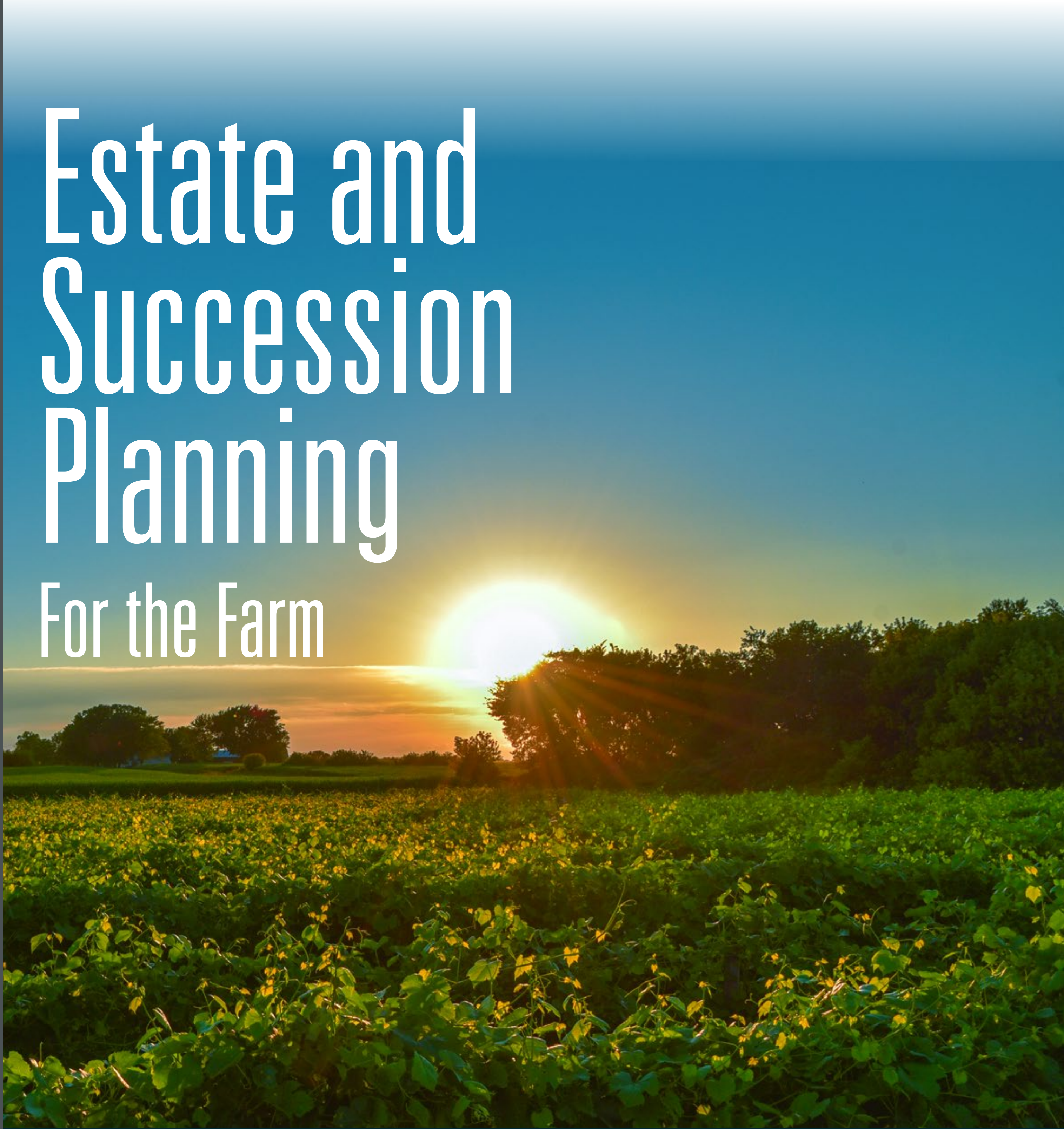
Iowa State University

Center for Agricultural Law and Taxation

Estate and Succession Planning

For the Farm



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This workbook is intended to educate readers about key estate and succession planning concepts. It is not intended to serve as a complete explanation of related topics. Examples and discussions address general, common situations. As with all estate and business planning, specific problems depend upon the facts of the case. This workbook is not intended as a substitute for legal counsel. Readers are encouraged to consult with legal and tax counsel when creating their estate and succession plans.

The Center for Agricultural Law and Taxation is a partner of the National Agricultural Law Center (NALC) at the University of Arkansas System Division of Agriculture, which serves as the nation's leading source of agricultural and food law research and information. This material is provided as part of that partnership and is based upon work supported by the National Agricultural Library, Agricultural Research Service, U.S. Department of Agriculture.

NATIONAL AGRICULTURAL LAW CENTER

Chapter 1

Introduction to Estate and Succession Planning

Many farmers, ranchers, and rural landowners have spent a lifetime building their business and caring for their property. Others are just starting out, wondering what their business will become. Regardless of their stage of life, farmers or landowners must consider the future. Planning for retirement, death, disability, or divorce will ease difficult transitions and ensure the owner's wishes are considered. While this task can seem overwhelming at times, information and education are key to smooth transitions.

Estate planning is arranging one's estate for the disposition and management of property at death using wills, trusts, insurance policies, beneficiary designations, and other tools. The goal of an estate plan often is to preserve the maximum amount of wealth possible and lessen the stress of management imposed on the **heirs** and beneficiaries.

Succession planning is preparing to transfer an operating farm, ranch or other business to successors, many times family members. Succession planning may involve the creation of business entities or structures or trusts.

Benefits of Estate and Succession Planning

A common misconception with estate and succession planning is that only wealthy individuals need an estate plan. This is far from the truth. Anyone with money in a bank account, minor children, a car, home, or land needs some form of an estate plan. Without such a plan, heirs will have to clean up loose ends. They likely will have to go through the **probate process** with no direction as to the wishes of the **decedent**. For those with minor children, the court will have to guess who the parent(s) wanted the guardians to be.

Without planning, those with a family business or farming operation lose the opportunity to direct whether and how the business should continue after the owner's death or disability. Succession planning is an important process to ensure that retiring farmers have a sufficient income stream at retirement and the farm operation continues to have the liquidity it needs to operate. Inadequate planning can lead to financial hardship and the premature end of a business.

Farmers and ranchers can avoid these consequences and save their loved ones time, money, and stress if they take the time during life to create an estate and succession plan. These plans are not always complicated or expensive. Each is customized to meet an individual's specific needs. For those who are married, the plan should be created together, equally considering the needs and wishes of each spouse.

Communicating With Family

Succession planning should not happen in a vacuum. The best plans involve discussions with family members, both with those who farm and with those who don't. Spending time listening to the needs, concerns, and desires of family members impacted by the plan will make it better. A good communication plan also will go far toward warding off disharmony among heirs down the road.

Setting Goals

Before creating the estate and succession plan, farmers and their family members should spend some time setting goals.

What do they want to happen to their farmland?

- Who will farm it?
- Who will own it?

What about the other farm assets?

- Who will own those?
- Who will use those?

What do they want to happen to the farm business?

- Who will manage it?
- Who will have an ownership interest in it?
- Who will provide labor for it?
- Who will earn income from it?

Do they want to retire?

- What do they want to do in retirement?
- What financial needs will they have in retirement?
- How will those needs change when one spouse dies?
- Are there relatives or others for whom they would like to provide?
- Are there charities to which they would like to contribute?

Farmers and ranchers should ask these and many other questions to determine what they hope to accomplish with their assets and the business they have developed.

Assembling a Team

Once goals have been determined, it is important to assemble a team of professionals to implement a plan. The team may include a lawyer, a tax professional, an insurance agent, a farm transition planner, and/or a financial planning advisor.

Getting Started

This workbook introduces farmers and ranchers to important concepts to consider when developing their estate and succession plans. The intent is to demystify the process and encourage everyone to start planning. For those who have created a plan, the goal is to continue to review it and update it as circumstances and applicable laws change.

Additional Resources

Evaluating Your Estate Plan: Estate Planning Goals, Ag Decision Maker extension.iastate.edu/agdm/wholefarm/html/c4-58.html.

Cultivating Your Farm's Future, University of Wisconsin Extension farms.extension.wisc.edu/programs/cultivating-your-farms-future/.

Notes

Chapter 2

Property Ownership

Taking Inventory

The first technical step in estate or succession planning is taking **inventory** of all assets and debts. The extent of all assets and liabilities must be known to understand the best way to transfer property or a farm business at retirement or death. In addition to listing assets and their value, it is important to understand how those assets are owned. Property can be held individually or jointly with other people. Married couples must determine what property they own individually and what property they own jointly. Part of the planning process is determining whether that is the best way to own the property. Property sometimes is owned by a trust for the provision of beneficiaries, or by a **business entity** for the profit of its owners. Property also may be held by a life tenant where the lifetime interest in the property automatically terminates at death. Each of these types of ownership comes with its own considerations and rules.

This chapter discusses joint tenancy, tenancy in common, payable on death or transfer on death transfers, and life estates. Chapter 6 discusses trusts, and Chapters 11 and 12 discuss business entities.

Joint Tenancy

Joint tenancy is a way of co-owning an asset that allows full ownership to automatically transfer to the other tenant or tenants at death, without the need for probate. Many married couples own their homes and bank accounts as **joint tenants**. This form of ownership comes with a **right of survivorship**. Joint tenancy for real property is created with a deed, which will list the joint tenants' names and then a specific phrase such as "with rights of survivorship" or "as joint tenants." In some states like Iowa, identifying the co-owners as husband and wife is enough to establish the presumption of joint tenancy with the right of survivorship.

If the property is held in joint tenancy between two people, when the first joint tenant dies, the other tenant will automatically become the sole owner of the property. That does not change if the decedent tried to give the decedent's share of the property to someone else through a will or trust. The surviving tenant will own 100% of the property at the death of the other tenant. The deceased tenant's interest in the property terminates at death. No probate administration is necessary for the surviving joint tenant to update the title. Instead, the survivor must generally file an **affidavit of survivorship** with the county recorder's office or the office responsible for land records.

Example: Rebecca and Robert are married and own their home as joint tenants with the right of survivorship. In Robert's will, he leaves his share of the house to his daughter from a previous marriage, Tina. Rebecca's will has her interest in the home going to a charity.

If Robert dies before Rebecca, then Rebecca owns the house. She will not need to pay Tina for Robert's share. When Rebecca dies, the house will go to the charity.

If Rebecca dies before Robert, then Robert will own the house. Nothing goes to the charity. When Robert dies, Tina will receive the house.

While most joint tenants with rights of survivorship are married, unmarried individuals also can hold property as joint tenants. If Robert and Rebecca had been siblings, the result would have been the same. Although not common, it also is possible for more than two individuals to own property as joint tenants with the right of survivorship. In this case, the last survivor of the joint tenants will be the sole owner of the property.

Federal Estate Tax Rules

Whether joint tenants are married does affect whether and to what extent joint tenancy property is included in the gross estate of a spouse who passes away for federal estate tax purposes. It also affects whether the property receives a **basis adjustment** at death. These concepts are discussed in more detail in Chapters 8 and 9, but outlined here are the specific rules for joint tenancy property.

For married couples, one-half of the joint tenancy property is included in the estate of the first spouse to die. That also means one-half of the joint tenancy property receives a basis adjustment at the death of the first spouse.

Note: Those in community property states (Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Washington, and Wisconsin) should consider the benefits of owning appreciated property as community property. Generally, at the death of the first spouse, one-half of the community or marital property is included in the estate of the first spouse, but all the property receives a basis adjustment.

With unmarried joint tenants, a "consideration furnished" rule applies. The law presumes that the first tenant to die supplied full consideration for the purchase of the property. As such, the full value of the property generally is included in the gross estate of the first tenant to die for federal estate tax purposes, and the entire property receives a basis adjustment. The surviving tenant can overcome this presumption by presenting evidence that they also furnished consideration for acquiring the property. The amount of property included in the deceased tenant's estate is adjusted based upon the percentage of consideration furnished by the surviving tenant.

Example: Ryan and Royal are brothers who own farmland as joint tenants with the right of survivorship. They each contributed half of the purchase price to acquire the land. When Ryan dies, Royal presents evidence of his initial contribution, and one-half of the property is included in the estate of Ryan. This also means that one-half of the property receives a step-up in basis.

Other Joint Tenancy Considerations

Although joint tenancy may seem like a simple way to hold property, the rules, which depend upon state law, can be complex. This section discusses considerations of joint tenancies that can vary from state to state.

Jointly holding an asset generally means any joint tenant can access 100% of the asset at any time. It is easy to think that a joint bank account means that each person is entitled to their proportional share, but it is not that simple. Absent an agreement to the contrary, one owner may be allowed to withdraw all the funds from a joint account. In some cases, the other owner may have no legal recourse. In some cases, the other owner may seek recovery of their proportional share in a conversion action. A written joint ownership agreement can detail and protect the rights of joint tenants.

Another consideration of joint tenancies is that the survivorship right sometimes may be destroyed or severed without the other owner's consent. Depending upon state law, each owner may have the right to sell, transfer, or partition their share of the interest during their lifetime. If the joint tenancy is severed, the ownership interest becomes a **tenancy in common**. Sometimes this transfer can occur inadvertently, such as by transferring joint tenancy property to a revocable living trust.

Note: In most jurisdictions, one spouse acting alone cannot sever a joint tenancy in a homestead. Such a transfer is generally void.

Another potential negative consequence of joint tenancy property is that the property is not protected from debt collection during the life of the joint tenant, even if only one owner is responsible for the **debt**. The **creditor** will have to follow state law and court procedure, but the creditor generally may force the sale of a jointly owned asset to pay debt owed by one tenant. If only one joint tenant was liable for the debt, the creditor generally is limited to retaining a proportional share of the proceeds.

The creditor's rights, however, generally dissolve once the joint tenant responsible for the debt passes away. In most states, a creditor can no longer make claims against the property if the surviving tenant was not obligated to pay the debt. This is usually true, even if the creditor had a lien on the property and could have foreclosed on the lien while the **debtor** was living. One exception to this general rule is Medicaid recovery. In some states, such as Iowa, the state Medicaid program may recover against jointly held property passing to the survivor at the death of the Medicaid recipient.

Example: Doris and Dale, who are cousins, decide to own 100 acres of farmland in joint tenancy. They each contributed 50% of the purchase price and pay 50% of the taxes and insurance.

Dale is involved in an accident after which the injured party prevails in a negligence lawsuit against him. A judgment lien attaches to Dale's interest in the farmland.

Dale dies before the injured party forecloses on the lien. The judgment creditor no longer has an interest in the property. Doris owns 100% of the farmland upon Dale's death.

Tenancy in Common

A tenancy in common is the default form of co-ownership. When two or more people inherit a parcel of land through a will, for example, they generally own the property as **tenants in common**. Distribution phrases in wills and trusts such as "share and share alike" or "split equally" create a tenancy in common. Tenants in common each have an **undivided fractional interest** in the whole property.

Example: Rolly owns 120 acres of farmland when he dies. In his will, he does not mention the real estate specifically. He states, however, that his entire estate will be distributed in equal shares to his three children. Rolly's children (if they survive him) will own the property as tenants in common. They will each own an undivided one-third interest in the 120-acre parcel. They do not each own 40 acres.

Regardless of their respective ownership interests, tenants in common each have the right to possess the entire parcel. A tenant in common with exclusive possession of the entire parcel must pay **rent** to the other tenants in an amount reflecting the non-possessing tenants' ownership shares. When tenants in common die, their respective shares are passed to their heirs in the same manner as their other property.

These basic rules aside, tenancies in common can get complicated. When the tenants in common cannot agree about how to manage the property, whether to sell the property, or who should rent the property, heated conflicts can arise. In such situations, the rights of the respective tenants in common are not always clear.

Example: Three siblings inherit 300 acres of farmland. They cannot each plant 300 acres of corn on the parcel. Instead, they must cooperate. They could decide to combine farming operations in a joint venture, rent the farm to a third party and share the rental income, or have one sibling farm the ground and pay the other two for rent.

Joint management is difficult among co-tenants because they must generally agree on all decisions. For example, a lease of the entire estate by one tenant in common is usually not binding on other tenants in common who have not authorized or ratified it. Likewise, all cotenants are liable for their share of property taxes.

Selling or Transferring Ownership Interests

Another difficulty of holding property as tenants in common is that any owner can sell, **gift**, or transfer their interest to someone else without the permission of the other owners. Cotenants' interests pass to their heirs or beneficiaries through intestacy rules or provisions in their will or trust. Similarly, a creditor may assume the ownership interest of one of the cotenants. Over the course of several generations, tenancies in common can lead to dozens of cotenants owning a single parcel of land.

Federal Estate Tax Rules

Because tenants in common own their interests individually, the value of their undivided ownership interest is included in their gross estate and the interest receives a basis adjustment at death.

Example: Veronica and her sister own 100 acres of farmland. They inherited the land from their father when it was worth $3,000/acre. In 2023, the land is worth $12,000/acre, and Veronica dies. Veronica's 50% undivided interest in the 100-acre parcel is passed to her two daughters through her will. Each daughter now owns a 25% undivided interest in the land. The basis of each of their interests is $300,000 ($12,000*50/2). The basis of Veronica's sister's share has not been adjusted. It remains $150,000. This can create different incentives between Veronica's sister and Veronica's daughters. The daughters could sell tax free, but the sister would have to pay tax on $450,000 of gain.

Partition

Because of the difficulty of jointly managing property, some co-owners desire to terminate a joint tenancy or tenancy in common. This is most easily accomplished through a voluntary agreement to divide the property equally or to have one tenant purchase the shares of the others.

Many times, however, joint owners are unable to agree on a fair division. Consequently, the law allows a tenant in common or a joint tenant to ask the court to **partition** the property.

Any owner, no matter how small the interest, has the right to ask the local court for a partition. Partition is the legal term for the court dividing the ownership of the land and destroying the tenancy in common or joint tenancy. How the land will be divided will be decided by the judge, according to state law and procedure. State law generally will provide for (1) **partition by sale**, where the property is sold and proceeds divided or (2) **partition in kind**, where the property is physically divided, and each co-owner receives a separate parcel.

Some states, such as Iowa, have passed laws favoring partition in kind for **heirs' property**. Heirs' property generally is land inherited from a family member that continues to be owned by relatives. In these cases, the court will seek to divide the land into separate parcels, rather than sell the land and divide the proceeds. The statute also generally provides a process under which the interests of those who would like to sell may be purchased by the other co-owners. Even with heirs' property, the court can order a partition by sale if it determines that a partition in kind would result in great prejudice to the co-owners as a group.

Note: Partition is a remedy available only to tenants in common or joint tenants. Land held in trust or by a partnership or other legal entity, such as an LLC, is not subject to partition.

Payable on Death

Payable-on-death (POD) or **transfer on death** (TOD) designations allow an asset to automatically transfer to the named **beneficiary** at the death of the owner. In contrast to a joint tenancy arrangement, the beneficiary of a POD account has no ownership interest while the account owner is alive. Owners of POD or TOD property must ensure their beneficiary designations are up to date, as this property will transfer according to the designation and not according to the provisions in a will or trust.

Property commonly transferred through POD or TOD designations include bank accounts, **life insurance**, and **retirement accounts**. Some states, such as Missouri, allow transfer on death deeds to automatically transfer title in real property at death. Iowa does not allow this type of transfer.

Note: POD bank accounts must be distinguished from joint bank accounts discussed in the joint tenancy section of this chapter. Account holders wishing to retain control of their accounts while they are alive should choose a POD option, rather than a joint account option. If an account owner wants another person to manage the funds, they may create a financial power of attorney (discussed in Chapter 7) under which the attorney-in-fact may write checks and pay bills on their behalf. These agents, however, must act in the best interest of the account owner and cannot use the account proceeds for their own benefit.

Problems may arise if a named beneficiary predeceases the owner, and no steps were taken to change the designated beneficiary. In such a case, unless a living **contingent beneficiary** was named, the asset will generally become part of the owner's estate and will be distributed through probate according to testate or intestacy laws.

Example: Anna designated her only child, Adam, as the beneficiary of a whole life insurance policy on her life. She did not list a contingent beneficiary because she assumed that Adam would outlive her. Unfortunately, he died at age 32, leaving a surviving wife and daughter, Beth and Clarissa. Anna died four years later with a will that named Dana, her long-time partner, as the sole beneficiary of her estate. Anna failed to update the beneficiary designation for her life insurance policy.

At Anna's death, the life insurance proceeds are payable to the Estate of Anna because there is no named beneficiary. Since Dana is the sole beneficiary of Anna's will, Dana will ultimately receive the life insurance payout. The value of the life insurance will be included in the probate estate, and court fees, attorney fees, and personal representative fees will be calculated based upon that amount.

If Anna had listed a contingent beneficiary, the contingent beneficiary would receive the proceeds. The insurance company would write the check directly to the beneficiary, and the value of the life insurance would not be part of the probate estate or the fee calculation.

Life insurance policies are very common transfer on death assets. Generally, during the lifetime of the owner, the owner has full control of the policy and can designate the beneficiary of their choice. The owner can borrow against the policy or cancel the policy without informing the named beneficiary. Because of this control, life insurance generally is included in the owner's gross estate for federal estate tax purposes. Unless the estate is the beneficiary, however, the insurance is not a probate asset. Beneficiaries of a life insurance policy do not pay **income tax** on the proceeds.

Life Estates

Another common type of property interest is the **life estate**, which provides **life tenants** with a limited right to use and profit from the property while they are living. At the death of the life tenant, the interest automatically ends, and the property passes to one or more remaindermen. If no **remainderman** is named, ownership of the property reverts to the estate of the grantor at the time the life estate ends.

Life tenants do not own a property interest they can transfer at death. The property does not transfer through the probate court or through a will or trust provision. Instead, when the life tenant passes away, ownership immediately vests in the **remainder interest** holder(s). Practically, the remainderman must file an affidavit with the county recorder's office (or land records office) after the death of the life tenant to change the property title. The actual transfer, however, happens automatically by operation of law.

Historically, the use of life estates as a planning tool has been a popular choice for many rural landowners. Today other estate planning tools often provide better options. Even so, many life estates remain.

Rights of a Life Tenant

While a life tenant is alive, the holder of the remainder interest has only a future interest in the property. The remainderman may not possess or use the property without the permission of the life tenant. The life tenant may lease the property or use the timber or other resources on the land for personal use but may not commit **waste**. The life tenant has a duty to preserve the property for the benefit of the remainderman. This includes an obligation to pay property taxes and make mortgage payments. The life tenant may not take out a new mortgage, sell the entire property, or otherwise encumber the property without the consent of the remainder interest holder. Although the life tenant has the power to sell the life estate, this rarely happens since the purchased interest would end when the life tenant dies. Occasionally, the remainderman will buy the life tenant's interest. When this occurs, the life tenancy dissolves, and the purchasers are the owners of the **fee simple** estate.

Leasing Farm Property from a Life Tenant

As noted above, life tenants may lease the property while they are living. State laws generally allow a farm lease to continue after the death of a life tenant, at least through the end of the crop year. Lease payments accruing after the death of the life tenant are paid to the remainder interest holder, whose title has ripened into a fee simple.

If the life tenant was a farmer, the **doctrine of emblement**s allows the life tenant's estate to harvest crops or at least receive the financial benefit of crops planted before the life tenant died.

Types of Life Estates

Life estates may be one of two types: a **granted life estate** or a **retained life estate**. A granted life estate is one given to a person other than the grantor, typically at the death of the owner.

Example of a Granted Life Estate: In her will, Monica directs that at her death, her farmland is to transfer to her husband, for life, and then to her children. Monica's husband will have a life estate in her property if he survives Monica. Her children will have a remainder interest.

A retained life estate is one preserved by the grantor, while transferring a remainder interest to another person, typically a child or spouse. While not generally recommended, retained life estates sometimes are created to avoid probate.

Example of a Retained Life Estate: Les does not want to pay a lawyer to create a revocable living trust but wants his property to transfer without probate at his death. Les **executes** a deed transferring his property to himself, for life, then to his children. Les no longer owns a fee simple interest in his property, but a retained life estate. His children have a remainder interest. Les has made a gift to his children in the amount of the present value of the remainder interest.

Special estate and tax rules apply to property held in a life estate. If a decedent was granted a life estate by another person, the property is not included in the estate of the life tenant at death and does not receive a step-up in basis. With a retained life estate, the property is included in the life tenant's estate and the property does receive a basis adjustment at death. This is because the life tenant had control over the property and voluntarily chose to restrict their ownership interest in the property while they were living.

