ESTATE PLANNING BASICS

Nebraska Network for Beginning Farmers/Ranchers

Prepared by: Joe M. Hawbaker, Hawbaker Law Office
Omaha, Nebraska
mjbaker@radiks.net

Need For Personal Legal Advice

The information in this presentation and accompanying material is provided for educational purposes only. It is not a substitute for individual legal consultation.

Estate Planning

- What is your estate?
- Who will receive your estate?
- How will your estate be transferred?

Preliminary Concepts

- Property & Titling
- Basis and Basis Adjustment

Property

- Real Property
  - Land, and what is built on it
    - Buildings, fences, wells, etc.
- Personal Property
  - Tangible – cattle, corn and combines
  - Intangible – accounts, stocks, insurance
- Subject to
  - Eminent domain
  - Taxing power
  - Zoning regulation

Titling

- Single ownership
- Co-ownership
  - Tenancy in common
  - Joint tenancy WROS

Titling

- Tenancy in Common
  - Owners have distinct and separate interests
  - No right of survivorship
  - Right of possession is undivided
  - Each owner may transfer interest, including by will
  - Right of partition – force sale

Titling

- Joint Tenancy
  - survivor takes all
  - Immediate access to property after death
  - Simplifies estate settlement
  - Be specific – "as joint tenants with right of survivorship and not as tenants in common"
  - After death, property not subject to deceased creditors' claims
  - Right of partition – force sale

Titling

- Life estate and remainder
  - Owner transfers property subject to life estate
  - Owner becomes "life tenant" – right to possession and control, benefits and obligations
- Payment on death designations
  - Bank accounts, retirement accounts, insurance
  - Who takes asset on death of owner

Basis & Capital Gains

- "Basis" means "cost" – what you paid for it or what it was worth when you inherited it + the cost of improvements
- If asset sold, capital gains tax is paid on difference between the sale price and the basis, with some adjustments
- Current maximum rate is about 15% Federal and 7% Nebraska

Capital Gains Tax

• Purchased	$150,000	
• Improvements	+ $ 30,000	
• Depreciation	- $ 20,000	
• Income tax basis	$160,000	
• Selling Price	$480,000	
• Capital Gain	$320,000	@ 22%
• Tax Due	$ 70,400	

Stepped Up Basis

- A time-of-death transfer wipes out locked-in capital gain tax liability
- Heir receives the asset with a basis equal to FMV at time of death
- Only occurs in time of death transfers
- No restrictions on step-up in basis for 2011-2012

Carry Over Basis

- If property is gifted during life, then Donee receives the property with the <u>same basis as donor</u>
- The basis "carries over" to new owner

<u>WHAT</u>

- What do you own?
- What is it worth?
- How much is the debt?

"<u>WHAT</u>" Come First Because of Taxes

Federal transfer taxes

- Estate Tax – 35% (2011-2012)
  - Paid on time-of-death transfers
- Gift Tax – 35% (2011-2012)
  - Paid on lifetime transfers

Critical Concept

<u>The Unified Credit</u>

- A "credit" that exempts transfers of assets from federal transfer taxes
- "Unified" because it is a single credit against both <u>gift</u> and <u>estate</u> taxes
- Each person has one unified credit

Unified Credit Estate Tax

How much can each person transfer <u>**at time of death**</u> without incurring estate tax liability?

- $5 million per person for 2011-2012
- Uncertain after 2012

Unified Credit Gift Tax

How much can each person transfer <u>**during life**</u> without incurring a gift tax?

- $5 million per person for 2011-2012
- Credit used against gift tax reduces amount available to use against estate tax

Critical Concept

Marital Deduction

- No estate or gift tax imposed on transfers between spouses

Examples

- Spouses own farm jointly
- After first spouse dies, survivor owns the farm alone
- No transfer tax paid on first death (marital deduction), BUT
- What happens on survivor's death?
- Value of estate above surviving spouse's unified credit is subject to transfer tax

Double The Unified Credit

- Take advantage of each spouse's unified credit – in effect doubling the unified credit for marital estate
- Use by-pass trust (credit shelter, family or disclaimer trusts)
- Use life estate transfers

Use of Life Estate

- First-to-die transfers only a life estate to surviving spouse
- "This property goes to my children but subject to my surviving spouse's life estate."
- Surviving spouse entitled to proceeds/income from life estate property
- Lacks flexibility of credit shelter trust and puts property out of reach of surviving spouse and into hands of other heirs

