Estate and Succession Planning: Key Concepts for A Successful Transition

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OVERVIEW

A significant percentage of farm and ranch families desire to keep the family agricultural activity in the family for future generations. Certainly, for some, that option is not possible as there is no heir interested in continuing the farming/ranching activity into the future. But, for those families interested in maintaining a viable business into subsequent generations, what are the practical steps that can be taken to help facilitate a transfer of business assets and control into the hands of the next generation of family operators in a manner providing for a viable economic unit?

Obviously, tax issues play a major role in transition planning, but other issues are also present. Some issues can be addressed with careful planning. Other issues require the proper family chemistry. All issues require an openness to discuss and a willingness to work out.

ESTATE-PLANNING ISSUES

2013 marked the beginning of major changes in the estate planning landscape and its impact on estates and beneficiaries. The American Taxpayer Relief Act (ATRA) of 2013 constituted a major income tax increase, and increased the tax rates on capital gains, dividends and transfer taxes. ATRA's changes were of a "permanent" nature – requiring a subsequent act of the Congress to change them. Also, the additional 3.8 percent tax on passive sources of income under I.R.C. §1411, included in the Patient Protection and Affordable Care Act ("Obamacare") which was enacted in 2010 and effective for tax years beginning after 2012, has important implications for the structuring of business entities and succession planning, particularly for taxpayers with passive sources of income.

Under ATRA, the transfer tax system, beginning in 2013, is characterized by four key components:

- Permanency;
- Indexing;
- Unification of the estate and gift tax systems; and
- Portability of the unused portion of the applicable exclusion at the death of the first spouse

THE CHANGED LANDSCAPE – 2013 AND FORWARD

In General

As noted above, the changes in estate planning beginning in 2013 are characterized by the following:

- Continuing trend of states repealing taxes imposed at death;

> **Note:** As of the beginning of 2019, 18 states (and the District of Columbia) have some variation of an estate tax or inheritance tax that is imposed at death. Those states are as follows: CT, DE, HI, IL, IA, KY, ME, MD, MA, MN, NE, NJ, NY, OR, PA, RI, VT and WA.

- Increase in the applicable exclusion and indexing of the amount (note – with moderate inflation, the exclusion is anticipated to be approximately $6.5 million by 2023 and $9 million by 2033).

- Reunification of the estate and gift tax;

- Permanency of portability of the deceased spouse's unused exclusion;

- Permanency of transfer taxes.

  Other changes that influence estate planning that began in 2013 include:

- An increase in the top federal ordinary income tax bracket to 39.6 percent;

- An increase in the highest federal long-term capital gain tax bracket to 20 percent;

- An increase in the highest federal "qualified dividend income" tax rate to 20 percent;

- The 3.8 percent net investment income tax (NIIT) of I.R.C. §1411;

- For agricultural estates, land values more than doubled from 2000 to 2010, and continued to increase post-2010. From 2009-2013, the overall increase in agricultural land values was 37 percent.[1] In the corn belt, from 2006-2013, the average farm real estate value increased by 229.6 percent.[2] During that same timeframe, the applicable exclusion increased 262.5 percent. For the year ending June 1, 2016, corn belt farm real estate values declined approximately one percent.[3] For the year ending June 1, 2017, farmland values increased 2.3 percent from the prior year.[4]

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[1] National Agricultural Statistics Service Land Values 2012 Summary, Cornell University, current through August 2, 2013.
[2] *Id.*
[3] USDA Economic Research Service, Farmland Value, accessible at https://www.ers.usda.gov/topics/farm-economy/land-useland-value-tenure/farmland-value/.
[4] USDA Economic Research Service, Farmland Value, accessible at https://www.usda.gov/nass/PUBS/TODAYRPT/land0817.pdf.

- Farmland values dropped from 2016 to 2020 by 1.3 percent, on average. But, U.S. farmland values remained high in 2020, averaging $3,160 per acre, a small decrease of 0.8 percent compared with 2019. At the same time, farm income increased (on average) nationwide in 2020 largely because of taxpayer dollars infused into the sector.

- However, with enactment into law on December 22, 2017, of "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018" (TCJA of 2017) the applicable exemption is doubled to $11.2 million per decedent (with subsequent inflation adjustments) for deaths in 2018 through 2025. For 2020, the exemption was $11.58 million per decedent. For deaths occurring and gifts made in 2021, the exemption equivalent of the unified credit is $11.70 million. The top (flat) rate remains at 40 percent.

State-Level Impacts and Income Tax Ramifications

At the state level, the landscape has dramatically changed. At the time of enactment of EGTRRA in 2001, practically every state imposed taxes at death that were tied to the federal state death tax credit. Since that time, however, the federal state death tax credit has replaced with a federal estate tax deduction under I.R.C. §2058 and, presently, only 17 states (and the District of Columbia) impose some type of tax at death (whether a state estate tax or a state inheritance tax). In those jurisdictions, the size of the estate exempt from tax (in states with an estate tax) and the states with an inheritance tax have various statutory procedures that set forth the amount and type of bequests that are exempt from tax.

The following table sets forth the various state death tax systems as of January 1, 2021:

States Imposing An Estate Tax			States Imposing An Inheritance Tax		
	Exemption Amount	Maximum Tax Rate		Exemption Amount	Maximum Tax Rate
CT	$7,100,000	12%	IA	Varies	15%
			KY	Varies	16%
DC	$4,000,000	16%	MD	Tied to Fed. Exclusion	10%
HI	$5,490,000	16%	NE	Varies	18%
IL	$4,000,000	16%	NJ	$0	16%
ME	$5,900,000	12%	PA	$0	15%
MD	$5,000,000	16%			
MA	$1,000,000	16%			
MN	$3,000,000	16%			
NY	$5,930,000	16%			
OR	$1,000,000	16%			
RI	$1,595,156	16%			
VT	$5,000,000	16%			
WA	$2,193,000	20%			

Note: Connecticut is the only state that imposes a gift tax.

Also, numerous states have no state income tax (AK, FL, NV, SD, TX, WA and WY), TN and NH only tax dividend and interest income and other states such as CA, HI, MN, NJ, NY and OR have a relatively high state income tax burden compared to other states having an income tax.

This all means that the post-2012 estate planning landscape is, generally speaking, characterized by lower transfer tax costs, higher income tax rates, and greater disparity among the states between transfer taxes and income taxes.

Note: Post-2012, *income tax issues* play a greater role in estate planning. Because of that, planners will need to consider whether it is possible for a client to minimize the overall tax burden for a particular client (or family) by moving to a state with a reduced (or eliminated) income tax and no transfer taxes. In general, clients domiciled in relatively higher income tax states will generally place an emphasis on ensuring a basis "step-up" at death. For those clients with family businesses, the ability of the client to be domiciled in a "tax favorable" state at death means that pre-death transition/succession planning will be important.

