

# RISK MANAGEMENT WORKSHOP SERIES

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## FARM & RANCH ESTATE PLANNING: AN INTRODUCTION

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*This article is not intended as a substitute for the advice of counsel. It is intended to introduce the reader to some of the basic legal issues and tools of estate planning.*

What do you want to happen to the farm or ranch after you die? Will it be sold and the money divided among our heirs? Will one or more of your grown children take over? What about the other kids? Will it have to be sold to pay for long-term care? What about slowing down? Will the farm or ranch pay for your retirement if you are not running the show? If one of your children chooses to farm, can the farm or ranch support both your retirement and that child's livelihood? Should you simply sell it all now? Do you sell machinery and livestock, then simply rent out the land?

The answers to many of these questions have nothing to do with the laws that govern estate planning. The answers come from knowing what you want to happen to your property. Sometimes estate planning is simple. This is often the case where the farm or ranch assets are worth less than \$2 million, or, in the case of spouses, \$4 million, and where there is no farming heir. In such cases, one simply looks for the least costly and most efficient way to divide the farm or ranch among the heirs. A charity might be included in the gift, as well.

Sometimes estate planning is complicated. In very large estates, multiple estate planning tools are used in order to avoid paying hefty taxes. However, often it is not legal or tax complications that create the most difficulty in estate planning. For example, in farm and ranch families, difficulties can arise when one of the children has stayed on the farm or ranch (the farming heir), while the other children have taken up lives in other places or in other endeavors.

Now comes time to say who will get what. The child who stayed on the farm may expect to inherit the farm; that child and his or her family's livelihood may be tied to the farm. It may be that he or she has been essential to the continued viability of the farm – the farm might have been lost without them. It may simply be that they are there to help when help is needed. But if the farm is given to that child, what about the other children?

Many parents in facing such a decision struggle against the deep-seated idea that fair is equal. Yet they know in some cases that the farm or ranch will not succeed if it is divided up or if the farming heir has to buy out the interests of his or her siblings. Record high land values and tight cash flows make the decisions more difficult: the farm may be worth a lot of money, were it to be sold, but the strength of its cash flow does not match its market value.

Planning an estate is not merely a legal decision. The most important part of planning an estate is deciding what to do with the assets. That decision is not merely a legal decision.

The purpose of this article is to describe the common legal issues that affect estate planning, and the legal tools that are used to address those issues. In many ways, estate planning boils down to three possibilities: give it away now, give it away at death, or give it away now but leave some strings attached. It is useful to keep these three categories in mind in thinking about the sometimes complicated issues of estate planning. It is also useful to know that people often have two estates for estate planning purposes: a **probate estate** and a **taxable estate**. More discussion of these estates follows.

## Taxes

The first thing to consider in planning an estate is the value of that estate. What do you own and what is it worth? How much debt encumbers the estate? In other words, what is your net worth? We start with a determination of net worth because of something called the **estate tax**. This is a federal tax paid on transfers that occur as a result of death, called time-of-death transfers. (There is also something called the federal **gift tax**, which applies to transfers that occur while one is still alive. More about this later.)

The idea behind the estate tax (and the gift tax) is that assets will be exposed to these taxes at each generational level, for the social purpose of preventing the concentration of wealth in too few hands. The federal estate tax rate is presently 46 percent – a hefty tax! But before we lose our breath at the idea that Uncle Sam will take at death half of what we worked to own, it is important to know that very few Americans pay any federal estate tax at all.

Why? Because of something called the **unified credit**. To put it simply, the unified credit excludes property from the estate tax. It enables people to transfer property without paying any federal estate tax if the property is worth less than \$2 million. So, if your estate is worth less than \$2 million, it is unlikely that any estate tax will have to be paid upon your death.<sup>1</sup>

There is also something in the tax laws called a **gift tax**. The gift tax applies to transfers that are made during a person's lifetime (the give it away now category), as opposed to the estate tax which occurs on transfers that happen at the time of death. The gift tax rate is presently 45 percent – another hefty tax. But the **unified credit** also applies to exclude transfers of property from the gift tax. However, the exclusion amount for gift tax is \$1 million per person, not \$2 million, and, more important, that \$1 million gift tax exclusion amount really represents the first \$1 million of the \$2 million estate tax exclusion.