Credit Shelter Trust

- Used to take full advantage of both unified credits
  - On death of first spouse, assets are transferred into trust for life-time benefit of surviving spouse
  - These assets are included in first-to-die's taxable estate and are not later included in surviving spouse's taxable estate
  - Value of assets transferred into trust equals an amount necessary to avoid federal estate tax
- Typically included in a will or revocable trust document

Disclaimer Trust

- Like a Credit Shelter Trust in providing for doubling of unified credit
- Surviving spouse may disclaim property given to her by deceased spouse
  - Disclaims in amount needed to take advantage of unified credit, but only if necessary
- Disclaimed property goes into DT for benefit of surviving spouse
- Typically in Will or trust document

NEW RULE 2011-2012

PORTABILITY OF UNIFIED CREDIT

- Unused exclusion amount of spouse dying after 12/31/2010 may be used by surviving spouse
- Only available if election made on timely filed estate tax return of predeceased spouse – whether estate tax return is otherwise required

Unified Credit Portability

- Spouse 1 dies in 2011 transferring $3 million in assets
- Election is made by Spouse 1 estate tax return to allow Spouse 2 to use unused exclusion amount
- Spouse 2 exclusion amount becomes $7 million

Unified Credit Portability

- Still a good idea to include disclaimer trust in estate plan
- Portability is a significant change in the law
- Will require careful review of regulations and forms once promulgated by IRS

Planning Zones

- Estate ≤ Single Exclusion Amount
- Estate ≤ Twice Exclusion Amount
- Estate ≥ Twice Exclusion Amount

Tools to Reduce Estate

- Use of annual gift tax exclusion
- Discounting value for lack of liquidity or control
- Use of special valuation procedures
- Insurance owned by someone else (three year look-back)
- Irrevocable trusts
- Installment sales
- Charitable Remainder Trusts

Gift Tax: Annual Exclusion

- Annual exclusion amount = $13,000
  - Does not reduce Unified Credit
  - No need to file gift tax return
  - Additional unlimited exclusion for education gifts and medical

Discounted Value

- Interests in closely-held family corporations, family partnerships or LLCs
  - May be discounted for lack of marketability/liquidity
  - Also discounted for lack of controlling interests
- A useful tool for transferring assets within the exclusion amount

Special Use Valuation

- Real estate used in family farm or closely held business: Section 2032A
  - Land is valued on basis of value as a farm and not at fair market value (IRC formula)
  - Maximum reduction in value is $1 million
  - Decedent or family member farmed land for 5 of 8 years preceding death
  - Heirs must farm for 10 years – recapture period

Insurance

- Insurance is not included in taxable estate if the insured does not own policy and does not pay premiums (also, insured's estate cannot be beneficiary)
- Let beneficiary pay premiums; or, insured may be able to give money to beneficiary to pay premiums (but insured should not pay premiums directly on behalf of beneficiary)
- If policy already owned in name of insured, may gift the policy away (short form available from insurance company) BUT three year look back from date of death

Irrevocable Life Insurance Trust

- Set up trust first
- Trust buys insurance
- Trust document needs to get it right
  - Life insurance as <u>one</u> of, not <u>only,</u> permissible investment vehicles
  - Trustee has all ownership rights
  - Trust can accept tax free gifts from you to pay premiums
- Insurance is not included in taxable estate if the insured does not own policy and does not pay premiums (also, insured's estate cannot be beneficiary)

Installment Sales

- Sell over time rather than outright
- Selling over time spreads tax on gain over time
- Sales to relatives need to be for "full and adequate consideration"
- Sales price – basis = gain
- Gain ÷ sales price = Gross Profit %
- Taxable Gain for each payment on note = principal payment x Gross Profit %
- Interest rate on note must meet minimum Applicable Federal Rate

Installment Sales

- At seller's death, unpaid principal remains part of taxable estate, <u>unless</u> note is a <u>Self-Canceling Installment Note</u> (SCIN)
- Unpaid balance canceled at death
- A <u>risk premium</u> needs to be added to SCIN to account for possibility that full payment won't be made, e.g. increasing principal payments, or increasing interest rate above AFR ("applicable federal rate")
- Complex rules for calculating premium

Charitable Trusts

- Charitable Remainder Trust (CRT): income paid to settlor/heirs, remainder goes to charity
- Charitable Lead trust (CLT): income paid to charity, remainder to heirs
- Complicated rules, numerous variations
- Favorable tax treatment – possible to avoid capital gains tax and transfer tax

WHO

- Who are your heirs?
- What will each heir receive?
- Will your estate carry on as a single farm or ranch business?
- Who will be in charge?
- Who will need income?
- Will estate be divided? Physically divided or divided by interests?
- Will you make charitable gifts?