Focusing Estate Planning Post-2012

The key issues for the "estate planning team" beginning in 2013 and going forward would appear to be the following:

- The client's life expectancy;
- The client's lifestyle;
- The potential need for long-term health care and whether a plan is in place to deal with that possibility;
- The size of the potential gross estate;
- The type of assets the decedent owns and their potential for appreciation in value;
- For farm estates, preserving the eligibility for the estate executor to make a special use valuation election;
- For relatively illiquid estates (commonplace among agricultural estates and other estates for small business owners), preserving qualification for various liquidity planning techniques such as installment payment of federal estate tax and properly making the election on the estate tax return;
- Whether a basis increase at death will be beneficial/essential;
- Where the decedent resides at death;
- Where the beneficiaries reside at the time of the decedent's death;

- If the decedent has a business, whether succession planning is needed;

- Entity structuring and whether multiple entities are necessary;

- For agricultural clients, the impact of farm program eligibility rules on the business structure;

- Asset protection strategies, including the use of a Spousal Lifetime Access Trust

- General economic conditions and predictions concerning the future. For agricultural clients, land values, and commodity prices and marketing strategies are important factors to monitor.

Impact of Coupling

Because of the "coupled" nature of the estate and gift tax systems and portability of the unused exclusion at the death of the first of the spouses to die, it will likely be desirable to use as little of the applicable exclusion during life to cover taxable gifts. For many clients, the applicable exclusion will shelter the entire value of their gross estate and inclusion of assets in the estate at death will allow for a basis increase in the hands of the heirs. Thus, for most clients, there will be little to no transfer tax cost. Again, that fact will cause most clients to place an emphasis on preserving income tax basis "step-up" at death. If there are to be asset transfers pre-death, such transfers will most likely occur in the context of business succession/transition planning. But, for many clients, gifting assets during life will take on diminished importance.

Portability

The amount of the estate tax applicable exclusion that is not used in the estate of the first spouse to die is available to be used in the estate of the surviving spouse, by election. This process is referred to as "portability." What is available to be "ported" to the estate of the surviving spouse is the "deceased spouse's unused exclusion amount (DSUEA). Before portability,

> **Note:** The inherited DSUE amount is available for use by the surviving spouse as of the date of the deceased spouse's death and is applied to gifts and the estate of the surviving spouse before his or her own exemption is used. Accordingly, the surviving spouse may use the DSUE amount to shelter lifetime gifts from gift tax, or to reduce the estate tax liability of the surviving spouse's estate at death.

The portability election must be made on a timely filed estate tax return (Form 706) for the first spouse to die.[5] That's the rule for nontaxable estates also, and the return is due by the same deadline (including extensions) that applies for taxable estates. The election is also revocable until the deadline for filing the return expires.

Role for traditional bypass/credit shelter trusts. Portability, at least in theory, can allow the surviving spouse's estate to benefit from basis "step-up" with little (and possibly zero) transfer tax cost. While traditional bypass/credit shelter trust estate plans still have merit, for many clients (married couples whose total net worth is less than or equal to twice the applicable exclusion), relying on portability means that

[5] I.R.C. §2010(c)(5)(A).

it is not possible to "overstuff" the marital portion of the surviving spouse's estate. This could become a bigger issue in future years as the applicable exclusion amount grows with inflation, this strategy will allow for even greater funding of the marital portion of the estate with minimal (or no) gifts. But, a key point is that for existing plans utilizing the traditional bypass/credit shelter approach, it is probably not worth redoing the estate plan simply because of portability unless there are extenuating circumstances or the client has other goals and objectives that need to be dealt with in a revised estate plan.

> **Note:** Portability planning is slightly less appealing to couples in community property states because, as discussed below, all community property gets a "stepup" in basis on the first spouse's death.

Portability "arbitrage." A surviving spouse can utilize multiple DSUEAs by virtue of outliving multiple spouses where the DSUEA election is made in each of those spouse's estates. The surviving spouse must gift the DSUEA of the last deceased spouse before the next spouse dies.

TRANSFER TAX COST AS COMPARED TO SAVING INCOME TAX BY VIRTUE OF BASIS "STEP-UP"

In General

As noted above, for many clients a beginning estate planning step is the attempt to determine the potential transfer tax costs as compared to the income tax savings that would arise from a "step-up" in basis. This is not a precise science because the applicable exclusion will continue to be adjusted for inflation or deflation. The rate of inflation/deflation and the client's remaining lifespan are uncontrollable variables. Also, as indicated above, the tax structure of the state where the decedent and beneficiaries are domiciled matters.

Under present law, the vast majority of estates do not face federal estate tax at death. Obtaining a basis increase for assets included in the gross estate is typically viewed as more important.

Benefitting From Basis "Step-Up"

The only way to capture the income tax benefits of the stepped-up basis adjustment is for the recipients of those assets to dispose of them in a taxable transaction. This raises several questions that the estate planner must consider:

- Whether the asset is of a type (such as a farm, ranch or other closely-held family business) that the heirs may never sell it, or may sell it in the very distant future;
- Whether the asset is depreciable or subject to depletion; and
- Whether the asset involved is an interest in a pass-through entity such as a partnership or an S corporation.

Exceptions To The Basis "Step-Up" Rule

There are also exceptions to the general rule of date- of-death basis:

- If the estate executor elects alternate valuation under I.R.C. §2032, then basis is established as of the alternate valuation date;

- If the estate executor elects special use valuation under I.R.C. §2032A, the value of the elected property as reported on the federal estate tax return establishes the basis in the hands of the heirs. This is true even though the executor and the IRS strike a deal to value the elected land at less than what would otherwise be allowed by statute (for deaths in 2021, the maximum statutory value reduction for elected land is $1,190,000).

- For land subject to a qualified conservation easement that is excluded from the gross estate under I.R.C. §2031(c), a carryover basis applies to such property.

- Property that constitutes income in respect of a decedent (includes unrecognized interest on U.S. savings bonds, accounts receivable for cash basis taxpayers, qualified retirement plan assets, and IRAs, among other things); and

- Appreciated property (determined on date of the gift) that was gifted to the decedent within one year of death, where the decedent transferred the property back to the original donor of such property (or the spouse of the donor). The donor receiving the property back will take as a basis the basis that the decedent had in the property immediately before the date of death.

Community Property Considerations

On the basis step-up issue, estates of clients in community property states have an advantage over estates of clients in separate property states. The ownership portion of the couple's community property that is attributable to the surviving spouse by virtue of I.R.C. §1014(b)(6) gets a new basis when the *first* spouse dies if at least one-half of the community property is included in the decedent's estate for federal estate tax purposes. This became the rule for deaths after 1947. Restated differently, there is a basis adjustment of both the decedent's and surviving spouse's one-half of community property at death if at least one-half of the community property was include in the decedent's gross estate under chapter 11. If future legislation repeals the federal estate tax (chapter 11), a question will arise as to whether the so-called "double basis step-up" for community property will survive.