Example: Grandpa passed away in 1989, leaving grandma a life estate in the farmland, valued at $100,000. In 2023, when the property is valued at $1 million, grandma dies, and Madge and Karl, the remainder interest holders, become fee simple owners of the property. Because this was a granted life estate, the property was not included in grandma's estate, and Karl and Madge inherit the land with a basis of $100,000.

Additional Resources

Appendix A, Evaluating Your Estate Plan: Estate Planning Questionnaire, Ag Decision Maker

Notes

Chapter 3

Distribution of Property at Death

Probate is the process of proving a will and supervising the distribution of the **estate**, with or without a will. Probate can sometimes be a long and expensive process, but that is not always the case. If the decedent has very little property and no real property, for example, the heirs may usually transfer the property by filing an **affidavit**. Most states also have simplified processes in place for "**small estates**." Even so, having an estate plan in place will usually help to streamline the process of distributing property at death. Chapter 4 of this workbook explains the probate process in more detail.

There are two forms of estate succession when a person dies: **intestate succession** and **testate succession**. Intestate succession gives a decedent no control over the passing of the estate. Testate or planned succession, on the other hand, seeks to honor the decedent's wishes and instructions.

Intestate Succession

A person who dies without a will dies **intestate**, meaning the estate is distributed based upon the law of the state where the decedent lived or where the decedent owned real property. State law controls how the property passes from the estate, and the wishes of the decedent are not considered.

The court will first appoint an **administrator**, someone to manage the estate through the probate process. Each state has a statute describing this process, but usually the court will appoint a surviving spouse or heir. The administrator collects the assets of the estate, pays the creditors during the settlement process, and pays the taxes if applicable. The administrator prepares a **final report** indicating to the court how the property has been distributed and that all claims and taxes are paid. After court approval, the administrator may distribute the last of the property to the heirs under the intestacy laws.

Intestate succession laws differ in each state, but there are many similarities. For example, if a decedent has no spouse or children but has surviving parents, the law will typically split the estate evenly among the surviving parents. If the parents have predeceased the decedent, the estate will generally pass through the parents to their heirs, which generally would be the decedent's siblings.

If the decedent dies with a spouse and no heirs, the spouse will usually receive the entire estate. In some states, the length of marriage can affect the spouse's portion. If the decedent and **surviving spouse** were only married for a few years, then the parents of the decedent might still receive property through **intestacy**. If the decedent leaves shared children with a surviving spouse, then the surviving spouse generally receives the entire estate. The policy behind this rule is that the surviving spouse is expected to provide for the children in the same way that the decedent would have provided for them. However, if the decedent leaves children that are not children of the surviving spouse, the surviving spouse will receive a certain portion of the estate and the children who were not the children of the surviving spouse will receive the rest.

Testate Succession

A decedent with a validly executed **will** is a **testator**. With testate succession, the court distributes the estate as directed by the will or any other **testamentary documents**, including **testamentary trusts**. A will gives the decedent control over who will receive the property, as well as what share each beneficiary will receive.

Spousal Elective Share

Even with a will, state law sometimes limits the amount of control a testator has over the distribution process. For example, in most states, testators cannot entirely exclude a spouse from receiving an **inheritance** absent a valid **prenuptial agreement**. State law usually dictates a minimum amount—called an **elective** or **statutory share**—that the spouse is entitled to receive from the decedent, even if the decedent attempted to write the spouse out of a will or trust document. The proportion of the estate to which the spouse is entitled varies from state to state, but the general range is one-third to one-half of the estate. Anyone wishing to provide for their spouse outside of a will or wishing to **disinherit** their spouse altogether must discuss their options with trusted legal counsel.

Provisions in a prenuptial agreement waiving a spouse's right to an elective share are generally enforceable. Some states also allow spouses to waive their elective share through a post-nuptial agreement. Other states, such as Iowa, do not enforce such provisions in post-marriage agreements.

Other Testate Matters

Apart from the spousal statutory share requirements, testators have the right to disinherit family members. Except in Louisiana, there is no legal obligation to include children or other relatives as beneficiaries of a will. Child support orders, however, typically will survive the death of the parent and generally are enforceable against the parent's estate.

Testate succession also may give the decedent control over when an heir can receive the property. With a testamentary trust, the testator can require the trustee to hold property for the benefit of beneficiaries until they reach a specific age or for a specific time. It also can direct the trustee to make available a specific amount each year for the beneficiaries. A trust can direct the trustee to spend the trust funds as needed for the support and well-being of a beneficiary. Trusts are discussed in more detail in Chapter 6.

Through a will, the testator also can retain some control over who becomes the **guardian** over minor children. If the testator's children survive them and there is no other surviving parent, the court typically will refer to the will to determine the testator's preferred guardian for the children. Courts usually take the wishes of the decedent into consideration when making this determination.

Assets Distributed Outside of Probate Process

To minimize or avoid probate, some choose to use trusts and other tools to take property out of their probate estate prior to death. Property titled in the name of a trust passes outside of probate according to the instructions in the trust instrument. Chapter 6 of this workbook explains the use of trusts in an estate and succession plan. Other property that can pass outside of the probate process includes the following:

- Payable on death accounts (with a valid POD designation).
- Transfer on death deeds (with a valid TOD designation) (not allowed in some states, including Iowa).
- Retirement accounts with beneficiary designations other than the estate.
- Life insurance with a beneficiary designation other than the decedent or the estate.
- Property held as joint tenants with the right of survivorship (JTRS).
- Property in which the decedent had only a life estate interest.

Note: The probate estate is different than the gross estate for federal estate tax purposes. The latter is discussed in Chapter 9.

Notes

Chapter 4

Explaining the Probate Process

The length of the probate process varies from estate to estate, but state law establishes general procedures and timelines.

Personal Representatives

When a person dies with a will, any interested person usually can file a petition in the district court of the county where the decedent resided to admit the will to probate and request the appointment of an **executor**. The court usually will appoint the executor named in the will unless that person is unable to serve. The court then will provide the executor with **letters testamentary**, which authorize the executor to act on behalf of the estate. If there is no will, a spouse, heir, creditor, or other person with a valid interest can petition the court to administer the estate. The court can appoint any qualified person as the administrator of the estate. The court will award the administrator of an intestate estate **letters of appointment**, demonstrating the administrator has the power to act on behalf of the estate. Executors and administrators are both called **personal representatives** in most jurisdictions.

Assets and Inventory

Until a personal representative is appointed, it may be difficult to access the accounts and assets that are part of the probate estate. The personal representative must organize and locate all assets, creditors, and beneficiaries of the decedent's estate. This can be a time-consuming process, especially if it is hard to identify what assets the decedent owned. If the decedent did not take the time to itemize and organize assets and debts before death, the personal representative usually must use tax statements, mailings, and credit reports to begin the search.

Once the assets are located, the personal representative cannot make any distributions to beneficiaries until a set amount of time has passed for any creditors to come forward and file their claims. The personal representative must provide notice of the probate estate in the newspaper and send personal notice to known creditors. If the creditors fail to file a claim within the timeframe established by state statute, they will not be able to collect their debt from the estate or the beneficiaries.

After the personal representative has located the creditors, assets, and beneficiaries, they must file an inventory with the court. States will have a set timeframe for when this must happen, but courts will grant deadline extensions if the personal representative has a good reason. Once filed, a copy of the inventory will be given to all beneficiaries and creditors with a claim. The inventory is usually a public record. If anyone has an issue with the inventory, they will notify the personal representative and the court. The inventory can be modified as additional assets are discovered.

Personal representatives are responsible for caring for the assets and paying the debts and taxes of the estate. Unless the will gives specific permission, the personal representative must seek court approval to sell any assets during the administration process. Interested persons who disagree with the way the estate is being administered may seek a hearing in front of the probate court. Eventually, the judge will order debts paid, administrative fees paid, and the remaining assets distributed. The personal representative then files a final report and seeks discharge from further obligations.

Probate Costs

Court oversight costs money. Probate court costs depend on the jurisdiction. For example, in Iowa the court will receive .2% of the estate value. Beginning in 2022, this value does not include **non-probate assets** such as retirement accounts with a valid beneficiary designation. In South Carolina, there are set amounts based on the value of the estate until the estate reaches a certain threshold. Then an additional percentage of the estate is owed. In Arkansas, there is one set fee that is equal to the fee for filing any other type of civil action.

Attorney fees and personal representative fees are in addition to the court costs. These fees generally are limited to "reasonable fees," although state statutes and courts vary as to what is reasonable. In Iowa, personal representatives and attorneys each generally are allowed a fee in an amount up to 2% of the value of the gross assets of the estate, excluding life insurance. Life insurance is included in the calculation, however, if the insurance is payable to the estate. Many personal representatives waive their right to a fee if they are a beneficiary under the will.

Personal representatives are free to negotiate the fees of the estate attorney. Increasingly, attorneys are billing an hourly rate for their work, which in many cases may be more cost effective than a percentage fee. Personal representatives should complete this negotiation before formally engaging the attorney to represent the estate. Court costs and fees generally are paid before taxes, debts, and beneficiary distributions, although each state has a specific order for the priority of payments.

Probate Benefits

The probate process has several important benefits. First, it ensures the beneficiaries can receive assets free of **clouds on the title**. In most circumstances, the beneficiaries will receive the assets outright. Probate rules shorten the time for creditors to make claims and recover debts. This provides certainty to the beneficiaries, and facilitates the efficient transfer of property, especially real property.

Second, probate has a well-designed process for settling disputes among heirs and interested parties. Although the executor administers the estate, a court reviews and approves the actions. Those **contesting** a will or alleging impropriety can get their day in court. Once these matters are resolved, the heirs and beneficiaries can move forward with certainty about their rights to the property.

Finally, the probate inventory provides a public record of the fair market value of the assets on the day of the decedent's death. This can be useful for estates that are not required to file federal estate tax returns. Beneficiaries wishing to later sell their assets can access a public record of the stated value to determine the basis of the asset they inherited.

Smaller Estates and Alternative Probate

Some states offer a "simplified estate" process. These procedures require less court oversight. Most of the time, an alternative administration process is available only to smaller estates. In Iowa, for example, that limit is $200,000. The costs associated with simplified probate generally are lower than the costs for standard probate.

In some jurisdictions, assets may transfer via affidavit if the total value of the estate is low enough and there is no real property. In Iowa, $50,000 is the limit for transferring estate assets by affidavit when there is no real property. In this situation, the assets are distributed to the heirs after a set amount of time. An individual uses the affidavit to obtain the asset and distribute it, instead of obtaining letters of appointment from the court. In some jurisdictions, the affidavit must be filed with the court, but no judge oversees the process. The affidavit is made public for the benefit of creditors.

The Necessity for Probate

If a family chooses to ignore probate responsibilities or move forward without knowledgeable legal counsel, beneficiaries will have difficulty proving their ownership of inherited property. This could plague the family for generations and ultimately deprive them of ownership of their heirs' property.

Survivors should contact a lawyer for assistance within a month after a family member dies. If costs are a concern, state bar associations and federal-funded Legal Aid programs may be able to provide support and resources to a surviving spouse or relative.

Additional Resources

Legal Aid Location Finder, www.lsc.gov/about-lsc/what-legal-aid/get-legal-help.

Notes

Chapter 5

Understanding Wills

A will is a document that allows people to control the distribution of their property after death. Even people who create trusts with the intent to avoid probate should create a **pour-over will** to ensure all property passes according to their wishes. This includes property inadvertently left out of a trust.

Who May Create a Will?

To create an enforceable will, a person must generally be at least 18 years old and have **testamentary capacity**. In Iowa, for example, a person who is either 18 years old or married may create a will if they are of **sound mind**. Having testamentary capacity or a sound mind is not a high standard. If testators have sufficient mental capacity to understand the nature of the will, the property to be disposed of, the identity of close family members, and the way they want to distribute their property, they generally are competent to make a will.

If a person challenges a will, arguing that the testator lacked a sound mind or testamentary capacity, they bear the burden to prove their claim. Similarly, a court may find a will invalid if a challenger is able to prove the will was the product of **undue influence**. This requires proof someone else coerced the person or inappropriately convinced them to change their distribution scheme. It also requires proof the testator was susceptible to influence. Where a claim of undue influence is successful, a person often has abused their position of trust in the testator's life.

Example: Dori is the agent acting under a power of attorney for her father, James. She also takes him to his medical appointments. James has a 500-acre farm that is farmed by Dori's siblings, Roni and Randy. As James' health starts to decline, Dori begins to talk to James about how Roni and Randy don't appreciate him and how they will not take good care of the farm once James is gone. She convinces James she is the only one of his children that loves him and that he should leave the entire farm to her. Three months before James dies, Dori sets up an appointment for James with his lawyer and drives him to the appointment. He changes his will to leave his entire estate to Dori. Roni and Randy are later successful in having the will set aside on the grounds of undue influence by Dori.

Executing a Will

Wills are not do-it-yourself documents. Those wishing to create a will should consult trusted legal counsel. Every state has its own requirements regarding the process that must be followed to create a valid will. These **testamentary formalities** or requirements are strictly enforced. Most states require the will to be in writing and signed by the testator. In Iowa, two **disinterested witnesses** must watch the testator sign the will. They must sign the will in the presence of each other and the testator. Although not legally required, it is best practice to have each witness also sign a **self-proving affidavit**. This is a notarized document that eliminates the need for the witnesses to later prove to the court the signature on the will belongs to them.

A few states will allow a testator to execute a valid will without any witnesses. Called holographic wills, these non-witnessed wills must be written in the handwriting of the testator. Iowa does not recognize **holographic wills**.

If the technical requirements of a will are not followed, the will cannot be admitted to probate, even if evidence shows the decedent intended to create a valid will.

Example: Fred lives in Michigan, where holographic wills are permitted. He writes and signs his will, storing it in a safe place known by his wife. Feeling satisfied, he tells his brother Ned to do the same. Ned writes his own holographic will. Unfortunately, Ned lives in Wisconsin, which does not recognize holographic wills. Fred dies, and his **probate assets** are distributed according to his will. Ned dies, but his assets will transfer according to the Wisconsin laws of intestacy.

Will Restrictions

Generally, testators who follow their states' requirements for executing a will can distribute their property any way they choose. Testators do not have a legal obligation, for example, to leave their property to their family members. Instead, they could choose to leave their assets to an unrelated neighbor or a charity.

Several exceptions exist to this rule, including the requirement explained in Chapter 3 that a spouse must receive at least a statutory or elective share. If the spouse wants their elective share, they have a set amount of time to formally request it with the court. If the spouse does nothing, they will have waived their right to the elective share and the assets will be distributed according to the will. If the spouse elects to take their share, then usually their share is paid first from the estate, with the rest of the assets distributed according to the will.

Testators may generally disinherit a child. A testator does not need to inform a disinherited child prior to death. The testator should, however, state clearly in the will that the child was intentionally omitted.

Another exception to the rule that testators may distribute their property how they choose is where the testator's distribution scheme would violate public law or policy. Courts will not uphold such provisions. A 2021 case from the Iowa Supreme Court illustrates this rule. The testator's will attempted to transfer property to beneficiaries, but then restrict them from selling or transferring the property outside of the family for 20 years. The Court ruled the provision was a prohibited **restraint on alienation** and was void. See *Estate of Vera E. Cawiezell v. Coronelli,* 958 N.W.2d 842 (Iowa 2021).

Note: The testator in this case could have accomplished his goal by creating a testamentary trust within his will or establishing an LLC or living trust before his death.

Storing the Will

Generally, the testator should sign only one copy of the will. Unsigned copies are strictly for reference. The executed will must be kept in a safe and secure place. Many attorneys provide a storage service for the wills they draft. In Iowa, wills may be stored with the Clerk of the District Court. They do not become **public records** until the will is offered for probate. Some testators keep their executed will in a locked safe, where a key is provided to a trusted family member or friend. It is not usually advisable to store a will in a safe deposit box because it often is difficult to access the box immediately after death. Regardless of how they store their wills, testators must communicate the location of the will and access instructions to trusted family members or friends.

When someone with a valid will dies, the original will is filed with the local probate court. The court oversees the distribution of the assets and ensures the terms of the will are followed, as explained in Chapter 4.

Common Will Provisions

A will typically comprises several common sections. Key will provisions include the following:

Recital. This section identifies the testator, the state where the testator lives, and declares the document to be the will. The recital also typically declares the testator has capacity and is acting without undue influence.

Identification of Important People. This section lists the names and relationships of important people. Usually, if the person would receive something under the intestacy laws, they will be listed. For example, the names of a spouse and any children should be listed. If a beneficiary has a common name, like Thomas Jones or Minh Nguyen, then this section will describe the relationship with the person to ensure the proper individual can be found during the probate proceeding.

Authorization to Pay Debts and Last Expenses. Usually included early in the will, this section authorizes the executor to pay the expenses of the last illness and any debts. If there is a specific pool of money or assets that should be used to pay these expenses, it will be identified.

Distribution Paragraph(s). Depending on the specifics of the will, this could include multiple sections. If a specific asset is going to a particular beneficiary, it usually will be included in its own section. Real estate interests commonly comprise their own section, with a legal description of the land included.

Residuary Clause. This section will identify the individual or individuals who receive everything not otherwise specified.

Identify Guardian/Conservator for Minor Children. The wills of parents of minor children usually identify the individuals they want to serve as guardian and/or **conservator** if both parents pass away before a child turns 18. A common misconception is that a godparent is automatically nominated. While a godparent may have religious responsibilities following the death of the child's parents, they do not have legal obligations or rights.

Nominate Executor. This section will nominate someone to be the executor. This person will be responsible for organizing the decedent's financial affairs and reporting to the Court. There usually is a backup executor identified, in case the first choice is unable to serve.

Specify Executor Powers and Bond Requirement. In this section, the powers of the executor are listed. While there are default powers given through state law, many times the testator will want to alter those powers to make the executor's job easier. For example, many times the **executor's bond** is waived.

No Contest Clause. This is a common optional clause. This clause explains the consequences, if any, to a person who challenges the validity of the distribution scheme of the will.

Attestation Clause. If placed in the will, it is usually at the end. It states the legal formalities of the will signing have been met.

Signatures. At the end, there should be a place to date and sign the will. There also will be room for the witnesses to sign.

Personal Property

In most states, testators have some flexibility when it comes to distributing their non-business **tangible personal property**, such as jewelry, household goods, or furnishings. Although these items can be distributed via standard will provisions, some testators may frequently change their mind about who should receive this type of property. To prevent the will from having to be re-executed every time a change in beneficiary is made, most states allow a testator to create a separate list of tangible personal property, naming the person to whom they would like each item distributed.

To be effective, the document is separate from the will, but must be referenced within the will. It can be changed as often as the testator would like, without the formalities required for executing a will. Any testator creating a separate tangible personal property list must ensure the executor knows where to find the document.

Planning for Contingencies

As part of the will drafting process, a testator should decide what should happen if a beneficiary unexpectedly dies before the testator. While many people plan for the possibility their primary heir may predecease them, they often fail to think about what they want to happen if both their primary beneficiary (often a spouse) and a secondary beneficiary (often a child) predecease them. If the will is silent on the issue, then state law controls what happens. Absent a contrary will provision, the deceased beneficiary's share generally will be distributed according to the state's **anti-lapse statute**. In Iowa, the property generally will pass to the deceased beneficiary's issue, which means the beneficiary's living **descendants**.

Many wills specifically direct a deceased beneficiary's share to go to the children or lineal descendants of the deceased individual. Because a conservatorship may be required if a minor is left an inheritance through a will, the will should direct the property to be left, in trust, for any beneficiary who is a minor.

Notes

Chapter 6

Introduction to Trusts

Trusts are important estate and succession planning tools. They can accomplish many purposes, including providing for the transfer and management of income and assets after disability or death, managing income and assets for the benefit of minors or the vulnerable, or ensuring privacy of the distribution of assets at death. For very wealthy individuals, trusts may be used to minimize estate tax liability.

What is a Trust?

According to Black's Law Dictionary, a trust is "an equitable or beneficial right or title to land or other property, held for the beneficiary by another person, in whom resides the legal title or ownership, recognized and enforced by courts." While this sounds very complicated, it is easier to understand in practice.

Creating a trust is accomplished by a **grantor** (creator of the trust) transferring property to a **trustee** (the person who will be in direct control of the property) for the benefit of a beneficiary. The property held in trust is called the **corpus** or **principal**. As discussed below, the kind of trust created dictates who the trustee and beneficiaries should be and what kind of property should be held in trust. The trust instrument should answer seven important questions.

1. What assets will be held in trust?
2. How will the assets be managed?
3. Who will manage the assets?
4. Who will receive the income from the trust?
5. Who has the right to access the income or principal?
6. When will the beneficiaries receive the income or principal?
7. When will the trust dissolve?

General Purposes of Trusts

Many people create trusts to provide for a smooth transition of property at disability or death, while maintaining use and control over their property during life. Because legal title to the property is in the trustee of the trust and not in the individual's name, the trust property is not part of the probate estate. It is dispersed according to the trust terms and not by a will or through the laws of intestacy. In other words, no court filings or hearings are necessary.

Others use trusts to provide for the needs of beneficiaries, while limiting their access to the property. It is common for parents to create trusts for their children, which prohibit their access to funds until the children reach a certain age or a milestone. It also is common to establish trusts to provide for the needs of surviving spouses, while allowing someone else (such as the grantor's children) to receive the trust funds after the death of the surviving spouse. Trusts also are a key tool in estate planning to limit estate tax on very large estates.

Others create trusts to control the use of their property after their death. For example, a trust may require that an on-farm heir always has the option to farm the land, even if off-farm heirs are beneficiaries of the trust. Similarly, the trust may provide an on-farm heir with a long-standing option to purchase at a reduced price.

Not every estate or succession plan needs a trust. Trusts come in many different forms. Some estate plans include multiple types of trusts, while others are complete with one trust. Determining whether a trust would benefit an estate plan and what types would be useful is an important part of the planning process.

A trust can be a living (inter vivos) trust or a testamentary trust. A **living trust** is created during the life of the creator. Living trusts can be **revocable** (may be changed) or **irrevocable** (may not be changed). The most common type of living trust is a **revocable living trust**, described in detail below.

A testamentary trust is effective only at the death of the creator. Testamentary trusts are irrevocable.

Testamentary Trusts

A testamentary trust is created through a will or living trust provision. A testamentary trust often is used as a vehicle for property management if both parents should die leaving minor children surviving. The testamentary trust for minors is a useful device for managing the property for the children's benefit until each attains a stated age. The trustee could be the same person named as guardian for the children, or it could be a different person or a bank or trust company providing further control over the funds. Typically, a testamentary trust for minors distributes income as needed to the minors while they are growing up or in college, with the principal distributed to the children at the age specified in the trust. A trust provides a way to control property during life, as well as after death.

Another common testamentary trust is a farm trust, where farmland is controlled for a period in order to help ensure the farming assets remain in the family and are not sold.

Example: Wilbur owned 480 acres of farmland in his name until his death. His will contained a provision placing the farmland in trust so that his brother, Orville, could rent the ground as long as he continued to farm at 80% of fair rental value. The trust provided that the rental income was to go to Wilbur's child, Milton. At Orville's death, the land was to pass to Milton directly. This type of trust is an irrevocable testamentary trust.

Unlike a will, a trust affords a decedent some control over assets after death. In many states, including Iowa, however, a trust may not continue indefinitely. At some discernable point in time, the trust must end, with the assets distributed to family members, other individuals, a charity, or a government entity. The general rule in these states is that a trust can only exist for 21 years after the death of a "life in being" at the time of creation. In practical terms, this means a person usually can control an asset, such as land, to the great-grandchild level through a trust. Once the trustee distributes the assets, beneficiaries are free to use the assets how they choose. A growing number of states, however, are abolishing this so-called **rule against perpetuities**. These states will allow a trust to continue in perpetuity.

Revocable Living Trusts

Revocable living trusts, often called "will substitutes," are popular estate planning tools. While living, the grantor (also called the settlor) retains the power to alter, amend, or revoke the trust. Usually, the grantor establishing the revocable living trust serves as the initial trustee. The grantor also is generally the primary beneficiary of the trust. This means the grantor can continue to use the property as they choose. The trust will name a **successor trustee**, as well as successor beneficiaries. The successor trustee will assume the responsibility of trustee upon the death or disability of the grantor. The successor beneficiaries will receive the benefits of the trust after the death of the grantor. Some revocable living trusts include a co-trustee who may be a spouse or family member. A co-trustee is authorized to manage the trust assets along with the grantor or successor trustee.

