusion by someone other than the person originally entitled to use it[21].
iv) Prior to January 1, 2011 (the effective date of portability), usually the only way to effectively take advantage of the deceased spouse's exclusion was to carve out assets equal in value to the deceased spouse's exclusion and hold the assets in a separate irrevocable trust (the Bypass Trust)[22].
v) When the exclusion was scheduled to return to $1M per individual at the end of 2010, portability seemed especially appropriate for couples like Harry and Wanda whose California residence alone can, in many cases, exceed $1M. While home ownership (like starting a family) should motivate a person to set up an estate plan, from experience we know that many persons with assets valued at over $1M, do not have an estate plan.
vi) We should note that not only was portability new, it, like the rest of the estate provisions in the 2010 Tax Act, was temporary, a two-year provision. While one might question whether it was proper to pay little attention to portability when planning couples' estates in 2011 and 2012, clearly portability needs to be part of virtually every estate planning discussion with couples going forward, farmers and non-farmers alike. It needs to be part of the planning discussion with both spouses and part of the discussion with the surviving

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19 Portability was included as part of the Permanent Estate Tax Relief Act of 2006 which passed in the House but failed in the Senate.

20 The "Applicable Exclusion Amount". The amount of the deceased spouse's exclusion that is available to the surviving spouse is the "Deceased Spousal Unused Exclusion" or DSUE.

21 The carry-over of tax benefits from one spouse to another is not an entirely new concept: see IRC Section 121(b)(4) where a surviving spouse can use the full $500,000 principal residence capital gain exclusion for two years after the deceased spouse's death.

22 Of course, the deceased spouse could have already used his or her exclusion via lifetime gifts or on death could leave the equivalent of the exclusion outright to, for example, children; but the most common estate plan provides for each other until the survivor dies and only then passes to others.

spouse after the passing of the deceased spouse[23].

vii) You may recall that as we approached 2010 and the one-year suspension of the Federal Estate Tax, estate planning meetings with clients tended to be longer than they had previously been. That trend, longer meetings, continues now that portability is permanent.

13) **Portability is not a complete substitute for a proper estate plan of course, but it can help ameliorate the estate tax costs for couples who fail to plan[24].**

a) One iteration of portability:

i) "Harry and Wanda" are new clients, married, come into your office, on or after June 12, 2015 (the effective date of the final Portability Regulations[25]) and have not updated their living trust since prior to 2011.

ii) They own a modest farm, but the property has significantly grown in value as has their investment assets.

iii) Assume further that Harry and Wanda have a traditional A-B-C trust[26]. You now need to explain that their existing trust was the standard practice at their last update, but there are new rules, and they have more choices in the design of their trust.

iv) The exclusion of $5M (indexed) per U.S. person is permanent (requiring an act of Congress to change it) and there is a new concept called "Portability". (The exclusion of $10M {indexed} is temporary though 2025).

v) Harry and Wanda need a joint planning meeting to discuss:

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23 In fact, we unequivocally state in our engagement letter with the surviving spouse (post-first death engagement) that a Federal Estate Tax Return, IRS Form 706, will be timely filed, either because the deceased spouse's estate exceeded the filing threshold or to elect portability (or both).

24 Had the exclusion dropped to $1M, portability would have offered a reasonable substitute for an estate plan in many cases. However, with a $10M exclusion, portability seems more difficult to justify: what overriding policy is served by giving a huge tax break to couples worth over $10M who are too busy, too lazy or too frugal to set up a proper estate plan? After all, since 2011, a standard A-B Trust plan could shelter a full $10M+ from estate tax without the need for portability. Portability does allow excess exclusion to be carried over to the surviving spouse so, for example, if the Bypass Trust only used $6M of the deceased spouse's exclusion, the remaining $4M+ could be carried over to the surviving spouse so that the survivor could shelter up to $15M at the survivor's death (if death occurs before 2026).

25 T. D. 9725, 80 Fed. Reg. 34279 (6/16/2015) ("2015 Final Regulations").

26 For purposes of our illustration the "A" Trust being the survivor's trust; the "B" Trust being the Bypass Trust and the "C" Trust being a QTIP trust (this is a relatively simple illustration…the trust could be A-B-C-C'-D Trust, with C' being the non-exempt QTIP trust for GSTT purposes and the D Trust being the disclaimer trust).