WHO

- This is not a legal question
- It is a determination of your own wishes and judgments

WHO: Often the Hardest Issue

- Parents tend to start with idea that fair means equal
- Not always possible to be equal
- Equal is not always fair
- Should estate be sold, cut up or kept together

WHO: The Farming Heir

- Farming Heir and The Other Kids
  - Farm/ranch is sufficient for one or two families but what about the other kids?
  - Cash flow v. fair market value
  - Will farm or ranch continue as a viable family operation?

WHO: The Farming Heir

- Life insurance
  - If affordable, life insurance is purchased for off-farm heirs
  - On-farm heir purchases life insurance on parents' lives for buying out siblings interests
- Partnership, LLC, Corporation
  - On-farm heir controls/manages operation
  - All siblings share in ownership
  - Operating entity owned by on-farm heir and land entity owned by all heirs

WHO: The Farming Heir

- Real estate divided among siblings
- Long term leases
  - On-farm heir has right to farm siblings' land for period of time
  - Perhaps siblings have right to receive rent only for period of years as "purchase" of property by on-farm heir
- Options
  - On farm heir has right to buy out siblings for a period of time at a determinable value
  - If siblings decide to sell, on-farm heir has right of first refusal

WHO: The Farming Heir

- Off farm heirs understand/agree to inherit less, in order to help on-farm sibling succeed
- Shared appreciation agreement
  - If on-farm heir sells real estate within a period of time, off-farm heirs share in appreciation

HOW

- Time of death transfers
  - Give it away at death (e.g. will, revocable trusts)
- Lifetime transfers
  - Give it away now (e.g. gift, irrevocable trust)
- Gifts of future interests
  - Give it away now with strings attached (e.g. life estate deed)
- Sale
  - Sell it all at once or over time (e.g. outright or installment sale)

TOOLS

- Titling
- Wills
- Lifetime Gifts
- Trusts
- Sales

Titling

- Tenancy in common
- Joint Ownership with right of survivorship
- Deeding
  - Deed it over outright
  - Deed it over with restrictions
- Life estate deed
- PODs
- Transfer of cow herds through share arrangements

Joint Tenancy

- Distinguished by right of survivorship: last one standing gets it all
  - on death of one owner, other owner(s) automatically succeeds to entire property
  - Not part of probate estate – avoids probate
  - Included in taxable estate
  - After death, not subject to decedent's creditors' claims

Taxation of Joint Tenancies

- Joint tenancy between spouses
  - One-half of value of property included in estate of first-to-die; survivor gets step-up in basis – useful if asset to be sold
  - No estate tax payable because property passes under marital deduction, depending on value
    - No doubling of unified credit
- Joint tenancy between non-spouses
  - All of value of property included in decedent's estate
  - Except to extent survivor contributed to acquisition

Life Estate Deed

- Property owner (grantor) deeds property to heir but reserves a life estate
  - Owns property for duration of life but cannot transfer/will
  - No changing mind without heir's consent
  - Avoids probate
  - Value of property is included in taxable estate
  - Inexpensive tool for estate planning
  - Triggers obligation to file gift tax return
- Heir acquires legal interest
  - Heir becomes "remainderman"
  - Remainder interest can be pledged, transferred or attached unless restricted in deed
  - Heir acquires stepped-up basis on death of life tenant

Life Estate Deed continued

- Restrictions may be imposed on the remainder interest
  - Voluntary transfers: no encumbrances; no sales
  - Involuntary transfers (as in judgment v. remainderman): restriction may not work
- BUT "restraints on alienation" limit restrictions that can be imposed on remainderman
  - Careful language, don't give a fee simple

Joint Accounts, POD, Beneficiary Designations

- Pay-on-death bank accounts
  - Simple form available at bank
  - During your life, person named to inherit has no right to money; you can change beneficiary, spend money, close account
  - At death, beneficiary shows death certificate and ID and takes funds
  - If account owned jointly with spouse, POD beneficiary takes only after death of both owners
- Retirement accounts
  - On account-opening forms designate beneficiary
  - Surviving spouse may have right to funds, if not named
  - Roth IRA has no withdrawal deadlines, gain is tax-free, and with named beneficiary it is simple to pass on funds
- Transfer-on-death registrations
  - Register ownership of stocks, bonds, brokerage accounts with beneficiary designation
  - Beneficiary has no rights until your death

WILL

- Will is revocable – can be changed
  - Revocable is to be preferred: circumstances and wishes change
- A Will typically requires probate

Probate

- A legal process (court proceeding)
- Accomplishes transfer of property
- Settles decedent's debts
- Pays taxes
- Testate – having died with a valid will
- Intestate – dying without a valid will

What is Probate?