> **Note:** The community property states are AZ, CA, ID, LA, NV, NM, TX, WA and WI. Two common law property states, AK and TN, allow couples to convert or elect to treat their property as community property. In these states, resident and nonresident couples can classify property as community property by transferring the property to a qualifying trust. For nonresidents, a qualifying trust requires at least one trustee who is a resident of the state or a company authorized to act as a fiduciary, and specific trust language declaring the trust asset as community property.

Presently, sixteen states (AK, AR, CO, CT, FL, HI, KY, MI, MN, MT, NY, NC, OR, UT, VA and WY) have enacted the Uniform Disposition of Community Property Rights at Death Act ("UDCPRDA"). Under the UDCPRDA, when the first spouse dies, half of the community property is considered the property of a surviving spouse and the other half is considered to belong to the deceased spouse. But, a couple can change their interests in the property (Act, §8), and can adopt an estate plan that control the inheritance of their property. One drawback for planner is that there aren't any cases or IRS rulings on the impact of the UDCPRDA on basis step-up under I.R.C. §1014(b)(6).

Observation. Because the unlimited marital deduction under I.R.C. §2056 essentially gives couples in community property states the ability to have no transfer taxes on the first spouse's death, this "step-up" in basis provides an immediate income tax savings for the surviving spouse's benefit. This changes the planning dynamic as compared to similarly situated clients in non-community property states.

Suggested Approach. The following is a suggested estate planning approach for married couples in community property states where emphasis is placed on achieving a stepped-up basis:

- Minimal gifting of assets during the lifetimes of both spouses, so that the maximum value of assets is included in the estates where they will be eligible for a basis increase under I.R.C. §1014(b)(6).

- After the death of the first spouse, if the value of the survivor's gross estate exceeds the available applicable exclusion, utilize strategies to reduce the potential estate tax in the survivor's estate consistent with the surviving spouse's goals. Such strategies may involve income tax planning, planning to avoid or at least account for the NIIT, gifting, and the use of entities to create minority interest and lack of marketability discounts, and discounts for built-in capital gain (applicable to S corporations).

Estate Planning Techniques Designed To Achieve Income Tax Basis "Step-Up"

The disparate treatment of community and common law property under I.R.C. §1014 has incentivized estate planners to come up with techniques designed to achieve a basis "step up" for the surviving spouse's common law property at the death of the first spouse. These techniques can be summarized as follows:

- General power of appointment given to each spouse over the other spouse's property which causes, on the death of the first spouse, the deceased's spouse's property to be included in the decedent's estate by virtue of I.R.C. §2033 (if owned outright) and I.R.C.§2038 if owned in a revocable trust. The surviving spouse's property would also be included in the decedent's estate by virtue of I.R.C. §2041. The power held by the first spouse to die terminates upon the first spouse's death and would be deemed to have passed at that time to the surviving spouse.

- Joint exempt step-up trust (JEST).[6] In essence, both spouses contribute their property to the JEST that holds the assets as a common fund for the benefit of both spouses. Either spouse may terminate the trust while both are living, in which case the trustee distributes half of the assets back to each spouse. If there is no termination, the joint trust becomes irrevocable upon the first spouse's death. Upon the first spouse's death, all assets are included in that spouse's estate. Upon the first spouse's death, assets equal in value to the first spouse's unused exclusion will be used to fund a bypass trust for the benefit of the surviving spouse and descendants. These assets will receive a stepped-up basis and will not be included in the surviving spouse's estate. Any asset in excess of the funding of the bypass trust will go into an electing qualified terminable interest property (QTIP) trust under I.R.C. §2056(b)(7). If the first spouse's share of the trust is less than the available exclusion, then the surviving spouse's share will be used to fund a bypass credit shelter trust. These assets will avoid estate taxation at the surviving spouse's death.

[6] For a detailed explanation of the JEST concept, see Gassman, Denicolo and Hohnadell, 40 Estate Planning, Nos. 10-11 (Oct and Nov. 2013).

Note: I.R.C. §1014(e) may operate to prevent the planning benefits of these techniques. Under I.R.C. §1014(e), property with a fair market value that exceeds its basis at the time of the transfer is ineligible for a basis step- up if the transferee dies within one year of the transfer and, as a result of the transferee's death, the transferred property is "acquired from" the transferee by the original transferor or "passes from" the transferee to the original transferor under I.R.C. §1014(e). The primary question is whether I.R.C.§1014(e) applies to the general power of appointment held by a deceased spouse over the surviving spouse's interest in trust property. The IRS has ruled negatively on the technique. In Priv. Ltr. Rul. 9308002 (Nov. 16, 1992), IRS disallowed a basis increase to the surviving spouse's one-half interest in a trust because the policy of I.R.C. §1014(e) requires relinquishment of dominion and control over the property transferred to the decedent at least one year before death. Because the surviving spouse (the donor) could revoke the joint revocable living trust at any time, the surviving spouse had dominion and control over the trust assets during the year before and up to the time of the decedent spouse's death. The IRS again ruled similarly in Priv. Ltr. Rul. 200101021[7] The 1993 letter ruling has been criticized.[8] However, there is support for the position of the IRS.[9]

Clearly, the drafting required to achieve the desired result is very complex. The administration of trusts always requires care. That level of care is elevated with respect to estate planning techniques designed to achieve a basis increase for common law property equivalent to that of community property.

BASIS OF ASSETS IN ESTATES

Date of Death Valuation and Alternate Valuation. The general rule is the basis of an inherited asset from a decedent is the FMV of the asset on the decedent's date of death. There are a number of exceptions to this general rule, including income in respect of the decedent (IRD) and certain gifts of appreciated property acquired by the decedent by gift within one year of death [10]

The executor of an estate may choose to use the FMV on the date of death **or** on the **alternate valuation date** when filing Form 706.[11] The alternate valuation date is the date that is exactly six months after the date of death. The alternate valuation election may only be made if it lowers the overall value of the estate, lowers the estate tax, and is used for all assets in the estate. If the executor makes an alternate valuation date election, the beneficiary's basis is equal to the FMV of the property as of the alternate valuation date.

The executor can make an alternate valuation election only if the value of the property in the gross estate *and* the estate's federal estate tax liability are both reduced by making the election. Thus, the decedent's gross estate must be a taxable estate.[11] The purpose of alternate valuation is to lessen the federal estate tax burden if values decline in the six-month period immediately following death. In that event, the estate can be valued up to six months after death.

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[7] Oct. 2, 2000.

[8] *See, e.g.*, Zaritsky, *Running With the Bulls: Estate Planning Solutions to the "Problem"of Highly Appreciated Stock*, 31-14 University of Miami Law Center on Estate Planning §1404; Williams, *Stepped-Up Basis in Joint Revocable Trusts*, Trusts & Estates (June 1994).

[9] *See, e.g.*, Keydel, *Question and Answer Session II of the Twenty-Eighth Annual Institute on Estate Planning*, 28-20, University of Miami Law Center on Estate Planning §2007.

[10] IRC §1014.

[11] IRC §2032.