Note: Unless they are in a community property state, married individuals should not create joint revocable trusts. These instruments create ambiguity as to the ownership and basis of assets. Instead, each spouse should create their own revocable living trust, in the same way they create their own will.

Administer Property Outside of Probate

Revocable living trusts are sometimes called **will substitutes** because they transfer assets outside of the probate process. This means that a court does not oversee the transfer of the property at death. Instead, the property transfers according to the terms of the trust document, which is not "admitted to probate," or made public. If property is in a revocable living trust, contradictory terms in a will have no effect. The assets do not transfer according to the terms of the will.

Even when a person has a revocable living trust, a pour-over will should be created to direct the distribution of any property inadvertently or intentionally left out of the trust.

Does Not Change Tax Liability or Value of Estate

While a revocable living trust can ease administrative burdens at disability or death, it does not alter tax or creditor liability or Medicaid eligibility. Property in a revocable living trust continues to be the property of the grantor for these purposes. It is included in the grantor's gross estate for federal estate tax purposes. Consequently, property in a revocable living trust receives a basis adjustment (commonly called a "step up" in basis) at the death of the grantor. Basis adjustments are discussed more thoroughly in Chapter 8.

When filing tax returns, the revocable living trust is generally disregarded. An individual will continue to file a Form 1040, and no Form 1041 (trust tax return) is required.

Protect Privacy

A revocable living trust may be useful for keeping the details of a decedent's property holdings private. In probate, the executor must compile and submit an inventory of every asset in which the decedent had an interest at death. This is a public document. Passing property through a revocable living trust will keep the details of the estate private.

Facilitate Multi-State Transfers

Another benefit of creating a revocable living trust is to facilitate the transfer of real property owned by the decedent in other states. Without a trust, the executor is required to open an **ancillary probate** action in the state(s) where the real property is located. The revocable living trust generally eliminates this burden.

Seamless Management Through Disability and Death

Revocable living trusts allow property in the trust to be managed seamlessly if the grantor becomes unable to serve as trustee because of a disability. Trust provisions will appoint a successor trustee, as well as establish the procedure that must be followed to prove the disability (such as secure a letter from a physician). This prevents the necessity of a court proceeding to appoint a conservator to manage the financial affairs.

At death, the trust property will be managed by the successor trustee, without the need for a court proceeding or hearing. Although durable powers of attorney allow someone to manage a person's assets when they become disabled, only a trust allows for the seamless transition of property management at the death of the grantor.

Disadvantages of Revocable Living Trusts

Despite their advantages, revocable living trusts are not without drawbacks. A trust generally costs more to create than a will alone. And the grantor still must create a pour-over will to ensure any property left outside of the trust will be passed according to the plan. A trust requires lifetime upkeep. Any newly acquired property must be titled in the name of the trustee of the trust or the trust will not control its disposition.

One common error is to create a revocable living trust and then fail to fund it or put assets into it. Assets outside of the trust will be part of the probate estate.

Finally, a trust still must be administered at the death of the grantor. The administration is just not court supervised. Notice to creditors of the death of the grantor should be published, and beneficiaries generally must receive notice of their right to an accounting. Sometimes, particularly where there may be disgruntled heirs, court supervision or statutory timelines built into the probate process are helpful. Trustees do not have the benefit of these provisions after the death of the grantor of a revocable living trust.

Funding the Trust

There is no trust vault or room that holds the assets of a trust. A trust is more of an account name than a physical repository. The legal term for the assets placed into a trust is **corpus**. The corpus also may be called the principal. Trust property can include cash, business entity interests, real property, tangible personal property, assets owned for business use, and assets owned for personal use. Putting property into the trust is called "funding" the trust. An attorney should oversee and guide this process. To place assets into a trust, the grantor retitles property or bank accounts into the name of the trustee of the trust. This might be easier explained through a basic example:

Example: John has the following assets: a car, a home, a bank account at ABC Bank, 50 shares of XYZ stock (a closely held corporation), and 300 acres of farmland.

John decides he wants to create a revocable living trust so he can retain access to these assets, but eventually avoid probate at his death. John's attorney creates a trust document stating he is the grantor of the John Doe 2023 Trust and will serve as Trustee until his death. He states his son Joe will become trustee at his death or disability. John is the beneficiary for life and then his wife will be the beneficiary after his death. John intends to place all his assets, except for his car, into the trust.

During his lifetime, John has the right to sell or transfer any assets in the trust. At his death or disability, the trust becomes irrevocable, and Joe, as trustee, must follow the instructions of the trust document when managing the property.

In order to move the assets to the trust, John takes the following steps:

1. His attorney will retitle the farmland and his home so the owner is John Doe Trustee, John Doe 2023 Revocable Trust. This generally is accomplished by creating a quit claim deed transferring the property from John Doe to John Doe, Trustee, John Doe 2023 Revocable Trust, and recording it. John discusses this transfer with his mortgage company and insurance company before the transfer to ensure he follows any of their transfer requirements.
2. John will change the owner of his bank account to John Doe, Trustee, John Doe 2023 Revocable Trust.
3. John verifies the bylaws of his closely held corporation allow him to have his stock certificates reissued in the name of John Doe, Trustee, John Doe 2023 Revocable Trust.
4. John executes an "Assignment of Personal Property," transferring all tangible personal property owned now or in the future to the trust.

These changes will move John's assets to the trust. When John writes checks, for example, he must sign them as John Doe, Trustee, rather than as John Doe.

In most cases, funding the trust is more complicated than illustrated above. Those wishing to create and fund a revocable living trust should work with a trusted estate planning attorney. Many details must be considered, such as whether vehicles should be titled in the trust. Grantors must work closely with lenders and home insurers to make sure the title change does not impact the mortgage or insurance coverage. Attorneys also will work with grantors to make sure the homestead exemption is preserved.

Note: Those wishing to establish a revocable living trust as part of their estate plan should work with a trusted attorney. The trust should be part of an individualized estate plan. Some groups promote trusts through seminars and group meetings. Instead of providing individualized service, these groups generally offer cookie cutter paperwork and little assistance with funding the trust.

Irrevocable Trusts

An irrevocable trust has many of the same attributes as a revocable trust, but with more limitations. The most important limitation is that an irrevocable trust cannot be changed, either during the lifetime of the grantor or generally after death. An irrevocable trust also is a separate tax entity that must file its own tax return, IRS Form 1041. Income passed through from the trust to beneficiaries is reported on Schedules K-1.

Creating an irrevocable trust during life is a completed gift. The grantor retains no more control over the assets. If the value of the assets transferred into the trust exceeds the annual exclusion amount for gifts (see Chapter 8), a Form 709, **Gift Tax** Return must be filed. Irrevocable trusts allow a settlor to put property in trust knowing the beneficiaries cannot access it or sell it, unless the instrument permits.

As noted above, a revocable trust becomes irrevocable at the death or disability of the grantor. Therefore, the rules pertaining to irrevocable trusts eventually come into play in the life of a trust that begins as a revocable trust.

Irrevocable trusts can be used to provide for the needs of certain relatives, to reduce tax liability, and to protect assets. Some common types of irrevocable trusts are reviewed here.

Special Needs Trusts

A **special needs trust**, also called a **supplemental needs trust**, provides supplemental benefits to needs-based government benefits recipients without jeopardizing their care. The funds in the trust can provide special benefits, such as a new television or a companion to travel to recreational activities, without affecting benefit eligibility.

Note: In some cases, these goals also may be accomplished through an ABLE account.

Spendthrift Trusts

A **spendthrift trust** often is set up for a relative with creditor problems. Instead of distributing money to the relative and having the money subject to seizure by creditors, a spendthrift trust is established for their benefit. The beneficiary has no control over the assets, cannot transfer any money from the trust, or make any decisions about when a distribution will occur. A trustee may make distributions for the benefit of the relative, based upon the directions provided in the trust document.

Trusts to Minimize Estate Tax

Some specialized irrevocable trusts are established with the primary purpose of minimizing federal estate and gift tax. These trusts may allow the grantor to maximize wealth transferred to heirs, while removing the assets from the **taxable estate**. Common names for these trusts include intentionally defective grantor trusts (IDGT), and grantor retained annuity trusts (GRAT).

Another type of trust sometimes established to reduce future estate, gift, and generation-skipping tax is a dynasty trust. These trusts generally are designed to continue in perpetuity, meaning that after the initial transfer tax is paid, no taxable transfers occur. Future generations, while benefitting from trust property, are not subject to estate, gift, or generation-skipping tax. While some states, such as Iowa, retain rules limiting the life span of a trust, other states, such as Wisconsin, Illinois, and South Dakota, have abolished those rules.

Note: As discussed in Chapter 8, high estate and gift tax exclusion levels mean very few estates currently are subject to estate and gift tax. If those exemption levels decrease, as scheduled in 2026, this could change. Until then, only the very wealthy are creating trusts to reduce estate tax. Most individuals have a greater need for income tax planning discussed in Chapters 9 and 10.

Spousal Trusts

Spousal trust planning was common before 2011, even for spouses without great wealth. **Portability**, explained in more detail in Chapter 8, has changed the landscape significantly. First available in 2011 and made permanent in 2013, a **portability election** allows the estate of a deceased spouse to transfer any unused estate and gift tax exemption to the surviving spouse. This exemption then is applied at the death of the surviving spouse, along with the surviving spouse's own exemption. In other words, portability allows married couples to preserve the estate and gift tax exemption amounts of both spouses without special trust planning.

Although the portability election has made planning with these trusts more infrequent, spousal trusts still may benefit larger estates or help spouses in a second marriage achieve their estate goals.

A-B or **A-B-C trust planning** may help minimize estate and gift tax owed by a marital couple owning property that may be valued at more than twice the exemption amount. At the death of the first spouse, the deceased spouse's assets—up to the amount of the current estate and gift tax exemption—are transferred to an irrevocable trust called a **credit shelter trust** or **bypass trust (B trust)**. No estate tax will be due on those assets at the death of the first spouse. Nor will estate tax be due on the assets (including appreciation) at the death of the second spouse, because the assets are not part of the surviving spouse's estate. This also means, however, that the assets will not receive a step-up in basis at the death of the surviving spouse. While alive, the surviving spouse is only entitled to the income produced from the trust's assets. The principal may not be used for the support or benefit of the surviving spouse, and the surviving spouse may not control the assets.

Under an A-B trust model, the rest of the deceased spouse's estate generally is transferred to a **marital deduction trust**, also called an A trust for the benefit of the surviving spouse. Although the A trust transfer is tax free because of the unlimited **marital deduction**, the trust assets (including appreciation) will be included in the surviving spouse's estate at death. Surviving spouses typically can use the assets in the marital trust any way they choose and may change the beneficiaries of the trust before their death. Because the assets are included in the surviving spouse's estate, they will receive a step-up in basis at the death of the second spouse.

Some spousal estate planning for very high wealth individuals involves a third trust. This planning is usually called A-B-C trust planning. The A and B trusts generally are created as explained above, but the difference between one-half of the marital property and the current exemption amount usually is transferred to a **QTIP Trust** or **C trust**. A QTIP trust is one for which a qualified terminal interest property (QTIP) election is made. This election allows the assets to be included in the estate of the surviving spouse, even though the spouse will only receive income from the trust during his or her life. The surviving spouse also cannot change the beneficiaries named by the first spouse to die. Without a QTIP election, the property in the C trust would be subject to estate and gift tax at the death of the first spouse because it would not be eligible for the unlimited marital deduction.

Even where estate tax is not an issue, spousal trusts sometimes are used to provide lifetime support for a spouse, without giving that spouse control of the assets. This type of planning is common in marriages where the spouses do not share the same children or where one spouse faces creditor liability.

Life Insurance Trusts

Life insurance often is a helpful tool for farm and ranch succession planning. Insurance proceeds can insure liquidity for a farming operation or provide a way to equalize the inheritance of off-farm heirs.

Life insurance is not taxable to the beneficiary, but it is included in the estate of the owner of the policy for estate and gift tax purposes. Although the person whose life is being insured typically is the owner, the policy can be owned by a spouse or a child or a third party. To prevent abuse, if the owner of the policy gives the policy to another person within three years of the original owner's death, the insurance proceeds will be included in the estate of the original owner. Similarly, if the owner of the policy lists the estate as the beneficiary of the policy, the policy proceeds will be included in the owner's gross estate.

Because of these rules, those with estates that may be subject to estate and gift tax sometimes choose to create an **irrevocable life insurance trust** (ILIT). If the trust, not the insured, owns the policy, the proceeds will not be included in the insured's estate at death. Likewise, a trust eliminates the problem of another owner dying before the insured. ILITs are irrevocable trusts created to purchase and own one or more life insurance policies. The trust sometimes is established with a fund to purchase premiums for term policies. Sometimes, a third-party, such as a spouse or child, makes the premium payment. If the rules for creating an ILIT are followed, the life insurance proceeds will pass to the beneficiaries at the death of the insured, and no income, estate, or gift tax will be due.

Because an ILIT is irrevocable, the terms of the trust, including beneficiaries, may not be changed during the life of the insured. One benefit of purchasing term policies is the executor can stop making premium payments, essentially ending the life insurance policy if circumstances change.

Asset Protection Trusts

Some individuals wish to shield their assets from future creditors or allow themselves to qualify for

Medicaid coverage for a nursing home stay. Some attorneys will work with individuals to establish asset protection trusts to achieve these goals. Such planning involves impoverishing the asset holder during their lifetime. Even when taking this drastic step, there is no guarantee goals will be met.

Medicaid is a federal program administered by state law. For this reason, specific qualification rules for Medicaid vary by state. Across all states, however, Medicaid rules provide a five-year look back period. This means if a person gives away assets within the five-year period before they seek to qualify for Medicaid, those assets will be attributed to them for qualification purposes. In other words, they will be deemed to have had those specific assets to pay the cost of their long-term care and they will not qualify for Medicaid if those assets would have been sufficient to cover the cost of care.

Example: Bitty created an irrevocable trust funded with farmland in 2021. She does not receive the rental income; her son Beau receives the income. In early 2024, Bitty needs to go into the nursing home. Within six months, she has no cash reserves left to pay for her care. Since the trust was created within the **five-year lookback** period, Bitty will be ineligible for Medicaid benefits.

If instead, Bitty seeks Medicaid coverage in 2027, the look-back period will have expired, and she will qualify for Medicaid benefits.

Charitable Remainder Trusts

Charitable remainder trusts (CRTs) are created to benefit a charity, while also preserving a right to income for the donor. In some cases, CRTs are used to defer income tax recognition. Chapter 10 discusses CRTs in more detail.

Changing an Irrevocable Trust

As described above, the terms of revocable trusts can be changed at any time. Irrevocable trusts, however, are intended to be permanent. Some trusts, while generally irrevocable, have provisions appointing a **trust protector**, who can amend the trust if situations warrant a change. The terms of most irrevocable trusts, however, are not easily changed.

Sometimes problems arise with the administration of these trusts. Perhaps the grantor did not anticipate a future situation, and the trust is not meeting the grantor's purposes and goals. Other times, there may be irresolvable conflict between a beneficiary and a trustee. Both problems may require court intervention.

Most states provide a process through which some changes can be made to irrevocable trusts. This process, however, is not easy. Sometimes, if all parties (grantor and beneficiaries) agree, certain terms of the trust may be modified. If the grantor has passed away, however, that agreement cannot be secured. In those cases, a court must generally approve a modification. Some states have **decanting** statutes that allow trustees to change terms under certain conditions. In other states, courts can modify the terms of a trust if changes in circumstances warrant such a change. In these cases, court intervention may be costly.

Example: A grantor placed farmland in a trust for the purpose of continuing the family farming operation. The trust specifically states all tillable land must be used for farming purposes. After the death of the grantor, it was determined by the beneficiaries and trustee it would be beneficial to allow solar panels on a portion of the ground.

The trust was established in a state where court approval is required, even if all parties agree to the change. The trustee and the beneficiaries can present their proposed modification to a court for approval. If the court approves the modification, the trustee is free to negotiate with the solar company.

Notes

Chapter 7

Other Key Estate Planning Documents

Anyone planning for the future must consider unexpected events. What will happen if I become disabled? Who will take care of my property and my medical needs? This chapter reviews several key estate planning documents everyone should execute.

Everyone should prepare for the possibility of cognitive disability. Whether because of dementia or an accident, many families every year face this unfortunate reality. As discussed in Chapter 6, revocable living trusts can provide for the seamless management of assets in the event of a cognitive disability.

A financial power of attorney is another document that can grant someone the authority to act on another person's behalf, even after disability.

Financial Power of Attorney

A **power of attorney** (POA) is a document that gives an agent, called the attorney-in-fact, the authority to act on behalf of another. In a typical arrangement, the agent's powers to act are broad. They will be able to sign contracts, move financial assets, and write checks without asking advanced permission from the original owner. The agent is under a **fiduciary duty** to act in the original owner's best interest. Agents risk financial and criminal liability if they mismanage assets or do not act reasonably.

The agent's power to act can be limited by the terms of the document or by state law. Sometimes the principal gives the agent only certain powers. Applicable law varies from state to state about what powers must be specifically given to the agent. Generally, agents cannot change a will. They can change a trust or make gifts if those powers are specifically granted to them. Additionally, real estate transactions usually require the POA form to be recorded.

A power of attorney form must be properly executed to be effective. Notarization often is necessary. Usually, the agent's power to act on the principal's behalf is effective immediately, meaning the listed agent could go to the bank and open an account right after the document is signed. However, the document can allow for the agent to only have power after a certain event or specific date. Additionally, there may be specific language required to ensure the POA is effective only after the principal loses mental capacity. This is called a **springing power of attorney**.

A **durable power of attorney** survives disability. This means the authorized agent can continue to conduct business on behalf of the principal after a cognitive disability is established. This disability usually is proven with a letter from a medical provider. A durable power of attorney prevents a costly conservatorship court proceeding.

No power of attorney authorization survives death. Once the principal passes away, the agent's power ends. In contrast, although a revocable living trust becomes irrevocable at the death of the grantor, the successor trustee has the power to manage the trust after the death of the grantor.

Note: Several agencies, such as the USDA and the IRS, require special power of attorney forms. A general power of attorney authorization usually is not sufficient. Those wishing to authorize an agent to complete USDA-FSA documents on their behalf generally must sign Form FSA-211. Those wishing to authorize an agent to work with the IRS on their behalf must sign IRS Form 2848. If the principal is incapacitated, a pre-existing durable power of attorney form that contains proper information may allow an attorney-in-fact to act on the taxpayer's behalf.

Co-Agents

Although a principal can appoint multiple people to represent them as powers of attorney, appointing two or more agents can create administrative delays and other issues. In some states, an agent must have approval from the majority of other agents before acting, unless the document states otherwise. In other states, all agents must agree.

Example: Lear owns 300 acres of farmland. Lear lists his three daughters Goneril, Regan, and Cordelia, as co-agents for his financial affairs. The POA, which is durable, authorizes the sale, financing, and pledging of real estate.

Lear is subsequently diagnosed with dementia. Goneril and Regan want to sell the land to a third party. Cordelia wants to rent out the land, with the three sisters paying the remaining amount for Lear's care so that the land can remain in the family.

In Iowa, Goneril and Regan could bypass Cordelia's objection and sell the land to a third party. In California, all three would need to agree to sell the land.

Healthcare Power of Attorney

Financial POAs do not authorize an agent to make healthcare decisions on the principal's behalf. Instead, a separate **healthcare power of attorney**, executed in the same way as a financial power of attorney, is required. A healthcare power of attorney authorizes a trusted agent to make medical decisions on the principal's behalf only in the event the principal is unable to make those decisions. A healthcare power of attorney is especially important where the principal wants only a particular person to speak on their behalf in the event of a medical emergency.

Living Will

A second key healthcare document is a **living will**. This document, separate from the healthcare power of attorney, instructs doctors or hospitals about which life-sustaining procedures the person wants if they become terminally ill and are not able to communicate their wishes. A living will can be especially helpful to family members who otherwise are left to make these difficult choices on their own. Living will provisions should be discussed with trusted relatives and the agent for healthcare decisions.

HIPAA Release Form

Healthcare data is subject to strict privacy laws created by the Health Insurance Portability and Accountability Act of 1996 (HIPAA). HIPAA prevents anyone other than the patient from accessing private patient information. A **HIPAA release** or authorization form grants permission for a family member or trusted friend to receive updates about the health of the patient. Without this authorization, the healthcare team is not allowed to disclose health information or even billing and payment records. Many healthcare power of attorney and living will forms include necessary HIPAA authorizations within them. The HIPAA authorization also can be executed as a stand-alone form.

Agent for Final Arrangements

A comprehensive estate plan also should designate a person to oversee the deceased's bodily remains and any desired ceremonies–such as a visitation, funeral, or wake. If a person is not designated, state law will control who can make these decisions.

Storing the Documents

Once estate planning documents are executed, these should be stored in a safe place where these are easily located. As with a will or trust, these documents should not be stored in a safe deposit box because these may be difficult to access when needed. Unlike a will or trust, multiple signed copies of powers of attorney forms can be executed to make sure all necessary parties have the form.

Financial powers of attorney should be given to the named agent, banking institutions, and tax professionals.

Healthcare powers of attorney should be given to the named agent, the primary physician, and local hospitals and treatment centers.

Copies of the disposition of final remains should be given to the named agent and the pre-contracted funeral home, if any.

A living will should be given to a physician and any health care facility providing treatment to the principal.

Notes

Chapter 8

Estate and Gift Tax Rules

When developing an estate and succession plan, it is important to consider how taxes will impact the transfer of property. For certain families, estate planning may be necessary to reduce estate and gift taxes and increase the wealth passed down to future generations. Under current law, however, income tax planning, specifically basis planning, is a more critical consideration for most farmers and ranchers. This issue is detailed in Chapter 9. Despite the current climate, it is important to remember estate and gift tax laws are subject to change, making it crucial for property owners to keep themselves informed of these changes. This chapter reviews current rules and explains estate and gift tax exemption levels are scheduled to decrease by 50% in 2026.

If the estate and gift tax applies, the tax rate is a significant 40%. Consequently, those with appreciating assets, such as farmland, should stay abreast of changing laws and consider whether their estate is at risk of being affected by the estate and gift tax in the future. If so, they should consult with an experienced estate planning attorney to determine what steps can be taken to mitigate this liability.

Estate and gift taxes are discussed together because the current federal estate and gift tax system is "unified." This means the value of assets transferred during life and at death are generally combined to determine the amount of tax due, if any.

Exemption from Tax (Basic Exclusion)

Currently, most Americans are exempt from estate or gift tax due to the large, combined exemption amount, also called the basic exclusion. The **basic exclusion** specifies the maximum value of an estate that can be transferred to others as a gift or after death, without incurring any estate or gift tax liability. As of 2023, the basic exclusion stands at $12,920,000 per person, and in the case of a married couple, each spouse is entitled to their own exclusion. The Tax Cuts and Jobs Act of 2017 temporarily increased the basic exclusion in 2018, and it is annually adjusted for inflation. Compared to a few decades ago, this exclusion is significantly higher, as evidenced by the data.

1997 = $600,000
1998 = $625,000
1999 = $650,000
2000 and 2001 = $675,000
2002-2009 = $1.0 million
2010 = $5 million or opt out with no step up
2011 = $5.0 million
2012= $5.12 million
2016 = $5.45 million
2017 = $5.49 million
2018 = $11.2 million
2019 = $11.4 million
2020 = $11.58 million
2021 = $11.7 million
2022 = $12.06 million
2023 = $12.92 million

Because of the high basic exclusion, the USDA-ERS recently estimated that of the approximately 31,000 principal farm operators expected to have died in 2020, 189 (0.6%) would be required to file an estate tax return, and only 50 (0.16%) would owe federal estate taxes. This high basic exclusion, however, is only temporary. In 2026, the exclusion will roll back to $5,000,000, indexed for inflation. This is the same exclusion that was in effect before 2018.

Note: Congress could choose to extend the increased exemption into 2026 or it could decide to end the increased exemption before that time. No one can accurately predict the actions of Congress. Consequently, farmers and ranchers should review the current status of the exemption each year with their estate planning team.

Even if an estate is not large enough to generate estate tax consequences under current law, estate and gift taxes should be considered if the value of an estate is near the pre-2018 exemption amount. The increase of land prices means more landowners may fall into this category. Most farmers and ranchers own a considerable amount of real and personal property. The value of the property may trigger estate tax if the exemption amount does not keep pace with asset appreciation.

