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Current estate planning for farmers and ranchers

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Introduction

As with the proverbial cobbler whose children have holes in their shoes, most farmers and ranchers like other Americans tend to be so preoccupied with daily living that they overlook the importance of estate planning. That is exemplified by the fact that 60% of Americans do not even have a Will.[1] Yet, there is not a subject in peoples' lives that is more pervasive than estate planning. That is because it applies to everyone regardless of how much or how little they have. Of course, the more wealth that people possess the more complicated the planning but it all begins with the universal need for four basic documents. Once those documents are addressed the planning process begins to take into consideration the level of a person's wealth and more specifically the implications of income and transfer taxes (Estate, Gift and Generation Skipping). In that regard, the substantial increase in the estate tax applicable exclusion ($5,450,000 in 2016) has shifted tax planning for the vast majority of people away from estate tax saving to legacy planning and income tax saving for future generations. Paralleling this de-emphasis on estate taxes is a survey which showed that nearly half of individuals with more than $3 million of investible assets consider the two most important aspects of their lives to be the closeness of their family and the success of their children.[2] Consequently, in the context of farming and ranching, this paper will cover an explanation of the basic estate planning documents, estate tax saving techniques and family oriented legacy planning/income tax saving. Finally, due to the dramatic impact that the cost of long-term care can have on a farmer's or rancher's estate information will be provided on long-term care planning.

Will

The first of the basic estate planning documents to consider is a farmer's or rancher's *Will.* In that regard, you should note that when a person dies intestate (without a *Will*) state law dictates who gets their property that could have passed by *Will.* This type of property called "probate property" does not include jointly held assets with right of survivorship (such as a home or a bank account) or assets that pass by terms of a contractual beneficiary designation (such as life insurance or qualified pension benefits). The undesirable consequences of having the property pass by state law include:

- The people who actually receive the property (and the portions they receive) may not be what the decedent intended or would have wanted.
- Often, an undeserving person in the family may get property, while a needy relative or friend is left out.

[1] June 30, 2008 press release on FindLaw.com.
[2] U.S. Trust, "Insights on Wealth and Worth", January & February, 2011.

- If property passes to a minor, the state determines who is made guardian of the property for the child— it could be a person the decedent did not like or trust (possibly a divorced spouse.)

Durable Power of Attorney

The next type of document that every adult individual should have is a D*urable Power of Attorney*. This is because during the course of their life everyone bears the risk of becoming mentally incapacitated due to age, illness or injury. If that happens in the absence of a D*urable Power of Attorney*, a court appointed Conservator or Guardian will have to be arranged to manage their personal and property interests. In that respect, a Conservator deals with management of the disabled person's property while a Guardian is responsible for taking care of their personal needs. The problem with this is that the process of appointment is expensive and time-consuming. Often, requiring the appointment of a temporary guardian during the proceedings; the posting of a surety bond; and expert medical testimony. Further, periodic judicial accountings are expensive and there is a lack of flexibility in administering the person's finances.

Here you should note that a regular *Power of Attorney* automatically terminates if the principal becomes incapacitated and consequently is of little use in estate planning situations. Consequently, pursuant to enabling state legislation (in all 50 states) a durable power is drawn in such a way that it remains effective even though the principal becomes physically or mentally incapacitated. A *Durable Power of Attorney* may be used to protect the principal's property during a period of incapacity without the need for a court proceeding. This is especially important from a personal perspective since court proceedings for the appointment of a Conservator or Guardian are not only time-consuming and expensive they also make a public record of highly sensitive and personal matters possibly setting the stage for family fights over control of the person and their property.