[11] Treas. Reg. § 20.2032-1(b)(1) (1958); Tax Reform Act of 1984, Sec. 1923(a), 98th Cong., 2d Sess. (1984).

Observation. If an estate would not be subject to federal estate tax, an alternate valuation election could allow the estate's heirs to obtain a higher income tax basis on property included in the gross estate if values had risen after death. That is not permissible.

For most businesses, alternate valuation is straightforward. There is one value as of the date of death and a different value six months after death. However, in some estates, events can occur during the six-month period immediately following the decedent's death. This of particular concern with respect to an agricultural estate. For example, a decedent may have planted a crop shortly before death, which was harvested and sold within six months after death. Or perhaps the decedent had cows that were bred before the date of death and calved after death and were sold after the six-month period following death. To determine whether these types of property are subject to alternate valuation requires a determination of "included" and "excluded" property. "Included property" is all property that is in existence at death. Under an alternate valuation election "included property" is valued six months after death or as of the date of sale, whichever comes first. Thus, crops that are growing as of the date of death and are harvested and sold after death are valued as of the earlier of six months after death or the date of sale. Conversely property coming into existence after death such as crops planted after death, are ignored for purposes of alternate valuation. This property is termed "excluded property." For property that exists as of the date of death, and is disposed of gradually during the six-month period after death (such as silage that is fed during the six months' period following death), every day's feeding is a disposition. Thus, a calculation must be made not only as to the value, but as to how much disappeared. The same is true of shelled corn, hay, or similar items. The inventory must show the disappearance over that time period, and some value must be attached to it.

Basis Consistency Rules

The Surface Transportation and Veterans Health Care Improvement Act of 2015 (Act) added I.R.C. §6035 to the Code. I.R.C. §6035 specifies that a decedent's estate that is required to file a federal estate tax return (Form 706) after July 31, 2015, must provide basis information to the IRS and estate beneficiaries by the earlier of 30 days after the date Form 706 was required to be filed (including extensions, if granted) or 30 days after the actual date of filing of Form 706. The purpose of the provision is to ensure that beneficiaries of estate assets use the same basis numbers when later selling the assets as were used in the decedent's estate.

The new rules do two things – (1) specify that the basis of property subject to the new rules cannot exceed the final value as determined for estate tax purposes in a decedent's estate; and (2) impose a reporting requirement with regard to the value of property included in a decedent's gross estate.

The Filing Requirement. Under the Act, I.R.C. §6035(a)(1) requires the executor of an estate that is required to file Form 706 by I.R.C. §6018(b) to furnish to the IRS and the person acquiring any interest in property that is included in the decedent's gross estate for federal estate tax purposes, a statement detailing the value of each interest in the property inherited as reported on Form 706 along with any other information that the IRS might require by regulation.[12]

Note: An estate executor must: (1) furnish a statement (IRS Form 8971 and the accompanying Schedule A) to the IRS identifying the reported value of each asset that was included in the gross estate; and (2) give that information (Schedule A of Form 8971) to each person who acquired the interests and identify those individuals in the report to the IRS.

[12] I.R.C. §6035(a)(2). Any statement filed under I.R.C. §6035 is subject to the failure to file penalties contained in I.R.C. §§6721 and 6722.

PRACTICAL (2021) ESTATE PLANNING

Clients with wealth less than $11.70 million (single) or $23.40 million (married couple). For these individuals, the possibility and fear of estate tax is largely irrelevant. But, there is a continual need for the guidance of estate planners. The estate planning focus for these individuals should be on basic estate planning matters. Those basic matters include income tax basis planning, and a focus on common errors with a plan to avoid them. In addition, for some clients, divorce planning/protection is necessary. Also, a determination will need to be made as to whether asset control is necessary as well as creditor protection. Likewise, a consideration may need to be made of the income tax benefits of family entities to shift income (subject to family partnership rules of I.R.C. §704(e)) and qualifying deductions to the entity. The entity may have been created for estate and gift tax discount purposes, but now could provide income tax benefits. In any event, family entities (such as FLPs and LLCs) will continue to be valuable estate planning tools for many clients in this wealth range.

Most of the moderate wealth clients will likely fare better by not making gifts and retaining the ability to achieve a basis step-up at death for the heirs. Also, consideration should be made to determine whether insurance is still necessary to fund any potential estate tax liability It also may be possible to recast insurance to fund state death taxes and serve investment and retirement needs, minimize current income taxes, etc.

Other estate planning points for moderate wealth clients:

- Trust-owned life insurance. Clients should be cautioned to not cancel policies before it is evaluated.

- Pension-owned life insurance – if the client's estate is safely below the exemption, the adverse tax consequences may be avoided.

- Evaluate irrevocable trusts.

- For durable powers of attorney, examine the caps on gifted amounts (annual exclusion is now $15,000) and make sure to not have inflation adjusting references to the annual exclusion.

- For qualified personal residence trusts (QPRTs) that were created when the estate tax exemption was $2 million, the conventional advice was to deed the house from the QPRT to the children or a remainder trust (which might have been a grantor trust), with a written lease agreement in favor of the parent/donor who would continue to live in the house. Now, it may be desired to have the home included in the estate for basis step-up purposes.

- While FLPs and LLCs may have been created to deal with the I.R.C. §2036 issue, it may not be wise to simply dismantle them because estate tax is no longer a problem for the client. Indeed, the client may actually want to trigger the application of I.R.C. §2036 and cause inclusion of the FLP interest in the parent's estate. This can be accomplished by revising the partnership or operating agreement and having the parent document control over the FLP. Then, an I.R.C. §754 election can be made which can allow the heirs to get a basis step-up.

Clients with Wealth Exceeding $11.70 million (single) or $23.40 million (married couple). A major issue for these individuals is their state of domicile and whether the state has a decoupled estate tax or not. If the client is middle-aged with a growing business, or a widow/widower with a large estate and a portable exemption amount from the pre-deceased spouse, the planning considerations turn on numerous factors. The relatively higher income taxes (and fewer deductions) on wealthier clients could push such clients to establish domicile/residency in a state with either no state income taxes or relatively low-income taxes (as well as property taxes). For these clients, creditor protection is often a major concern. If a small business is involved, business succession and retirement planning is also important. Common "bypass" trust schemes may no longer appreciate the complexity of the current transfer tax system which includes the permanency of portability.

Observation. Estate plans that rely simply on portability, the estate of the first spouse to de forfeits the generation skipping transfer tax exemption. Thus, if grandchildren are part of estate plan and the assets exceed the applicable exclusion, sole reliance on portability is not estate and GSTT tax optimal.

Common Objectives of Succession Planning

I. Successfully bringing the next generation of owners and managers into the business.

II. Providing a vocation for the next generation of owners.

III. Establishing a base for a financially successful business into the future.

IV. Establishing a base for personal satisfaction of the next generation of owners and managers.

V. Providing a plan for the older generation of owners and managers to retire in the way they want and enjoy their success of years of hard work.