Although the estate and gift tax system is unified, sharing a tax rate and basic exclusion, there are distinctive reporting and filing requirements for each.

The Federal Estate Tax

The federal **estate tax** is a tax imposed on estates that are valued at more than the lifetime basic exclusion amount, currently $12,920,000. Estates that have a value of more than the exclusion amount pay a 40% tax on the excess. This tax generally is paid out of estate funds and is not the responsibility of the heirs of the estate. In general, if an estate passes to the surviving spouse, it will be exempt from estate taxes at the first spouse's death because of an unlimited marital deduction. This **marital deduction**, however, can lead to a large taxable estate at the second spouse's death if that spouse holds most of the property when they pass away.

Portability

Portability may limit the imposition of estate tax at the death of the surviving spouse. If portability is elected at the death of the first spouse, any unused exemption (**deceased spouse unused exemption** or **DSUE**) may be passed to the surviving spouse to be used at their death. At the current exclusion amount, this would result in the estate of the surviving spouse being able to apply up to a $25,840,000 basic exclusion if none of the exemption was used when the first spouse died. To elect portability, the executor of the estate of the first spouse to die must file an estate tax return, IRS Form 706, even if no estate tax is due.

An estate tax return is like an income tax return, but focuses solely on the property the decedent held at death or gave away during life and the value of that property. For taxable estates (those with property valued above the exclusion amount), Form 706 is due nine months after the decedent dies. If the executor files Form 706 only to elect portability, current IRS rules allow the return to be filed up to five years after the date of the death. Whether or not the decedent has a taxable estate or a need to elect portability, it may sometimes be beneficial to file a Form 706 to lock in the tax basis of a hard-to-value asset. If an estate tax return is filed, the IRS has three years to challenge the value of the listed assets. After that time, the IRS may not challenge the listed value when a beneficiary later sells that asset.

Valuing the Gross Estate

The taxable estate is determined by first valuing the decedent's gross estate. The **gross estate** includes all property or interests in property that the decedent holds at death. Property included in the gross estate generally includes cash and securities, real estate, insurance, trusts, annuities, business interests and retirement accounts. The gross estate includes both non-probate property, such as retirement accounts, and probate property.

Note: As discussed in Chapter 2, life insurance proceeds are included in the gross estate of the decedent if the decedent owned the policy, if the estate was the beneficiary, or if the decedent had transferred ownership of the policy to another person within three years of death.

The property or interests held at death generally are valued as of the date of death. In some cases, an alternate valuation six months after death is used. Estate assets are valued at their **fair market value**, which is the value at which the property would change hands between a willing buyer and a willing seller, neither of whom are under a compulsion to sell or buy. In some cases, certain interests in family-owned businesses may be eligible for a **valuation discount**.

Special Use Valuation

Real property used in a farming business may be valued at a lower rate based upon its **special use valuation**. Instead of valuing this property at its "highest and best use," which is the default requirement, this tax code provision allows qualifying property to be valued at a "current use" value.

Special use valuation is made possible by Section 2032A of the tax code. Specifically, for a qualifying family farm, Section 2032A allows a reduction from value of up to $1,310,000 for those who die in 2023. Although this amount is adjusted each year for inflation, it has not kept pace with the appreciation of farmland values that have occurred since the rates were established in 1997. It also is true, however, that not many farmers need to apply special use valuation because few are currently subject to estate and gift tax liability. Under current law, those who may benefit from special use valuation can reduce their estate tax by no more than $524,000.

Special use valuation is complicated, but to qualify, farmers generally must meet the following conditions:

- The decedent must have been a citizen or resident of the United States.
- The executor must elect special use valuation on the estate tax return.
- Every person with an interest in the property must file a consent for the election to be made.
- The property must be **qualified real property**:
    - The adjusted value (FMV - debt) of the real or personal property used in the farming business must be at least 50% of the value of the decedent's gross estate. That amount must pass to "qualified heirs," which include spouse, children, grandchildren, brothers, sisters, nieces, nephews, and spouses of these relatives.
    - During five or more years in the eight-year period ending with the decedent's death, the real property must have been owned by the decedent or a member of the decedent's family and held for use as a farm or other business.
    - The decedent or member of the family must have "materially participated" in the operation of the farm for five or more of the eight years before the earlier of the decedent's disability or retirement or death.

If these requirements are met, the executor is allowed to elect a special use valuation discount. Calculation of this value usually is made by applying a cash rental capitalization formula:

Average annual gross cash rental per acre – property taxes ÷ the average annual effective interest rate for all new Federal Land Bank loans where the land is located (for the most recent five years).

Example: Gus died leaving 400 acres of qualified real property with an average cash rental value of $250/acre and property taxes of $50 per acre. If the average Federal Land Bank Loan rate is 4.57%, the discount value is $4,376/acre ($250–$50)/.0457) or $1,750,547. Because this amount exceeds $1,310,000, the maximum special use valuation discount available to Gus' executor is $1,310,000.

Once a special use valuation is made, **recapture** (requirement to pay back the tax savings) is possible if within ten years, the property is sold to non-family members or the farm ceases to be used for farming purposes. Families wishing to take advantage of special use valuation must discuss this option with qualified counsel and understand the risks and benefits of the provision.

Conservation Easements

Section 2031(c) of the tax code allows an executor to elect to exclude from a decedent's gross estate up to 40% of the value of land restricted by a "qualified conservation easement." To qualify for this reduction, the land must be:

- Located in the United States,
- Owned by the decedent or a member of the family for at least three years before the death, and
- Subject to a conservation easement by the decedent, a member of the family, the executor of the estate, or the trustee of a trust that holds the land.

The qualified conservation easement exclusion may not exceed $500,000.

Taxable Estate

The taxable estate is the difference between the value of the gross estate and permissible deductions. The taxable estate is the amount against which the 40% tax will apply. These deductions include:

- Marital deduction (all property included in the gross estate and passing to the surviving spouse is eligible for the marital deduction).
- **Charitable deduction** (if the decedent leaves property to a qualifying charity, it is deductible from the gross estate).
- Mortgages and debt.
- Administration expenses of the estate.
- Losses during estate administration.

After the net taxable estate is calculated, the value of any lifetime gifts above the amount of the annual exclusion is added to the total. A 40% tax then is calculated on this amount.

The amount of any gift tax paid during the decedent's life is subtracted from this tentative tax, as is the **unified credit** (the amount of tax corresponding to the basic exclusion and any deceased spouse unused exclusion). Any tax remaining is the amount that must be paid by the estate.

Basis Adjustment at Death

When property is transferred at death, it generally receives a **basis adjustment** (often called a **stepped-up basis**). This means the person receiving the property from the decedent will take that property with an income tax basis equal to the fair market value of the property at the time of the decedent's death. Although the value at death usually is greater than the basis in the hands of the decedent, that is not always the case. If the asset has declined in value, the basis will receive a step down. This means the basis in the hands of the beneficiary will be lower than the basis in the hands of the decedent.

Because of the basis adjustment rule, any gain attributable to appreciation during the decedent's lifetime is eliminated. In other words, no **capital gains tax** will be owed if the property is sold shortly after death by the heirs. Similarly, the heirs will have no depreciation recapture for depreciation deductions that were taken during the decedent's lifetime. Conversely, the heirs will have no loss recognition for property that declined in value while the decedent owned it. Chapter 9 explains in more detail the impact of the basis adjustment rules on farm succession planning.

The Federal Gift Tax

Lifetime gifts may be subject to gift tax. As explained above, the estate and gift tax share a combined $12,920,000 basic exclusion in 2023. If lifetime gifts exceed that amount, the gift tax will be due when the gift is made. Otherwise, gifts given during life (above the annual exclusion amount explained below) are included in the calculation of the final estate and gift tax at death.

While alive, a person must file a Form 709 gift tax return for any gift given to an individual if the value of the gift exceeds the **annual exclusion amount**. As noted above, gift tax is only due if the sum of lifetime gifts exceeds the basic exclusion.

Annual Gifting

Beginning in 2023, the annual exclusion amount is $17,000. This means a person can gift $17,000 each year to any number of individuals without having that gift amount count against the estate and gift tax exclusion. If a husband and wife each make a gift to the same person, their combined exclusion for that split gift is $34,000. No Form 709 is filed and no gift tax will be calculated for gifts at or below the annual exclusion amount.

No Basis Adjustment

Unlike transfers at death, a lifetime transfer by gift does not yield a basis adjustment. Instead, the recipient of the gift receives the property with the giver's basis (called a **carryover basis**). For example, if the giver of the gift bought land at $1,000 per acre and gives the property to the recipient when the land is worth $10,000 per acre, the recipient of the gift will receive the land with a carryover basis of $1,000 per acre. If instead the owner of the land dies and passes the land to the beneficiary through the estate, the beneficiary receives the land with a stepped-up basis of $10,000 per acre. High basic exclusion amounts have made basis planning an important part of the succession plan.

Any property gifted to a person within one year of their death will not receive a basis adjustment if the decedent transfers the property back to the donor (or the donor's spouse) at death. This rule limits gifting strategies designed exclusively to achieve a basis adjustment. If the donor **disclaims** the inheritance, the contingent beneficiary will receive a basis adjustment.

Example: Roy owns 10,000 shares of stock with a basis of $1 per share and a fair market value of $100 per share. He gifts the shares of stock to his elderly grandfather and asks his grandfather to transfer the shares back to him through his will at death. Roy's grandfather dies nine months after the stock transfer. Roy inherits the shares with a $1 per share basis.

If Roy disclaims the inheritance, the contingent beneficiary of the shares will receive them with a $100 per share basis.

Generation Skipping Tax

A tax separate from the estate and gift tax is imposed on very wealthy individuals who transfer property to their grandchildren or anyone else at least 37½ years their junior. The so-called generation skipping tax (GST) applies in addition to any estate and gift tax liability for the same transfer. The purpose of the GST is to prevent wealthy families from lessening overall estate tax liability by skipping generations with their gifting strategies. The GST has its own $12.92 million exemption in 2023. The tax applies to transfers in excess of the exclusion amount to those who are 37½ years or more younger than the decedent or donor. If the GST applies, it is a 40% tax.

State Inheritance and Estate Tax

Another factor to consider when planning an estate is any estate or **inheritance tax** imposed by a state. Presently, 12 states impose an estate tax, and six states impose an inheritance tax on at least some heirs receiving inherited property. Iowa, for example, is currently phasing out its inheritance tax, which will end in 2025. For now, however, non-lineal descendants generally must pay a reduced tax on their Iowa inheritance. Some states have significant estate tax and do not share the federal basic exclusion. Illinois, for example, provides only a $4 million exemption for the estate tax, which can climb as high as 16%. Illinois does not offer portability among spouses and does not exempt assets transferred to lineal descendants.

For farmers and ranchers in states with an inheritance or estate tax, state estate tax planning continues to be very important.

Notes

Chapter 9

Income Tax Considerations

In the current environment, many estate and succession planning decisions are driven not by estate or gift tax considerations, but by income tax consequences. Farmers may face significant income tax liability if they sell assets during their lifetime. That liability may dissolve if they hold their property until they die. Conversely, farmers holding property that has declined in value will lose the ability to claim a loss on that property if they hold it until death. This section provides an overview of important income tax considerations affecting transfer decisions.

Income Tax Basis

The income tax liability arising because of a property transfer depends on the **adjusted basis** of that asset. While **basis** often is thought of as the cost, basis is that portion of the asset for which tax liability has already been accounted for. The original basis is determined based upon whether the asset was purchased, gifted, or inherited.

Purchased Assets

For purchased assets, the adjusted basis is the price paid (cost), plus the cost of any improvements made to that asset. For **business assets**, adjusted basis also is reduced by any depreciation or Section 179 expense deductions taken for that asset.

Example: Geri purchased 500 acres of farmland in 2001 at a cost of $3,000 per acre. Geri purchased the land as an investment, not for a farm business. She improved the property with $30,000 in conservation improvements in 2013. Geri's adjusted basis in her land in 2023 is $1,530,000 [$1,500,000 ($3,000 × 500) + $30,000].

Gifted Property

For property received as a gift, the adjusted basis is the basis of the property in the hands of the donor on the date the gift was made, plus the cost of any improvements made to the property after the gift, or the amount of any depreciation deductions taken after the gift was made.

Example: In 2023, Geri from the previous example gives the 500 acres of farmland to her son Greg while she is alive. Greg's basis in the farmland is $1,530,000.

Inherited Property

For inherited property, the adjusted basis generally is the fair market value of the asset on the date of the owner's death, plus the cost of any improvements made, minus any depreciation deductions taken after the property is inherited.

Example: In 2020, Ron died, leaving a fully depreciated combine to his daughter Josi. Because the combine was valued at $100,000 in the year of Ron's death, Josi inherited the combine with a basis of $100,000. She began depreciating the combine, and three years later she decided to sell it. Because she had taken $17,493 in depreciation deductions at the time of the sale, Josi's adjusted basis in the combine was $82,507.

Capital and Business Assets

In addition to the adjusted basis of the asset, the tax liability arising from a sale or exchange depends on the nature of that asset. Was it used in a business, held for investment, or strictly acquired for personal use? The tax law treats assets differently depending upon their use.

Capital Assets

Almost everything a person owns and uses for personal or investment purposes is a **capital asset**. Capital assets sometimes are called **Section 1221 assets**, referencing the section of the tax code that governs the disposition of those assets. Examples of capital assets include:

- Home.
- Car used for personal use.
- Stocks or bonds held for investment.
- Land held for investment.
- Gold, silver, and other metals.

Capital gain generally arises when a person sells a capital asset for more than the adjusted basis of that asset. For these assets, capital gain is the difference between the sales price and the adjusted basis. Capital gain generally is taxed at a preferential rate. This means the tax rate applied to the gain usually is less than the tax rate applied to the same amount of ordinary income, such as income earned as a wage from a job.

If a capital asset loses value, a taxpayer may be able to recognize a **capital loss** upon the sale or exchange of that asset. Capital losses are limited in application, however, because they can only offset capital gain, plus $3,000 of ordinary income per year. Capital losses also are limited to **investment assets**. Although taxpayers must pay tax on any gain arising when they sell a personal use asset, taxpayers cannot recognize a loss upon the sale of these assets.

Business Assets

Assets used in a trade or business, such as farming or ranching, often are called **Section 1231 assets**. These are excluded from the definition of capital assets. Section 1231 of the tax code applies to gain or loss arising from the sale or exchange of depreciable business property and non-depreciable real property used in a trade or business.

Although the tax rules for the sale of business assets are similar to those for capital assets, Section 1231 is more favorable to businesses. In addition to applying the preferential capital gain tax rate for gain arising upon the sale of a business asset, Section 1231 also applies ordinary loss rules to losses. This means a loss arising from the sale of a business asset generally can offset any income, not just capital gain.

Examples of Section 1231 assets used in a farming business include:

- Farm machinery.
- Single purpose agricultural and horticultural buildings (i.e. hog or poultry barns).
- Multi-purpose agricultural buildings (i.e. machine sheds).
- Dairy, draft, and breeding livestock.
- Drainage tile.
- Fencing.
- Land used in the farming business.

Note: Farm products held for sale are not Section 1231 assets. These products include raised and purchased market livestock and crops, such as corn or soybeans. When a farmer sells these products, the net income from the sale is taxed at ordinary income tax rates and subject to self-employment tax.

Depreciation Deductions

The tax law generally allows **depreciation deductions** for property used in a business and property held for investment. Because land does not wear out, it is not depreciable. Other assets, however, have a useful life, meaning they do not last forever. The tax law allows owners to recover the cost of these assets through annual depreciation deductions over the life of the asset (as determined by IRS tables). Depreciation deductions reduce ordinary income.

The current system used for recovering the cost of depreciable assets is the modified accelerated cost recovery system (**MACRS**). Under the general MACRS approach, new farm machinery is depreciable over five years, while used farm machinery is depreciable over seven years. Drainage tile is depreciable over 15 years, while a multi-purpose farm building is depreciable over 20 years. Farmers who wish to slow down depreciation can take deductions using the MACRS-based alternative depreciation system (**ADS**), which allows smaller deductions over a longer period. Taxpayers also can depreciate property using the straight-line method.

Accelerated Cost Recovery

In some cases, the tax law allows for **accelerated cost recovery**. Specifically, **bonus depreciation** and **Section 179** allow taxpayers to immediately depreciate or expense the cost of an asset. While these provisions can provide cash flow to an operating farm, these also can create tax problems down the road when it is time to sell assets or retire.

Bonus Depreciation

Bonus depreciation is additional first-year depreciation sometimes allowed by tax law. While standard depreciation always is available, bonus depreciation is dependent upon Congress enacting special provisions that usually sunset. Congress often allows bonus depreciation when it is seeking to stimulate the economy by incentivizing businesses to purchase assets.

Bonus depreciation works by allowing owners of business or investment assets to depreciate a set percentage of the cost of the asset in the year it is placed into service. From 2018 through 2022, Congress allowed a 100% bonus depreciation deduction for "qualified property." This meant a taxpayer could immediately depreciate 100% of the cost in the year the property was purchased, ready, and available for use. Qualified property includes property used in a trade or business, and property used in an income producing activity. This means cash rent landlords are eligible to take bonus depreciation if they purchase an asset such as drainage tile. Bonus depreciation also is available for multi-purpose farm buildings. Beginning in 2023, the deduction began to phase-down as follows:

- 80% of the cost is deductible if placed in service after December 31, 2022, and before January 1, 2024.
- 60% of the cost is deductible if placed in service after December 31, 2023, and before January 1, 2025.
- 40% of the cost is deductible if placed in service after December 31, 2024, and before January 1, 2026.
- 20% of the cost is deductible if placed in service after December 31, 2025, and before January 1, 2027.

Bonus depreciation is automatic for assets that qualify. If an owner does not wish to take this additional first-year depreciation deduction, they must elect out on their tax return.

Section 179

Section 179 allows those in an active trade or business to immediately expense the cost of tangible personal property (and certain other property). Unlike bonus depreciation, Section 179 only applies to assets used in an active trade or business. In the farming world, poultry barns and hog barns, machinery, grain bins, and drainage tile are eligible for the Section 179 deduction. Multi-purpose farm buildings are not. Cash rent landlords may not use Section 179, because this activity is not considered an active trade or business.

The maximum Section 179 deduction for 2023 is $1,160,000, reduced $1 for every $1 over the $2,890,000 investment limit. Both the section 179 deduction limit and the phase-out threshold are indexed yearly for inflation. Married taxpayers are treated as one taxpayer for purposes of the dollar and investment limits.

Other Considerations

Although Section 179 and bonus depreciation apply to both new and used assets, accelerated cost recovery is not allowed for inherited or gifted assets. It also is not allowed for assets purchased from certain relatives or related entities. For this purpose, siblings are not considered related parties.

Taxpayers can use Section 179, bonus depreciation, and MACRS at the same time. Section 179 is applied first, followed by bonus depreciation and MACRS. Section 179 is very flexible, allowing taxpayers to choose any amount to expense. Bonus depreciation, on the other hand, is limited to the specific percentage allowed for the year. In that respect, bonus depreciation is all or nothing. Section 179 can be taken in an amount up to trade or business income. Bonus depreciation, on the other hand, can create a loss. Adding to its flexibility, Section 179 elections can be changed on an amended return. Conversely, decisions relating to bonus depreciation cannot generally be changed without IRS consent.

Example: Lynn built a new poultry barn in 2023, placing it into service that year. The cost of the building was $200,000. Although Lynn could choose to expense the entire cost using Section 179, the CPA suggests a different approach to help Lynn arrive at the best overall result.

On the 2023 tax return, Lynn expenses $100,000 of the cost using Section 179, takes bonus depreciation for 80% of the remaining basis ($80,000), and will depreciate the remaining $20,000 over the next 10 years.

Recapture

Depreciable assets are either Section 1245 or Section 1250 assets. Sections 1245 and 1250 of the tax code seek to ensure that depreciation deductions (including bonus depreciation and Section 179 deductions) are recaptured or taxed at a fair rate upon the sale or exchange of the asset. To accomplish this purpose, the gain arising from depreciation deductions generally is recharacterized as "ordinary income" and taxed at ordinary income tax rates. This ensures a taxpayer who has offset ordinary income with depreciation deductions will not pay lower capital gain tax rates on the corresponding gain arising from a later sale.

Observation: Although the income offset by the depreciation deductions was self-employment income, self-employment tax is not assessed against taxable gain arising from recapture.

In general, Section 1245 includes depreciable personal property, but it also includes some real property. Section 1250 includes depreciable real property that is not Section 1245 property. The type of property matters because the recapture provisions operate differently.

Section 1245 generally requires depreciation or Section 179 deductions to be recaptured as ordinary income upon the sale of the asset. Recapture is limited to the total amount of depreciation taken or the gain, whichever is less. Common Section 1245 property used in a farming business includes:

- Poultry or hog barns.
- Farm machinery.
- Drainage tile.
- Fence.
- Grain bins.
- Purchased dairy or breeding livestock.

Example: Robin purchased breeding heifers for $50,000 and fully depreciated them. To reduce the herd, Robin later sells them for $20,400. Because these cows were fully depreciated when sold, Robin must pay ordinary income tax on the $20,400 in sales proceeds.

Note: Section 179 expense deductions also must be recaptured if business use falls to 50% or less. This rule does not apply to depreciation deductions.

Section 1250 property used in a farming business includes general-purpose farm buildings. The recapture for Section 1250 is a little less onerous, but more complicated. It requires ordinary income recapture only to the extent the farmer's actual depreciation exceeded straight-line depreciation. The rest of the depreciation (to the extent it is less than the purchase price) is taxed at a special rate (maximum of 25%) for unrecaptured 1250 gain.

Example: Leonard invested $150,000 to build a machine shed in 2018. He fully depreciated the building using 100% bonus depreciation when he placed it into service that same year. If Leonard sells the building six years later (in 2024) when it is worth $175,000, he will have to pay ordinary income tax on $105,300, which is the amount of bonus depreciation that exceeded straight-line depreciation. He will pay up to 25% tax on the $44,700 of depreciation that would have been taken using the straight-line method (unrecaptured 1250 gain), and up to 20% in capital gains tax on the $25,000 that represents the increase in the value of the building since he built it.

Actual depreciation = $150,000

Straight line allowable = $44,700

Actual minus straight line = $105,300

Capital gain = $25,000 ($175,000 - $150,000)

For all property, to the extent the sales price exceeds the purchase price, the resulting gain is taxed at capital gain rates.

Example: Randy and Ruby own 1,000 acres of farmland. They purchased 500 acres in 1974 at a cost of $550 per acre. They purchased 500 acres in 1987 at a cost of $800 per acre. If Randy and Ruby sell their farmland in 2023 for $7,200 per acre, they will have taxable capital gain of $6,525 per acre or $6,525,000. This will be taxed at capital gains rates. Because land cannot be depreciated, it is not subject to Section 1245 or Section 1250 recapture rules. Note, however, some recapture may apply to the sale of farmland if, for example, conservation expenses were deducted or cost share payments previously were excluded from income.

Tax Liability upon Sale

Capital Gain

A special tax rate applies for most capital gain, as defined above. The tax rate for capital gain is dependent upon whether the gain is short-term, which generally arises when the asset is held for one year or less, or long-term, which usually arises when the asset is held for more than one year. Current law affords a preferential rate schedule for **long-term capital gain**. **Short-term capital gain** generally is taxed as ordinary income. As shown in the following chart, the top long-term capital gain tax rate for 2023 is 20%. The applicable tax rate is calculated based on all taxable income, capital gain and ordinary income. In 2023, for those who are married filing jointly, there is no capital gain tax if overall taxable income is $89,250 or below.

Long-Term Capital Gain Rates by Filing Status and Income

Status	0%	15%	20%
Single	Up to $44,625	$44,626 to $492,300	Over $492,300
Married filing jointly	Up to $89,250	$89,251 to $553,850	Over $553,850
Married filing separately	Up to $44,625	$44,626 to $276,900	Over $276,900
Head of household	Up to $59,750	$59,751 to $523,050	Over $523,050

Example: Milt and Lois have $100,000 in taxable income in 2023. $50,000 of that income is long-term capital gain. The 15% tax rate will apply to $10,750 of this capital gain, and no tax will be due on the remaining $39,250 of gain. The $50,000 of ordinary income will be taxed at ordinary income tax rates.