In other words, the gift tax exclusion and the estate tax exclusion are cumulative: each person has a \$2 million dollar unified credit but can use only \$1 million of that credit to exclude property that you “give away now” from the gift tax. So, if you give away \$1.5 million in

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<sup>1</sup> It is important to know that the unified credit amount of \$2 million per person will change under federal law as it is presently written. In 2009, the amount goes up to \$3.5 million per person that is excluded from estate tax. In 2010, the federal estate tax will expire. As the law presently stands, there will be no federal estate tax on the estates of people who die in 2010. In 2011, unless Congress and the President enact new laws, the unified credit will go down to \$1 million per person. Keep an eye out for changes in the law, for it appears that they are certain to come.

property while you are alive, you will pay gift tax on \$500,000. (\$1 million is excluded, leaving \$500,000 to be taxed.) If you give away \$1.5 million in a time-of-death transfer, your estate will pay no estate tax. (The unified credit was originally called *unified* because the gift and estate tax exclusion amounts were the same.)

It is also important to know about something called the **annual gift tax exclusion**. A person can give away each year as much as \$12,000 to as many separate people as he or she likes, without having either to pay any gift tax or to file a gift tax return. In addition, this annual exclusion amount does not use up a person's unified credit.

For example, you may give \$12,000 to each of your children each year with no tax consequence. However, if you were to give each child in each year any amount over \$12,000, you would trigger an obligation to file a gift tax return and though it is not likely that you would have to pay any gift tax, you would decrease your unified credit by the amount that your annual gift exceeds \$12,000. So, for example, if you were to give your son \$15,000 this year, you would decrease your unified credit by \$3000.

Each person has a unified credit. This means that a married couple, with a minimal amount of estate planning, can in effect double the unified credit to exclude \$4 million of property from federal estate tax. One common tool for doubling the unified credit is to put a **credit-shelter trust** into the spouses' wills. In a credit shelter trust (also called a by-pass trust or a family trust), upon the first spouse's death, some assets are transferred into a trust for the benefit of the surviving spouse. Those assets are excluded from estate tax under the deceased spouse's unified credit, and so may be as high in value as \$2 million. Those same assets are not later included in the surviving spouse's estate at the time of his or her death, because he or she does not own those assets, rather the credit shelter trust owns them. Under a credit shelter trust, the surviving spouse may be assured of the life-time, beneficial use of those assets; typically the surviving spouse is entitled to all income from the credit shelter trust.<sup>2</sup>

Spouses may plan for a doubling of the unified credit even more simply by the way in which they own, or title, their property. Spouses typically own assets as **joint tenants**, meaning that each spouse owns the entire asset. For example, in a joint bank account, either spouse may withdraw all of the funds. In jointly owned real estate, upon the death of the first spouse, the surviving spouse automatically becomes the sole owner of the property. In other words, joint ownership is characterized by what is called the **right of survivorship**. And because any amount of property may transfer between spouses without tax consequence, there is no use of the

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<sup>2</sup> Trusts are very flexible legal tools. They can be used to accomplish a wide range of estate planning, family, and charitable goals. A discussion of the many uses of trusts is beyond the scope of this article. It may be useful, however, to borrow a well-worn illustration to explain the very basics of a trust. 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 trustee. I possess the second \$5 and I have the right to spend it, but only as I have been told. My brother is the beneficiary, 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 fiduciary duties to my brother. My brother would then complain to my mother (or to a court) and seek enforcement of the trust. My mother is the settlor or grantor of the trust; she set up the trust and funded it. Some trusts are set up and funded during the grantor's lifetime; these are called living trusts, or inter vivos trusts. Some trusts are set up at death; these are called testamentary trusts. Living trusts may be revocable or irrevocable, meaning that the grantor either can or cannot undo the trust.

deceased spouse's unified credit. This may create an estate tax problem at the time of the surviving spouse's death if his or her estate at that time is worth more than the unified credit.

