




Specialty Estate Tax Seminar for Farm Families
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Speaker Introduction

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CliftonLarsonAllen**



- Frequent national speaker on taxation, agricultural, farm bill and estate tax topics
- Current chair of the AICPA National Agriculture Conference committee.
- Vice President of Farm Financial Standards Council
- Author of the "FarmCPA" Top Producer column
- Author of the "FarmCPA" blog on www.agweb.com



Estate Tax Seminar - Agenda

- ✓ The post-cliff Estate Tax System
- ✓ Structures for farm transitions
 - Disposition of operating assets
 - Part gift/part sale on direct land transfers
 - Use of entity for land: No heirs
 - Use of entity for land: Farm successor
 - Life insurance trusts




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Gift & Estate Tax System

Lifetime Gifts

- ✓ \$14,000 annual exclusion per donee (was \$13K)
- ✓ Husband-wife gift splitting permitted
- ✓ Gifts exceeding annual exclusion: Use \$5.43M unified gift-estate exemption (for 2015)
- ✓ Carryover income tax basis on lifetime gifts




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Gift & Estate Tax System

Estate Tax


- ✓ \$5.43M unified exemption (2015 amounts)
 - + Plus deceased spouse's unused exemption (post-2010 "portability")
 - Prior gifts in excess of annual exclusion
- ✓ Increase of \$1.1M for Sec. 2032A farm special use
- ✓ Step-up in income tax basis to FMV for heirs
- ✓ State Estate Tax exposure considerations
 - 15 States with estate tax currently
 - 2 States with a gift tax



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Example: Portability


- ✓ H dies in 2014
- ✓ H has taxable transfers at death of \$3.0 million
- ✓ Election is made in his filed estate return to permit W to use H's unused \$2.34 million exemption
- ✓ W at death has \$7.68 million exemption [\$2.34 million from H and \$5.34 million (+) of her own]
- ✓ Gifts are made out of ported amount first (gift tax arbitrage?)
- ✓ But watch out for ported about not indexed to inflation – still must consider "family trust"



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Gift & Estate Tax System


- ✓ Estate Tax Special Use Valuation (Sec. 2032A)
 - ≥ 50% of estate consists of farming assets
 - Actively farmed prior to death or retirement
 - An heir continues to actively farm ≥ 10 yrs. post-death
- ✓ Value land at lower 5-year. ave. capitalized rent value
 - Valuation reduction limited to approx. \$1.1M



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Specific Farm Estate Planning Objectives


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



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Lifetime Gifts vs. Estate Transfers


- ✓ Carryover tax basis vs. step-up to FMV tax basis
 - Is fresh depreciation important?
 - Is reduced gain on eventual sale important?
 - Current 40% estate tax versus 30%+ capital gains rate including state income taxes
- ✓ Timing of the transfer
 - Lower value today vs. at estate?
 - Income and cash flow reduction to donor if gift



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Farm Transition Planning


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



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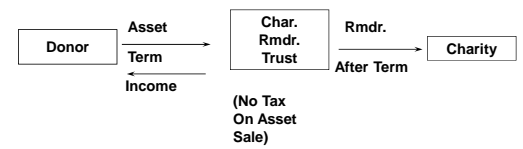

Disposition of Operating Assets

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



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Charitable Remainder Trusts

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Disposition of Raised Grain: No Successor

- ✓ Spread sales over several tax years
 - Multiple yrs. of lower tier Soc. Sec. tax (15.3% on first \$118,500 - 2015)
 - Miss high grain prices by holding crop?
- ✓ Sell early at high price and take installment payments
 - Credit risk?
 - Same Soc. Sec. tax cost




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Charitable Remainder Trusts

Advantages

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




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CRT Examples

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

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

[Current IRS rate: About 2.0%!]



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C Corp. with Land Inside: No Successor


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



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Transitioning Farm Operations to Successor

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




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Case Study 1: Active Operations to Successor

Facts:

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




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Case Study 1: Active Operations to Successor

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

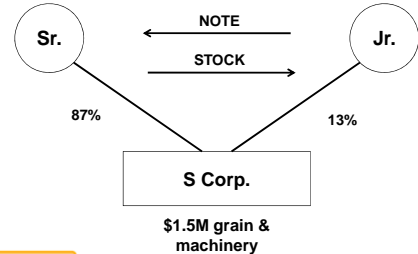

Asset	Federal tax		Total
	Income tax (35% blended)	Soc. Sec. tax (9% blended)	
\$800K grain	\$280K	\$72K	\$352K
\$500K machinery	\$175K	\$ -	\$175K
\$1.3M	\$455K	\$72K	\$527K

41%



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Case Study 1: Active Operations to Successor