Net Investment Income

In addition to capital gains tax, the law also imposes a net investment income tax (NIIT) on the gain arising from the sale of investment assets. This 3.8% tax applies to net investment income—which generally includes rental income—when the taxpayer's modified adjusted gross income exceeds the threshold levels shown here.

Filing Status	Threshold Amount
Married filing jointly	$250,000
Married, filing separately	$125,000
Single	$200,000
Head of household (with qualifying person)	$200,000
Qualifying widow(er) with dependent child	$250,000

Also called the Medicare tax, Congress instituted the NIIT in 2013 to help pay for the Affordable Care Act. Under current law, active farmers do not pay NIIT on the sale of their farmland or on their self-rental income. Retired farmers, however, generally pay the NIIT on the sale of their farmland and on their cash rental income if their income exceeds the threshold.

Ordinary Income

Income that is not subject to capital gain tax rates—including depreciation recapture and income from the sale of farm products—is ordinary income. The Tax Cuts and Jobs Act (TCJA) of 2017 generally lowered ordinary income tax rates from 2018 through 2025. In particular, the TCJA lowered the top individual income tax rate from 39.6% to 37% and increased the income levels at which higher rates are reached.

In 2026, absent intervention by Congress, the top tax rate again will increase to 39.6%. Additionally, the higher rates will apply to lower income brackets.

Exclusion of Gain for Personal Residence

Section 121 of the tax code allows individuals to exclude from tax up to $250,000 ($500,000 for married filing jointly) of gain arising from the sale of a principal residence (primary home). To take advantage of this provision, the person must have lived in the home for two of the prior five years. After the owner passes away, the estate may take advantage of this exclusion if the decedent met the requirements. Likewise, widows or widowers can take the full $500,000 exclusion if they sell the home within two years of the death of the spouse. Finally, a person who is in the nursing home must only have lived in the home for one out of the last five years before the sale to exclude the gain from the sale of the home from income.

Under Section 121, a taxpayer also may exclude gain from vacant land adjacent to the home if:

- The vacant land was used as part of the taxpayer's principal residence.
- The taxpayer sells the home in a sale or exchange that meets the requirements of Section 121 within two years before or two years after the date of the sale of the vacant land.
- The requirements of Section 121 have otherwise been met with respect to the vacant land.

The gain from the sale of the home and the vacant land are combined and must stay within the $250,000-$500,000 limit. Farmland or buildings that have been used in the farming business cannot be included in the exclusion.

Ordinary Income Tax Rates by Filing Status, 2023

Tax rate	Single	Head of household	Married filing jointly or qualifying widow	Married filing separately
10%	$0 to $11,000	$0 to $15,700	$0 to $22,000	$0 to $11,000
12%	$11,001 to $44,725	$15,701 to $59,850	$22,001 to $89,450	$11,001 to $44,725
22%	$44,726 to $95,375	$59,851 to $95,350	$89,451 to $190,750	$44,726 to $95,375
24%	$95,376 to $182,100	$95,351 to $182,100	$190,751 to $364,200	$95,376 to $182,100
32%	$182,101 to $231,250	$182,101 to $231,250	$364,201 to $462,500	$182,101 to $231,250
35%	$231,251 to $578,125	$231,251 to $578,100	$462,501 to $693,750	$231,251 to $346,875
37%	$578,126+	$578,101+	$693,751+	$346,876+

Self-Employment Income

Wages and self-employment earnings also are subject to employment taxes under the Federal Insurance Contributions Act (FICA) and the Self-Employment Contributions Act (SECA). This includes a 12.4% social security tax on wages or self-employment earnings (capped at $160,200 in 2023) and a 2.9% Medicare tax on all wages or self-employment earnings (no cap).

Since 2013, the law also has imposed an additional 0.9% Medicare tax on wages and self-employment earnings of taxpayers above the income thresholds of $200,000 for single and head of household filers and $250,000 for joint filers.

For many farmers, self-employment tax comprises a large portion of tax liability. For some farmers, however, earned income (and thus self-employment earnings) are very low because of large depreciation or expensing deductions.

Farm Optional Method

Without a consistent history of paying into the social security system, a farmer will not be eligible to draw social security or disability benefits. Nor will their family members be eligible for survivor's benefits. To ensure coverage, farmers are eligible to use the farm optional method to calculate self-employment earnings from a farming business. This method ensures that an eligible farmer can earn quarters of coverage, even when no self-employment tax would otherwise be owed.

Note: Social security planning, which is beyond the scope of this workbook, is an important component of overall retirement planning for farmers.

Sale of Farm Products

Net income a farmer or retiring farmer receives from the sale of farm products is subject to self-employment tax. This includes income from selling grain in the bin after retirement or crop share income received by a materially participating landlord. Self-employment tax also applies to farm program payments, crop insurance proceeds, and net income from the sale of market livestock.

Rental Income

Land rental income is not subject to self-employment tax. This includes income from cash rent and non-materially participating leases. It also includes rental income received from a commonly owned farming entity through a self-rental arrangement. Rental income received under an equipment lease generally is subject to self-employment tax unless the equipment is rented along with land.

State Income Tax

In addition to federal tax liability, most farmers also must consider state tax consequences arising from the sale of farm assets. In 2023, eight states have no state income tax. These states include Alaska, Florida, Nevada, South Dakota, Tennessee, Texas, Washington, and Wyoming. Farmers in other states, however, must add state tax to the tax they must pay when they dispose of assets. In Iowa, for example, the top tax rate in 2023 is 6%. Farmers who sell land used in the business of farming may be able to deduct the capital gain from the sale from their Iowa taxable income.

Notes

Chapter 10

Income Tax Planning for the Transition

Selling Assets

As explained in Chapter 9, farming assets are subject to many different tax rules. Because farmers generally depreciate and expense their assets and because land generally appreciates in value, farmers often face significant tax liability if they choose to sell their assets.

The chart on the right illustrates the taxable gain associated with a 400-acre crop and livestock farm. This is especially problematic for farmers wishing to retire or transfer the farm to the next generation.

If the owner of this farm were to liquidate the assets, the sale would result in $6,370,000 of taxable gain, generating a federal tax bill of around $1.5 million.

Any state tax would further increase the tax liability. If the farmer were to hold the land, buildings, and bins, but liquidate the other assets, the federal tax bill would approach $500,000.

Holding Assets until Death

Under the current tax law, all tax liability disappears when the owner dies. As shown in the chart on the following page, if the owner of the farm were to pass away, the basis of the farm assets would step up to their fair market value on the date of death (or six months after if an alternate valuation method is used). If the heirs were to sell the assets, they would recognize no gain on the sale and they would incur no tax liability. If they were to hold onto the depreciable assets and use them in a farming business, they could again depreciate them.

Note: Although typical farm assets increase in value, any assets that have decreased in value while the farmer owned them will have a step-down in basis at death. For this reason, farmers should sell these assets while alive to offset other income with the recognized loss.

Tax Attributes of Assets from 400-Acre Crop and Livestock Farm

Asset	FMV	Basis	Gain	Character
Raised dairy and breeding heifers (at least 24 months)	$75,000	0	$75,000	1231 Gain
Farmland	$4,800,000	$800,000	$4,000,000	1231 Gain
Purchased dairy and breeding heifers	$200,000	$50,000	$150,000	1245 Gain
Machinery	$600,000	$150,000	$450,000	1245 Gain
Poultry, hog or dairy barn	$250,000	0	$250,000	1245 Gain
Bins	$75,000	0	$75,000	1245 Gain
Multi-purpose building	$500,000	$100,000	$400,000	1250 Gain
Personal residence	$300,000	$100,000	$200,000	Excluded
Raised dairy and breeding (< 24 months)	$30,000	0	$30,000	Ordinary
Feed inventory	$50,000	0	$50,000	Ordinary/ SE Tax
Stored grain	$500,000	0	$500,000	Ordinary/ SE Tax
Supplies and fuel	$40,000	0	$40,000	Ordinary/ SE Tax
Livestock held for sale	$150,000	0	$150,000	Ordinary/ SE Tax
	$7,570,000		**$6,370,000**	

This tax rule makes it more difficult for younger farmers or the next generation of farmers to own assets. Because older farmers who sell appreciated or depreciated assets will face high income tax liability if they sell, many choose to own their assets until death.

Gifting the Assets

If the retiring farmer were instead to gift some of the assets while living instead of waiting to pass them on at death, there is no present tax liability from the gift, assuming the gift combined with all other lifetime gifts is below the basic exclusion amount discussed in Chapter 8.

The trade-off, however, is that the recipients of the gift take the property with a carryover basis equal to that of the owner. For farming heirs, this means, for example, that they would take fully depreciated machinery with a zero basis and would have no additional depreciation to deduct while using the equipment.

Some older owners of farmland choose to gift the land while they are alive to encourage their heirs to never sell. They reason that if the basis is low and the tax liability in a sale would be high, the heirs will choose to hold onto the property instead of sell it.

Occasionally, lifetime gifting may lower tax liability. Inventory in the hands of a non-farming heir, for example, is not inventory, but a capital asset. Consequently, a farmer may gift grain to a non-farming adult child. That grain is a capital asset (not inventory) in the hands of the non-farmer, meaning that if the one-year holding period is met and the recipient sells the grain, it would be taxed at long-term capital gain tax rates (maximum of 20%) instead of ordinary income tax rates (maximum of 37%), plus self-employment tax. Special kiddie tax rules apply to grain gifted to dependent children.

Strategies for Mitigating Income Tax Liability

Farmers who wish to sell some of their assets while they are living may consider several strategies to lessen their tax liability.

Like-Kind Exchange

A special provision of the tax code, Section 1031, allows those who own real property used in a trade or business or held for investment to exchange that property for any other business or investment real property and defer the recognition of gain from that exchange. Deferring recognition of gain means that no tax on the gain will be due unless the farmer later sells the newly acquired property.

Tax Attributes of Same Assets after Owner Dies

Asset	FMV	Basis	Gain	Character
Raised dairy and breeding (at least 24 months)	$75,000	$75,000	0	1231 Gain
Farmland	$4,800,000	$4,800,000	0	1231 Gain
Purchased dairy and breeding	$200,000	$200,000	0	1245 Gain
Machinery	$600,000	$600,000	0	1245 Gain
Poultry, hog or dairy barn	$250,000	$250,000	0	1245 Gain
Bins	$75,000	$75,000	0	1245 Gain
Multi-purpose building	$500,000	$500,000	0	1250 Gain
Personal residence	$300,000	$300,000	0	
Raised dairy and breeding (< 24 months)	$30,000	$30,000	0	Ordinary
Feed inventory	$50,000	$50,000	0	Ordinary/SE Tax
Stored grain	$500,000	$500,000	0	Ordinary/SE Tax
Supplies and fuel	$40,000	$40,000	0	Ordinary/SE Tax
Livestock held for sale	$150,000	$150,000	0	Ordinary/SE Tax
			$0	

Example: Lionel, who farms in western Iowa, wants to move to eastern Iowa to be closer to grandchildren. His 500-acre farm has a basis of $600 per acre. It is now worth $11,500 per acre. Lionel has found a farm in eastern Iowa of equal value.

Using a Section 1031 exchange, current law allows Lionel to sell his farm in western Iowa and reinvest the proceeds into the farm in eastern Iowa without incurring tax liability. Lionel’s basis in his new 500-acre farm (also worth $11,500 per acre), is $600 per acre.

To receive tax deferral through a **like-kind exchange**, a farmer must engage knowledgeable counsel. Unless the farmer is directly swapping property with another person, a third-party intermediary must be employed to hold the funds from the sale of the relinquished property and use the funds to purchase the new property. From start to finish, a like-kind exchange must be completed within 180 days or by the tax return due date (including extensions) for the year of the exchange, whichever is earlier.

Note: Since 2018, farmers can no longer complete like-kind exchanges for personal property such as machinery. A machinery trade now is treated as a sale and a purchase, rather than a tax deferred exchange.

Farm Income Averaging

Some farmers may reduce the income tax liability arising from the sale of some of their farming assets by using **farm income averaging**. This is a special provision available only to farmers, recognizing that farm income may vary significantly from year to year. If a taxpayer has a sudden spike in income, more of that income is taxed at a higher right under the marginal tax rates system than if that same income had been spread out evenly over several years. Income averaging allows farmers to take some income from the current high-income year and drop it into unfilled tax brackets from the three prior tax years. The goal is to reduce the overall marginal tax rate applied to the income.

Farm income averaging may be used for gain from the sale of all farming assets, except land. It may even be used for the gain arising from the sale of buildings on the land. Farm income averaging reduces only income tax liability. It does not reduce self-employment tax.

Installment Sales

Structuring a sale of assets as an **installment sale** can reduce income tax and net investment income by spreading income over future years where it may be taxed at lower rates. This can benefit a farmer wanting to get out of business, particularly when the farmer expects future income to be low and is not looking to reinvest in other farm assets. It also can benefit a buyer by reducing the cash flow burden.

Although the tax savings of an installment sale can be significant, this approach is not without drawbacks. The seller acts as a lender, thus incurring the risk of a defaulting buyer. Additionally, the installment method does not defer the recognition of Section 1245 gain. All recapture income (as explained in Chapter 9) must be recognized in the first year of the sale, regardless of the amount of the first payment. As such, installment sales should not be used for the sale of depreciated assets. Installment agreements may, however, be a useful tool for the sale of land, market livestock, or stored grain.

Another drawback of an installment sale is there will be no step up in basis if the seller dies before all payments are completed. The heirs will continue to receive the installment payments after the seller dies, but they will continue to pay tax on the portion of the installment payment attributable to gain. The payment is considered **income in respect of decedent (IRD)**.

Installment contracts must include a minimum rate of interest or part of the sales price is automatically treated as interest and taxed as ordinary income. This minimum rate of interest required is called the **Applicable Federal Rate (AFR)**. IRS publishes a monthly revenue ruling announcing AFRs for short-term (three years or less), mid-term (more than three years but less than 10 years) and long-term (10 years or more) contracts. The AFR need not be charged when: the total sales price is $3,000 or less, or, all contract payments are to be made within one year of the sale date.

In addition, no interest must be charged on payments made within six months of the sale date, regardless of the length of the contract.

A special rule applies to the sale of land between family members. The tax law sets the interest rate at the lesser of the AFR or a 6% rate compounded semi-annually for these sales. This rule applies only to $500,000 of land sales in any given tax year.

Note: Farmers should be wary of promoters that promise tax deferral that sounds too good to be true. The IRS has warned that so-called "monetized installment agreements" that promise decades of tax deferral with no monetary risk do not meet the criteria for an installment sale. Entering into one of these contracts could subject a farmer, upon audit, to immediate tax liability, plus significant penalties and interest. Farmers should seek advice from a trusted tax professional before entering into any installment agreements.

Charitable Remainder Trusts

Charitable remainder trusts (CRTs) may be beneficial to a charitable-minded farmer facing a large influx of taxable income from highly appreciated property or property that would trigger high tax liability if sold. For example, a retiring farmer, a farmer holding a large amount of stored grain or machinery, or a farmer liquidating a dairy herd or farmland may be able to use a CRT to spread out income across multiple tax years, lowering overall tax liability, while also benefitting a charity.

CRTs are split-interest trusts in which a non-charitable beneficiary receives a stream of income for the duration of the trust, and a designated charity receives the remaining trust assets upon termination. Common CRTs include charitable remainder annuity trusts (CRATs) or charitable remainder unitrusts (CRUTs), depending on the method used to calculate the payment amounts. CRATs and CRUTS usually involve the following basic steps:

1. The farmer works with an attorney to create an irrevocable CRT.
2. The farmer transfers assets into the CRT.
3. The farmer may qualify for a charitable contribution deduction, depending upon the type of the asset and its basis. (Contributions of raised or fully depreciated non-capital gain property, such as stored grain or machinery, will yield no charitable deduction because the basis of the property is zero.)
4. The charity sells the assets—without present tax liability—and invests the proceeds.
5. The CRT generally makes regular income distributions to the donor for the donor's lifetime, or for a set number of years between two and 20.

The income the donor receives from the annual payments is taxable, but likely is taxed at a lower tax bracket than if the donor had received income from the sale of all of the property at once. Payments will be taxed as ordinary income if the assets put into the trust would have been taxed as ordinary income. These will be taxed at capital gain rates if the property would have been taxed as capital gain.

The amount remaining in the trust is paid to the named charity upon the termination of the trust. If the grantor of the trust dies before the end of the trust term, the beneficiaries will continue to receive the income stream.

Example: In 2023, Rodney is retiring from farming. He has $1 million in fully depreciated machinery and grain on hand that he would like to sell. If he sells the property outright, however, he will pay more than $400,000 in tax, leaving $600,000 to invest for retirement. Rodney also wants to donate to his favorite charity.

Amount transferred to CRT	**$1,000,000**
Annuity trust payout (AFR Aug 2022 = 3.8%)	$78,400 for 15 years
Present value of annuity	$899,292
Present value reminder	$100,708

After meeting with his advisors, Rodney decides to contribute the machinery and the grain to a CRAT. He receives no charitable deduction for this contribution (because the basis of the property is zero), but the CRAT sells the assets without paying any tax. The CRAT then invests the $1 million proceeds in diversified funds.

Rodney, who is 65 years old, chooses a 15-year term, with a distribution percentage of 7.84%. His terms are shown here:

If Rodney passes away before the 15 years is up, his heirs will receive the income stream. Rodney will receive a fixed income stream of $78,400 for 15 years, and the charity will receive a projected $100,708 when the trust terminates. Because Rodney's payments are level, he can keep his income in a lower bracket. Rodney will pay ordinary income tax on the payments, but these will not be subject to self-employment tax.

Note: IRS has warned that some promoters are encouraging farmers to create illegitimate charitable remainder trusts. The hallmark of these arrangements is that they promise tax-free annuity payments over the course of several years. This is another example of the rule that tax savings devices that sound too good to be true generally are.

Rental Arrangements

Many retiring farmers will choose to rent their land or their equipment to another farmer. Renting equipment can be an especially good strategy for older farmers in a family business.

Selling the depreciated equipment would create significant tax liability, but renting the equipment provides the farmer with yearly income. The rental income will be subject to ordinary income tax rates and self-employment tax. If the equipment is rented with the farmland, the rent is subject to ordinary income tax rates, but not self-employment tax.

Retiring farmers can rent their equipment until they die, when the basis of the machinery will step up to the fair market value. The farming heirs could then depreciate the equipment again, although bonus depreciation and Section 179 are not available to inherited assets.

In structuring the rental arrangement, the lease rate can be based on the fair market value of the machinery, using a reasonable capitalization rate.

Renting farmland, buildings, or livestock is another common retirement strategy for farmers. Farmers renting property through a standard cash lease, or a nonmaterially participating share lease are subject to ordinary income tax, but not self-employment tax, on the rental income. The same would be true for most flexible leases. Only leases under which the farmer materially participates are subject to self-employment tax.

Business Entities

Business entities, in particular LLCs taxed as partnerships, may provide additional options to farmers wishing to retire from the business. These entities can provide a workable structure for transferring the management and equity of a business. Likewise, tax-advantaged redemption options for retiring partners may be more favorable than installment sale provisions. More information about business entities is included in Chapters 11 and 12. Farmers considering their options should seek trusted counsel experienced in farm business succession.

Notes

Chapter 11

Introduction to Business Entities

Estate and succession plans may include business entities to facilitate the transfer of the business after death. Entity planning should be a topic discussed with the estate and succession planning team. While these are not necessary for everyone, business entities can provide many benefits, including:

- Creating a workable management and governance structure.
- Limiting personal liability of owners.
- Preventing partition of farmland.
- Providing a mechanism for transferring ownership and management.
- Allowing for valuation discounts.
- Expanding tax planning options.
- Allowing for outside investment.
- Maintaining family control of farmland or business.

On the downside, business entities may increase operational costs and complexity or reduce eligibility for farm program payments. This chapter explores and explains key features of common business structures. Chapter 12 discusses some planning options.

Overview of Common Business Structures

Sole Proprietorships

Individual ownership is the default structure for those operating businesses on their own. A major benefit of a **sole proprietorship** is simplicity.

Individual ownership means the business is not a distinct entity apart from the owner. The individual will own all assets in his or her own name and will be responsible for all management decisions.

General Partnerships

A **general partnership** is formed when two or more individuals conduct business together for a profit. While most partnerships are formed through an intentional agreement, partnerships can arise inadvertently through conduct. General partnerships are managed by the partners. State law provides the default rules for formation, operation, and termination of a partnership. Instead of operating by the default rules, however, partners should execute a written partnership agreement establishing at the very least:

- The purpose of the partnership.
- Required **capital contributions** from each partner.
- Management and voting rights.
- Profit and loss allocations.
- Whether guaranteed payments will be made.
- How partnership interests and rights may be transferred.
- A **buy-sell agreement**.

Certain legal obligations cannot be bargained away. For example, the partnership agreement cannot eliminate the fiduciary duties of loyalty, care, or good faith imposed on the partners toward each other. Additionally, partners generally have the right to see **business records** during the years they were partners.

Limited Partnerships

Many states allow **limited partnerships**. These entities retain many elements of the general partnership while also offering **liability protection** for owners called **limited partners**. **General partners** make managerial decisions and control the business, while limited partners provide capital and share in profits and losses. They do not make business decisions. In other words, limited partners are the investors and general partners are the managers. A limited partnership must have at least one general partner and one limited partner.

Partners establish a limited partnership by filing a Certificate of Limited Partnership with a state agency where the partnership is located. The limited partnership usually requires ongoing reporting to the state. For example, in Iowa, the limited partnership must file a biannual report with the Secretary of State.

Note: Many states also allow limited-liability partnerships. These entities are very similar in features to limited liability companies and will not be reviewed separately here.

Corporations

Corporations are formal business entities created when an incorporator files **articles of incorporation** with a state agency. The articles of incorporation include basics such as the corporate name, number of shares, and the identity of the incorporators. Once established, the corporation must continue to file regular paperwork with the applicable state agency, informing the public of its officers and the identity and location of its registered agent.

Shareholders, **directors**, and **officers** are the key participants in the management of a corporation. A shareholder participates in the business through voting for the **board of directors**. The directors are responsible for ensuring the business operates and generates a profit. The directors generally appoint corporate officers, such as the president, vice president, and treasurer of the corporation. Corporate officers generally manage the day-to-day operations of the corporation.

After a business is incorporated, the board of directors creates **bylaws** to govern the management of the business. In all states, corporations offer liability protection to their shareholders, directors, and officers. In exchange, the corporation must follow rigid formalities, such as holding regular meetings, keeping minutes, and maintaining adequate business records. Because they are separate from their owners, corporations continue after the death of the owners. Once it is created, a corporation must be formally dissolved if the business ends.

While very popular among some farmers in the 1970s and 1980s, corporations have become less popular with the rise of the **limited liability company (LLC)**. As discussed below, corporations are no longer the entity of choice for owning farmland or equipment.

Limited Liability Companies

The LLC emerged in 1977 and has since become the most popular business entity across the country. The LLC blends the liability protection of corporations and the flexible management features of partnerships to create a robust hybrid entity.

An LLC is formed by filing a **certificate of organization** with the proper state agency. In general, LLCs require fewer formalities than a corporation. For example, LLC owners must file biennial reports with the state agency, but member meetings are not required by statute. Although written **operating agreements** should be in place for all LLCs, these are not required. Owners of LLCs are **members**. They own **interests** in the LLC in a similar way shareholders own shares in a corporation.

LLCs can choose between two management structures: manager-managed or member-managed. If the operating agreement is silent, the default rule in most states is that the LLC is managed by its members.

In a **member-managed LLC**, the members have equal rights to participate in the daily management of the business. In a **manager-managed LLC**, the managers oversee the daily operations. Even if the LLC is manager-managed, members must vote to sell company property, to amend the operating agreement, or to conduct activities outside of the ordinary course of business.

Managers owe the members a duty of loyalty and a duty of care. Courts have interpreted this to mean a manager must refrain from **self-dealing** and must act in the best interest of the company. In a member-managed LLC, members owe the same duties to fellow members.

Key Features of Business Structures

Limiting Personal Liability

The default rule is owners of a business are personally liable for all debts and obligations of that business. This means a creditor or someone injured in a negligence action could recover against personal assets that are unrelated to the business, if insurance coverage or business assets are insufficient to meet the obligation.