- Legal process for proving the validity of a **Will**
  - Someone has to start the process, not automatic
  - Petition court to probate will and grant letters testamentary (authority) to executor
  - notice of hearing; Will contest would commence here
  - Grant letters testamentary

Probate Continued

- PR
  - Prepares inventory
  - Obtains appraisal, if necessary
    - Real estate values often TAV + markup (24-30%)
  - Gives notice to creditors to file claims
  - PR may reject claim, lawsuit on claim may result
  - If claims not filed, forever barred

Probate Continued

- PR
  - Collects and preserves property of estate
  - Pays debts, expenses and taxes
  - If any property left, PR distributes property as directed in Will or, if no Will, then by rules of intestacy

Probate can take time; ties up distributions; costs money – maybe more than alternatives

Avoiding Probate

- Reduce your probate estate to ≤ $50,000
- How to accomplish and still control assets:
  - Joint tenancies
  - Payment on death bank accounts
  - Naming beneficiaries for retirement accounts
  - Register stock, bonds, brokerage accounts in "transfer on death" forms
  - Life estate deed
  - Living trust
  - Insurance
  - Gifting (you lose control with this option)

Avoiding Probate

- Avoiding probate may be oversold idea
  - In Nebraska, inheritance tax requires much of same work as probate
  - Probate procedures streamlined in Uniform Probate Code
  - Probate settles the estate, clears title, resolves debt
- Petition for Determination of Inheritance Tax
  - Filed with county court
  - Requires inventory and valuation of estate

Nebraska State Inheritance Tax

Relationship	Rate	Exclusion
Spouse	0%	Unlimited
Immediate	1%	$40,000 each
– sons, daughters, siblings, parents, gr'parents		
Remote	13%	$15,000 each
– nieces, nephews, aunts, uncles		
Other	18%	$10,000 each

Nebraska State Inheritance Tax

- Payable within 12 months of death
- Penalties and interest for late payment or nonpayment

Probate Estate v. Taxable Estate

- Assets may be part of one estate and not the other
- Anything a person has an interest in at the time of death goes into the taxable estate to the extent of that interest: this includes more than probate property, such as
  - Property transferred with strings attached
  - Value of an annuity
  - Joint tenancy property
  - Life insurance proceeds
  - Interests retained from previous inter vivos transfers

IRAs

- Pre-tax dollars used to fund
- Taxes have to be paid on distributions
- Fairly involved rules on decedent IRAs
  - Sometimes a choice for heirs/beneficiaries to cash in all of IRA and pay tax or to take distributions over time
  - Time may be calculated based on actuarial life expectancy of deceased IRA owner or life expectancy of oldest beneficiary

TRUSTS

TRUSTS

My brother's lunch

My younger brother and I are going to the carnival and our mom gives me $10. She says: $5 is for you and with the other $5 make sure your brother eats lunch. The first $5 is mine; the second $5 I hold as <u>trustee</u>. I possess the second $5 and I have the right to spend it, but only as I have been told. My brother is the <u>beneficiary</u>, he does not possess the money but has the right to have it spent on his lunch. In legal terms, I have legal ownership and my brother has equitable or beneficial ownership.

If I were to spend part of that $5 on myself, I would have violated my <u>fiduciary duties</u> to my brother. My brother would then complain to my mother and seek enforcement of the trust from my parents.