VI. Providing an estate plan that is fair to on-farm and off-farm heirs.

VII. Minimize tax impact of property transfers.

Ways Children Become Involved in a Farming Operation

I. Long-term acquisition with supplemental off-farm income.

A. Child establishes his own small farm business and gradually acquires farm assets by way of renting and ownership.

B. The child will most likely work off farm for several years to provide for family needs. This becomes the child's way of life and eventually, maybe not until retirement, he quits the off-farm job, and continues to farm during the retirement years.

II. Off-farm employment coupled with rental arrangement.

A. A child establishes his own small farm business and gradually acquires farm assets by way of renting and ownership.

B. The child most likely works off farm to provide family expense income and invests whatever capital he can into farming assets. Sometimes the off-farm income is also provided by a spouse.

C. At some point mid-career in time the child has increased the size of his farm asset base to the point he can farm on his own without the need for the off-farm income or at least without the husband working off farm. This is a big step with lots of risk incurred by the child. In this scenario the child has as an objective of becoming a full- time farmer as quickly as possible.

D. The spouse of the farmer may continue to work off farm.

Note: An important reason for working off farm is to participate in an employer sponsored health insurance plan.

III. Sharing of labor and capital.

A. Parents may loan machinery to a child so the child can rent or purchase some land in the neighborhood and start a farming business.

B. Over time there may be a sharing of labor and machinery between parent and child with each continuing to operate his own farming business as a sole proprietorship.

Note: It is not unusual to see some equipment purchased jointly with a portion being depreciated on each farmer's depreciation schedule. This seems to be a rather common arrangement and often works well.

C. A concern is that if an accident should occur, the court may find the two individuals are in a partnership and experiencing joint and several liabilities.

1. This plan sets the stage for parent retirement hopefully enabling the child to be in a position to operate their farm at that time.

D. Separate businesses.

1. The child uses, rents and purchases farming assets from parents and starts up his own farming business.

2. Often, this is the situation if parents are at or nearing retirement age and are ready to slow down at the same time the child is ready to take on the farm responsibilities. In this setting Dad may become an employee of the child. E. The partnership or joint operation.

1. The parent and child may jointly start a partnership, Limited Liability Company, or corporate form of business and both become gainfully employed and full "partners" in the business.

2. This situation may happen if parents are young enough and desire to continue in the business and the child is old enough and desires to farm with parents.

3. Usually when this is the way a child gets started into the business two or more business entities are formed. A partnership, corporation, or LLC is formed for the operating business and the real estate and possibly other assets are not placed into the operating business but are instead rented from the parent. Over time the child may also acquire real estate outside the operational business and rent that real estate to the business as well.

4. A plan still is required for the day the older generation decides to retire and younger generation furthers his goal of continuing in the business.

5. A plan still is required to determine how best to treat off farm children fair.

F. The "do-nothing" plan - no plan at all and farming child is left with no business upon dad's death.

Advantages and Disadvantages of Various Entity Forms

(from Roger A. McEowen, *Principles of Agricultural Law*, Chapter 9, Appendix)

Issue	**Sole Proprietor ship**	**C Corp.**	**General/ Limited Liability Partnership**	**Limited Partnership**	**Limited Liability Company**	**S Corp.**
Nature of Entity	Legal person same as the owner	Legal person separate from shareholder owners	Aggregate of two or more persons	Aggregate of two or more persons	Aggregate of two or more persons	Legal person separate from shareholder owners
Life of Business	Fixed term; ends when owner dies	Perpetual or fixed term of years	Agreed term; terminates at death of partner; LLP must register annually	Agreed term; terminates at death of partner	Agreed term; terminates at death of partner	Perpetual or fixed term or years
Management Decision	Sole proprietor	Elected directors and officers selected by directors	Usually agreement of partners	Usually general partner	Usually manager is elected	Elected directors and officers selected by directors
Formation of Entity	Very simple	Relatively simple	Relatively complex; LLP must register	Relatively complex	Relatively simple	Relatively simple
Flexibility in Capitalization	N/A	Very flexible	Very flexible	Very flexible	Very flexible	Somewhat inflexible
Limited Liability	None	Yes	No; LLP partner exempt from copartner's torts	No for G.P./Yes for L.P.	Yes	Yes
Flexibility in Conducting Business Affairs	Inflexible	Flexible	Flexible	Relatively flexible	Relatively flexible	Somewhat inflexible
Flexibility in Taxable Year	None	Yes	No	No	No	Little

Allocation of Income, Losses, Deductions, and Credits	N/A	Somewhat inflexible	Very flexible	Very flexible	Very flexible	Generally inflexible
Tax Effects Upon Liquidation	No double tax	Difficult to avoid double tax	No double tax	No double tax	No double tax	Generally, no double tax (Section 1374)
Convertibility to Another Entity Tax-Free	Yes	Some restrictions	Yes	Yes	Yes	Some restrictions
Line of Business	Very flexible	Few restrictions	Flexible; LLP some restrictions	Very flexible	Few restrictions	Few restrictions

Issue	**Sole Proprietorship**	**C Corp.**	**General/ Limited Liability Partnership**	**Limited Partnership**	**Limited Liability Company**	**S Corp.**
Self-employment Income from Entity	Yes	No	Yes	Yes - GP No - LP	Usually; See Proposed Regs § 1.140-2(a)-18	To extent of salary and bonus
Effect of Passive Loss Limitation Rules	N/A	Applies at corp. level/generally avoidable for larger corps.	Partners may or may not materi-ally participate	Ltd. partners deemed not to materially participate	Members may or may not materially participate	Shareholders may or may not materially participate
Availability of Entity Losses to Owners	N/A	No	Flow through of losses to owners	Flow through of losses to owners	Flow through of losses to owners	Flow through of losses to owners
Fringe Benefits	Limited compared to C Corp	Widest available	Limited compared to C Corp	Limited compared to C Corp	Limited compared to C Corp	Limited compared to C Corp
Estate Planning Opportunities	Fair	Very good	Good	Very good	Very good	Fair
Accumulated Earnings & PHC Tax	N/A	Section 531 & Section 541 applicable	No	No	No	No

State Taxes	Same as individual	Generally uniform & deductible	Generally uniform	Generally uniform	States vary	States vary
Dividend Received Deduction	N/A	Allowed	Not allowed	Not allowed	Not allowed	Not allowed
Effect of Bus. Liabilities on Owner's Basis	Full effect	No effect	Proportionate share	Limited partners share in nonrecourse	Proportionate share	Only shareholder's own loans
Alternative Minimum Tax	Subject to AMT	Subject to corporate AMT	Preference items flow to each partner	Preference items flow to each member	Preference items flow	Preference items flow to
					to each member	each shareholder
Method of Accounting	Cash method	Depends on size and ownership	Generally may use cash method	Generally may use cash method	Generally may use cash method unless farming syndicate	Generally may use cash method