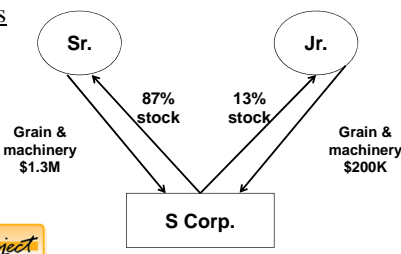




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Case Study 1: Active Operations to Successor

Plan B: Use an Entity to Transition Operating

Assets





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Case Study 1: Active Operations to Successor

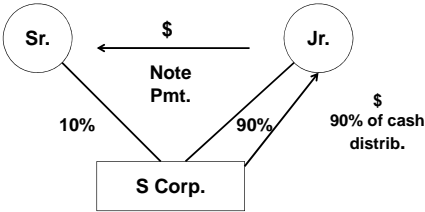

Strategies with corporate entity:

- ✓ Capital gain & no SE tax to Sr. on stock sale
 - Cuts effective tax rate from 40% to 20%
 - Spread gain over term of note (e.g., 10 yrs.)
- ✓ Sell stock in minority increments with discounts
- ✓ Consider reorganizing into voting & non-voting shares
 - Sr. can dispose of most stock, but retain control if desired



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Case Study 1: Active Operations to Successor

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Case Study 1: Active Operations to Successor


(Entity)	Plan A Sale	Plan B
Value of grain/machinery	\$1,300K	\$1,300K
Less stock discount (25%)		(300K)
Less tax cost: A @ 40%	(520K)	
B @ 20%		(200K)
Net to Sr. after taxes	\$780K	\$800K



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Case Study 1: Summary

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



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Transitioning the Land

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

[Same choices, whether transferring acres or entity shares]




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Part Gift – Part Sale Strategy

Example

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



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Part Gift – Part Sale Strategy

<u>Example</u>	<u>Per acre</u>	
✓ Full appraised FMV	\$9,500	} \$4,500 gift
✓ Sale price (to family)	\$5,000	
✓ Tax basis (cost)	\$1,000	} \$4,000 cap. gain



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Part Gift – Part Sale Strategy

Planning tips

- ✓ Importance of a qualified appraisal to prevent IRS attack on amount of gift
- ✓ Opportunity: Lock in low interest rate on installment note to family member
 - Based on IRS AFR% for month of sale
 - November 2014 rate: Over 9 yr. term: 2.91%
 - November 2014 rate: Over 3 yr. & ≤ 9yr.: 1.90%




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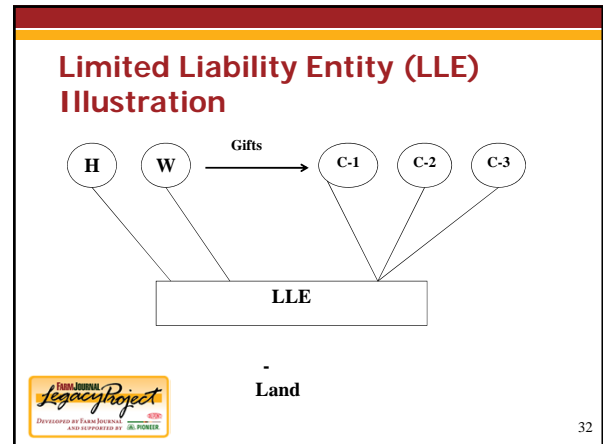
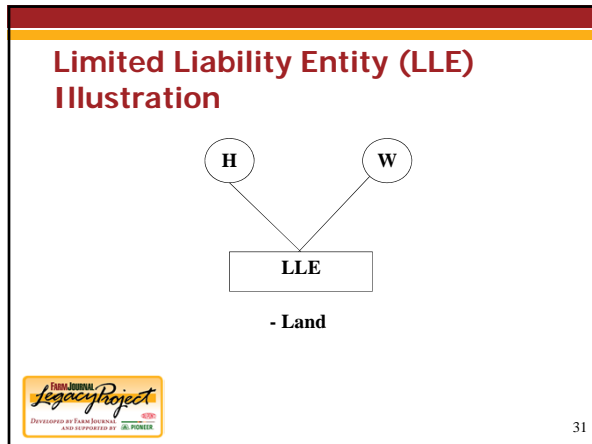
Case Study 2: No Farming Successor

Facts:

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



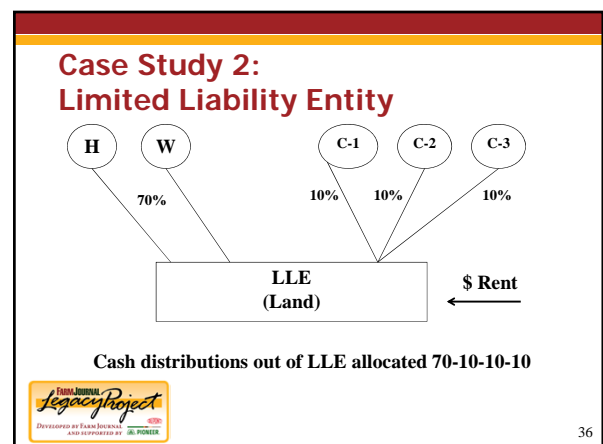
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- ### LLE Advantages
- ✓ Facilitates gifts
 - Annual exclusion of \$14,000
 - Discounts for minority and lack of marketability
 - ✓ Most units non-voting (to allow management control to selected partners)
 - Centralized management
 - ✓ Terms for buy-out of a member
 - Discount if early exit (e.g. 80%-90% of appraised value)
 - Specify pmt. terms (long term /low interest rate to preserve entity cash flow)
- In the bottom left corner is the 'LegacyProject' logo with the text 'Developed by FARM JOURNAL AND SUPPORTED BY THE FOUNDER'. In the bottom right corner is the number '33'.

- ### LLE Advantages
- ✓ Include binding mediation/arbitration language if disputes arise
 - ✓ Design of LLE document forces family communication pre-death
 - Require each child to invest cash at formation to force legal and emotional buy-in to the operating agreement
 - ✓ Require super-majority to liquidate the partnership/distribute land
- In the bottom left corner is the 'LegacyProject' logo with the text 'Developed by FARM JOURNAL AND SUPPORTED BY THE FOUNDER'. In the bottom right corner is the number '34'.


- ### LLE Disadvantages
- ✓ Fees
 - Legal costs of document drafting/planning
 - Appraisal fee for land valuation
 - Appraisal fee for discount valuation
 - ✓ IRS valuation disputes
 - ✓ Annual partnership tax return
 - Separate checking account
 - ✓ Proper allocations of any cash distributions each year
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Case Study 3: Farming Successor

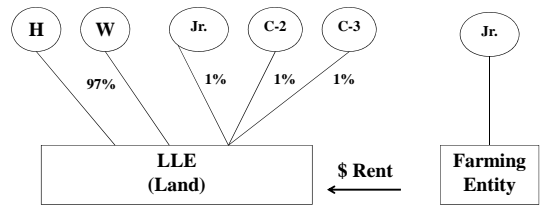

Facts:

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



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Case Study 3: Limited Liability Entity





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Case Study 3: Limited Liability Entity

Additional FLP document issues if tenant-successor:

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




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Limited Liability Entity

Avoiding family conflict:


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



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Life Insurance and Estate Planning


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



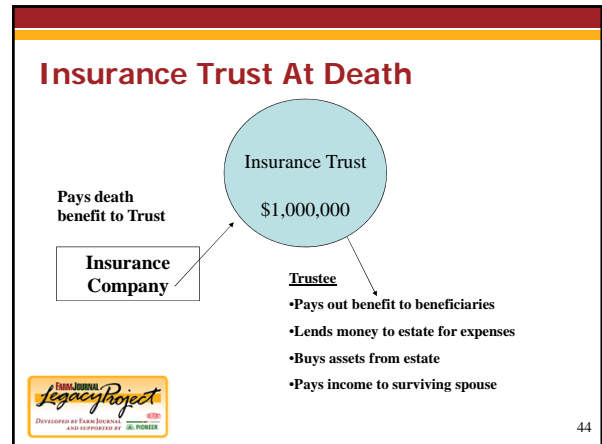
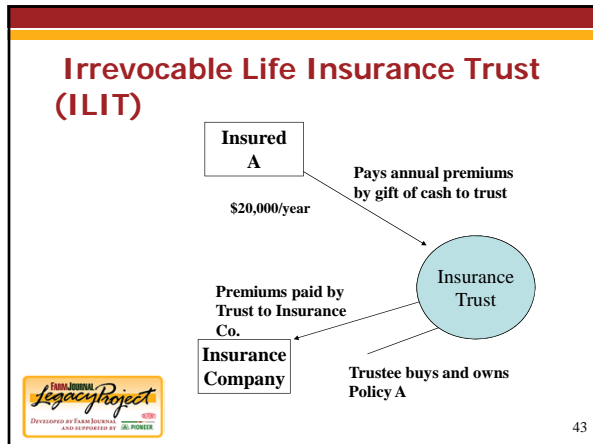
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Life Insurance: Estate Tax on Death Benefit

- ✓ Total Estate – Assume \$ 11.0 million
 - Life Insurance
 - ♦ Husband has \$2.0 million death benefit with wife as beneficiary
 - ♦ Assume husband dies and wife collects death benefit
 - Total Estate now \$ 13.0 million
 - ♦ \$2.0 million exposed to Federal Estate Tax
 - ♦ Estate tax cost estimated \$700,000
 - Net death benefit after estate tax erosion is \$1.3 million



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- ### Insurance Issues to Consider
- ✓ Transfer of existing policies to insurance trust
 - Gift value
 - Three year rule
 - ✓ Payment of premiums
 - Annual gift exclusion
 - GST exemption allocation
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Questions?

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Thank You!

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