Recognizing this difficulty, state statutes give limited liability protection to owners of certain business entities. These statutes generally provide that the debts, obligations, and liabilities of the business are those of the business alone, not the owners. To receive this protection, however, the business must formally organize and file paperwork putting the world on notice of its limited liability status.

Because they have not been formally organized, sole proprietors and partners in general partnerships remain personally liable for all debts and obligations of the business. This means if the business defaults on a loan, fails to fulfill a contract, or is the subject of a large legal judgment, any of the owners' non-exempt assets may be accessed by the creditor through judicial process, if necessary, to pay the debt.

Example: Riley and Taylor operate a cattle business as a general partnership. The partnership rents its land from Riley, who owns it individually. Riley and Taylor contribute equal capital and labor to the business and share equally in profits and losses. Unfortunately, Taylor hits another vehicle while hauling livestock for the business, severely injuring the other driver.

Although he was not involved in the accident, Riley is personally liable for damages assessed against the partnership in a subsequent lawsuit. If the judgment amount exceeds the assets of the partnership, Riley's personal assets, including his land, are at risk.

Liability insurance can mitigate this risk, but judgments in serious accidents can exceed even substantial policy limits.

One major incentive to create a corporation or an LLC or a limited partnership is the liability protection afforded to the owners of these entities. If a creditor obtains a judgment against a corporation, for example, only the corporation's assets are at risk. Assets owned by members of LLCs or shareholders of a corporation generally are protected, with a few exceptions.

Members of an LLC or shareholders or officers of a corporation remain personally liable for their own **tortious conduct**, such as negligence, even when it is committed in the scope of employment. Similarly, if a member or shareholder personally guarantees a loan for the business, they will be personally liable for that debt. Even so, an entity with liability protection can shield owners from many unexpected risks. If, for example, Riley and Taylor from the last example place their partnership into an LLC, the difference is significant.

Example: Riley and Taylor operate a cattle business as an LLC. The LLC rents its land from Riley, who owns it individually. Riley and Taylor contribute equal capital and labor to the business and share equally in profits and losses. Unfortunately, Taylor hits another vehicle while hauling livestock for the business.

Because the cattle business is an LLC, Riley is not personally liable for damages assessed against the LLC in a subsequent lawsuit. If the judgment amount exceeds the assets of the LLC, Riley's land is not at risk. Note that Taylor may remain personally liable for the accident because her negligence was the cause. The injured driver could sue her in her individual name.

Taxation

Sole Proprietors

Sole proprietors report business income on their individual income tax returns. A farmer or rancher will file an IRS Form 1040 along with a Schedule F, which reports all farm income and expenses. Farm income includes the sale of livestock or produce, cooperative distributions, crop insurance proceeds, and agricultural program payments. Sole proprietors pay self-employment (SE) tax on their farm income.

Partnerships

A legal partnership is a pass-through entity for tax purposes. This means income and losses pass through the entity and are included or deducted directly by the partners. Although the partnership does not pay taxes, it must complete its own tax return, Form 1065, to report partnership income and losses. Each partner receives a Schedule K-1, which allocates profits and losses and some separately stated deductions among the partners. Partners generally report the information from the K-1 on Schedule E of Form 1040.

The default rule under the Uniform Partnership Act is that partners split profits and losses equally. The partnership agreement, however, can alter this arrangement. The IRS will honor the allocations established by the partnership. Partners in a general partnership pay self-employment tax on net profit **distributions** and guaranteed payments. Limited partners in a limited partnership do not pay self-employment tax on distributions. They must, however, pay SE tax on any guaranteed payments. Guaranteed payments are like wages, but partners can never be employees and do not receive a W-2.

Income generally retains its character and tax features when passing through to the partners. For example, rental income passing through to partners is not subject to self-employment tax. Similarly, long-term capital gain will be taxed at a preferential rate on the partner's return.

When a partner dies, the basis of the partnership interest is adjusted to fair market value. The partnership also can make a Section 754 election to adjust the basis of the deceased partner's interest in the underlying assets to fair market value as well. For this reason, partners do not lose the benefit of a step-up in basis at death for property owned by a partnership.

Note: Spouses who farm together may elect to operate as a qualified joint venture instead of a partnership. This is an option available only to spouses for tax purposes. With a joint venture, the spouses jointly file their Form 1040, but each spouse files a separate Schedule F. If the couple chooses to operate as an LLC, they generally do not have the joint venture option and must file a Form 1065 partnership return. One exception to this rule is in community property states where spouses may be able to treat their LLC as a disregarded entity for tax purposes.

Corporations

A corporation is taxed as a **C corporation** by default. The board of directors also may elect to be an **S corporation** using IRS Form 2553. Both names are derived from the specific subchapter of the tax code, which governs the taxation of the entities. Except for very different tax rules, S corporations and C corporations are the same.

The business income of a C corporation is "double" taxed. It is first taxed at the entity level at a flat rate of 21% and again taxed at the shareholder level when **dividends** are paid. Dividends are taxed at a maximum rate of 20%. The wages of owner-employees also are subject to employment tax.

C corporations file IRS form 1120 and pay their own income tax. Dividends are reported to shareholders on a 1099-DIV. C corporations may provide tax-favored fringe benefits, such as healthcare insurance, to their owners.

Conversely, S corporations are pass-through entities, meaning income tax is paid at the shareholder level, not the corporation level. Like a partnership, the S corporation must file a tax form, IRS Form 1120-S. The corporation also must provide Schedule K-1s to the shareholders. S corporation shareholder-employees receive a W-2 wage for which employment taxes are paid. Although shareholders must be paid "reasonable compensation" for their services, any distributions of net profit beyond this compensation are not subject to self-employment tax.

Note: Some advisors will recommend that all farm businesses incorporate and make an S election to save self-employment tax. Before taking such a step, a farmer should meet with a trusted tax advisor to see if that option is a good fit. Although S corporations can be a good option for some, in other cases, the promised savings may be illusory, and incorporation will complicate tax compliance.

S corporations have some restrictions. These can only have one class of stock, which can limit flexibility. Despite this limitation, if the stock has identical rights with respect to distribution and liquidation proceeds, the S corporation may issue voting and non-voting stock. Generally, only individuals and certain trusts and estates may hold stock in an S corporation. Partnerships, corporations, or non-resident alien shareholders cannot own stock in an S corporation. Violating these rules can cause the S election to terminate, and the entity will revert to being taxed as a C corporation.

When a corporate shareholder dies, the basis of the shares is adjusted to fair market value. The basis of the underlying assets, however, does not receive a basis adjustment. This means appreciated assets within a corporation are difficult to get out without tax liability, even at the death of a shareholder. This is true for both C corporations and S corporations, although the S corporation has only a single level of taxation.

Note: S corporations owning farmland must be careful about cash renting the ground. If an S corporation with accumulated earnings and profits (from a time when it was a C corporation) has passive income in excess of 25% of its gross receipts in three consecutive tax years, the S election is terminated on the first day of the following year. This problem is avoided if the lease requires the corporation to provide significant services. Owners of S corporations wishing to rent their farmland should consult with a knowledgeable tax advisor about options.

Limited Liability Companies

LLCs can elect to be taxed like a partnership, a C corporation, or an S corporation. If an LLC consists of a single member, the entity is, by default, disregarded for tax purposes, and the business is taxed like a sole proprietorship. Even so, the owner of a single member LLC can choose to be taxed like a C corporation or an S corporation. If there are two or more members, an LLC is, by default, taxed like a partnership. Multi-member LLCs may instead choose to be taxed like a corporation. There are no special tax provisions or forms for LLCs.

LLC members who exercise management or control over the business are subject to SE tax on net income if the entity is taxed as a partnership. LLC members who do not exercise control or manage the business are treated like limited partners. They are not required to pay SE tax on their distributive earnings. All LLC members must pay SE tax on guaranteed payments. Despite these general rules, some ambiguity exists with respect to when LLC members must pay SE tax on distributive earnings. LLC members should discuss self-employment tax requirements with their tax advisors.

When an LLC member dies, the basis of the membership interest will be adjusted to fair market value. The basis of the underlying assets can only be adjusted if the LLC is taxed as a partnership or a disregarded single member LLC. If the LLC is taxed as a corporation, the basis of the underlying assets is not adjusted.

Farm Program Payments

Farm program payments are an important consideration for any farm business. Although the rules vary across specific programs, the general rule is that a person or legal entity is not eligible to receive farm program payments or benefits if their average yearly adjusted gross income (AGI) over the past three years exceeds $900,000. Additionally, most farm programs have payment limitations, meaning each person or entity is limited to a maximum payment per program. For many programs that limit is $125,000. Sole proprietors and general partners in a partnership have their own AGI limit and payment limitation. This means all partners actively engaged in farming generally are eligible for a farm program payment, up to applicable limits.

Other entities, however, generally are subject to AGI limits and payment limitations at the entity and the owner level. In other words, it does not matter how many owners an LLC or a corporation has, the entity itself is ineligible for a farm program payment if its average AGI exceeds $900,000. Similarly, an LLC may be limited to a single $125,000 payment for a particular program. If one member of a five-member LLC is ineligible, the LLC will receive only $100,000.

Farm program payment eligibility is an important factor to consider when choosing a business structure. In recent years, some ad hoc programs such as the Emergency Relief Program and the Market Facilitation Program have relaxed these entity restrictions. Even so, these remain a fundamental part of the farm program payment scheme.

What Happens at Death?

Because a sole proprietorship is not an entity, the business “dies” along with the owner. At the owner’s death, the assets of the business will pass according to the owner’s estate plan, if one was created, or through the intestacy process if no planning was done. This process is discussed in Chapter 3.

Planned transfers during life include transfers by gift or by sale. The tax consequences of these options are discussed in Chapter 10.

When a partner dies, the partnership interest passes according to the partner’s estate plan. The partnership agreement, however, will determine whether and how the partnership continues and what will happen with the deceased partner’s interest. In many cases, a buy-sell agreement will pay the deceased partner’s heirs the value of the interest. In other cases, the heirs may step into the shoes of the deceased partner. If no **partnership agreement** exists, default state law controls.

An LLC generally will continue to exist as a separate entity after the death of an owner if the LLC continues to have at least one member. Absent special provisions in the operating agreement, an LLC member can only transfer a right to distributions, not management authority, when they die. Thus, the heirs of a deceased member generally will become **transferees**, not members, absent a contrary provision in the operating agreement or documented action by the other members.

When a shareholder of a corporation dies, the shares are transferred according to the estate plan or by intestacy. Corporate bylaws or a buy-sell agreement generally define the rights of these shareholders. If there is no agreement and the bylaws are silent, the heirs will have the same voting rights as the decedent. When a board member or officer dies, the vacancy will be filled according to the terms of the bylaws.

Note: Many estate plans place business entity interests, such as shares or membership interests, into a revocable living trust. At the death of the owners, the shares are transferred according to the terms of the trust. Caution should be exercised when transferring S corporation shares to ensure the shares do not remain in a standard trust after death. This can invalidate the S election. Some business entity interests also can pass outside of probate with transfer on death designations. Farmers should discuss the best options for transferring their business entity interests with their advisors.

Notes

Chapter 12

Transfer Strategies

Different goals require different planning strategies. This chapter discusses several strategies designed to achieve common succession planning goals of farmers and ranchers. Although examples are helpful, every family's needs will be different, and each plan should be customized to meet those specific needs.

Several common transition goals addressed in this chapter include:

- Continuing the viability of the farm business.
- Providing for the financial needs of the retiring owners.
- Providing for the financial needs of the successor farmer(s).
- Keeping farmland in the family.
- Allowing farmers to farm, but leaving an inheritance to nonfarmers as well.

Using Entities to Transfer the Business

Many farmers want their farming business to continue beyond their retirement, disability, or death. In these cases, the farmer often wishes to bring other family members into the operation. In other cases, the successor farmer may be a neighbor or a key employee. Regardless of the details, business entities can be useful tools for transferring equity, management, and labor to the next generation of farmers over time. These also can assist with providing an income stream to the retiring farmer or providing financial gifts to non-farming family members.

A Common Structure

Although there is no cookie cutter method for farm succession planning, one common approach is to separate the land from the operating business and create at least one entity for each. Only farmers are members of the operating entity, while non-farming heirs can be members of the land-holding entity. Families can create many variations of this basic structure, but the benefits and drawbacks of this approach are described below.

Land Holding Entity

It often is advisable to place farmland into an entity separate from the operating business. For reasons more thoroughly discussed in Chapter 11, the current entity of choice for a land holding company is the LLC. In many cases the owners of the land, often spouses, will transfer their ownership to an LLC. While they may choose to gift some shares during their lifetime to their children, they typically will continue to own the majority of the shares until they die, at which point the shares are transferred to the designated family members. Placing the land in an LLC can offer several benefits, depending upon the goals of the owner. Some long-term benefits may include the following:

- Protecting the land from partition.
- Designating a long-term management structure for the farmland.
- Providing for retirement income (rent) for the retiring owner.
- Providing a method and price for buying out interests of deceased or departing members.
- Restricting ownership of membership interests to family.
- Allowing off-farm heirs to receive financial benefit from what is often the largest family asset.
- Assuring farming member(s) may rent the property long-term at a designated price.
- Preserving the step-up in basis at death.
- Providing for continuity and control of the land after the death of the original owner(s).
- Eliminating self-employment tax on income paid for rent.

Farmers also must consider the drawbacks.

- Legal fees must be paid to create an LLC and transfer the land into the name of the entity.
- Biennial returns must be filed with the state.
- Legal advice must be sought when changes to the operating agreement are made.
- All leases, loans, and contracts must be titled in the name of the LLC.
- A bank account must be established in the name of the LLC.
- Partnership tax returns must be filed each year (unless the LLC is a single member LLC), with a Schedule K-1 provided to each of the members.
- While the LLC does not have many required formalities, members should treat the entity like a business, hold meetings, and keep adequate records.
- In some families, operating a family business may increase opportunities for conflict.

Operating Entity

A separate structure is created for the operating business. This entity is responsible for conducting the farming operation and usually will hold the equipment, inventory, and vehicles. Only farmers and farming heirs or successors should have an ownership interest in the operating entity. The operating entity can be an LLC or a corporation or a partnership. Farmers must work with an advisor to consider the pros and cons of each entity. As discussed in Chapter 11, a partnership will not offer liability protection, but it may increase farm program payment eligibility. An S corporation may reduce self-employment tax, but it comes with the sacrifice of the step up in basis of assets (such as inventory and machinery) at death. A C corporation may offer tax-free fringe benefits (such as health care and sometime meals and lodging), but it comes with double taxation and the loss of a basis step-up at death. An LLC offers liability protection, single taxation, and a step-up in basis at death, but the entity generally receives a single farm program payment. Additionally, active LLC members generally must pay self-employment tax on all distributions.

With a partnership or LLC, farmers coming into the business can begin building a profits interest in the operating entity from the beginning. Over time, they can build an equity interest through purchasing membership interests or receiving gifts of interests from the older farmer(s). As the older farmer gets closer to retirement, the younger farmer can assume management responsibility for the farming operation. The operating agreement can spell out the specific terms of the succession plan, including what happens at death, divorce, disability, or retirement.

Depending upon the structure of the business, the plan may include a redemption of the retiring farmer's shares, which could provide the older farmer a retirement income stream. At the death of the older farmer, the estate plan may transfer the rest of the equity interest in the operating business to the younger farmer(s).

Other Entities as Desired

If the farm has livestock, a separate entity may be created for single-purpose agricultural or horticultural buildings and the associated land. Likewise, if the younger farmer purchases new assets, such as land or a livestock building, the younger farmer can create a separate LLC for that solely owned property.

Note: Some beginning farmers' eligibility for government loans and other programs may be impacted by the business structure.

Tying the Entities Together

With the above setup, the operating entity will rent the property from the land-holding entity or the livestock facility entity. The property entities do not pay self-employment tax on the rental income, and the payments are deductible by the operating entities.

Both farming and non-farming heirs can receive gifts of equity interests, during lifetime and at death, in the real property holding entities. These interest holders will receive income in the form of rental payments. The operating agreement specifies the rights of members, including who can own interests and what happens if a member dies, divorces, or wants to be bought out. This usually is accomplished through a buy-sell agreement, detailed in the next section. Likewise, the operating agreement can specify rental terms and the method through which membership interests are valued.

As discussed in Chapter 11, the land holding entity can restrict membership rights to family members. In such cases, creditors or in-laws will be limited to a transferee interest, receiving only the right to share in the income of the business. They cannot force a sale of the underlying asset.

The entities execute long-term leases and contracts to facilitate the goals of the succession plan.

Buy-Sell Agreements

Regardless of the type of entity, a buy-sell agreement should be created to facilitate the transfer of ownership interests in the business. The buy-sell agreement often is a part of the partnership agreement, operating agreement or bylaws, but it can be a stand-alone contract between owners. If there is no buy-sell agreement, the terms of a transfer are dictated by the applicable entity agreement and state law.

The main purpose of the buy-sell agreement is simplification and certainty regarding the exit process for any business interest holder. The agreement also affords the company and business owners protection if unexpected financial or transfer events occur in the future. Even with a buy-sell agreement, owners sometimes may agree to change the terms to allow for an alternative arrangement.

A buy-sell agreement should address five primary questions:

- Who can purchase?
- What is the timeframe?
- How will the price be determined?
- When will the agreement apply?
- How will the transfer be funded?

The buy-sell agreement is tailored to meet the specific needs of the business and its owners.

Who Can Purchase?

Many buy-sell agreements for family businesses restrict the ability of owners to sell or gift their ownership interests in the business to people outside of the family. In this case, the company or other owners must agree to buy the business interest pursuant to specific terms. The buy-sell agreement may offer rights of first refusal to certain owners or may require the company to buy back the shares.

Although not common in a family business, the agreement could allow the seller to find a willing third-party buyer.

What is the Timeframe?

Two important time periods should be established by the buy-sell agreement: the **purchase option** deadline and the payment timeframe. The purchase option deadline is how long after a triggering event the owner or company will have to decide whether to purchase the available interest. Typical agreements provide 30-90 days for these decisions.

The payment timeframe will specify the period over which payments dictated by the buy-sell agreement may occur. Depending on the goals of the owners, the terms can be buyer- or seller-friendly or somewhere in between.

How is the Price Determined?

The buy-sell agreement also must specify how the price of membership interests will be determined. To prevent minority owner oppression, business owners must have a right to receive a "fair value" payment for their interest. Since the company is a private company and not available for the public to purchase, this fair value can be hard to determine. Ideally, the sales price of the business will be determined annually at a company meeting where minutes are recorded, and owners agree. A backup valuation scheme, however, should be established.

The valuation method can be formula-based or appraisal-based. With a formula-based method, terms like "book value" or "fair value" are too broad and could have multiple definitions. If an appraisal method is used, the agreement must specify who will pay for the appraisal and who will choose the appraiser. It also should specify what will happen if one party is unhappy with the price.

When Will the Agreement Apply?

The buy-sell agreement also must specify the situations to which it applies. It is typical for the agreement to cover all transfers. The reason for this broad language is so the agreement will cover unplanned situations such as divorce, unexpected disability, or individual financial troubles. If those situations arise, it may be in the best interest of the company to purchase those shares.

A planned transfer occurs when one owner wishes to exit the business. The buy-sell agreement can place conditions upon when an owner can be "bought out."

The owners also must decide if the buy-sell agreement should require or allow the company to purchase the business interests of an owner when they die. If the buy-sell does not allow this to happen, the estate initially will be the holder of the interest, and the business interest will transfer according to the owner's estate plan.

How Will the Transfer Be Funded?

The final provision that must be included in the buy-sell agreement determines how to fund the transaction. There are several typical options. The first option, cash, requires liquidity. A second option, an installment note, can be an easier option for the buyer, but the seller will have to wait to receive full payment. A third option, life insurance, can be expensive, and it will only work if the transfer occurs due to death or sometimes disability. If life insurance is chosen to fund the transaction, the company must ensure premiums are paid and that solid records are maintained. A final option is for the company to borrow money to fund the purchase. The buy-sell agreement can be written to allow for multiple funding methods.

Entities versus Trusts

While business entities are popular vehicles for accomplishing long-term management goals for farms and farmland, some of these goals also may be accomplished through trusts. Some succession plans call for the farmland to be placed in a trust at the death of the owner for the benefit of specified beneficiaries, usually family members. The appointed trustee and successor trustees will manage the farmland and distribute the income to the beneficiaries.

This approach can meet the goals of keeping the farmland in the family, providing a financial benefit for farming and non-farming heirs, and exercising long-term control of the land. It does, however, come with some drawbacks.

- Net income must be distributed to the beneficiaries in the year it is earned, or it is taxed at a rate of 37% (income over $14,450 in 2023).
- Property in an irrevocable trust will not receive a step-up in basis at the death of the beneficiaries.

Note: This also means the land will not be in the gross estate of these beneficiaries, which is beneficial if estate tax is an issue.

- It may be difficult to end the trust or buy out a beneficiary, even if all the beneficiaries want out (see Chapter 6).
- The trustee holds all management authority (acting in accordance with the trust document), and the beneficiaries have no voice.
- If the trustee is the person farming the land through a lease arrangement, **fiduciary** concerns may arise.

Controlling the Land After Death

If a landowner transfers farmland directly to beneficiaries at death, the owner's control over that land generally ends with the transfer. Placing farmland into a trust or entity, however, can help ensure specific wishes are carried out. This section reviews some common provisions that may be included in a trust or operating agreement to help meet the goals of the original owner, even after death.

Option to Purchase

A purchase option often is used when the grantor wants to give the on-farm heir or a longstanding tenant the right to purchase the property in the future. Purchase option clauses included in trusts or operating agreements often allow the purchase at a set price, which often is less than fair market value. Sometimes, the entity may finance the purchase.

Example: Lewis has two daughters. His daughter Kelly farms the land with him. His other daughter, Penelope, does not. Lewis wants Kelly to own the land, but also wants to financially benefit Penelope.

In his farm trust, Kelly and Penelope are beneficiaries. The trust specifies that Kelly has the right to purchase Penelope's share of the land from the trust at a discounted price. The trust specifies that the funds from the sale are to be given to Penelope.

If Kelly decides to purchase the land, Penelope will receive cash, the trust will dissolve, and Kelly will own the land individually.

Any right to purchase must address what happens if the person dies before exercising the option. The document could specify that someone else receives the purchase option or the purchase option could terminate.

It also is important that the right to purchase specifies how the price will be determined. Merely stating the price will be set at "fair market value" could lead to disagreements and ultimately litigation.

If a price is to be set by an appraiser, a procedure should detail who can choose the appraiser, who will pay for the appraisal, and what will happen if someone dislikes the initial appraisal.

An easily overlooked issue is how the purchase will be funded. The purchase option may allow the entity or trust to finance the purchase. In this case, the purchaser will sign a promissory note promising to pay the entity the value of the purchase price and a mortgage will be placed upon the property. If the purchaser defaults on their payments, the entity would be able to foreclose on the mortgage and regain title to the property.

Right of First Refusal

Trusts or entities also may provide a **right of first refusal** to a farming heir or someone else. If the trust or entity ever decides to sell the property, it must offer the land for sale under the same terms first to the person holding the right of first refusal. A right of first refusal must specify the timeframe within which the purchase must be completed.

The right of first refusal can be combined with other provisions that allow for a reduced price or favorable financing terms.

Right to Rent the Farmland

Another potential benefit of a trust or entity is the ability to better control who will rent the ground. A trust or business entity can provide a **rental option** to a selected person.

Example: Julio is a third-generation farmer. His daughter, Juanita, wants to farm, but his other two children do not. Julio places the farmland in an LLC as part of his overall estate plan. Each child will have a one-third interest in the LLC once Julio passes.

Julio can stipulate in the operating agreement that Juanita has the right to rent the farmland from the LLC at a set price. This would give her assurance she may continue to farm the family land. He will provide the provision can only be changed by unanimous consent of the members. If Julio does not put this clause in the operating agreement, Juanita's two brothers could vote to rent the farm to someone else.

A well-drafted rental right provision will have a clear method for determining the rental rate. Failure to do so can result in disagreement. The rental option usually requires the person to farm the land themselves. This ensures the person does not take advantage of a reduced rental rate by subletting the land at a higher rental rate.

Farming Practices

An entity or trust also can specify the use of the land. For example, it may require the land always be used for agricultural purposes.

Additionally, the entity or trust provisions could require certain conservation practices, such as cover crops or certain crop rotations. They also could specify what improvements could be made to the property and limit other improvements.