(1) "last deceased spouse rule "
(2) Inter-vivos gifting,
(3) Assuming Harry dies first (becoming the "deceased spouse"), and his exclusion is "ported"[27] to Wanda (using an even $5M for simplicity),
(4) If Wanda remarries ("Han") and Han also dies before Wanda, then Harry's $5M DSUE is lost and Han's DSUE is what Wanda ultimately receives;
(a) which could also be $5M, but could be less if Han had used up some or all of his exclusion with lifetime gifts,
(b) However, Wanda could use both Harry's and Han's DSUE, despite Han being the last deceased spouse if she is willing to and does use Harry's DSUE before Han dies.[28]

vi) assume in your fact gathering you learn that Harry and Wanda have a combined trust estate of $10M, all community property.[29]
vii) Since $5M is below the indexed exclusion ($5.45M for 2016, {$11.4M for 2019}), their existing A-B-C Trust would result in an A-B Trust if Harry had died in 2016.[30]
viii)This means, no new basis step-up at the surviving spouse's death: since the B Trust is intended to pass estate tax free to the next generation, no matter how much it grows between Harry and Wanda's death, it can have a zero inclusion ratio for GSTT purposes; it provides a certain level of asset protection, but portability can do more.

b) Eliminating the B trust from A-B-C Trust:
i) Instead of the traditional A-B Trust for Harry and Wanda, if we could be certain that the estate would not be subject to estate tax at the survivor's death[31], then we could advise Harry and Wanda that they could set up a trust

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27 A newly coined verb.
28 Client intake questionnaire should be updated to ask whether the client had a spouse who died on or after January 1, 2011; and if so; did the spouse leave any DSUE and if so, how much (and double check the Form 706).
29 For purposes of this illustration ignore retirement accounts, deductible expenses after the first death and different funding formulae and assume no prior taxable gifts.
30 A $5M trust, revocable by the survivor (the "A" or Survivor's Trust); and a $5M irrevocable trust (the "B" or Bypass Trust) for death in 2016 (or after 2025).
31 We know that the DSUE is frozen the year of death, e.g., $5.45M if Harry dies in 2016 (and could be entirely lost if Wanda remarries and that second spouse also dies and has a smaller DSUE. Wanda's exclusion will continue to increase each year until and unless Congress acts. But will the estate grow in value? The estate planning process has always been a team effort, but even more so now will we need the financial advisors to monitor the growth of the estate. If growth is pushing the estate into the estate taxable realm, then the surviving spouse can use DSUE to make gifts (of course a gift is a gift and Wanda may not be willing to part with assets or income

that looks very much like their existing trust, the A-B-C Trust, but just eliminate the B Trust (two trusts being simpler than three). Or in the case of a common law property estate a simple trust, a QTIP Trust, would be funded after the first death. What if Harry died in 2019, when the exclusion was $11,400,000 and Wanda claims $11,400,000 DSUE, does not remarry and lives past 2025, will part of the $11,400,000 be cut-back ("clawed-back" in 2026 when the exclusion is scheduled to drop by 50%? The answer appears to be no based on Anti-Clawback Prop. REG 106706-18.

ii) You may have heard that there was a concern whether an "unnecessary QTIP" would be respected. We now know that pre-portability Rev. Proc. 2001-38, will not prevent a couple from "bypassing" the Bypass Trust in favor of the QTIP Trust even if the deceased spouse's estate is below the estate tax exclusion, Rev. Proc. 2016-49. While presumably DSUE will be needed to shelter the QTIP marital trust which is included in the surviving spouse's estate under IRC Section 2044, in most cases the QTIP trust will be exempt from GSTT by making a reverse QTIP election and allocating the deceased spouse's GSTT exemption to the QTIP Trust. So similar to the Bypass Trust, the QTIP Trust can have a zero inclusion ratio for GSTT purposes and provide a certain level of asset protection. But unlike the Bypass Trust, the QTIP Trust assets will receive a new basis step-up (or down) at the surviving spouse's death. The QTIP Trust will pass entirely estate tax free or partially estate tax free32 (or possibly be fully taxable if there is a new last deceased spouse who has no DSUE to port). But if we have a $10M community property trust estate at Harry's death; Wanda does not remarry; the exclusion law does not change; and the indexing of Wanda's exemption keeps pace with the growth of the combined estate, then the A-C Trust will have provided a superior tax result to the A-B Trust (if there has been appreciation in the assets held in the QTIP Trust)[33].

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therefrom). On the other hand, if Wanda really doesn't want to have anything to do with the farm, perhaps starting to gift the farm to the children would make sense.

32 To minimize the effect of estate taxes reducing assets in the QTIP trust available for distribution to the remainder beneficiaries, we include in our A-C Trust documents a requirement that the DSUE be used first to cover estate taxes on the QTIP Trust before using DSUE to offset estate taxes elsewhere, such as the survivor's trust. As indicated previously, the DSUE could be unavailable due to the last deceased spouse rule. In addition, the surviving spouse could use DSUE by making inter-vivos gifts so there is a risk of substantially unequal distributions if the remainder beneficiaries of the Survivor's Trust and QTIP Trust are different.