Revocable Living Trust

A document that can sometimes take the place of both a *Will* and *Durable Power of Attorney* is called a *Revocable Living Trust*. This is a trust that is set up during the farmer's or rancher's life to own their major assets. To work correctly, it is used in combination with a *Pour-Over Will* that transfers any probate assets that the farmer or rancher owned outside of the *Revocable Living trust* to the *Revocable Living trust* at the farmer's or rancher's death. It should be noted that while these trusts typically pose no significant tax advantages they can provide the following benefits:

- Probate costs are eliminated or reduced.
- The trustee can manage the farmer's or rancher's property during a period of mental incapacity.
- The assets in the trust that pass to heirs at the farmer's or rancher's death without a public record since the trust document does not become recorded like a *Will* upon the farmer's or rancher's death.

Health Care Documents

The next type of document that everyone should have is a medical *Advanced Directive*. This is because relatively recent advances in medical science make it possible to prolong life under circumstances which present difficult issues for the farmer or rancher considering:

- Religious and moral beliefs.
- The tremendous cost of prolonged health care.
- The extreme pain or discomfort of some medical procedures such as chemotherapy.

This area of the law is relatively new but a combination of English Common Law and the US Bill of Rights forms the basis for the doctrine of "Informed Consent". Under that doctrine, medical decisions are made through a process of discussion and disclosure between physician and patient. Moreover, it has been held by the courts on a consistent basis that the right of self-determination in medical matters is equally available to incompetent persons. As a result, the courts have indicated that whether or not a health care decision for an incompetent can be made and by whom depends upon whether there is “clear and convincing” evidence that the patient made an informed decision regarding the medical treatment through an *Advanced Directive*.

Living Will

The most basic Advanced Directive is a *Living Will* that allows an individual whose death is imminent to direct his or her doctor and hospital to refrain from using certain life sustaining medical treatments. To take advantage of such an opportunity where it exists a farmer’s or rancher’s *Living Will* should state completely and explicitly those areas of health care about which they have made definite decisions as to whether he or she wishes, or does not wish, to refuse the treatment. Further, the farmer or rancher should decide how long any desired treatment should be tried if significant improvement is not made. In any case, there are three areas of particular importance on which the individual should state their preference. Those are:

- Providing artificial nutrition and hydration.
- Administering pain medications even though they may hasten death and/or retard consciousness.
- Use of other means of prolonging life (mechanical breathing machines and organ transplants), including those that can be extremely expensive.

The most common criticisms of *Living Wills* are that they only apply to the terminally ill and do not help with medical decisions other than the decision to withhold or withdraw life sustaining treatment. Further, many health care providers complain that *Living Wills* are too general to provide meaningful guidance when a specific treatment decision has to be made. In addition, many *Living Will* statutes prohibit the withholding or withdrawal of medically applied nutrition and hydration that are the most commonly used form of life sustaining treatment. Finally, the statutes generally only deal with the authorization to remove life sustaining treatment and do not authorize maximum care and treatment.

Health Care Proxy (Durable Power of Attorney for Health Care, or Medical Decision Power of Attorney)

The *Health Care Proxy* is a form of Advance Directive that can overcome the shortcomings of a living Will. This is because a *Health Care Proxy*, unlike a Living Will, can be used for a broad range of health decisions. In particular, it may be used to authorize maximum medical treatment without regard to cost if that happens to be the desire of the principal. Further, some people prefer to have others make health care decisions for them when they are no longer able to do so. A *Health Care Proxy* allows a person to vest broad decision-making authority in one or more individuals. This is important because under present law it is unclear how health care providers are supposed to reconcile different instructions from different family members. In any case, the most important part of the *Health Care Proxy* is the appointment of the person to make health care decisions but other points should be considered for inclusion:

- Define the scope of the agent’s powers or limitations.
- Provide guidelines for the agent to follow.
- Name successor agents if the primary agent should become unable to act.

Combination of Living Will and Health Care Proxy

In theory, it makes good sense to combine the living will and health care proxy but state law needs to be checked to be sure that the contents and formalities for signing are compatible.

Copies, Notice and Storage

Copies should be given to the health care agent and the farmer's or rancher's individual's physician. The individual or drafting attorney should keep the original. Further, it would be a good idea for the person to carry a wallet size card stating that they have made an advance directive and where it can be located.