Example: Henrietta successfully converted 360 acres into certified organic land for corn and soybean. It is important to her the land continues to qualify as organic. Henrietta places her land into a revocable trust as part of her overall estate plan. Upon her death, the trust becomes irrevocable, and her children are the beneficiaries.

If Henrietta places a clause in the trust providing the land must continue to be farmed organically, then the trustee must abide by her wishes. If there is no clause requiring continued organic farming, the trustee could decide to return to conventional farming practices. Chapter 6 discusses circumstances under which an irrevocable trust may be changed.

Notes

Glossary of Terms

1031 Exchange–A tax provision that allows a taxpayer to exchange real property used in a trade or business or held for investment for any other business or investment real property and defer the recognition of gain from that exchange. Also called a like-kind exchange.

A Trust–A term, used in the A-B trust planning or A-B-C trust planning model, for the trust that uses the unlimited marital deduction to avoid estate taxes at the death of the first spouse.

ABLE Account–A tax-advantaged savings account where contributions can be made to meet the qualified disability expenses of the designated beneficiary. The funds within the account will not be counted when determining if the beneficiary is qualified for needs-based government programs. ABLE is an acronym for Achieving a Better Life Experience and is authorized by IRS § 529A.

A-B Trust Planning–A technique used by married individuals to legally maximize their estate tax exemptions. The strategy involves creating two separate trusts after one spouse passes: A Trust (marital deduction trust) and B Trust (bypass trust). Portability has made this type of planning less frequent.

A-B-C Trust Planning–A technique used by generally well-off married individuals to legally maximize their estate tax exemptions. The strategy involves creating three separate trusts after one spouse passes: A Trust (marital deduction trust), B Trust (bypass trust), and C Trust (QTIP trust).

Accelerated Cost Recovery–Special tax rules that allow business assets to be depreciated at a faster rate than what would be allowed using standard depreciation.

Ademption–The failure of a bequest from a will because the property is no longer in the estate. Example: The decedent leaves "My car to my niece," but owns no car at the time of death.

Adjusted Basis–The value of an asset for tax purposes that includes basis at acquisition, plus the cost of improvements, minus depreciation adjustments.

Administrator–A person appointed by a probate court to carry out the transfer of a decedent's assets according to state law if no will was created.

ADS–Short for "alternative depreciation system" that is allowed by the IRS to determine the depreciation on business assets for income tax purposes.

Advanced Directive–A written document by which a person directs that his or her life is not prolonged by extraordinary measures when there is no reasonable expectation of recovery from severe mental or physical disability.

Advancement–A gift made during a donor's life to a family member, usually when the donor anticipates his or her own death. The value of the advancement is included in the calculation of the net probate estate when the donor dies intestate.

Affidavit–A written statement of fact that states it was given under oath and signed by an individual attesting to the truth of the statement, which can be used in a variety of legal proceedings. State law controls what procedure or language is required to make a valid affidavit.

Affidavit of Survivorship–A document placed upon the land record stating that one owner of joint tenancy real estate has died.

Agent–The person receiving a grant of authority to act on another's behalf. The power given to this person is controlled by the power of attorney document.

Ancestor–The relative of a particular individual from whom that individual is descended directly. For example, a person's parent, grandparent and great-grandparent are their ancestors.

Ancillary Probate–A secondary probate court proceeding that occurs when the decedent lived in one state and owned real estate outside of their residential state. The ancillary probate ensures the out-of-state real estate is properly transferred to the next owners.

Annual Exclusion Amount–A tax policy that sets the amount of money one person may transfer to another as a gift without incurring a gift tax or affecting the unified credit. This annual gift exclusion can be transferred in the form of cash or other assets. In 2023 the amount is $17,000.

Anti-lapse Statute–If a testator devises property to a person in his will and that person predeceases the testator, an anti-lapse statute will allow the devised property to pass on to that person's descendants or through their estate rather than force the gift to pass through intestacy.

Applicable Federal Rate (AFR)–The minimum interest rate the Internal Revenue Service allows for loans between two private individuals or entities.

Articles of Incorporation–The founding document of a corporation. This document must be filed with a state agency and state law dictates what information must be found within. Usually, the number of shares and type of shares of the corporation are listed within this document.

Asset Protection Trust–An irrevocable trust that purposely impoverishes the grantor in order to shield the assets from creditors and possibly Medicaid estate recovery.

Assignment–Transfer of property (real or personal) to another including all rights associated with the assignment.

Assignee–One to whom a right, title, or interest is assigned; also referred to as grantee.

Assignor–One who assigns a right, title, or interest to another, also grantor.

Attestation Clause–A clause at the end of a will, which sets forth the legal requirements the document must satisfy, states that those requirements have been met, and is signed by one or more witnesses. An attestation clause strengthens the presumption that the requirements have been met.

B trust–A term, used in the A-B trust planning or A-B-C trust planning model, for the trust that holds assets in value up to the amount of the current estate and gift tax exemption available to the deceased. Any additional assets go to the A trust/marital deduction trust or C trust/QTIP trust.

Basic Exclusion–The amount of the federal unified tax credit that determines the lifetime amount will be exempt from gift and estate taxes. The credit amount determines how much one can gift during their lifetime or pass on as part of their estate without having to pay gift tax or estate tax. The credit amount changes annually; in 2023 the amount is $12,920,000 per person.

Basis–The value of an asset that is used when determining the gain or loss for tax purposes when the asset is sold.

Basis Adjustment–A tax policy that uses the fair market value of assets at the time a person inherits these, instead of the value when the prior owner purchased the assets, to determine the new owner's basis in the asset.

Beneficiary–Person named in a will or trust to receive some benefit or thing from the estate or trust.

Bequest–Usually personal property received under a will. Also known as legacy.

Board of Directors–The governing body of a corporation responsible for overseeing management and setting the strategy of the business. Typically, shareholders will elect the directors.

Bonus Depreciation–Additional first year depreciation sometimes allowed by tax law.

Business Asset–Property used in a trade or business and subject to rules found in IRC §1231 when sold or exchanged.

Business Entity–An organization structure that conducts business. This term encompasses more specific terms such as Limited Liability Company (LLC), partnership, corporation, and sole proprietorship.

Business Records–Documents used to keep track of business transactions. This includes, but is not limited to, invoices, receipts, contracts, financial statements, bank account statements, and meeting minutes.

Buy-Sell Agreement–A document agreed to by the business and its owners on how, when and at what price an owner may transfer or sell ownership interest in the business.

Bylaws–A business document that details and controls the financial and functional decisions including rules, regulations, and provisions of the corporation. The purpose of the document is to govern and control the internal operations and transfers of ownership. Usually, only corporations use this term.

Bypass Trust–A term, used in the A-B trust planning or A-B-C trust planning model, for the trust that holds assets in value up to the amount of the current estate and gift tax exemption available to the deceased. Any additional assets go to the A trust/marital deduction trust or C trust/QTIP trust.

C-corporation–The tax term used to describe the default federal income taxation of a corporation. The corporation is taxed at corporate tax rates, and any dividends distributed to shareholders are subject to the owner's individual federal income tax.

C Trust–A term, used in A-B-C trust planning model, for the trust that holds assts where the spouse can receive the income generated from this trust, but not the assets themselves. This trust follows tax rules established in IRC § 2056.

Capital Asset–Property held by a taxpayer, usually held for personal or investment purposes. The disposition of these assets is controlled by IRC §1221.

Capital Contribution–Cash or other assets an owner contributes to the company at the company's inception or throughout the life of the company.

Capital Gains Tax–The tax on profits realized upon the sale of long-term capital or business assets.

Capital Loss–When a capital asset is sold or exchanged for less than the adjusted basis of the asset.

Carryover Basis–A tax policy that uses the basis of the prior owner to determine the new owner's basis in the asset when the asset is gifted to the new owner instead of inherited.

Certificate of Organization–A document required to be filed with a state agency to register a limited liability company (LLC).

Charitable Deduction–An estate and gift tax rule that allows one to transfer an unrestricted amount of assets to qualified charities at any time, including at death, free from tax and without the transfer counting against the basic exclusion.

Charitable Remainder Trust (CRT)–A trust where a non-charitable beneficiary receives a stream of income for the duration of the trust, and a designated charity receives the remaining trust assets upon termination. This type of trust typically is used to avoid higher tax liability.

Class–A group of people with the same rights, usually the same distributive rights that must be apportioned among the group.

Closely-Held Corporation–A corporation where the shareholders also are the members on the board of directors and the officers.

Clouds on the Title–Any document, claim, unreleased lien, or encumbrance that might invalidate, impair, or cause doubt on the ownership of an asset or real property.

Codicil–A formal amendment to the terms of a will, usually an addition or supplement that explains or modifies a provision, or revokes part of the will.

Comingle–When someone or some entity mixes funds belonging to one party with funds belonging to another party.

Conservator–A person who has been appointed by a court or otherwise has the legal authority and the corresponding duty to make decisions relevant to control of assets and debts of a minor or other person who is deemed legally incompetent.

Contesting–To oppose, dispute, or challenge through formal or legal procedures.

Contingent Beneficiary–A person, organization, or institution that receives estate property when the first named beneficiary is unable or refuses to take the property.

Corporation–A business structure authorized by state law that creates a legally established entity that is separate from its owners and is allowed to enter into contracts, own assets and incur debt, sue, and be sued.

Corpus–In the context of trusts, the assets that are placed into and titled to a trust. Also referred to as principal.

Credit Shelter Trust–A term, used in the A-B trust planning or A-B-C trust planning model, for the trust that holds assets in value up to the amount of the current estate and gift tax exemption available to the deceased. Any additional assets go to the A trust/marital deduction trust or C trust/QTIP trust.

Creditor–A person or business entity who is owed money or has a financial claim against a debtor.

Deadhand Control–A legal term for provisions and terms found within wills and trusts that control how property is managed after your death and far into the future.

Death Benefit–Insurance or pension money payable to a deceased person's designated beneficiary.

Debt–A financial liability or obligation owed by one person, the debtor, to another, the creditor.

Debtor–A person or other legal entity who owes money or services to another person or company.

Decanting–In the context of trusts, the legal process necessary to change a trust when it is irrevocable, either by design or due to the death of the grantor(s). This process usually is costly, requires court oversight and is done to correct drafting errors, avoid adverse tax consequences, or to extend the life of a trust when necessary.

Deceased Spouse Unused Exclusion (DSUE)–An estate tax election that allows the surviving spouse to use the unused portion of the predeceased spouse's estate tax exemption.

Decedent–The person who died.

Deduction–A provision in the tax code that reduces taxable income. There are many deductions available in the current federal tax code.

Depreciation–The estimated reduction in value of fixed assets within a fiscal year. It is an expense claimed as an income tax deduction if the asset is used in a trade or business pursuant to IRC § 167.

Descendant–A descendant is a person born in a direct biological line. For example, a person's children, grandchildren and great-grandchildren are their descendants.

Devise–A transfer of real property by means of a will.

Director–An individual who sits on the governing body of a corporation (board) and who is responsible for overseeing management and setting the strategy of the business. Typically, shareholders elect the directors.

Disclaim–When a beneficiary or heir refuses to receive property they would otherwise be entitled to.

Disinherit–To deliberately prevent someone, usually a relative, from receiving assets from an estate.

Disinterested Witnesses–Individuals who oversee the will signing ceremony and who will not receive anything under the will.

Distribution (Tax)–When a company disburses company income to the owners of the business.

Distribution (Estate Plan)–When a beneficiary receives a benefit from an estate or trust.

Dividend–The distribution of a corporation's profits to its shareholders, which is determined by the company's board of directors. This term typically is reserved for certain payments from c-corporations to shareholders. The IRS defines dividend under IRC § 316.

Doctrine of Emblements–A legal rule that allows a life tenant's estate to harvest crops or receive the financial benefit of crops that were planted before the farmer life tenant died.

Durable Power of Attorney–A written authorization to another to act on one's behalf that continues even after the principal has diminished cognitive capability or severe mental decline.

Elective Share–The legal right of a spouse to a portion of decedent's estate, regardless of the provisions found in the will or revocable trust.

Emblements–Annual crops to which a tenant who cultivated the land is entitled. If the tenant dies before harvest, the right to harvest the crops will pass to his or her heirs.

Escheat–The revision of a person's property to the state when death occurs and there is no will or heirs.

Estate–The total property, real and personal, owned by an individual prior to death that requires distribution to an heir after their death.

Estate Planning–The arrangement of one's estate for the disposition and management of property at death using wills, trusts, insurance policies, beneficiary designations, and other tools.

Estate Settlement–Settling the affairs of a deceased person.

Estate Tax–A tax on your right to transfer property at your death. There is a federal estate tax and some, but not all, states also have an estate tax. The federal estate tax statutes are found in 26 USC §§2001-2210.

Execute–To sign or complete all formalities necessary to make a document legally effective, such as signing, notarizing, or witnessing.

Executor–A person named within the will and tasked with administering the estate of the decedent and carrying out the provisions of the will. While the term usually refers to both genders today, the term executrix refers to a female executor.

Executor's Bond–A type of surety bond obtained by the executor, usually from an insurance company, and filed with the court that helps to ensure the executor properly administers the estate. If the executor mismanages funds or absconds with estate property, the bond money will reimburse the estate for the executor's bad actions.

Fair Market Value (FMV)–The amount for which a piece of property (real or personal) would be sold in a voluntary transaction between a buyer and seller, neither of whom is under any obligation to buy or sell.

Farm Income Averaging–A federal tax provision that allows a farmer to average some or all of the current year's farm income equally over the previous three years with the goal of reducing the marginal tax rate of the income. The statue controlling this technique is IRC § 1301.

Fee Simple–Land ownership where the owner is entitled to the entire asset with unconditional power to use the property, restrict others from using it, and can transfer to whomever at any time.

Fertile Octogenarian Rule–A legal concept that a person is capable of having children no matter the age.

Fiduciary–A person who is responsible for proper oversight and management of assets. Fiduciaries include executors, administrators, personal representatives, agents listed in a power of attorney, and trustees.

Fiduciary Duty–A legal obligation to act in the best interest of another, including the duties of good faith, loyalty, due care, and disclosure.

Financial Power of Attorney–A written authorization to another to act on one's behalf for financial purposes.

Final Report–In the probate process, the report given by the administrator to the court detailing what was done, accounting of assets and monies, and final distribution of decedent's assets.

Five-Year Lookback–A rule across all states that has the Department of Health or other applicable state agency reviewing a Medicaid applicant's finances for the previous five years before entering the nursing home to see if any assets were sold for less than fair market value, transferred, or given away. If any assets have been given away or transferred for less than fair market value, the applicant will be deemed ineligible for Medicaid assistance for a period of time, even if they would otherwise finically qualify for Medicaid.

General Partner–Applicable to limited partnerships only, a general partner manages the partnership business and can be personally liable for the business's activities. Compare with limited partner, who is not personally liable for the business's activities.

General Partnership–A business structure where two or more individuals conduct business for profit. Every owner is personally liable for the business's debts, liabilities, and assets.

Gift–The voluntary transfer of property to another person completely free of payment or obligations while both the giver and the recipient are still alive.

Gift tax–A tax on your right to gift property to another. There is a federal gift tax, but no state gift tax except for Connecticut. The federal gift tax statutes are found in 26 USC §§2501-2524.

Granted Life Estate–A life estate created by the original owner and given to someone else, typically at the death of the original owner.

Grantor–The original owner of an asset who gives away an ownership interest in the asset. In the context of trusts, they are the individual who creates, and usually funds, a trust.

Gross Estate–For estate tax purposes, the value of all property or interests in property that the decedent holds at death, plus the value of all property gifted during life that counted towards the basic exclusion.

Guardian–A person who has been appointed by a court or otherwise has the legal authority (and the corresponding duty) to make decisions relevant to the personal needs and interests of a minor or other person who is deemed legally incompetent.

Healthcare Power of Attorney–A written authorization to another to act on one's behalf for healthcare purposes.

Heir–In a strict legal sense, a person designated by intestacy law who will receive the property of the deceased when there is no will. In common usage, heir refers to anyone who receives property from the deceased individual.

Heirs' Property–A term used to describe family-owned land that is co-owned by descendants of a deceased person, where individuals have an undivided interest in the real estate.

HIPAA release form–An additional form attached to the healthcare power of attorney that should authorize an agent under a healthcare power of attorney the right to access the principal's patient health information, which is subject to HIPPA protections.

Holographic Will–A will written in the testator's handwriting, signed and dated without witnesses observing the signature. This type of will is only valid in some states; it is not valid in Iowa.

Hotchpot–Putting together or mixing various properties in order to achieve equal division among beneficiaries or heirs.

Income Tax–A tax levied on the wages, salaries, dividends, interest, and other monies a person earns throughout the year. The federal income tax statutes are found in 26 USC §§1-1524.

Income in Respect of Decedent (IDR)–Income received after someone dies but not included in the final tax return of the individual. Instead, the income is reported on the estate tax return or a beneficiary's tax return.

Individual Retirement Account (IRA)–A specific type of retirement account that allows the individual to put money away for retirement in a tax-advantaged way.

- **Traditional IRA**–A designated retirement account where an individual contributes pre-tax dollars where investments grow tax-deferred until withdrawal during retirement.
- **Roth IRA**–A designated retirement account where an individual contributes post-tax money, then all future allowable withdrawals are tax-free.
- **SIMPLE IRA**–A retirement savings plan that can be used by most small businesses with 100 or fewer employees. Employers can choose to make a 2% retirement account contribution to all employees or an optional matching contribution of up to 3%.
- **SEP IRA**–A simplified employee pension (SEP) IRA is a retirement savings plan established by employers, including a self-employed individual, for the benefit of their employees and themselves. Employers may make tax-deductible contributions on behalf of eligible employees to their SEP IRAs.

Informal Business Entity–A business structure where there are no filing requirements and few, if any, maintenance requirements. The business is not separate from its owners; any debts or wrongdoings within the business can impact an owner's individual finances.

Inheritance–Assets received from someone who has died.

Inheritance Tax–A tax on the assets received by a beneficiary of an estate and usually paid by the beneficiary of an estate. There is no federal inheritance tax and only six states have an inheritance tax. Iowa's inheritance tax will end January 1, 2025.

In-kind–Refers to payment, distribution, or substitution of goods or services in lieu of money within the context of estate distributions.

Installment Sale–A sale of property where the seller receives at least one payment after the tax year in which the sale occurs.

Interest–For business entity purposes, a unit of ownership in a limited liability company. Owning an interest makes an individual member. Depending on how the interest was obtained and the operating agreement, the owner may be entitled to participate in the management of the business.

Inter Vivos Trust–A trust that takes effect during the life of its creator.

Intestacy–The statutory system for who will receive the assets of an estate when the decedent died without having a will. This term is a noun.

Intestate–A person who has died without having a will. The term is an adjective.

Intestate Succession–The statutory system for who will receive the assets of an estate when the decedent died without having a will. Also referred to as intestacy.

Inventory–A required filing with the probate court that lists the creditors, beneficiaries, assets, and debts of the decedent that have been located by the personal representative.

Investment Assets–Assets passively managed by an individual that are subject to the net investment income tax (NIIT) when they are sold. The NIIT is found in IRC § 1411.

Irrevocable Life Insurance Trust–A trust that is owner of a life insurance policy in order to ensure the proceeds of the policy are not included in the insured's estate at death.

Irrevocable Trust–The trust cannot be amended, revoked, or altered. Some trusts are irrevocable by design; others become irrevocable once the grantor dies.

Issue–The lineal descendants of an individual. Examples include children, grandchildren, and great-grandchildren.

Joint Tenancy–A form of co-owning an asset during an owner's lifetime that allows the asset to automatically transfer to the other owner upon the death, without the need for probate. The legal term for the automatic transfer is called "right of survivorship."

Joint Tenant–The term used to identify an owner of an asset held in joint tenancy.

Judgment–A decision of a court regarding the rights of parties, costs, and financial awards in a legal action or proceeding.

Lapse–The termination of a right, interest, duty, or obligation as a result of the passage of time, or failure of a condition, or a change in circumstance.

Legacy–Personal property received under a will. Also known as bequest.

Letters of Appointment–Documents issued by the probate to the administrator of the deceased's estate empowering them to carry out the necessary administration of the decedent's estate.

Letters Testamentary–Documents issued by the probate court to the executor of the deceased's estate empowering them to enforce the terms of the deceased person's will and carry out the necessary administration of the decedent's estate.

Liability Protection–One of the main benefits of certain business entities, this legal concept protects an owner's individually held assets from any debts or wrongdoings, also known as liabilities, that are the result of the business's actions or dealings.

Life Estate–The conveyance of a property interest for the duration of someone's life. At death, the interest automatically ends, and the property passes to a remainder interest holder.

Life Insurance–A contract in which an insurer, in exchange for a premium, guarantees payment to an insured's beneficiaries when the insured dies.

Life Tenant–One who holds a property interest for the period of their lifetime or the lifetime of another specified person. The property interest is called a life estate.

Like-Kind Exchange–A tax provision that allows real property used in a trade or business or held for investment to exchange that property for any other business or investment real property and defer the recognition of gain from that exchange. Also referred to as a 1031 exchange.

Limited Liability Company (LLC)–A business structure authorized by state law where the owners must register the business to have liability protection like a corporation, but there are fewer required formalities for the business compared to a corporation.

Limited Partner–Applicable to limited partnerships only, this partner has limited liability, but has no management authority of the partnership business. There can be tax advantages to being a limited partner.

Limited Partnership–Authorized by state law, a partnership that has two types of owners, general partners and limited partners. Limited partners receive the benefit of limited liability, but have no management authority. General partners manage the partnership business, and can be personally liable for the business's activities.

Living Trust–A trust that takes effect during the life of the grantor. However, the trust may continue after death depending on the terms found within the trust document.

Living Will–A written document by which a person directs that his or her life is not prolonged by extraordinary measures when there is no reasonable expectation of recovery from severe mental or physical disability; different from "Do Not Resuscitate" (DNR) directives. Also known as an advanced directive.

Long-Term Capital Gain–When a capital asset is sold above its adjusted basis and was held for longer than a year by the owner, it receives a preferential capital gain tax rate.

MACRS–Short for "modified accelerated cost recovery system," the common depreciation rate used for business assets for income tax purposes.

Manager-managed LLC–An LLC where the managers, who usually are appointed by the members via vote, are tasked with the daily management and necessary decisions of the business. Compare with member-managed LLC.

Marital Deduction–An estate and gift tax rule that allows one spouse to transfer an unrestricted amount of assets to the other spouse at any time, including at death, free from tax and without the transfer counting towards the lifetime basic exclusion.

Marital Deduction Trust–A term, used in the A-B trust planning or A-B-C trust planning model, that uses the unlimited marital deduction to avoid estate taxes at the death of the first spouse.

Member–An individual who owns a business interest and has at least some management rights in a limited liability company.

Member-managed LLC–An LLC where all owners, titled members, have equal rights in the daily management of the business. The operating agreement of the LLC specifies if the LLC is a member-managed LLC. Compare with manager-managed LLC.

Monetized Installment Agreement–An installment agreement where the seller receives all of the proceeds from the sale of a highly appreciated asset in the year of the sale, but attempts to defer paying the corresponding tax well into the future by claiming the transaction is an installment sale. The IRS has identified this strategy as an "abusive tax arrangement" and often will not uphold the deferral of tax owed.

Non-Probate Assets–Assets in which transfer of title is controlled by a survivorship mechanism, such as a trust, joint ownership, or transfer-on-death designation. These assets will change ownership after the death of an individual outside of probate court.

Officer–An individual responsible for the day-to-day management of a corporation or limited liability company. In a corporation, the board of directors usually is responsible for hiring these individuals. In an LLC, the operating agreement controls who hires these individuals.

Operating Agreement–A business document that details and controls the financial and functional decisions including rules, regulations, and provisions of the business. The purpose of the document is to govern and control the internal operations and transfers of ownership. Usually, limited liability companies use this term.

Ordinary Income Tax–The default income tax that applies to any income received that is not subject to an exemption or other taxation rate. The tax rate is determined by the tables found in IRC § 1.

Pass Through Entity–The tax term used to describe when a business does not pay federal income tax on its own. Instead, the owners of the business are responsible and obligated to pay the tax of the business on their individual return.

Partition–A court action to divide co-owned property.

Partition in kind–When the partition action results into a parcel being separated into distinct portions so each co-owner may hold his or her proportionate share individually and without co-ownership.

Partition by Sale–When the partition action results in a parcel being sold under court supervision and each co-owner receives his or her proportionate share of the profits from the sale.