33 The 40% Federal Estate Tax rate is usually higher than the combined Federal and State capital gains rates in most, but not all, cases. In addition, timing of capital gains tax is usually more controllable, and, in some cases, such as an IRC Section 1031 exchange, capital gains may be

iii) Alternatively, particularly if it is a first marriage for Harry and Wanda and they desire (relative) simplicity, the $10M trust estate could remain in a single trust, revocable by the surviving spouse and the deceased spouse's estate could elect portability.
   (1) Note that portability must be elected on time (including extensions) on the IRS Form 706[34].
   (2) so, portability will not eliminate post-mortem planning, even if the couple has failed to set up or chosen not to set up a Bypass Trust.
   (3) Filing the Form 706 only to elect portability can create other considerations such as who will pay for filing the Form 706. The surviving spouse, as such, has no inherent right to force the filing of the Form 706. For this reason, if someone other than the surviving spouse is named as the executor or successor trustee, consideration should be given to creating contractual rights, perhaps in the revocable trust or a prenuptial agreement, to force the filing of the Form 706.35

c) Portability coupled with a Disclaimer Option Trust[36] will provide the most flexibility but is not necessarily the most tax efficient plan.
   i) For one thing, the GSTT exemption is not portable
      (1) so, the deceased spouse's GSTT exemption will be lost if Harry and Wanda choose a Disclaimer Option Trust (unless Wanda actually

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avoidable. So, in cases where an estate tax is anticipated, the standard A-B trust may be preferred to portability (avoiding estate tax on the appreciating B Trust rather than receiving a second step up in basis at the surviving spouse's death).

34 The IRS has rejected the concept of a Form "706EZ") merely to elect portability. The service, however, has offered simplified 706 reporting if the estate will qualify for the marital deduction or the charitable deduction. However, this does not appear very useful in many cases for a couple of reasons: first, for basis purposes estimating values seems inappropriate; and second, what happens with deductible expenses, e. g., post-mortem attorney fees? If Harry and Wanda's estate is well under $10M and estate attorney fees are $25,000, previously the $25,000 attorney fees would be deducted for income tax purposes and thus not qualify for marital deduction treatment because the fees went to the attorney not the surviving spouse. Logically then $25,000 of the deceased spouse's exclusion would be applied to eliminate estate tax at the first death but also, likely, preclude using the simplified 706 method. As an aside, beginning February 29, 2016, a new uniform basis form, IRS Form 8971, needs to be filed within 30 days of filing the IRS Form 706. If the 706 is filed merely to make the Portability Election, Form 8971 will not need to be filed.

35 If an A-C Trust is employed, we typically provide in the trust document that the trustee will use the deceased spouse's DSUE for the QTIP trust first before using DSUE for the Survivor's Trust.

36 A revocable trust established by husband and wife in which everything remains in a revocable trust after the deceased spouse dies unless the surviving spouse disclaims, in which case the disclaimed property passes to an irrevocable disclaimer trust for the benefit of the surviving spouse and remainder beneficiaries.

disclaims into a bypass-type trust after Harry's death and then Harry's GSTT exemption is allocated to that irrevocable trust).

(2) In our example, assume further that the trust estate includes $1M of "penny stock", the value of which could explode prior to the surviving spouse's death. The survivor might disclaim the penny stock which would then pass to the Disclaimer Trust.

(3) The remaining $9M could remain in a trust revocable by the surviving spouse.

(a) In this case the deceased spouse's estate would file a Form 706 to disclose the disclaimer and report the assets passing through the decedent's estate;

(b) in addition, the portability election would be made for the deceased spouse's exclusion passing to the surviving spouse ($4M in this case giving the surviving spouse a combined exclusion of $9M)[37]

d) Incorporating IRAs, and other assets into portability

i) Portability may be especially useful in the context of a large IRA or qualified plan account.

ii) In the $10M example discussed above, assume instead that the $10M is comprised of Harry's $5M IRA, a $2M farm and a $3M portfolio of stocks and bonds.

iii) One approach (before portability) would be to use the aggregate theory of community property taking into account both trust and non-trust (i.e., IRA) assets for funding purposes. That could allow the IRA to pass to the survivor while the farm and stocks and bonds could pass to the Bypass Trust. With portability, it might be more appropriate, in many cases, to elect portability, allow the IRA to pass to the survivor, and place 50% of the trust assets (most of the stocks and bonds) into the Bypass Trust, while allowing the farm to remain in the Survivor's Trust in case survivor wishes to start gifting the farm.

14)**Why set up an Estate Plan After Portability**?

a) One of the practical effects of portability that all of us should consider: portability

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37 Note that while the post-death appreciation of the "penny stock" would not be included in the surviving spouse's estate (unless somehow the surviving spouse was deemed to hold an IRC Section 2041 general power of appointment over the B Trust), under the special statute of limitations rule of portability, the amount of the "penny stock" could be adjusted after the surviving spouse's death in order to lower the value of the DSUE. Or put another way: if the deceased spouse's estate includes a few million dollars of "penny stock", perhaps the preferred approach in that case would be to fill the Bypass Trust with all the "penny stock" and other assets to the full exclusion amount and forget portability.

combined with an increased exclusion, may cause people who should be setting up or revising estate plans to do nothing. In fact, there appears to be a sentiment among some, now that we have portability: there is no need to set up an estate plan[38].