Who Should Prepare Advance Directives

While there are forms available to the public from various organizations plus state statutory prototypes, it is best to have the document or documents drafted by an attorney familiar with the subject. In this respect, there are lawyers now specializing in the area of "Elder Law" which includes the subject of Advance Directives.

Finding and working with an estate planning attorney

To properly have the above documents prepared a farmer or rancher will need to engage the services of a lawyer. In that regard they will want a specialist who has training and experience in Estate Planning/Elder Law. To find such a specialist they should ask lawyers or accountants they know for a reference to someone who specializes in Estate Planning/Elder Law. Another source of information can be the trust department of a local bank. You may also refer the farmer or rancher to an attorney but in doing so you should be familiar with the attorney's qualifications and something of their fee structure. In that respect, it should be noted that lawyer's fees can vary significantly by geographical area and are affected by considerations such as the attorney's training and experience. Further, the customer may be billed on the basis of the amount of time involved, the nature of the service or a combination of the two. The customer's best course is to ask the attorney up front about the approximate cost of what they need and ask for an itemized bill before they pay.

What to take to the first meeting

An attorney's time costs money so the better prepared the farmer or rancher is for their meeting the more of the lawyer's time and their money they are likely to save. So they should take with them:

- An inventory of their assets and liabilities.
- Records showing how major assets, like their home, ranch/farm or investments are owned (in joint names or individually).
- A list of their potential heirs, friends and charities they may want to benefit from their present income and estate.
- Copies of existing Wills, Trusts, etc.
- Their thoughts about what kind of medical treatment they are willing and unwilling to accept.
- The names of persons and their alternates they would want to serve if necessary as executors, guardians, trustees and holders of a Power of Attorney or Health Care Proxy.

Plan reviews

Because we live in an ever changing world, estate planning is not something you can set in place and never look at again. Consequently, farmers and ranchers should regularly review their estate plans, especially after life-changing events such as:

- Births and deaths of family members and business associates.
- Marriages and divorces of family members.
- A substantial change if net worth.
- Approaching retirement or the pending sale of the farm or ranch.
- Changes in state and federal tax laws.

The federal estate tax

The federal estate tax applicable exclusion is $5,450,000 for 2016 as adjusted for inflation. This means that unless a farmer or rancher has an estate in excess of that figure they are not exposed to the estate tax. Better yet, if they are married as will be seen below, they and their spouse may be exempt to the extent of twice that figure or $10,900,000. On the other hand, if the individual's or couple's wealth exceeds these figures they have an estate tax exposure. This brings up the problem that farmers and ranchers are typically strapped for cash so when they die leaving an estate large enough to be exposed to the federal estate tax the family can expect to have to sell something to cover the tax. That does not have to be the case, however, as the estate tax has been described as a "voluntary" tax. Voluntary, that is, if you are willing and able to take advantage of the planning opportunities that are in the law. If not, as will be seen below, life insurance can be a very appealing alternative to having to sell the family farm or ranch.

By-Pass Trust/Marital Deduction

Basic estate tax planning begins with an understanding of the interplay between the federal estate tax applicable exclusion and the marital deduction. In that regard, the applicable exclusion, as previously stated, is a specific amount of property that is automatically exempted from federal estate tax when you die. ($5,450,000 in 2016). On top of that, the marital deduction exempts any additional property that you leave to your spouse when you die. Consequently, an individual's Will is usually drafted to provide that property equal to their applicable estate tax exclusion be placed in what is called a "By-Pass" trust with the remainder of the estate given to the surviving spouse under the marital deduction. This approach avoids any estate tax at the first death because the amount in the By-Pass Trust is shielded by the applicable estate tax exclusion while the balance is covered by the marital deduction.