Choosing the Proper Business Structure – Critical Factors

A. Income taxation.

For Tax Years Beginning in 1993 Through 2017		**For Tax Year 2020**	
Corporate Taxable Income	Rate (in percent)	Individual Taxable Income (MFJ)	Rate (in percent)
0 - 50,000	15	0-19,900	10
50,000 - 75,000	25	19,901-81,050	12
75,000-100,000	34*	81,051-172,750	22
100,000-335,000	39	172,751-329,850	24
335,000-10,000,000	34	329,851-418,850	32

10,000,000-15,000,000	35	418,851-628,300	35
15,000,000-18,333,333	38	Over 628,300	37
Over 18,333,333	35		

***Note:** For 2017, if corporate taxable income exceeded $100,000, the tax was increased by the lesser of 5 percent of the excess or $11,750. For corporate taxable income exceeding $15,000,000, the amount of tax was increased by the lesser of 3 percent of the excess or $100,000. **Beginning in 2018, the corporate tax is a flat rate of 21 percent.**

1. For tax years beginning after 2017 and before 2026, an individual business owner (other than the owner of a personal service business with income of $315,000 (MFJ) and above for the tax year) as well as an owner of an interest in a pass-through entity is entitled to a deduction of 20 percent of the individual's share of qualified business income (QBI).

   a. QBI is the net amount of income, gain, deduction and loss attributable to the business less net long-term capital gains.

   b. However, the deduction comes with a limitation. The limitation (computed on a business-by-business basis) is the *greater* of (a) 50 percent of the W-2 wages paid with respect to the qualified trade or business, or (b) the sum of 25 of percent of the W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.

      1) But, the wage limitation does not apply if the business owner's income is less than $315,000 (MFJ).

      2) As noted, the ability of a personal service business to claim the deduction is phased-out once taxable income reaches $315,000 (MFJ). The phase-out range is $100,000 (MFJ).

2. The 20-percent deduction is not allowed in computing adjusted gross income. It's allowed as a deduction reducing taxable income.

   a. Thus, for example, the provision does not affect limitations based on adjusted gross income.

   b. However, the deduction is available to both nonitemizers and itemizers.

   c. The QBI deduction is allowed when computing AMT. Thus, it does reduce AMTI.

B. Social Security tax -

1. The social security and the Medicare taxes are payable only on the salaries paid if in a corporation. If in a partnership or a LLC the total eligible distributions are subject to tax, FICA and income, at the individual level even if net profits are not all distributed.
2. The Medicare portion of the tax (2.9%) applies to the taxable income without top limit. The pension portion of the tax (2.4%) applies for to first $142,800 of earnings in 2021
3. Beginning in 2013, an additional 0.9% tax is imposed on wage and/or self-employment income exceeding an applicable threshold ($250,000 MFJ; $200,000 single).

C. Continuity and Transferability of the Business

1. It is generally easier to transfer partnership interests, LLC interests, and corporate interests than it is to transfer individual assets such as items of machinery and real estate.
2. But, there are many ways to transfer machinery and real estate outside of a partnership, LLC or corporation.

D. FSA Payment Limitations

1. The Farm Service Agency payment limitations are an important consideration.
2. Often this consideration dictates the business entity of choice regardless of other attributes.
3. Any business organization with limited liability has one payment limitation.
4. In recognition of this treatment of limited liability business entities often a general partnership must be elected.
   a. Under regulations released in early 2009, payments that are made to a joint venture or general partnership cannot exceed the payment limit limited by the number of persons or legal entities (other than joint ventures and general partnerships) that comprise the direct ownership of the joint venture of general partnership.
   b. The regulations would appear to apply to any type of pass-through entity, but USDA currently takes the view that LLCs and revocable trusts are to be treated under the rule applicable to C corporations.

E. Management Structure

1. With the corporation, there is great flexibility in structuring the management structure that is desired.
2. However, it is possible by agreement to determine who is to be responsible of different activities regardless of the form of business.

F. Liability of Owners

1. Sole proprietorships and general partnerships are characterized by unlimited liability. So, if an accident or some other event occurs that creates liability, a person's business and personal assets are all exposed to the risk.
2. An added concern with general partnerships is that the partners are jointly and severally liable for each other's acts that are related to the business.
3. LLC and corporations have the characteristic of limited liability. So, if an event creating liability occurs within the business, no owner should be personally liable. The business is liable, but personal assets outside the business are not at risk. An exception to this rule is if the event creating liability is caused by one of the owners. In that case, that owner's personal assets are also exposed to the risks.
4. With respect to limited partnerships, the limited partners have limited liability but the general partners have joint and several liability. Some businesses structured as a limited partnership cause the general partnership interest to be corporation or a LLC to achieve the limited liability for the general partner.

5. Having adequate insurance needs to be a consideration *before* relying on the business entity to provide the liability protection.

G. Fringe Benefits

1. The focus here is primarily on health insurance and retirement plans.

2. Health insurance is a 100% income tax deduction for a business person organized as a sole proprietorship, partnership or in an S corporation. (Partners in a general partnership are regarded as being self-employed for tax purposes.) This 100% deduction is a deduction against income tax and not against FICA taxes (i.e., it is a deduction on form 1040 and not on Schedule F or Schedule C).

3. For C corporations, corporate-paid health insurance is deductible before the calculation of either the income or the FICA taxes.

4. Qualified Retirement Plan options (2020 Contribution Limits):

   - IRAs, Individual contributions based on wages: the lesser of $6,000 or 100 percent of taxable compensation for the year (the lesser of $7,000 or 100 percent of taxable compensation for the year for those over age 50).

     Note: For 2021, the Traditional (not covered by employer plan) and Roth IRA contribution AGI deduction phaseout starts at $198,000 on a joint return (and spouse has an employer plan), and is completely phased-out at $208,000 (MFJ).

   - SIMPLE plans - employee contribution plans for employers with up to 100 employees (age ≤50) $13,000; $3,000 additional for those over age 50.

   - I.R.C. §457: deferred comp plans for not for profits
     $19,000 (additional $6,000 for employees age 50 and over)

   - 401(k), 403(b), SEP: Employer Plans - contributions may be made by either employer or employee (under 50) $19,500

     Note: There are provisions for additional contributions for persons over age 50

H. Liquidation Costs

1. C Corporations have the highest liquidation costs of any form of business. If distributing assets, the assets are considered as having been sold inside the corporation and tax is paid by the corporation.

   a. Corporation distributions which result in shareholders' stock being worth more than their basis causes capital gains tax to be incurred by the shareholders.

   b. Unlike other business entities there is no step up in basis upon a death of an owner of shares of stock. As a result, when the corporation is dissolved or an asset is distributed the basis in place when the asset was transferred to the corporation or the basis when the asset was purchased by the corporation becomes the reference for tax calculations.

2. S Corporations have the second highest liquidation cost. This is true to a great degree because the S corporation assets do not receive a stepped-up basis at the death of a shareholder. The advantage that the S corporation has over the C corporation is that there is a single tier tax. There is no double taxation of the liquidation proceeds.