Partner–An individual who owns a business interest in a partnership business entity. In a general partnership, every partner has management rights and income rights.

Partnership Agreement–A business document that details and controls the financial and functional decisions including rules, regulations, and provisions of the business. The purpose of the document is to govern and control the internal operations and transfers of ownership. Usually, partnerships use this term.

Passive Income–A tax term for income derived from an enterprise where the recipient does not materially participate in the business. There are unique federal income tax consequences associated with passive income. The IRS defines this type of income in IRC § 469(c).

Payable-on-Death (POD)–When an asset is titled in order to allow a named beneficiary to receive the property immediately upon the original owner's death without having to utilize the probate court, but the beneficiary does not have access to the property during the original owner's life. This is only allowed with certain assets, typically bank accounts or stock portfolios.

Personal Representative–A person appointed by a court to oversee the distribution of an estate. This term includes both administrators (intestacy) and executors (testamentary).

Pierce the Veil–Occurs when a court holds a corporation's shareholders or directors or an LLC's members or managers personally liable for the business's actions or debts. This usually occurs when the business structure and formalities have not been honored and followed.

Portability–An estate tax election that allows the surviving spouse to use the unused portion of the predeceased spouse's estate tax exemption.

Pour-over Will–A will that contains a provision to place any estate assets not in the trust at the time of death into a living trust to be overseen by a trustee upon the testator's death.

Power of Attorney–A written authorization to another to act on one's behalf or as one's agent.

Prenuptial Agreement–An agreement between spouses executed before the marriage. The agreement determines their rights regarding property and support when the marriage ends either by death or divorce and can bypass statutory provisions pertaining to surviving spouses and divorce.

Principal (Power of Attorney)–The person giving another a grant of authority to act on the giver's behalf.

Principal (trust)–In the context of trusts, the assets that are placed into and titled to a trust. Also referred to as corpus.

Probate–The term used to describe when a court of law oversees the transfer of the decedent's estate. The probate court has the authority to verify the legality of a will, carry out its instructions, distribute property to the correct individuals and oversee the executors' actions.

Probate Assets–Assets in which transfer of title after death of the first owner is overseen by the probate court and subject to the probate state laws.

Probate Process–The procedure and filings required by state law that must be followed for the probate court to effectuate and oversee the transfer of decedent's assets.

Purchase Option–A real estate interest that gives an individual or entity the right to purchase property at a certain price within a certain time period but without an obligation to purchase.

Public Record–Filings, transcripts, or any other document a court is required to maintain that are accessible to anyone who asks for a copy, even if they are not involved with the case.

Qualified Joint Venture–A tax election for a business arrangement between spouses who file a joint tax return that offers no liability protection but allows the individuals to avoid partnership taxation and instead receive sole proprietor taxation. This election is controlled by IRC §761(f).

QTIP trust–A term, used in A-B-C trust planning model, for the trust that holds assets where the spouse can receive the income generated from this trust, but not the assets themselves. This trust follows tax rules established in IRC § 2056.

Recapture–A requirement to pay back a tax benefit. Commonly used to describe the gain realized by the sale of a depreciated asset that must be reported as ordinary income for tax purposes. Depreciation recapture is determined by the depreciation deductions taken by the taxpayer on the asset. Recapture also is possible with special use valuation.

Remainder interest–A future interest in property held by a remainder person usually following a life estate or term interest.

Remainder person–One who is entitled to hold a remainder interest. Commonly referred to as a remainderman, if one, or remaindermen, if multiple.

Rent–Money paid to the owner of an asset in return for use of the asset.

Rental Option–A contractual right to be offered the ability to rent an asset, usually farm ground, before another individual or entity could rent the asset.

Restraint on Alienation–A prohibition or limitation on how a new owner can convey an interest in real property. Many states limit a testator's ability to create a restraint on alienation.

Retirement Account–A designated account established to specifically allow a person to put money away for retirement in a tax-advantaged way.

Retained Life Estate–A life estate one preserved by the original owner for themselves while transferring the remainder interest to another person(s), typically a spouse or children.

Revocable Living Trust–The grantor creates the trust during his or her lifetime and retains the power or right to amend, revoke, or alter the trust during the grantor's lifetime. These trusts may save estate settlement costs, but do not remove the assets from the taxable estate for federal estate tax purposes.

Right of First Refusal–A contractual right giving someone the option to purchase an asset before any third party could purchase the asset.

Right of Survivorship–A feature of joint tenancy whereby the surviving tenant or joint tenants automatically acquire all the rights, title, and interests of the deceased joint tenant.

Rule Against Perpetuities–A legal rule adopted by most states that prevents a trust from owning an asset indefinitely, or puts deadhand control measures in estate planning documents that extend a time long beyond the lives of people living when the estate plan was written. The default rule disallows control more than 21 years after the death of a person who is alive at the time the trust or estate plan is enacted.

S-corporation–The tax term used to describe an optional taxation structure for corporations for federal income taxation purposes. If a corporation qualifies, the business can elect to be taxed at the shareholder level and be a pass-through entity, and not taxed at the business entity level.

Section 179–An income tax provision that allows those in a trade or business to immediately expense, and therefore deduct, the cost of tangible personal property, subject to financial limitations.

Section 1221 Assets–Property held by a taxpayer for personal or investment purposes. The default is that the asset is subject to capital gain or loss upon sale of the asset. The disposition of these assets is controlled by IRC §1221.

Section 1231 Assets–Property held for more than one year that is used in a trade or business and subject to rules found in IRC §1231 when sold or exchanged.

Self-dealing–When an owner of a business or a fiduciary uses their position within the business to better their own interests to the detriment of the business.

Self-Employment Tax–Taxes self-employed individuals, independent contractors, and small business owners pay to the federal government to fund Medicare and Social Security. Employees pay these taxes as well, but a portion of the tax is paid by the employer.

Self-proving Affidavit–An affidavit where the witnesses swear before a notary stating the will was validly executed, and the testator had testamentary capacity.

Share–A unit of equity ownership in the capital stock of a corporation. Owning a share makes an individual a shareholder and entitles that person to shareholder rights under state law and the corporation's bylaws.

Shareholder–An owner of a corporation who is entitled to the profits of a corporation and may have voting rights on specific issues if authorized by the bylaws.

Short-Term Capital Gain–When a capital asset is sold above its adjusted basis and was held for a year or less by the owner, it is taxed at ordinary income tax rates.

Small Estate–An estate that contains property with a value small enough to be eligible, under state law, for simplified probate procedures or out-of-court transfers of the deceased person's property.

Sole Proprietor–Someone who is the sole owner of a non-formalized business.

Sole Proprietorship–A business structure where all business assets are individually owned and there is no legal distinction between the individual and the business.

Sound Mind–The mental ability to make a will measured by a legal test. In Iowa, the testator must have sufficient mental capacity to understand the nature of the will, the property to be disposed of, the identity of close family members, and the way they want to distribute their property.

Special Needs Trust–A specific type of trust that allows a needs-based government benefits recipient to continue to be enrolled in the program without having to use the trust funds for their care. Very specific language is required within the trust to ensure the goals of the trust are met.

Special Use Valuation–A federal estate tax election that allows property to be valued according to its current use rather than the usual "highest and best use" as required under fair market value. This election is established in IRC § 2023A, and there are many necessary conditions to allow this election.

Spendthrift Trust–A specific type of trust where the beneficiary has no control over the asset, and the trustee has the power to determine how the trust funds are spent for the benefit of the beneficiary.

Springing Power of Attorney–A power of attorney where the agent is not authorized to act on behalf of the principal until a certain event or time has occurred. Once that event or time occurs, then the agent's powers "spring" into existence.

Spousal Trust–An irrevocable trust designed to hold the deceased spouse's assets that exceed the amount that can be sheltered from estate taxes. The transfer to the spouse is tax-free due to the unlimited marital deduction.

Statute of Limitations–A law that gives a deadline for when someone can bring an action or claim before a court.

Statutory Share–The legal right of a spouse to a portion of decedent's estate, regardless of the provisions found in the will or revocable trust. Also called elective share.

Stepped-up Basis–A tax policy that adjusts the basis of the assets in a decedent's estate to fair market value at the time of death.

Succession planning–The process of preparing to transfer an operating farm or ranch to the next owner(s).

Successor Trustee–A person or entity listed in the trust document who is nominated to become trustee once the initial trustee dies or is no longer able to serve.

Supplemental Needs Trust–A specific type of trust that allows a needs-based government benefits recipient to continue to be enrolled in the program without having to use the trust funds for their care. Very specific language is required within the trust to ensure the goals of the trust are met.

Surviving Spouse–A living spouse who was not divorced from the decedent at the time of the decedent's death, and therefore is entitled to an elective share.

Tangible Personal Property–Individually owned assets that can be felt or touched, and physically relocated. Includes: furniture, most family heirlooms, jewelry, etc. Does not include bank accounts, stocks, intellectual property, warehouse receipts.

Taxable Estate–For federal estate tax purposes, the value of the decedent's gross estate minus permissible deductions plus any lifetime taxable gifts. The value of the taxable estate determines the amount against which the estate tax rate applies.

Tenancy in common (TIC)–The shared ownership of a single property among two or more persons. The interests need not be equal, and no right of survivorship exists.

Tenants in common–Persons who jointly own an undivided interest in property. Tenants in common do not have a survivorship right.

Testamentary Capacity–The mental ability to make a will measured by a legal test. In Iowa, the testator must have sufficient mental capacity to understand the nature of the will, the property to be disposed of, the identity of close family members, and the way they want to distribute their property.

Testamentary Documents–A document that controls how a decedent's assets will be handled at death and is operative only upon that person's death. Includes: will, trust set forth or contained in a will, and codicil.

Testamentary Formalities–The process and steps necessary to properly execute a will. State law determines what formalities must be followed and evidenced in the will.

Testamentary Freedom–A legal concept that allows an individual to direct their assets to anyone they wish after they die, and that their issue is not entitled to their estate. A spouse's entitlement to an elective share is a restriction on testamentary freedom.

Testamentary Trust–A trust that is created after death through a provision in a decedent's will or trust.

Testate Succession–Transfer of the decedent's estate, after satisfying all existing obligations, according to the manner set out in a valid and properly executed will.

Testator–A person who has validly executed a will.

Tortious Conduct–Behavior that causes harm or wrongs another and makes an individual or entity liable to be sued as a civil wrong.

Transferee–A term applicable to partnerships and LLCs, for individuals who obtain ownership in a business and therefore hold a right to the financial benefits of a business, but not the right to manage the business.

Transfer on Death (TOD)–When an asset is titled in order to allow a named beneficiary to receive the property immediately upon the original owner's death without having to utilize the probate court, but the beneficiary does not have access to the property during the original owner's life.

Trust–A specific legal vehicle that owns an asset, which is managed by a trustee for the benefit of another. A trust document details the management rights of the trustee.

Trustee–The individual or entity responsible for the control, management, and oversight of trust assets.

Trustor–One who creates the trust. Also referred to as Grantor or Settlor.

Trust Protector–A person or entity named by the trust to carry out enumerated administrative and strategic purposes generally not reserved to the trustee, settlor, or beneficiaries.

Undivided fractional interest–A term used to describe the right to use the entire property when two or more persons own the same property. For example, if three people have an undivided interest in 120 acres, they do not each own 40 acres. Instead, they each have a third interest in all 120 acres and can occupy the full 120 acres.

Undue Influence–When one person uses coercion or inappropriate persuasion in order to cause another person to change their estate distribution plan, which results in inequity between the beneficiaries.

Unified Credit–A federal tax credit that determines the lifetime amount that will be exempt from gift and estate taxes. The credit amount determines how much one can gift during their lifetime or pass on as part of their estate without having to pay gift tax or estate tax.

Uniform Transfer to Minors Act–A statute, adopted by almost all states, that provides a method for transferring property to minors and arranging for an adult to manage it until the child is old enough to receive it. Currently, Iowa Code Chapter 565B.

Valuation Discount–For estate tax purposes, discounts on closely-held business entity interests that account for lack of marketability, lack of control, or built-in gains tax on a corporation's appreciated assets.

Waste–A legal concept that prevents a life estate holder from destroying, misusing, altering, or neglecting the property, and requires the life tenant to preserve the property for the remaindermen.

Will–A written legal document directing the disposal of one's individually titled property after death.

Will Substitutes–A term for the various documents used to transfer assets outside of the probate court process after the death of an individual. A revocable living trust is a common will substitute.

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Appendix A

Evaluating Your Estate Plan: Estate Planning Questionnaire

Ag Decision Maker
extension.iastate.edu/agdm

File C4-57

TABLE OF CONTENTS

NOTE: Iowa State University Extension and Outreach does not provide legal advice. Any information provided is intended to be educational and is not intended to substitute for legal advice from a competent professional retained by an individual or organization for that purpose. Additional pages may be added to this questionnaire if space allotted for a category is insufficient.
Any information entered and saved in this document is saved on the local device, no information is retained by using this form online.

Revised May 2021

IOWA STATE UNIVERSITY
Extension and Outreach

Date of Completion: ______________________________

I. PERSONAL AND FAMILY INFORMATION

Your Full Name: ______________________________

City, State, Zip: ______________________________ Telephone: (______) ______________________________

Cell Phone: (______) ______________________________ Personal Email Address: ______________________________

Birth Date: ______________________________ Social Security Number: ______________________________

Current Marital Status ___ Single ___ Married ___ Widow/Widower (attach IRS Form 706)

___ Married but separated ___ Divorced and remarried ___ Divorced and single
(if divorced, attach copies of divorce decree and property settlement agreement)

Date, County, and State Where Married: ______________________________

Spouse's Full Name: ______________________________

Spouse Phone: (______) ______________________________ Spouse Email Address: ______________________________

Birth Date: ______________________________ Social Security Number: ______________________________

Employer(s)	***Example***	**Business 1**	**Business 2**
Business Name:	*Shady Acres Farm*		
Position or Self-employed:	*Farmer (self)*		
Business Address:	*123 X Ave, Charles City, IA*		
Business Email:	*shadyacres@crt.com*		
Business Telephone:	*(641) 123-4567*		

Parents

Yourself Father's Name ________________ Birth Date ____/____/____ Date of Death ____/____/____

Mother's Name ________________ Birth Date ____/____/____ Date of Death ____/____/____

Spouse Father's Name ________________ Birth Date ____/____/____ Date of Death ____/____/____

Mother's Name ________________ Birth Date ____/____/____ Date of Death ____/____/____

Children and Grandchildren

Child	Date of Birth	SSN	City/State	Biological/Adopted/Step
Example: Mary Kate Peterson	*9/6/74*	*111-11-1111*	*New Hampton, IA*	*Biological*
Spouse Name: *Mark Miller*		Grandchildren Name(s)		Date of Birth
		Andrew Paul		*5/22/00*
		Meredith Jane		*8/12/03*
		Matthew John		*11/5/06*

Child	Date of Birth	SSN	City/State	Biological/Adopted/Step
1.				
Spouse Name:		Grandchildren Name(s)		Date of Birth
2.				
Spouse Name:		Grandchildren Name(s)		Date of Birth

Child	Date of Birth	SSN	City/State	Biological/Adopted/Step
3.				
Spouse Name:		Grandchildren Name(s)		Date of Birth
4.				
Spouse Name:		Grandchildren Name(s)		Date of Birth
5.				
Spouse Name:		Grandchildren Name(s)		Date of Birth
6.				
Spouse Name:		Grandchildren Name(s)		Date of Birth

Other Family Information

Are there any persons dependent on you? Yes ____ No ____

If yes, list names and relationship: ____________________

____

____

Does any child or grandchild have a health problem or handicap? Yes ____ No ____

If yes, please explain: ____________________

____

____

Pets

Names	Ages	Special Medical Conditions	Future care instructions

II. CURRENT ESTATE PLAN INFORMATION

Do you have a will or trust at the present time? Yes ____ (attach a copy) No ____

Location of original(s): ____________________

Does your spouse have a will or trust at the present time? Yes ____ (attach a copy) No ____

Location of original(s): ____________________

Do you have a marital property (prenuptial) agreement? Yes ____ (attach a copy) No ____

Who do you recommend as executor for your estate? ____________________

If the above were unable to serve, who would you recommend as an alternate? ____________________

Who do you recommend as guardian(s) for any minor children? ______________________________

If the above were unable to serve, who would you recommend as alternate(s)? ______________________________

Do you have a testamentary trust in place for minor children? Yes ___ No___

Who do you recommend as trustee(s) of this testamentary trust for any minor children? ______________________________

____

III. ADVANCED DIRECTIVES

a. Do you or your spouse have a **Financial Power of Attorney**? Yes ___ No___

If not, who would you choose to have as a Financial Power of Attorney? ______________________________

If this person were unable to serve, who would you choose as an alternate? ______________________________

b. Do you or your spouse have a **Medical/Health Care Power of Attorney**? Yes ___ No___

If not, who would you choose to have as a Medical/Health Power of Attorney? ______________________________

If this person were unable to serve, who would you choose as an alternate? ______________________________

c. Do you or your spouse have a **Living Will**? Yes ___ No___

If yes, where is a copy located? ______________________________

d. Do you or your spouse have a **Do Not Resuscitate Order**? Yes ___ No___

If yes, where is a copy located? ______________________________

e. Do you or your spouse have any special directives on where or how you want your remains to be disposed? Yes ___ No ___

If yes, please explain: ______________________________

____

IV. ASSETS

a. Real Estate: includes land and what is built on the land or attached to the land. This may include buildings, fences and subsurface tiling. Mineral, wind, cellular tower, carbon, manure, pipeline or other utility rights may also be a consideration in regard to real property.

Type of Property and Location (legal description)	Titling*	Fair Market Value	Mortgage Amount	Cost Basis**
Example: Home Farm, Franklin County, Iowa, 160 acres	*Ma and Pa Johnson, Tenancy in Common*	*$1,280,000*	*$300,000*	*$480,000*
	Total Value of Real Estate			

*Titling is the name or names that appear as grantees on the deed for each property and the form of ownership. Forms of ownership in Iowa are Fee Simple, Tenancy in Common, Joint Tenancy, Life Estate and Trust. If land is owned in a life estate, indicate the remainderman. If land is owned by a trust, indicate the successor.

**Cost Basis describes the value of an asset for the purpose of determining the gain or loss on its sale or transfer; or in determining the value of the assets in the hands of a donee (recipient) of a gift. The cost basis is determined at the date of purchase. If the property was inherited, then the cost basis was determined at the time the property was inherited.

b. Closely Held Business Interests

Name of Business	Titling	Ownership Percent	Entity Type*	Fair Market Value
Example: Shady Acres Farm	*Ma and Pa Johnson*			
Total Value of Business Interests				

*Entity types: Sole Proprietorship, Partnerships, Subchapter C Corporations, Subchapter S Corporations, Limited Liability Companies, Limited Liability Partnerships and Cooperatives.

c. Bank Accounts and Certificates of Deposit

Name of Financial Institution	Titling*	Account Number	Account Type	Fair Market Value
Example: Home Community Bank	*Ma & Pa Johnson, Joint*	*012345*	*Checking*	*$4,500*
			Total Value of Bank Accounts	

*Titling should be who is listed on ownership card from financial institution. It may be beneficial to include copies of ownership cards or bring original cards. This may differ from individuals who are listed as a signer or depositor with no ownership of the account.

d. Stocks, Mutual Funds, Annuities,

Name of Investment Firm or Brokerage	Titling	Account Number	Beneficiary	Fair Market Value
Example: XYZ Investment Co.	*Ma and Pa Johnson, Joint*	*00234567*		*$345,000*
Total Value of Investment Accounts				

e. Life Insurance

Insurance Company and Type*	Policy Owner**	Policy Number	Insured	Beneficiary or Contingent	Loans on Policy	Net (of loans) Face Amount
Example: ABC Ins., Ind. Term	*Pa Johnson*	*LF-04567*	*Pa Johnson*	*Ma Johnson*	*$0*	*$500,000*
					Total Value of Life Insurance: Net Face Amount	

*Insurance policy types include Group Term, Individual Term, Individual Whole Life (cash value) and Survivorship Whole Life (second to die).
**Policy owner: usually the insured, but can be beneficiaries, a trust, a business or others.

f. Long Term Care Insurance

Do you and/or your spouse have long-term care insurance? Myself ____ Spouse ____

If yes, please describe: ____

____

g. Retirement Plans

Account Owner or Participant	Type*	Account Number	Account Location	Beneficiary	Fair Market Value
Example: Pa Johnson	*IRA*		*Home Community Bank*	*Ma Johnson*	*$150,000*
				Total Value of Retirement Accounts	

*Retirement account types include Annuities, IRAs, SEPs, SIMPLE plans, 401(k) plans, profit sharing plans (PSP), 403(b) plans, 457 plans and others.

h. Tangible Personal Property: Tangible personal property includes anything that can be touched – from household goods, jewelry and clothing, and may include livestock, machinery, stored grain, vehicles and inventory items. Specify if items listed should go to a specific person. It may be beneficial to attach photographs of items or additional pages if space allowed is insufficient.
For **tangible farm assets** attach current depreciation schedule.

Non-Farm Personal Property				
Type of Property	**Titling**	**Description**	**Specific Beneficiary**	**Fair Market Value**
Example: Jewelry	*Ma and Pa Johnson*	*Diamond earrings*	*Meredith Jane*	*$2,000*
			Total Value of Personal Property	

i. Other Assets

Interest in Trusts or Estates

Does any member of your family have any relationship to an existing trust as donor, trustee or beneficiary? Yes ____ No ____

Has any member of your family in the past received an inheritance from an estate? Yes ____ No ____

If yes, please explain:____________________

Does any member of your family have any interest (e.g. as a beneficiary) in a pending or potential future estate?

Maybe ____ Yes ____ No ____

If yes or maybe, please explain: ____________________

Loans Made or Other Outstanding Receivables

Have you or your spouse loaned another individual money? Yes ____ No ____

If yes, please explain: ____________________

V. LIABILITIES (OTHER THAN REAL ESTATE MORTGAGE):

Liabilities (other than real estate mortgage) would include current debt, such as operating notes, accounts with crop or livestock input suppliers, debt against intermediate term assets like breeding stock and farm equipment, and unsecured debt (credit cards).

Borrower	Type	Account Number	Lender	Payment Amount	Payment Frequency	Balance Outstanding
Example: Ma and Pa Johnson	*Auto loan*		*Home Community Bank*	*$525*	*monthly*	*$8,500*
			Total Debt			

VI. GIFTING

Have you or your spouse made gifts in any one year to a person(s) that exceeded in value the annual gift tax exemption amount for that year (ex: $3,000 in 1980 or $15,000 in 2020) or ever filed an IRS Form 709 Gift and Generation Skipping Transfer Tax Return?
See *IRS Publication 559*: Survivors, Executors, and Administrators (www.irs.gov/publications/p559) for a list of historic amounts.

Yes____ No ____

If yes, specify the amount of gift, date, recipient and include a copy of the 709(s) if filed:

Gift Item and Value	Date of Gift	Recipient
Example: $10,000	*5/10/1999*	*Mary Jane & Mark*

VII. PROFESSIONAL ADVISORS

Attorney: ______________________________

Address: ______________________________

Telephone: (______) ______________________ Email address: ______________________

Insurance Agent: ______________________________

Address: ______________________________

Telephone: (______) ______________________ Email address: ______________________

Financial Advisor: ______________________________

Address: ______________________________

Telephone: (______) ______________________ Email address: ______________________

Accountant: ______________________________

Address: ______________________________

Telephone: (______) ______________________ Email address: ______________________

Lender: ______________________________

Address: ______________________________

Telephone: (______) ______________________ Email address: ______________________

Other Advisor: ______________________________

Address: ______________________________

Telephone: (______) ______________________ Email address: ______________________

VIII. EASEMENTS OR OTHER RELEVANT INFORMATION

Have you granted or are you the benefactor of any easements, such as wind towers, cell towers, manure easements, carbon credits, pipelines, or other, that is more than a year in length? Use the space provided below to provide details or additional notes for any section of this questionnaire.

Visit the Ag Decision Maker website for additional resources on Farm Business Transition and Estate Planning, www.extension.iastate.edu/agdm/wdbusiness.html.

United States Department of Agriculture

National Institute of Food and Agriculture

NORTH CENTRAL EXTENSION RISK MANAGEMENT EDUCATION

Reviewed by Kelvin Leibold, extension farm management field specialist; Original author Tim Eggers former extension field economist

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