b) Another effect may be increased stale-funding (or non-funding) of the trusts after the death of the deceased spouse. Failure to fund a B Trust after the first death may be understandable if the trust assets are modest compared to the new $10M exclusion but that conscious failure normally would not relieve the trustee of liability for failing to fund. For a good discussion of stale funding see Trusts and Estates Quarterly, Winter 2010.[39]

c) The technical requirements of portability[40] include:
   i) a spouse must have died (the "deceased spouse"),
   ii) the deceased spouse must have had unused exclusion,
   iii) only the unused exclusion carries over to the surviving spouse (for example if part of the exclusion was supposed to be used to shelter the Bypass Trust, but the Bypass Trust was never actually funded, arguably the amount of exclusion ported to the surviving spouse would be the full exclusion minus amount which was supposed to be used to shelter the Bypass Trust),
   iv) if there is more than one deceased spouse, only the remaining exclusion of the later spouse to die can be carried over (the statute calls this person the "last deceased spouse"),
   v) the exclusion must be claimed on a timely filed (including extensions) RS Form 706,
   vi) normal statute of limitations rules do not apply for purposes of determining whether the amount of exclusion claimed to be carried over is correct[41], and
   vii) once made (on the 706), the portability election is irrevocable.

d) The Treasury Department is expressly given regularity authority under Section 303 of the 2010 Tax Act, IRC Section 2010(c)(6), and has spoken with final

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38 Sunset legislation followed by continual retroactive legislation (the investment tax credit being only one notable example) makes for bad policy; it stifles planning. The author has had clients comment that the instability and uncertainty caused by this way of enacting and reenacting legislation makes the U.S. appear like a third world country.

39 See Revitalizing A Stale Trust: Improvement, If Not Perfection, James P. Lamping, California Trusts and Estates Quarterly Vol. 15, Issue 4 (Winter 2010).

40 Section 303 of the 2010 Tax Act replaces existing IRC Section 2010(c)(2) with new 2010(c)(2)-(6).

41 Similar to Estate of Frederick R. Smith vs. Commissioner, 94 T.C. 872 (1990) under prior law where the IRS could change values on an otherwise closed Form 709 for purposes of redetermining adjusted taxable gifts on the Form 706.

regulations.

e) Drafting considerations include:
   i) adding a standard provision to Will forms to authorize the executor to make an election on IRS Form 706 to carry over the DSUE,
   ii) Include provisions in the revocable trust such as: (for Mandatory 706 (e.g. larger "disclaimer trust") and use for QTIP first.

      The Trustee is authorized and directed to file a Federal Estate Tax Return, IRS Form 706, to elect portability under Internal Revenue Code Section 2010(c)(2)-(6) (or, if there is an Executor of the Estate of the Deceased Settlor, the Trustee shall cooperate and work with such Executor to make such election). In addition, the Trustee and the Executor of the estate of the surviving settlor are authorized and directed to first apply the Deceased Spouse's Unused Exclusion (DSUE) to assets taxable in the surviving settlor's estate by reason of IRC Section 2044 before using the DSUE for assets otherwise included in the surviving settlor's taxable estate.

   iii) Or a more general provision (e.g. if there is no QTIP Trust):

      The Trustee is authorized and directed to file a Federal Estate Tax Return, IRS Form 706, to elect portability under Internal Revenue Code Section 2010(c)(2)-(6) (or, if there is an Executor of the Estate of the Deceased Settlor, the Trustee shall cooperate and work with such Executor to make such election).

   iv) Where there is a Bypass Trust & General POA consider:

      The Trustee is authorized and directed to determine whether "portability", under Internal Revenue Code Section 2010(c)(2)-(6), should be elected in this case and if so, the Trustee is further authorized and directed to file a Federal Estate Tax Return, IRS Form 706, to elect portability (or, if there is an Executor of the Estate of the Deceased Settlor, the Trustee shall cooperate and work with such Executor to make {or not make} such election). Once made, such an election is irrevocable. The Trustee, Executor of the Estate of the Deceased Settlor, and the Surviving Settlor are held harmless for any actions taken or not taken with respect to the Deceased Settlor's exclusion which is, or is not, carried over to the survivor. In addition, the Surviving Settlor and Executor of the estate of the Surviving Settlor are entitled to utilize the Deceased Settlor's carried over exclusion in any manner (or not at all) as such persons see fit. In addition, if a portion of the Bypass Trust is included in the taxable estate of the Surviving Settlor, the Trustee and the Executor of the estate of the Surviving Settlor are authorized to apply the Deceased Settlor's

Unused Exclusion (DSUE) to that portion of the Bypass Trust included in the taxable estate of the Surviving Settlor, but only after the DSUE has been applied to all other assets includable in the Surviving Settlor's taxable estate.