By taking the By-Pass Trust/Marital Deduction approach, the advantage becomes especially apparent when the surviving spouse dies. That is because the value of the property in the By-Pass Trust will not be included in the spouse's estate and will not be subject to estate tax. The reason is that the spouse will not be deemed to own the property in the Trust and only property that the spouse owns at death is subject to the estate tax. So, whatever is left in the By-Pass Trust, at the spouse's death, can go to the couple's children or other beneficiaries free of estate tax. In any case, what will be taxed at the surviving spouse's death will be the amount of property that the spouse has in excess of the spouse's own estate tax applicable exclusion. This figure will be comprised of the spouse's own separate property plus what remains of the property that the spouse received under the marital deduction.

Portability

Turning to portability, this is a relatively new concept to the federal estate tax that was introduced by the 2010 tax act. Basically it allows the executor of a deceased farmer's or rancher's estate to transfer any of their unused estate tax applicable exclusion to their surviving spouse. For portability to apply, however, the executor of a decedent who intends to make the portability election must file an estate tax return Form 706 and that requirement places a burden on the estates of decedents that are not otherwise required to file a return. Moreover, the unused exclusion from a particular predeceased spouse spouse will be lost if the surviving spouse remarries and survives his or her next spouse.

Revocable Living Trust

You should note that besides setting up a *By-Pass Trust* and marital deduction in a person's *Will* you can also do this through the use of a *Revocable Living Trust*. The way this works is that the farmer's or rancher's lawyer drafts a trust document that sets up a trust during the farmer's or rancher's life that takes effect upon the farmer or rancher signing it and transferring their property to it. When I say "property" I am speaking about the prospect's major assets like their home, stock portfolio or other significant assets. The terms of the *Revocable Living Trust* state that upon the farmer's or rancher's death the property in the Trust is divided into two shares with one share forming a *By–Pass Trust* and the other a marital deduction amount. The result is the same as was previously described where a farmer or rancher can do the same kind of allocation of their property through their *Will*. Further, to make sure that the *Revocable Living Trust* covers all of the farmer's or rancher's property when they die the lawyer also drafts what is called a *Pour-Over Will*. This document simply provides that any of the farmer's or rancher's property that was not placed in the R*evocable Living Trust* during their life is transferred to the trust at their death.

QTIP Trusts

An important point with regard to the previously mentioned marital deduction is that the property that qualifies for the deduction may be given directly to the farmer's or rancher's spouse or set aside for that person in a trust. Normally, when property is given to the spouse through a trust that qualifies for the marital deduction the spouse must be given the right to say what happens to the property remaining in the trust upon the spouse's death. That can present problems in the case of a second marriage situation where the farmer or rancher wants to take care of the second spouse for their life but wants to leave the trust remainder to the children of the farmer's or rancher's first marriage. To fix this common problem Congress provided for the creation of what is called a *Qualified Terminal Interest Property Trust* or "QTIP". Under these arrangements the farmer or rancher provides in their W*ill* or R*evocable Living Trust* that the second spouse's marital share is to be placed in a trust with all of the trust income going to the second spouse and as much of the principal as the trustee thinks appropriate but on the second spouse's death the remaining property in the trust goes the children of the farmer's or rancher's first marriage.

IRC §§ 2032A and 6166

Turning to IRC §§ 2032A the purpose of that provision is to allow farmers and ranchers who have real estate used in a farm or ranch to value that property in a way that reflects how it is actually used and not what it could be sold for to a developer. For example, assume that a farm is worth $600,000 as a farm considering the income that it generates but that it could be sold to a real estate developer for $1,600,000. Pursuant to IRC § 2032A, at the farmer's death, the property could be entered on the estate tax return at a value of $490,000 rather than the $1,600,000 it could be sold for. This is because for the year 2016 § 2032A allows such a farm property to be reduced in value by up to $1,110,000 for estate tax reporting purposes ($1,600,000 - $1,110,000 = $490,000). The idea is to give the families of farmers a break so that they do not have to sell the farm to pay estate tax on the higher value.
IRC § 6166 was also designed to give farmers or ranchers a break by providing that any estate tax attributable to the farm or ranch can be paid in installments over a period of fifteen years rather than all at once when the estate tax return is due nine months after the decedent's death. Further, the farmer's or rancher's heirs need only pay interest at a low rate for the first five years and then pay the tax due over the next ten years.