For example, assume a couple who own jointly a \$3 million ranch. Upon the death of the first spouse, the survivor automatically comes to own the entire ranch. The surviving spouse now owns property worth \$1 million more than the unified credit, and without some other kind of estate plan and the time to accomplish it, upon his or her death only \$2 million will be excluded from estate tax, leaving \$1 million subject to a 45 percent tax.

If, however, the spouses title their assets not as joint tenants but as **tenant-in-common**, then each owns an undivided half interest in the property. Upon the death of one of the spouses, his or her half-interest in the property becomes part of his or her estate for federal estate tax purposes. The unified credit applies to exclude that half interest from estate tax. However, the surviving spouse now owns only an undivided half-interest in the property because the deceased spouse's half interest has transferred to an heir other than the surviving spouse; indeed, to make use of the deceased spouse's unified credit, his or her half interest cannot go to the surviving spouse.

The surviving spouse typically ends up owning the property as a tenant in common with the children. The surviving spouse has no legally protected interest, or right to beneficial use, of the deceased spouse's half interest. This is why many people prefer to use a credit shelter trust rather than simple tenancy-in-common, because it ensures that the surviving spouse will continue to enjoy the benefit of all the marital property until he or she dies.

Very few people have estates that are worth \$2 million, let alone \$4 million. However, if you are among the fortunate few whose estates exceed the unified credit, the tax consequences of failing to plan your estate may be significant, if not severe. The tools that are used in planning very large estates are beyond the scope of this article.

In general, the goal in such estates is to reduce the size of the taxable estate. Some of the more common tools that may be used to achieve this goal include: a) irrevocable trusts, b) gifting under the annual exclusion amount of \$12,000, c) special valuation or discounting procedures for closely held or family owned business and farms, d) use of business entities, such as corporations or limited liability companies, and e) installment sales.

Some states also have taxes that apply to time-of-death transfers, often called inheritance taxes. The rates are typically much lower than the federal estate tax rate, but typically the exclusion amount is also much less. For example, in Nebraska, which has an inheritance tax, the first \$10,000 of the estate is excluded from taxation. After that, the rate is 1 percent on transfers to immediate family, with the rate increasing for transfer to remote family members and to unrelated persons.

Avoiding taxes is very often the first issue that an estate planner will focus on, because the consequences for some estates can be serious. However, for most people, the unified credit is sufficiently large that there is no real risk of paying hefty estate or gift taxes. So, what are the other legal issues that affect estate planning?

### **Basis Adjustment, or Wiping Out Built-In Capital Gains**

There are advantages to giving it away at death, as opposed to giving it away now, including the larger unified credit, not to mention the fact that you continue to control the property until you die. Another tax-related advantage is **basis adjustment**, or **step-up in basis**. In a nutshell, transferring assets in a time-of-death transfer allows the heirs to acquire a step-up in basis in the assets, and potentially to avoid capital gain taxes.

Here's how it works. **Basis** is a tax term to describe the cost of an asset to the owner, and it is used to calculate capital gain. For example, if you purchased a piece of land for \$500 an acre 15 years ago, and that land is now worth \$1000 per acre, there is \$500 of capital gain "built-in" to each acre of that land. If you were to sell it, you would likely have to pay capital gains tax on that \$500. (The maximum federal capital gains tax rate is presently 15 percent, to which some states will add their own capital gain tax. In Nebraska, the rate is approximately 7 percent.)

Now, if you transfer that land to your heirs in a time-of-death transfer, they can receive a stepped-up basis, that is, the law will deem that they paid for the land whatever it is worth at the time of your death (\$1000, in our example). This happens without the payment of capital gains tax. Should your heirs then turn around and sell the land, little or no capital gains tax would have to be paid, because their basis would presumably be equal to the selling price.

A time-of-death transfer is the only way to wipe out a built-in capital gain tax liability. As with most laws, there is a wrinkle in this time-of-death step-up in basis. Under current law, the basis adjustment that is available for time-of-death transfers is set to expire at the same time that the estate tax expires, that is, in 2010. However, even in 2010, basis may still be adjusted upwards but only to a limit of \$1.3 million on all transfers to beneficiaries. So, the step-up in basis is taken away, but not entirely.