3. A major advantage of partnerships and LLCs taxed as partnerships is that the assets, with some planning, can be distributed tax free. If the assets are sold then there is a single tax at the partner level and not the partnership level. The major cost of liquidating a partnership may be the attorney and accountant fees and not taxes.

I. Ability to Finance

1. Often there is very little financing differential.

2. Regardless of the business entity, individuals usually have to sign as individuals.

J. The Net Investment Income Tax (NIIT – I.R.C. §1411)

1. Beginning in 2013, the NIIT (contained in Obamacare) imposes a 3.8% tax on "passive" sources of income including rents, royalties, interest, dividends, annuities and net capital gains from disposition of non-business property. The tax is 3.8% of the lesser of the taxpayer's net investment income for the year or the amount of MAGI exceeding a threshold amount. The thresholds are $250,000 (MFJ), $200,000 (single) and $125,000 (MFS).

2. The tax is inapplicable if the taxpayer's business activity satisfies the material participation test of I.R.C. §469.

3. A special rule for "retired" farmers applies. Under the rule, if the taxpayer materially participated in farming for at least five of the eight years immediately preceding the earlier of death, disability or retirement (defined as receipt of Social Security benefits), then the capital gain from the sale of the farmland is not passive.

4. Implications for entity structuring.

a. Sole proprietorship

b. Partnership

c. S corporation (FICA tax saving on amounts above reasonable compensation)

d. Manager-managed LLC

VI. Possible Business Organization Strategies

A. Single entity or multiple entities?

1. Often as a farming business is being reorganized, more than one entity results. The operational entity includes the checking account, crop and/or livestock

production activities, and some or all of the machinery. Real estate and some or all machinery may be held out of the operational entity.

2. The *Mizell* problem - *Mizell v. Comr., T.C. Memo. 1995-571*

3. The potential planning solution of *McNamara* and *Martin.*

B. Operational Entity or Entities

1. The typical choices for the operational entity include sole proprietorship, general partnership, LLC, C corporation or S corporation.

2. Entity selection for farm operations must take into account the impact on federal farm program eligibility and the payment limitation rules.

3. Multiple entities are often tied together by leasing arrangements.

C. Land Holding Entity or Entities

1. The land holding entities usually selected include sole proprietorships or limited liability companies.

2. Because of the inability to get a step-up in basis with an entity organized as a corporation it is seldom wise to put real estate into a corporate form of business.

VII. How to Equitably to Treat the Heirs not in the Business

A. Usually it is not a good idea to involve off-farm heirs in the day to day operational business.

1. Often, farm businesses do not distribute any income by way of dividends or other net earnings.

2. Usually the operational business has day to day decisions which do not match with the objectives of off farm heirs, for example, whether to purchase an item of machinery or to distribute earnings.

3. Usually the ownership of the off-farm heirs is small in comparison to the onfarm heirs and thus their voting power is very limited.

4. There is very little incentive for the operating entity or the on-farm heirs to spend capital purchasing out the interest of the off-farm heir.

5. As a result, the value of the off-farm heir's minority interest is subject to a severe valuation discount.

6. Off-farm heirs that own interests in the farming entity may become disappointed by the lack of dividends and seek a buy-out. As noted, the minority interest will be discounted to reflect lack of control. This has led to some high-profile "minority oppression" cases in recent years.

B. The off-farm heirs should receive the non-farm assets by inheritance or gift, become the beneficiaries of life insurance policies and retirement plans, or acquire an interest in farm real estate.

1. The off-farm heir may not be distributed an equal share in the value of assets in comparison to what the on-farm heir might receive.

2. If the off-farm heir were to receive farm real estate, that real estate might be:

(1) subject to a long term rental contract in favor of the on farm heir's business; or (2) subject to purchase options in favor of the on farm heir in case the off farm heir wishes to sell; or (3) placed into a business entity like a limited liability company in which either all heirs, farm and non-farm, or all non-farm heirs are co-owners.

3. Seldom is it recommended that the real estate be inherited by children so that they end up owning it as tenants in common.

i. Joint decision making within a tenants-in-common ownership is difficult.

ii. Each co-owner has a power of partition regardless of the how small the ownership interest might be which could cause a courthouse sale of the property.

iii. There usually is no structured buy out provision put in place with a tenants-in-common ownership.

iv. There often is a question about who has rights of possession, especially if the situation is adversarial.

v. Ownership is with in-laws upon child's death.

vi. Nieces, nephews and cousins become owners eventually.

VIII. Transferring Assets

A. Gifting Strategies. A concern for transferors (and transferees) is the loss of stepped-up basis on gifted property/interests.

B. Rental Strategies. In many estate and business planning situations, a passive lease can create negative consequences

C. Sale Strategies (could start to sell while still working to assist in making payments).

1. Real estate.

2. Farm machinery

3. Residence

4. Stock

D. Inheritance Strategies

IX. Social Security Planning

A. Retirement at full retirement age – maximum monthly benefits (2021) are $3,148.00 (retire at age 66 and two months). If a person waits until age 70 to retire, the maximum monthly benefit is $3,895. If filing is made at age 62, the maximum monthly benefit is $2,324.

i. Born 1938: age 65 + 2 months ii.
Born 1939: age 65 + 4 months

iii. Born 1940: age 65 + 6 months
iv. Born 1941: age 65 + 8 months
v. Born 1942: age 65 + 10 months
vi. Born 1943 — 1954: age 66 vii. Born 1955: age 66 + 2 months
viii. Born 1956: age 66 + 4 months
ix. Born 1957: age 66 + 6 months
x. Born 1958: age 66 + 8 months
xi. Born 1959: age 66 + 10 months
xii. Born 1960 and after: age 67

B. Retirement before full retirement age: (note that the limit on earnings for the months before full retirement age is $50,520; starting with the month a person reaches full retirement age, there is no limit on earnings).

1. Can retire at age 62 and receive benefits (basically, it's $2,209/month)

   a. Benefits are reduced approximately 5/9 of 1% for each month of early retirement for the first 36 months.

   b. Benefits are reduced approximately 5/12 of 1% for each month of early retirement after the first 36 months.

   c. If work during the early retirement period benefits are reduced by $1 for each $2 of earnings over the base of $18,240 (for 2021) (prior to the year of retirement).

   d. In the year of retirement, benefits are reduced $1 for each $3 of earnings above the base.

2. There is also an hourly test, if a self-employed person works (materially participates) more than 45 hours per month he/she is not considered to be retired. There are other factors considered than the 45 hours such as if it only would take 45 hours to perform all the work.

3. After reaching full retirement age there is no earnings or hourly test.

C. Most farms have deferred income tax over the years by purchasing inputs before the year's end for the next year.

1. For sole proprietors and partnerships his creates an issue to be dealt with in the year of retirement.

   a. As the crops are sold, usually after the first of the year, there will be little if any expenses to offset the income.

   b. This causes high social security tax in the year the crops are sold.

   c. Crop inventory sales in the year after retirement will not hurt social security benefits but the self-employment tax will still be owed.