It should be noted that the problems with IRC §§ 2032A and 6166 are that they are limited to those who meet certain special qualifications and they are very complicated to apply in practice. Consequently, they are not a very viable solution to deal with the valuation or payment problems of most prospects. The better solution as will be explained later is for those facing an estate tax liability to employ tax saving techniques or pre-fund that obligation through the purchase of life insurance.

Estate tax saving through gifting

The next level of estate tax planning begins with the recognition that farmers and ranchers with estates in excess of the estate tax applicable exclusion (and married couples with twice that amount) face the possibility of federal estate tax liabilities upon their deaths. In that respect, the only way to avoid the tax is to dispose of the excess before death or to leave it to charity at death. As to dispositions before death, for those who can afford it, a lifetime gifting program provides a means of estate tax savings while enjoying the personal satisfaction that comes from helping others. The problem, however, is that the donor is exposed to gift tax on the transfers. That may be reduced, however, through the use of the donor's gift tax Annual Exclusion and gift tax Applicable Exclusion amount.

The gift tax Annual Exclusion and $5.45 million gift tax Applicable Exclusion

The gift tax Annual Exclusion is simply a rule that allows a farmer or rancher to give to as many people as they want each year $14,000 gift tax free. Further, if they are married and their spouse consents in making the gift the couple can transfer $28,000 to as many individuals as they choose gift tax free. For example, a farming or ranching couple with three children could give each child $28,000 for a total of $84,000 gift tax free.

The gift tax Applicable Exclusion is a rule that permits farmers and ranchers to give away over the course of their lives $5.45 (in 2016) million gift tax free. This $5.45 million is in addition to what can be given away using the Annual Exclusion. For example, assume that a farming or ranching couple gave each of their three children $88,000 for a total of $264,000. This would result in a gift to each child of $60,000 in excess of the amount that the parents can give tax free by utilizing their combined gift tax Annual Exclusions ($88,000 - $28,000). To avoid having to pay a gift tax on the $60,000 excess to each child, the parents would offset the excess against their $ 5.45 million gift tax Applicable Exclusions. Since each parent's share of the excess would be $30,000 per child (1/2 of $60,000) and there are three children, the reduction in each parent's gift tax Applicable Exclusion would be 3 x $30,000 or $90,000. Further, for every year that the gifts are repeated, each parent's gift tax Applicable Exclusion would drop by another $90,000. Consequently, if the gifts were continued for ten years, each parent's gift tax Applicable Exclusion would be reduced by 10 x $90,000 or $900,000.

Coordination between the gift tax Applicable Exclusion and the estate tax Applicable Exclusion

You should also understand that the gift and estate tax Applicable Exclusions are "unified' to the extent of their overlap. For example, if an individual uses up their entire $5.45 million gift tax Applicable Exclusion and dies in 2016, there will be a corresponding reduction in the amount of their estate tax Applicable Exclusion and they will have no estate tax Applicable Exclusion remaining to offset their estate tax liability.

Gifting at a discount

With the above gifting opportunities in mind it is apparent that a farming or ranching individual or married couple can significantly reduce the size of their estate and consequent estate tax exposure through a gifting program to their heirs using the Annual Exclusion and $5.45 million Applicable Exclusion. At the next level of planning, however, farmers and ranchers may reduce the size of their estates through a form of gifting program that leverages the Annual Exclusion and $5.45 million Applicable Exclusion. This is done by repackaging the interest that is to be given away in a business structure that allows discounts to be taken against the value of the gift for lack of marketability and lack of control. The idea behind leveraging with discounted gifts is to structure the transfer in a way that permits the value of the gift to be reduced before applying the gift tax Annual Exclusion and the $5.45 million gift tax Applicable Exclusion. This means that more property can be transferred for the same amount of Annual Exclusion and $5.45 million gift tax Applicable Exclusion.

