






Specialty Estate Tax Seminar for Farm Families  
Randy Netek, CPA & Brandt Self, CPA  
CliftonLarsonAllen

### Speaker Introduction

**Randy Netek, Principal, CliftonLarsonAllen**


- Principal In Charge of the CLA Texas Growth Network Agribusiness group
- Bachelor's of science in accounting, magna cum laude, from University of North Texas, Denton, Texas
- Master's of science in taxation from University of North Texas, Denton, Texas
- Certified Public Accountant in the state of Texas
- American Institute of Certified Public Accountants
- Texas Society of Certified Public Accountants
- University of North Texas Accounting Advisory Council, Past Board Member

### Speaker Introduction

**Brandt Self, Manager, CliftonLarsonAllen**

- Tax Leader of the CLA Texas Growth Network Agribusiness group
- Bachelor's of science in accounting, magna cum laude, from University of North Texas, Denton, Texas
- Master's of science in taxation from University of North Texas, Denton, Texas
- Certified Public Accountant in the state of Texas
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### 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

```

    graph LR
      Donor[Donor] -- "Asset  
Term" --> CRT[Char. Rmdr. Trust]
      CRT -- "Income" --> Donor
      CRT -- "Rmdr.  
After Term" --> Charity[Charity]
      CRT --- Note["(No Tax  
On Asset  
Sale)"]
  
```

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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

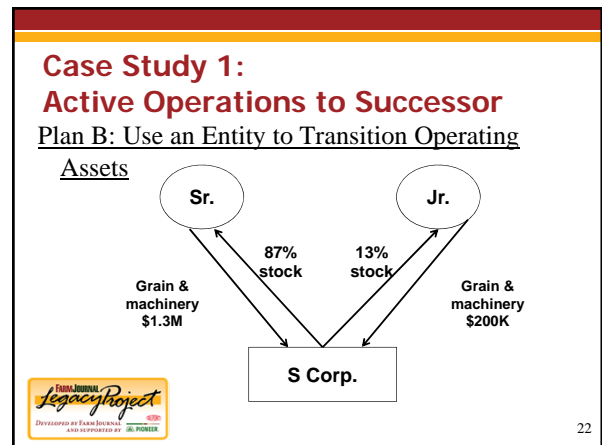
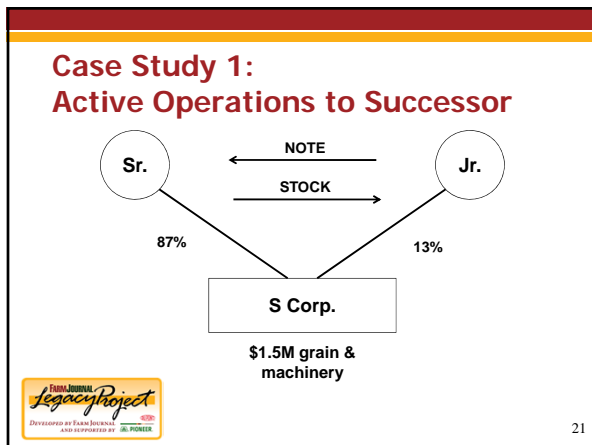
Plan A: Liquidate grain/lease & sell machinery to Jr.

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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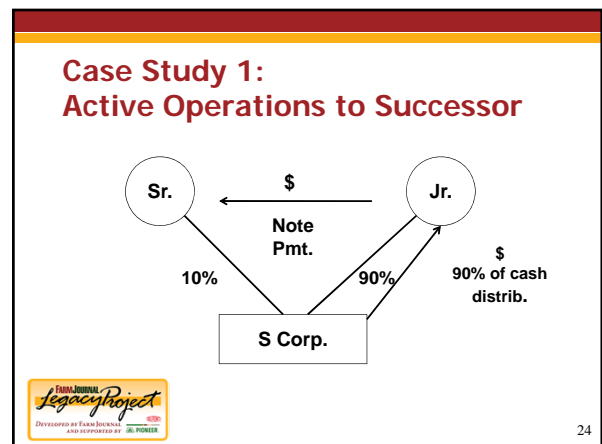
### Case Study 1: Active Operations to Successor

**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


(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

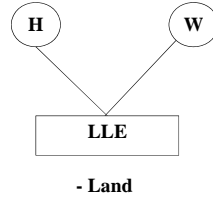

**Facts:**

- ✓ 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



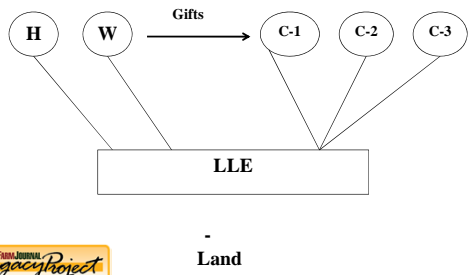

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### Limited Liability Entity (LLE) Illustration

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### Limited Liability Entity (LLE) Illustration

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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)



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### 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



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### 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 2: Limited Liability Entity

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

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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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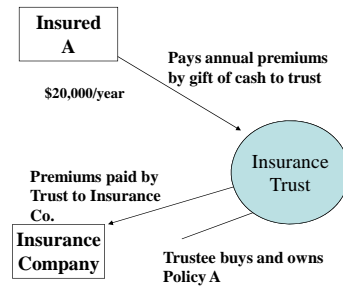

## Life Insurance: Estate Tax on Death Benefit

- ✓ 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



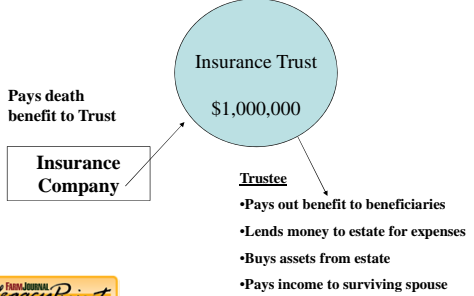

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## Irrevocable Life Insurance Trust (ILIT)

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## Insurance Trust At Death

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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?



## Thank you

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