v) since in many cases an executor will not be appointed, the living trust should grant similar authority to the trustee.[42]
vi) authorize, or in some cases mandate, making the portability election in the trust instrument. Inclusion of such language can alert the trustee to the possibility of portability,
vii) formula clauses should be reviewed to make sure that under a catch-all provision or otherwise, portability does not alter the formula, and
viii) consider whether forms need to be modified to add the term: "applicable exclusion amount" and "deceased spousal unused exclusion".[43]

f) Portability and tax savings: While important for many clients, tax savings can often be the motivating factor that encourages farmers to set up an estate plan in the first place. The use of the standard A-B Trust has non-tax advantages over portability. An A-B, A-C or A-B-C Trust allows the deceased spouse to determine ultimately where his or her assets will pass. The blended family, where husband and wife have separate children, is a common example where trusts are and will remain critical to proper estate planning even if portability will allow the survivor to utilize both exclusions without having to employ multiple trusts. If there is only a single trust, revocable by the surviving spouse, neither the ultimate asset disposition nor the tax benefit of the exclusion will be determined by the deceased spouse.[44]
g) Another result of portability is that almost invariably your planning meetings (with married clients) will be longer and more complicated than prior to 2010

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[42] Under IRC Section 2203 the definition of executor includes more than a court appointed fiduciary in a probate proceeding.

[43] Which is defined as $5 million, as adjusted for inflation (in $10,000 increments). Note: the TCJA doubled the $5 million through 2025.

[44] Query whether the spouses could enter into a contract where the surviving spouse would agree to use the carried over exclusion to benefit the deceased spouse's family. However, the author is of the opinion that if the couple is willing to engage in complicated and somewhat uncertain contract planning, the couple should instead be willing to set up a customary A-B-C Trust which would allow the deceased spouse to determine ultimate asset disposition and provide more certainty of tax result. See also <u>Vose v. Lee</u>, 390 P. 3rd 238 Okla. (2017) where fiduciary duties were an issue.

Ultimately, the trust design and the portability plan should be the clients' call; but the attorney must explain thoroughly the alternatives so that the couple[45] can make an informed decision.

15) **What does higher exclusion (scheduled to drop in 2026) mean?**

a) In short, many fewer farmer's (and others) estates will be subject to estate tax.
b) Of course, as well as confirming what the Federal exemption is ($11.4M per individual for 2019) the advisor needs to check the specific state (a number of states still have lower exemptions).
c) Also, depending on location and size of farm property, the farm itself could very well exceed the exclusion[46].

16) **Valuation discounts:** The farm that exceeds the estate tax exclusion in value would benefit from valuation adjustments, principally lack of marketability and minority interest discounts.

a) These discounts are frequently achieved by having the farm held in an LLC or other entity and fractionalizing the ownership of the entity.
b) Recent cases have put into question the efficacy of using the family limited partnership (FLP) or family limited liability company (LLC) as a vehicle to pass on family wealth to the next generation.
c) The IRS challenges are typically leveled as passive business, not active farms.
d) Nevertheless, in order to be respected as a separate legal entity both for IRS purposes and for limitations on liability, basic practices and procedures should be adhered to from inception.
e) These practices and procedures include making sure there is:
   i) a separate company bank account,
   ii) that the FLP or LLC income is deposited in the company bank account,
   iii) treating the FLP or LLC as any other business,
   iv) keep good books and records,
   v) avoid paying personal expenses from the company,
   vi) Make intelligent business decisions,
   vii) In addition, distributions should be made regularly (we recommend at least annually) to all the partners/members and when making distributions, make

45 Making sure that appropriate written conflict waivers are in the file.

46 A random recent internet search results in a farm in central Kansas listed for sale for $5.6M. I would assume that the owner of this farm has other assets which would put him well into a taxable estate situation beginning in 2026.

sure that the distributions are according to the partnership or LLC Operating Agreement, frequently pro-rata (keeping in mind the rather onerous limitations on family entities under IRC Section 2701 and 2704

17) Discount tax cases:

a) In 1987, the IRS lost a big family partnership case. In fact, the IRS considered the loss so significant, it prevailed upon Congress to change the law. Even with the 1990 law change by Congress, the IRS continued to regularly lose FLP cases, mainly because the partners were following proper practices and procedures.
   i) During the mid to late 90's, the FLP became an increasingly popular tax reduction technique. In many cases, lawyers, accountants, promoters, and families got sloppy or just did not know what they were doing. Sometimes the advisors failed to explain proper procedures; sometimes the families ignored the procedures or were just careless.
   ii) Then the IRS began winning some of the FLP cases. Especially worrisome are two cases won by the IRS in 2003, a partial IRS victory in 2005 and a troublesome case in 2017.
   iii) Under the pre-2003 cases, the courts essentially held that by not following proper practices and procedures, the decedent retained the use of or income from the property. One of the long-standing IRS rules provides that if someone makes a gift but continues to benefit from the property, then the gift is not effective and the property is taxed in the donor's estate when the donor dies (IRC Section 2036). This result can occur by the stated terms of the transfer (e.g., mom transfers rental property to her son but the transfer document states that mom retains the income for the rest of her life), or the result can occur by what actually happens (e.g., mom transfers rental property to her son but, even though the transfer document is silent as to rental income, the tenant continues to send the rent checks to mom, and she keeps the money). In either case, the rental property will be included in mom's estate at death.
   iv) For example, in a 1997 case, after the partnership agreement was signed and the gifts of partnership interests were made, the decedent, Mrs. Schauerhamer, continued to deposit partnership rent checks into her personal bank account (which the IRS argued she would use for her personal expenses). The Tax Court concluded that Mrs. Schauerhamer continued to benefit from the income of the gifted property so the partnership gifts to her children were ineffective and the entire partnership was included in her estate at death. Or put another way: since the partnership failed to make pro-rata distributions according to the percentages owned by each partner, the

partnership failed to follow (or ignored) its own rules. As a result, the IRS was free to ignore the partnership agreement, and the Court held that all of the property was includible in Mrs. Schauerhamer's taxable estate at death.