Of course, another way to avoid paying capital gain tax on an appreciated asset is never to sell the asset. To some farm and ranch parents, leaving the built-in capital gain in the land may be part of an estate plan to ensure that their heirs do not sell the land. The idea being that the prospect of having to pay up to 22 percent of the sale price to the government will discourage the heirs from selling the land.

What kind of transfers qualify as time-of-death transfers for basis adjustment purposes? Transfers that take place because of death. For example, property that is transferred by a will is a time-of-death transfer. But there are other transfers that occur while one is alive that still qualify as time-of-death transfers for basis adjustment purposes: the "give it away now but with strings attached category."

For example, a **life estate deed**. In a life estate deed, you deed your land to an heir but keep for yourself a life estate, which basically means that you own the property for as long as you live. Your heir becomes what the law calls a **remainder person** and you become the **life tenant**. You possess the property and have the rights and obligations of ownership for the duration of your life. Your heir has a legally enforceable property interest, because the only thing that comes between the heir and possession of the property is your life, and death is certain.

The IRS considers a life estate deed to be an incomplete gift and, as such, it qualifies as a time-of-death transfer under which the remainder person can acquire a stepped-up basis at the time of

the life-tenant's death. The life estate deed is sometimes called the poor man's trust, and it can serve numerous estate planning purposes. It is also an inexpensive tool to use.

There are consequences to a life estate deed, however, that one should consider, such as the fact that once the deed is done it cannot be undone unless the remainder person agrees. In addition, the remainder person's interest is a property interest that can be pledged as collateral. It may also be attached and sold by creditors. The transfer of a remainder interest triggers the obligation to file a gift tax return if the value of the remainder interest exceeds \$12,000.

Another example from the "give it away now with strings attached category" is a **revocable trust**, sometimes popularly referred to as a "living trust." In a typical revocable trust, John Doe transfers his property to himself, John Doe, as Trustee of the John Doe Revocable Trust. John Doe still calls the shots with respect to the property, but the property is now titled in the name of the trust. Upon the death of John Doe, the property typically transfers to John Doe's heirs as the trust or his will directs. The heirs are entitled to step-up in basis.

A revocable trust, often called a will substitute, typically costs more to prepare than a will, though it is said to save some of the costs and constraints of probate. (See discussion of probate that follows.) In fact, avoidance of probate has been described as the chief virtue of the revocable trust. In certain states this will mean more than in other states. In states that impose an inheritance tax, such as Nebraska, the advantages of revocable trusts as a will substitute are often overstated, as discussed below.

### **Probate, or Avoiding Probate**

Probate is a court proceeding to determine the validity of the will of a person who has died, otherwise known as the *decedent*. Probate may also be used in the case of a person who has died without a will, otherwise known as dying **intestate**. In probate, the property of the decedent is identified, inventoried, and appraised; debts and taxes are paid; and property is distributed to heirs as the will directs, or, in the case of intestacy, as the law provides.

Many people think that probate should be avoided. There is a common perception that probate is both expensive and time-consuming. In addition, some people do not like the fact that probate is a public proceeding.

There are numerous ways to plan an estate in order to avoid probate. If the decedent's probate estate is worth no more than \$25,000, there is no need for a probate – a simple affidavit will suffice to transfer property without the need for a court proceeding. If the decedent's property is titled or owned jointly with someone who survives the decedent, then that property does not become part of the decedent's probate estate and need not go through probate.

If the decedent has filled out forms that specify who is to receive certain assets upon his or her death, also known as beneficiary designations, that property will not become part of the probate estate. For example, insurance policies that name the beneficiary are not part of the probate estate, nor are "payable on death" bank accounts. These assets transfer not through probate but through contract.

Recall that a decedent's **probate estate** is not always the same thing as his or her **taxable estate**. The taxable estate as a general matter is made up of anything that the decedent has a property interest in at the time of his or her death. An example of property that is part of a taxable estate but not part of a probate estate would be property held in joint tenancy. John and Mary own a farm jointly with right of survivorship. John dies before Mary. Mary automatically becomes the sole owner of the farm upon John's death, with no need for the farm to pass through probate: John's interest in the farm is not part of his probate estate. However, the value of half of the farm is included in John's taxable estate for federal estate tax purposes.<sup>3</sup>

An additional example is an insurance benefit: the amount of the insurance death benefit is part of the decedent's taxable estate even though in most circumstances the benefit transfers to the named beneficiary automatically without the need for probate.<sup>4</sup> Life estate deed property is part of the taxable estate though it is not included in the probate estate. Any property that the decedent transferred prior to death with strings attached will typically become part of the taxable estate, though it may not be part of the probate estate.