Elements of a Trust

- Settlor/Grantor
  - person who creates the trust; funds the trust
- Trustee
  - Holds title to trust property; manages and deals with trust property
- Fiduciary
  - Position of trust and confidence; the relationship between trustee and beneficiaries (like guardian/ward, principal/agent, director/shareholder)
- Beneficiary
  - Person for whose benefit trustee owns and manages the trust property
- Corpus
  - The property that is held in trust (also called trust res, trust assets, principal, or trust estate)
- Trust instrument
  - Document that embodies the terms of the trust

Basic Trusts

- Trust may be
  - Intervivos – established during life
    - Revocable - can be changed
    - Irrevocable – cannot be changed
  - testamentary – established at time of death, often by Will
- Trust may be joint (one trust for both spouses) or separate

Uses of Trusts

- Protect assets from beneficiaries: separate management from enjoyment
- Manage property or investments
- Avoid probate or minimize probate costs
- Avoid guardianship requirements of transfers to minors or incapacitated persons
- Protect privacy in property transfers
- Guard against will contests (but trust can be registered in court by disgruntled beneficiary)
- Save estate tax, in some cases

Inter Vivos Revocable Trust "Living Trusts"

- Avoids probate of trust assets
  - Assets can be quickly transferred after death
  - Costs more to create than a will, but avoids probate costs
  - Particularly useful to avoid probate in another state where property is held
- Property remains part of taxable estate
  - Not useful for reducing value of estate for estate tax planning
  - Heirs do receive step-up in basis
  - Spouses can use to double unified credit
- May be less susceptible to attack than will
  - Not subject to rules of testamentary proof (contract not a will)
  - "Seasoned" or in existence for some time before death
- Can be fully funded at creation or subject to pour-over provisions of will
- Can be used to manage assets – name heir as trustee and see how they do

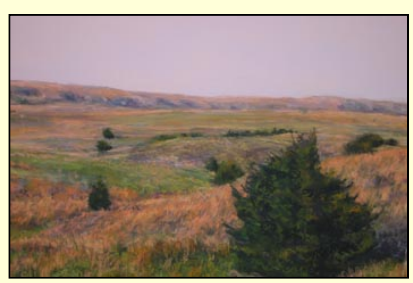
Irrevocable Inter Vivos Trust

- Can reduce value of taxable estate
- If grantor/settlor does not retain interest in income or corpus of trust
  - Trust must benefit others
  - No retention of life estate in income
  - Enjoyment by beneficiaries cannot be contingent on death of settlor – must be present interest (some room to plan for minors)
  - Cannot retain power to change the transfer of property
- Transfers still subject to Gift Tax: over $13,000 per person reduces unified credit but appreciation occurs outside of estate

Charitable Remainder Trust

- Transfer property into trust irrevocably
- Trust pays settlor income for life or term of years
  - May provide for successive income beneficiaries
- Remainder of trust goes to charities after death of settlor/successor beneficiary or after term of years
- May transfer appreciated property into CRT without capital gain recognition
  - CRT may sell appreciated property without recognizing capital gain
- May receive charitable deduction

Some Additional Tools in the Kit



Living Will

- Medical directive or “living will”
  - Permanent vegetative state – what are your wishes with respect to life support
  - May ease difficult decisions for survivors
  - Should be part of estate planning documents

Durable and Health Care Powers of Attorney

- Grant of power to another to look after assets and manage affairs, make health care decisions
- Anticipates possibility of incompetence: avoids need for incompetency hearing or approval of guardian
- Statute defines powers (plenary – complete, unqualified)
  - Should also include express powers for tax returns, life insurance matters, making gifts, transferring property into trust, accessing safe deposit box, dealing with retirement plans and Social Security
- May be *contingent* or *present*
  - Contingent – effective only upon incompetence
  - Present – effective when executed and continues in spite of incompetence

Long Term Care & Medicaid

Strategies to Provide for Long-Term Care

- Adequate income or reduction of assets
  - After tax available income
  - Earnings and asset sales
- Long-Term Care Insurance
- Medicaid safety net
  - Deprivation of Resources

Deprivation of Resources

- Transfers for less than “fair market value”
- Within 60 months of Medicaid application - “Look Back” period
- Ineligibility determination calculations
- Ineligibility period begins only after a) move to nursing home, b) spend down assets to $4000, c) apply for Medicaid and d) be approved for coverage but for the transfer

Medicaid

- Give away now
- Give away with strings attached
  - Life estate deed
- Sale on contract
- If spouse working ranch or farm, it may be excluded

A FINAL FEW THOUGHTS

Questions

- Who can get into safety deposit box
- Have you made a list of your wishes for personal property, i.e. heirlooms, family possessions?
- Where is your will located?
- Should heirs know what you plan?
- Have you compiled all end-of-life information in one place, made copies?

Resources

- Nebraska Network for Beginning Farmers/Ranchers
- Nebraska Farm Hotline
  800-464-0258
- Nebraska Farm Mediation Service Farm & Ranch Clinics (Nebraska Department of Agriculture)
  800-464-0258