v) The results in Schauerhamer and the other cases won by the IRS prior to 2003 were not surprising and the rationale was understandable.

b) Three cases that followed shortly after Schauerhamer are more examples where the family did not follow the rules:
   i) Bigelow vs. Commissioner T.C. Memo 2005-65 (March 30, 2005),
      (1) decedent did not have sufficient assets outside the partnership to pay her personal expenses,
      (2) the partnership was established after decedent suffered stroke at age 85,
      (3) she died at 88 and the partnership was terminated a year later,
      (4) leading Tax Court to conclude that partnership was only used "to facilitate gift giving and to reduce Federal Estate Tax."
   ii) Estate of Korby vs. Commissioner T.C. Memo. 2005-102 & 103 (May 10, 2005)
      (1) In Korby husband and wife were in failing health when they established the FLP,
      (2) over the next couple of years, the partnership paid personal expenses such as property taxes on the primary residence, and
      (3) failed to make pro-rata distributions to all the partners.
   iii) Estate of Abraham vs. Commissioner (No. 04-1886, 1st Circuit, 5/26/2005),
      (1) decedent lacked capacity prior to setting up the FLP,
      (2) the probate court in Massachusetts approved the FLP and transfer arrangement,
      (3) but, the monies that the decedent's daughters paid for the FLP interests they purchased went into an FLP account, not, as the probate court ordered, into an account held by the decedent's living trust.

c) Most significant case: Estate of Bongard vs. Commissioner 124 T.C. No 8 (2005).
   i) An LLC that was established to, in part, facilitate corporate restructuring, was respected,
   ii) whereas the FLP which appeared to be set up principally to facilitate estate planning, was not.
   iii) In the post-Bongard era the non-tax reasons (sometimes referred to as "business purpose") for setting up the partnership or LLC can be critical to the success of the entity on estate or gift tax audit.
   iv) Again, with an active farm operation, by following proper practices and procedures, an IRS attack on the viability of the entity should fail. But with the

significant increase in exemptions, in many cases the family no longer desires a 30% - 50% discount when the senior owner dies

d) Troubling (expansion?) of RS FLP attack in Powell?
   i) Mom incapacitated
   ii) Son acts under DPA
   iii) Son exceeds scope of DPA authority
   iv) Assets transferred to FLP: mostly cash & securities
   v) Mom only limited partner
   vi) Death-bed case (Mom dies seven days later)
   vii) Tax Court in Estate of Powell vs. Commissioner, 148 T.C. No.18, holds that IRC Section 2036(a)(2) applies (where a decedent, alone *or in conjunction with any person,* can control the amount or timing of distributions, etc....taken to (illogical?) extreme, Powell would seem to jeopardize any FLP/LLC case where the senior family member had a say in distributions, either as general partner of an FLP or a Manager of an LLC.
   viii) It remains unclear whether Powell will be limited due to its extreme facts.
   ix) Of course, the increased exclusion means that less farmers will need discount planning.

18) **Basis step-up at death:** if the value of the estate, including the farm, is likely never to exceed the estate tax exclusion, then fractional discounts and lifetime transfers would seem unnecessary, at least from a tax perspective.
   a) That said, one could envision a case where the prodigal son might say to dad: "I'll only stay on the farm and continue farming if you give me part of the farm now."
   b) See discussion below on family dynamics.

19) **Lifetime gifting with annual exclusions**[47]:
   a) But as the (perhaps a bit aggressive) case of Mikel vs. Commissioner, T.C. Memo 2015-64, illustrated, with sixty annual exclusions a lot of wealth can be transferred over a few years.
   b) Again, though, this technique really only makes sense when the value of the estate will likely exceed the exemption, at least as far as appreciating assets are concerned: Annual exclusion cash gifts are always welcome by the donee and "Crummey" gifts used in connection with the Irrevocable Life Insurance Trust

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[47] For 2019 the annual exclusion remains at $15,000 per donor per donee.