Family Limited Partnerships

To gain an understanding of how this concept works, assume that a farming or ranching couple owns an operation worth $20,000,000 that they would like to pass on to their three children. Assume further, that they want to reduce their potential estate tax liability on the farm or ranch. To do this the parents could form a Family Limited Partnership in 2016 and transfer the farm or ranch operation to the partnership in return for partnership interests that they subsequently transfer to the children by gift. In making gifts to the children the parents can choose to make outright gifts of the partnership interests using their gift tax Annual Exclusions and $5.45 million gift tax Applicable Exclusions. Further, depending upon the facts of the case, the value of the interests transferred to the children may be substantially reduced for the lack of marketability and lack of control discounts. These marketability and control discounts relate to the fact that a stranger to the family would not pay full price to acquire an interest in a farming or ranching business for which there is not a ready resale market and in which they would have a non-controlling interest.

From a leveraging perspective, what this means is that the discounts allow the parents to magnify the amount of property that they transfer to the children gift tax free through utilization of their Annual Exclusions and gift tax Applicable Exclusions. For example, if upon establishing the family limited partnership described above, the parents were able to give the children limited partnership interests equal to the parent's combined Annual Exclusions and $5.45 million gift tax Applicable Exclusions at a 35% discount, the children would receive $16,898,461 of discounted partnership interests. Without the discounts the parents could only have transferred $10,984,000 gift tax free ($10,900,000 of the parents' combined $545,000,000 million gift tax Applicable Exclusions in 2016 plus $84,000 of their combined gift tax Annual Exclusions for the year = $10,984,000). Consequently, the discounts allow the parents to transfer an additional $5,914,461 of value using the same amount of Annual Exclusions and $5,450,000 gift tax Applicable Exclusions. Further, in subsequent years the parents could continue to make tax free discounted gifts by utilizing their gift tax Annual Exclusions even though their $5,450,000 gift tax Applicable Exclusions are used up. This would have a dramatic impact on the reduction of the parents' potential estate tax liabilities without generating any gift tax.

It should be noted, however, that the parents might die before they give away all of their remaining partnership shares to the children using their gift tax Applicable Exclusions. If that were to occur, depending on the amount of the rest of their wealth, the parents might be subject to estate tax on the remaining ungifted partnership shares since they would have used up their estate tax Applicable Exclusions by fully utilizing their corresponding gift tax Applicable Exclusions. (Remember that every dollar of gift tax Applicable Exclusion that is used during life reduces the individual's estate tax Applicable Exclusion available at their death.) The solution is to have the parents purchase a term policy at the beginning of their gifting program in an amount sufficient to cover any estate tax that would be generated by their deaths before all the partnership shares are gifted to the children.

Grantor Retained Annuity Trust ("GRAT")

Besides making direct gifts to the children of interests in the family partnership the farmer or rancher can transfer the partnership interests to a trust and retain a right to income from the trust for a period of time. After the expiration of the farmer's or rancher's income period the remainder interest in the trust assets (partnership shares) passes to the family member(s). The value of the remainder interest is a gift to the family member(s). This is a useful approach where the farmer or rancher wants to give the property to the family member(s) but would like to retain a right to income for a period of time. For example, assume that in 2013 Bill at age 65 transferred $1 million of family partnership interests to a GRAT retaining the right to receive 4% or $40,000 per year for 10 years

- Assume further that the present value of Bill's right to income is worth approximately $350,000

- The gift of the remainder to family members is worth approximately $650,000 and may be offset against his $5.25 million lifetime gift tax exclusion
- If the trust assets earn 7% per year the family will receive approximately $1,400,000 at the end of 10 years

It should be noted that if the farmer or rancher dies during the income period the property will be brought back into their gross estate. To offset any possible estate tax that might result the farmer or rancher can buy a term insurance policy for the duration or the income period in an amount sufficient to cover any possible estate tax.