Does it always make sense to plan to avoid probate? Probably not. In most states, probate proceedings have become fairly simple and straightforward under the Uniform Probate Code. In addition, the costs of probate have been reduced from the days when lawyers charged a fee based on percentage of the estate.

In states which have an inheritance tax proceeding, such as Nebraska, much of the work that goes into a probate proceeding must still occur in order to determine the state inheritance tax, even where property has been previously transferred out of the probate estate, as with revocable trusts or life estate deeds, for example. In addition, there are advantages to probate that are not otherwise available. For example, in probate proceedings, creditors have a specific amount of time to file claims against the decedent's estate, after which time those claims are forever barred.

## **Long Term Care and Medicaid**

People worry about the costs of extended stays in long-term care. They worry that everything they worked to own will have to be sold to pay for such care, the costs of which may range from \$3000 to \$6000 per month. In farm and ranch situations, it may be that the farm or ranch itself would have to be sold to pay for long-term care. That farm or ranch may represent the livelihood of the next generation.

How to plan for the possibility of costly, extended stays in care facilities? Some people choose to buy long-term care insurance. Some people choose to roll the dice, so to speak, in reliance of the statistical fact that most of us will not spend extended periods in long-term care. Some people plan on having sufficient income to pay for such care, so that assets will not have to be sold to meet the costs. Some people expect to rely on Medicaid.

If a person cannot meet the costs of long-term care, they may apply for Medicaid. Medicaid rules and regulations are complicated, and they are subject to change. Medicaid planning has been a

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<sup>3</sup> Although the value of half of the marital joint property is included in John's taxable estate, it does not make use of his unified credit. This is because under the tax law a transfer of assets between spouses is not taxed.

<sup>4</sup> The death benefit amount may be excluded from the decedent's taxable estate as well if the decedent was not the *owner* of the insurance policy but only the *insured*.

part of some people's estate plan, but planning for Medicaid became significantly more difficult with the passage of the federal Deficit Reduction Act on February 8, 2006 ("DRA").

Medicaid is a welfare program. It is designed to pay nursing home costs for those who cannot otherwise afford long-term care. It is funded federally and by the state. In order to receive Medicaid benefits, a person needs to prove eligibility. In general, eligibility is based on income and assets.

In the income test, in the nursing home context, an applicant must expect to commit all of his or her income to meet nursing home costs. The costs that are not covered by an applicant's income may then be paid under Medicaid, if the person is otherwise eligible. The income that is counted for this purpose is the income of the applicant, and not income that is received solely in the applicant's spouse's name.

Jointly received income is typically divided pro rata between the spouses. There are somewhat complicated rules that allow the spouse of an applicant to keep a minimum amount of income whether that income is received in the applicant's name or jointly. In 2005, the minimum amount was approximately \$1,562 per month. These amounts are typically adjusted annually.

In the asset test, to over-simplify, the general rule is that an applicant's assets (sometimes called resources) must be worth less than \$4000. (This is the present figure for Nebraska. It may differ by state.) Certain assets, called excluded assets, are not counted. In addition, Medicaid rules allow for the spouse of an applicant to keep certain assets. Generally stated, if the couple's combined assets are worth less than \$18,552, the applicant's spouse may keep all of the assets (plus the \$4000). If the couple's assets are worth more than \$18,552, the applicant's spouse may keep half of those assets up to a value of \$95,100, plus the \$4000. All other assets must be sold and the proceeds used to pay nursing home costs before Medicaid will step in to pay.

Congress imposed a penalty on people who transfer assets for less than fair market value that could otherwise have been used to pay for long term care. The penalty works like this: the value of the asset that was transferred for less than fair market value is determined, that value is divided by the monthly cost of the nursing home and the applicant becomes ineligible for Medicaid for however many months that asset would have paid for long term care.