(ILIT) remain viable (see Life nsurance discussion under paragraph 23, infra)

20) **Lifetime gifting with exemptions:**

a) Back in the 90's when the tax-free estate (unified credit equivalent) was $600,000; prior to the gift tax return "adequate disclosure" rules, the estate owner had to actually pay at least one dollar of gift tax to get the statute of limitations to run on the gift.

b) We had cases back then where dad gave $611,000 worth of the farm (typically held in an entity) to the child ($600,000 was tax-free via unified credit; $10,000 tax-free via annual exclusion and dad would pay $370 of gift tax so the statute of limitations would run). Since the $600,000 (but not the $10,000) would be added back as "adjusted taxable gifts" on the Form 706, unless that $600,000 gifted property appreciated significantly post-gift, it actually was not beneficial overall tax-wise due to the carry over tax basis with a gift under IRC Section 1015. But in cases where there was significant post-gift appreciation, the IRS devised an end-around the statute of limitations (see footnote 41). On audit of the Form 706 the IRS could not re-open the closed gift matter for gift tax purposes, after the statute had run, but the IRS was permitted (according to Estate of Frederick R. Smith) to adjust the value of the gift for adjusted taxable gift purposes thereby increasing the estate tax (by bumping the estate into a higher tax bracket). Finally, Congress reacted to the IRS end-around and enacted the "adequate disclosure rules". There is no longer a need to pay gift tax to start the statute of limitations running on the gift; but you still must file a gift tax return, IRS Form 709, and must adequately disclose the gift for the statute to run (see, for instance, Field Attorney Advice 20152201F where the taxpayer failed to adequately disclose the partnership gifts). The value of the gift (as properly reported) still is added back on the Form 706 as an adjusted taxable gift so if the post-gift appreciation is not significant, the loss of basis step-up frequently makes the gift unattractive. That said, if much of the value of the farm was in non-depreciable land and the family has no intention of ever selling the farm, then the loss of basis step-up may not be that critical[48]

21) **Lifetime Sales:** If the value of the farm greatly exceeds the estate tax exclusion or if the exclusion was previously used: perhaps in 2012 when there was grave concern

48 Perhaps the farm is currently valued at about $8,000,000 and even combined with other assets the entire estate is below $11.4M. What if we have a change in Administration in 2020? Former President Obama had indicated that an exclusion of $3.5M (the 2009 amount) was where it should be.

that the exclusion would drop from $5M to $1M, then the various sale techniques should be considered. There are a number which should be mentioned here but a full discussion of which is beyond the scope of an Estate Planning Fundamentals for Farmers:

a) Installment Sale under IRC Section 453,
b) Private Annuity,
c) SCIN (self-cancelling installment note), and
d) sale to the intentionally defective grantor trust (IDGT).
   i) It should also be noted that the sale to the IDGT is often compared to the Grantor Retained Annuity Trust (GRAT) under IRC Section 2702 in that both techniques include a transfer to an irrevocable trust for the children (perhaps grandchildren in the case of the IDGT), and
   ii) both techniques result in payments back to the grantor (annuity payments in the case of the GRAT and principal and interest payments in the case of the IDGT)
   iii) It is important to understand that in both cases (GRAT and sale to IDGT), the farm (or other assets) transferred to the irrevocable trust must appreciate more rapidly than the IRS interest rate assumptions for the technique to "work".
   iv) Stated differently: the GRAT and the sale to the IDGT are estate "freeze" techniques not estate reduction techniques. That said, if coupled with entity discounting (discussed in Paragraph 16, supra), then the combined technique could be a freeze and reduction technique.

22)Other Tax Considerations:

a) Special Use Valuation under IRC Section 2032A & Conservation Easements under IRC Section 170(h)
   i) IRC 2032A, Conservation Easements and extended estate tax payments under IRC Section 6166 are not unique to farmers but the number of estate planning clients able to use any of these provisions is outside the farming community is small:
   ii) 2032A can reduce the value of real estate for estate tax purposes from highest and best use (the normal test) to actual use if the property is used for farming (or in anther trade or business); similarly, 6166 (extended estate tax payments) also requires some sort of business, a "closely held business" for which most farms would qualify (but does not require that there be any real estate in the business); and 170(h) requires that there be real estate subject to a conservation easement.
   iii) A detailed discussion of IRC Sections 2032A, 170(h) and 6166 is beyond the scope of these materials but a quick review to see if any might apply is

appropriate.

iv) 2032A requires continued usage of the property in the farming operation[49] by a "qualified heir" for ten years after the decedent's death.

v) There are percentage tests that must be met: essentially 50% of the value of the estate must consist of property used in the business of farming and 25% of the value of the estate must consist of real property used in the business of farming.

vi) The maximum reduction in value (for 2019) under IRC 2032A is $1,160,000. Courts are split over whether Special Use Valuation under IRC Section 2032A and valuation discounts are mutually exclusive.

vii) 6166 also requires a business such as a farm but has a different percentage test to qualify: at least 35% of the adjusted gross estate must consist of the value of the farm/business (and only the estate tax attributable to the farm/business can be deferred under IRC Section 6166).

viii) There is no "qualified heir" usage requirement under IRC Section 6166 but dispositions can accelerate the tax that is otherwise paid over approximately 15 years (with the first 5 years being interest only).

ix) Both 2032A and 6166 can apply to farms held in entities[50]. Due to the percentage tests of both 2032A and 6166, pre-death analysis is needed to assure qualification.

x) Often contrary to traditional estate tax reduction planning (fractionalize to reduce the value of the farm), maybe non-farm assets should be transferred instead so that the above percentage of the estate tests are met.

xi) The Estate Tax Qualified Conservation Easement is permitted under IRC Section 2031(c) and allows a 40% reduction in value of the real estate subject to a qualified conservation easement but the reduction in value cannot exceed $500,000.

xii) Finally, note that the Family Owned Business Deduction under IRC Section 2057 (which applied to farms while in existence) was repealed in 2014 (although the recapture provisions still apply if the deduction was employed before repeal).