Life Insurance – the Palatable Alternative

Finally, let's talk about the effects of the farmer's and rancher's increasing age on attitudes toward estate tax planning. The issue is that going forward fewer and fewer farmers and ranchers are likely to be interested in rearranging their affairs to save taxes on their children's inheritances. This is because as the baby boomers age they will not like change and estate tax reduction techniques typically involve creating changes in how property is owned and managed as well as making large gifts to the next generation. The result is that professional advisors need to find a palatable alternative for these farmers and ranchers with taxable estates. In that regard, an alternative is to purchase life insurance through an ILIT. That is because:

- It does not require changing the farmer's or rancher's life.
- Premiums are an affordable alternative to large estate reducing gifts.

In any case, when purchasing life insurance through an ILIT it is desirable to not have the death proceeds included in the insured's estate. To accomplish that goal the trustee and not the insured should be the applicant, owner and beneficiary of the policy and the trust must be in existence when the application is submitted. It is not adequate that the application refer to a trust that is not in existence but is created a short time later. Here are some practical tips that should be observed if problems with the IRS are to be avoided:

- The trustee should be given the discretion to purchase insurance, but must not be required to do so.
- The term "insurance" should not be used in the title (name) of the trust.
- Cash gifts to the trust should not be in the exact amount of the policy premiums.
- A separate bank account should be opened in the name of the trust, using the trust's own taxpayer identification number (TIN).
- There should be a check payable to the trustee from the grantor and a separate check from the trustee to the insurance company for the payment of premiums. The trustee should not just endorse the grantor's check over to the insurer.

These pointers are so that the trust is seen as a separate legal entity that is administered by an independent trustee that is not just the alter ego of the insured. Otherwise, the death proceeds will be included in the insured's gross estate if the insured dies within three years of the purchase. The reason is that the situation will be seen as being no different than if the insured had purchased the policy and transferred it to the trust within three years of death. (Remember, IRC §2035 requires death proceeds to be included in the insured's gross estate when the insured has made a transfer of the policy within three years of death.)

In situations where the farmer or rancher is unwilling to spend the time and money to have an ILIT established before applying for the coverage (often because they do not know if they're insurable or insurable at a price they are willing to pay) a trial application should be used to determine underwriting. Then, if the prospect is willing to proceed with the actual purchase, an ILIT can be established to make the application.

Estate Equalization

Another potential life insurance sale stems from the fact that often times in the case of family farms and ranches there are heirs that do not want or should not receive an interest in the operation. In those situations there is the potential for resentment among the heirs that will not receive an interest in the business. The solution is to have the farmer or rancher purchase life insurance naming as beneficiaries the family members that are to be excluded from involvement with the operation. A key understanding in that regard is that the amount of life insurance purchased for the excluded family members does not have to exactly equal the value of the farming or ranching interest that is passed to those family members actively involved in the operation. That is because the situations among the active and uninvolved family members are different. The active members must work at the farm or ranch to enjoy economic and other benefits while the non-active members will receive nontaxable life insurance death proceeds for no effort. For this reason, perhaps one-half or less of the value of the operation would be an appropriate amount of life insurance to provide a fair or equitable inheritance to the non-involved family members.

Current tax planning

As was previously noted, the increase in the estate tax Applicable Exclusion has shifted the central focus of the estate planning conversation away from estate tax saving. This does not mean, however, that taxes are forgotten but rather they become one of several parts of a larger legacy planning discussion. In this respect, traditional estate planning techniques like the limited partnership example above centered on saving estate taxes by reducing the size of the farmer's or rancher's estate through discounted gifts utilizing the gift tax Applicable Exclusion. Now clients such as farmers and ranchers are encouraged to not utilize their gift tax Applicable Exclusion to make estate reducing gifts. Instead, due to the minimal difference between the top income and estate tax rates, they are encouraged to keep appreciated property in their estates and offset any estate tax with the estate tax Applicable Exclusion. This gives heirs a stepped-up basis and eliminates any income taxable gain to the heirs. That approach would make sense in the above example if the family did not expect to keep the farm or ranch after the parents' generation and intended to sell it.