2. Options:

   a. Just know it is going to happen.

b. Bunch up income in the year of retirement or the year after so the base social security wage is exceeded ($142,800 in 2021).

c. Place stored crops into a charitable remainder trust and have the trust pay benefits for a period of time with the remainder going to the charity. For example, if the benefits paid out are 10 percent per year for 10 years, this eliminates the social security tax on the sales, gives a charitable deduction, and spreads out the income tax. The charity has to receive 10 percent of the original corpus in the end.

d. If the business is to continue, the continuing owners could employ you and pay a wage.

XII. Importance of Buy Sell (a.k.a. "Stock Purchase") Agreements.

A. If business interests were potentially going to be transferred to persons who should not be in the business, a buy-out should be planned.

1. Those who are permitted to be in the business are often referred to as "permitted owners".

2. Permitted owners are usually limited to those who are going to be active in the business.

3. In the case of a business primarily organized for investment purposes, like real estate holding businesses, the ownership class of people is usually broader and really needs to be given a lot of thought.

4. If spouses are not permitted owners and yet as expressed above a spouse needs the income from the business or investment the interest might be held in a trust for the benefit of the spouse. In this case the trust would be in the class of permitted owners.

B. A buy-sell agreement should be arranged for in almost every partnership, limited partnership, LLC, C corporation or S corporation when there are two or more owners. C. Typical provisions within a buy-sell agreement include:

1. Triggering events:

a. Death

b. Desire to get out of business

c. Retirement

d. Divorce

2. Who should have the right to purchase the business interest?

a. The business entity.

b. Parents who are also owners in the business.

c. Other business co-owners.

3. Valuation of the business interest.

a. Value the underlying assets.

b. Discounts for factors like lack of marketability and lack of control.

4. Funding the buy-out.

a. Life insurance

b. Allow the purchaser to pay the seller over time.

c. Cause the purchaser to look outside the business for financing.

XIII. Succession Planning in the Event of Divorce

A. Major concern for many going into business with a family member or non- family member.

1. What if divorce occurs after gifting has already begun? If funds are not comingled with the funds of the spouse, then they should be protected from being allocated to the in-law.

2. What if divorce occurs after an inheritance has been received? If funds are not co-mingled with the funds of the spouse, then they should be protected from being allocated to the in-law.

3. Role of trusts.

a. Funds in a trust established by the parents need not be distributed to the spouse, and should be available for the grandchildren.

b. Could use generation skipping concept to prevent any of funds which are desired to be protected from going to spouse.

4. Role of buy-sell agreement - spouse may not be a permitted owner.

5. Concern about divorce affects business entity selection.

6. Should spouses be co-owners in the business?

7. What if in business with a son-in-law, what would be the impact of a divorce?

B. A good succession plan involves an analysis of how a divorce would impact the business if it is organized as a sole proprietorship, a partnership, or a corporation.

1. With a sole proprietorship, an ex-spouse will likely take a large proportion of the assets.

2. If the business structure is a partnership or LLC, a spouse who is not already a partner or member could be assigned a partnership interest. However, an assignee is only entitled to his/her share of profits and is not entitled to a periodic accounting and cannot force a termination of the business.

3. If the business is organized as a corporation, a spouse could receive stock and would be entitled to vote the stock. The value of the stock would likely be discounted in a settlement.

C. Plans which will mitigate the impact of a divorce.

1. Buy-Sell Agreement which provides for discounting, long term buy-outs with low interest rates on outstanding balances.

2. Partnership form of business.

3. Give consideration to prenuptial agreements.

XIV. Planning for Long Term Health Care

A. Long term care expenses can threaten the long-term existence of a business.

B. The Medicaid laws of February 8, 2006 created a 5-year look back period, a look back for transfers for less than full fair market value within the 5-year period prior to application for Medicaid.

   1. Transfers within the 5-year look-back period must be avoided. The disqualification period (tied to the value of the transfer and the monthly cost of care in the jurisdiction) *begins* to run when the person is in the nursing home *and* has spent down assets and otherwise become eligible for Medicaid.

   2. The receipt of the use of property from a third party other than the spouse is treated as an "available resource."

   3. The creation of a retained life estate within the look-back period is deemed to be an "available resource."

C. Long term care insurance may be the primary way of protecting the business assets.

D. An evaluation must be made of the client's income and assets and a projection made as to how long the client will be able to private pay for long-term care without the need to liquidate business assets. Consider the following sources of liquid assets and income sources:

   1. Bank accounts
   2. Pensions
   3. CDs
   4. Stocks
   5. Bonds
   6. Insurance (cash value)
   7. Social Security
   8. Rental income
   9. Royalties
   10. Other

E. Know the income restrictions and the spend-down limit for non-exempt assets and spousal limit (if applicable).

Possible asset transfer strategies for protecting family business assets:

1. Option to family members to buy land (or business assets) as funds are needed to pay for long-term care. The triggering event is the need for funds to pay long-term care. Receipt of funds can be timed so that nursing home expenses offset the gain from the land sales – land sold without income tax consequence, and buyers received purchase price basis. Bottom line – land remained in the family.
2. When additional cash is needed, family members can be given option to buy land on installment basis (income offset by nursing home expenses). Contract terminates on death of family member in nursing home and land that has already been paid for will be conveyed and unpaid portion of land will be included in decedent's estate (step-up basis).
3. Money can be borrowed against the business via a long-term loan (i.e., a loan that will not become due and payable during the life expectancy of the person requiring long-term care). Basis step-up is achieved for the business assets included in the decedent's estate.

XV. The Role of Life Insurance in Succession Planning

A. Providing for a spouse and dependent children.

B. Funding the buy-out set forth in a Buy Sell Agreement.

C. To cause the distribution of value among heirs to be more equitable.

D. D. To provide funds to the business to aid in the transition during the loss of a key person.

E. Pay debt.

F. Pay estate settlement costs

XVI. Providing Income to Parents During Retirement Years – Liquidity Planning

A. Land rent.

B. Machinery rent.

D. Sale of assets (but may cause unnecessary taxes).

E. Dividends or other preferred payments from business interests.

F. Retirement plans.

G. Social Security

H. Royalty income

XVII. Transferring Leadership and Management

A. Recognizing the difference between the leader and the manager. A leader gives focus to the following:

1. Vision

2. Financial
3. Provide Leadership
4. Personnel
5. Facilities, equipment, software, and supplies: making sure someone is responsible for these necessities and makes prudent decisions related to these items.
6. Business structure
7. Day to day decisions
8. Conflict management
9. Public Relations

B. Identifying the next leader (this is easier if there is only one successor).

C. Training the next leader

D. Developing an exit plan for the older generation

XVIII. Utilizing Outside Advisors

A. Possibilities – attorney, accountant, financial planner, counselors, business consultants, mediators, etc.

B. Form an advisory committee.

C. Form a board.

D. Really an investment not to be regarded as just a cost.