For example, if you give away a farm that is worth \$300,000, and the monthly cost of care is \$3000, you will be ineligible for Medicaid for 100 months. However, (before passage of the new DRA) the only transfers that were considered are those that occurred within 36 months of the date a Medicaid application was made. This is called the look-back period.

So, to continue the example, if you transferred the farm on January 1, 2003 and applied for Medicaid on February 1, 2006 – 37 months later – the transfer of the farm would not affect your Medicaid eligibility. If you applied for Medicaid in December, 2005, only 35 months after the transfer, you would be ineligible for Medicaid for the 100 months. (The look-back period for transfers into and out of certain kinds of trusts is 60 months.)

The look-back period under the new DRA has been extended to 60 months for all transfers (not just transfers to and from trusts), if those transfers occur after February 8, 2006, the date of the new law. So, if you transferred the farm before February 8, 2006 and you wait more than 36

months before applying for Medicaid, the transfer of the farm will not affect eligibility. Our earlier example holds true. However, if you give away the farm after February, 2006, you would have to wait 60 months before applying for Medicaid in order to avoid an ineligibility period.

The DRA made another significant change in the asset test. Under the old law, the ineligibility period (the 100 months of our example) would begin to run from the month of the transfer, or the very next month. Under the DRA, the 100-month ineligibility period does not begin to run until you have a) moved to a nursing home, b) spent down your other assets (if any) to the \$4000 asset limit, c) applied for Medicaid and d) been approved for coverage but for the transfer.

It is critically important, therefore, that people who make significant transfers of assets not apply for Medicaid until after the 60-month look-back period has expired.

Planning for Medicaid can be complicated and almost invariably requires an analysis of individual circumstances. It must occur within the restrictions imposed by the rules and regulations that govern Medicaid. The look-back period, the spousal impoverishment program, the spend-down period, homestead protections, exclusions for trade and business property, the use of trusts, annuities, installment contracts and life estate deeds, all present possibilities for planning in the Medicaid context. It is also important to note that planning for long-term care in the farm and ranch context is often only one piece of an estate planning puzzle. Many other concerns crop up: cash flow, taxes, control, succession planning, and treatment of heirs.

Finally, planning for Medicaid typically falls into the category of “give it away now,” which often means that Medicaid planning conflicts with other estate planning purposes, such as continuing control over one’s assets and basis adjustment. The “give it away now with strings attached” category may have some Medicaid advantages, but even a “transfer with strings attached” typically must occur more than five years before a Medicaid application is made.

## **Will Contests**

Some people wish to take steps while they are alive to avoid the possibility that their heirs will end up in a fight about their inheritances. As a general rule, the experience of the law is that transfers that are accomplished while a person is alive may be less susceptible to attack. It is also important to make sure that wills, or other documents for the transfer of assets, are properly executed, and clearly written. Some people advise that the heirs be made aware of the estate plan before death.

## **Other Estate Planning Tools**

It is considered a good idea to include in an estate plan some other basic documents. A **durable power of attorney** is a document that typically authorizes another person to look after assets and manage affairs in the event of incompetence. It may be drafted to take effect only upon incompetence or it may take effect upon its execution. A durable power of attorney will avoid the need for an incompetence hearing in court or the approval of a guardian.

A **health care power of attorney** authorizes someone to make medical decisions on your behalf where you are unable to make those decisions yourself. It may be a separate document or the health care powers may be written into a durable power of attorney.

A **living will** or **health care directive** may set forth your wishes with respect to life support in the event you enter a permanent vegetative state. This document may ease difficult decisions for your survivors.

**Conclusion**

For reasons almost as varied as people’s lives, planning an estate can be complicated. It may also be simple. Individual circumstances need to be considered before determining a plan. Most important, the plan needs to reflect and accomplish a person’s wishes. It should be said, however, that laws exist in most states (called the **rules of intestacy**) to provide for the transfer of assets upon death where the decedent remained silent as to his or her wishes.

It should also be said that there is a fourth category, in addition to “give it away now,” “give it away at death,” and “give it away now with strings attached.” That fourth category is: “Don’t give it away at all.” Some people may choose an estate plan in which they want the last check they write to bounce, or nearly.

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