23) **Life Insurance:** often the easiest way to provide for continuation of the family farm is to have sufficient life insurance in place to

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49 Or other business but for purposes of our discussion here we will refer to usage as part of the farming business.

50 Regulations under IRC Section 2032A and in the statute (and Regulations) under IRC Section 6166.

a) cover estate taxes,
b) provide liquidity for continuing operations,
c) have funds available in case a farm manager needs to be hired[51]
d) pay off creditors, and
e) buy out non-active beneficiaries[52].
f) Life insurance has advantages over all other types of assets:
   i) generally, the inside build-up in the policy is not taxed,[53]
   ii) proceeds are generally received income tax free (subject to the transfer for value rule), and
   iii) if properly owned, the insurance proceeds are not subject to estate tax on the death of the insured.
g) ILITs as Crummey Trusts: often the insurance is held in a separate trust called an Irrevocable Life Insurance Trust (ILIT).
   i) Many ILIT's are structured as Crummey Trusts, named for the 1968 case Crummey vs. Commissioner, 397 F. 2nd 82 (9th Cir.).
   ii) It stands for the proposition that short-term withdrawal powers (vested in the children) allow gifts to qualify for the annual exclusion (a $15,000 tax-free gift per year, per donee).
   iii) If the estate owner already gifts $15,000/year per child or intends to start such a gifting program, a simple Crummey Trust would not be useful.
   iv) Sometimes a simple Crummey Trust is used to transfer wealth down one generation over a few years.
   v) If the Crummey Trust is used to hold life insurance, then the trust will last beyond the insured's lifetime.
   vi) The Crummey Trust can provide a longer term; many continue for the lives of the children and ultimately pass to grandchildren. This lengthened term adds to the complexity. Generation-skipping transfer tax (GST) provisions would also need to be included in the trust and these are necessary but complicated as well.
   vii) The bottom line: if the insured does not have any incidents of ownership in the policy, then the proceeds of the policy are received estate tax-free by the

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51 Perhaps the family wants the farm to continue after the founding farmers, mom and dad, die, but all the children have successful careers and cannot drop everything to take over the farming operations.

52 For example, if the farm comprises most of the estate and mom and dad want to pass the farm to daughter who is active in the farming operations but want to essentially equalize the bequests to daughter and son, the bulk of the insurance proceeds can pass to son.

53 But see Webber vs. Commissioner, 144 T. C. No. 17 (June 30, 2015), where the "investor control doctrine" was employed to cause taxation of inside build-up.

ILIT or other owner.[54]

24) **Family Dynamics:** This is perhaps the most important aspect of estate planning for farmers. The abbreviated discussion here should not be in any way viewed as suggesting these less technical topics are less important. But they are not new (unlike many recent tax changes discussed above). A few remarks are appropriate.

a) Control, decision making process, succession plan, conflict resolution and more
   i) Control: getting the senior farmer to give up control is, in some cases, impossible.

b) Succession planning: Even getting the senior farmer to discuss this issue can often be difficult.

c) Conflict resolution: Is whatever dad says the absolute rule? What happens when dad starts "losing it" or dies?
   i) The recent Redstone cases, while not a farming business, nevertheless illustrate what can happen without a good conflict resolution process: protracted family litigation.
   ii) It is believed that what finally caused the family to settle was mom pleading with her sons to quit killing the family.

d) Farming families are probably not that different from other families, but a larger percentage of children may want to leave the farm for greener pastures – Conflicts between children "inside" the business and those who left the farm (traitors?) can be devastating. The estate planner usually wants to treat the "outside" children equally ("fairly" would be the better term). Addressing these and other issues before they become real problems is a critical part of the estate planning process.

25) **Who do you represent?**

a) It is often tempting to be the family attorney (or other advisor) and try to represent everyone.
b) Possible conflicts of interest abound.
c) Can you represent mom and dad with respect to their contingency estate plan and represent the farming LLC and all the members as it relates to the farm?
d) What if dad later calls you to amend his will which previously left the farm 50/50 to son and daughter but he has now decided to leave the entire farm to his

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54 If the farmer has only one child and that child is a responsible adult and will likely carry on the farming business, then outright ownership of the life insurance policy by the child will avoid estate inclusion of the proceeds in the farmer's estate and is simple. Of course, if child dies before the farmer, what happens to the policy? But that likely will not be the biggest obstacle to continuation of the family farm.

daughter? Can you inform son of this change?

e) There are few easy answers to these ethical questions but ignoring them is only a recipe for disaster.