In any case, to the extent that the client's estate exceeds the estate tax Applicable Exclusion they may preserve their exclusion and avoid any estate tax on the excess by making non gift transfers to heirs. This may be done by selling the actual property or partnership shares to the family member(s) using an installment sale, self-canceling installment note, sale to a defective grantor trust or a life insurance funded buy & sell agreement.

Installment sale

Under this approach the farmer or rancher sells the property or partnership shares to the family member(s) for a series of installment notes. It is particularly appropriate where the farmer or rancher has used up their gift tax exclusions or they want to receive income payments during retirement. The farmer or rancher may purchase life insurance on the family member(s) to cover the possibility that the purchaser(s) will die before all the installments are made.

Self-canceling installment note

This is also an installment sale situation. What is different is that the family member(s) pays a premium for the right to have any unpaid installments canceled at the farmer's or rancher's death. This would keep any unpaid installments out of the farmer's or rancher's estate for federal estate tax purposes. Again, the farmer or rancher should insure the life of the purchaser(s) to cover the possibility that the purchaser(s) will die before all the installments are paid. It is critical under this technique to hire a professional appraiser to provide a credible value on the amount of cancellation premium to be paid by the purchaser or the transaction may be challenged by the IRS.

Installment sale to a defective grantor trust

This approach involves the farmer or rancher setting up a trust that has certain provisions that cause the trust's income tax consequences to be reported to the farmer or rancher. The trust is for the benefit of the family member(s) who is to receive the property or partnership shares. The farmer or rancher generally seeds the trust with a gift of income producing assets that is offset by their $5.45 million gift tax exclusion. The farmer or rancher then enters into an installment sale with the trust. (The rule of thumb is that for every dollar gifted to the trust the trust may purchase ten dollars of property or partnership interests from the farmer.) The trust then pays off the installment notes with the income from the gifted and purchased assets. The result is that since the farmer or rancher is treated as the owner of the trust for income tax purposes, it is as though the farmer or rancher sold the property or partnership shares to themselves and consequently he or she should recognize no taxable gain on the sale.

Buy & sell agreement

The farmer or rancher and the family member(s) enter into a life insurance funded buy and sell agreement. If the sale takes place during the farmer's or rancher's life the cash value of the policy can serve as a down payment with the rest of the sales price made up of installments. If it is a sale at death the death proceeds cover the purchase price. Note that due to the flexibility of buy & sell agreements as an exit strategy tool they may also be used with co-owners and outsiders as well as family members.

Family Trust

Returning to the previously mentioned survey which showed that the two most important aspects of peoples' lives are the closeness of their family and the success of their children the emergence of these trends suggests that professional advisors seeking a vehicle to implement a farmer's or rancher's newfound interest in legacy planning should consider a life insurance funded Family Trust. In that regard, since a farmer's or rancher's goals and values are at the heart of legacy planning it is imperative that you attempt to learn how they want to affect the lives of their children and grandchildren. To do that, begin by asking questions such as:

- What type of life do you want for your children and grandchildren?
- What values do you want reflected in the lives your children and grandchildren?
- Is there anything exceptional or unusual that you would like to do for them?
- Do you want to be involved in providing for their education?
- Do you have any charitable interests?

Achieving balance

Focusing on the importance of values in legacy planning, it is essential to understand that farmers and ranchers as parents need to achieve a balance in securing the financial wellbeing of future generations while not spoiling them. This is where a Family Trust may be used as a tool to accomplish that balance between two seemingly conflicting goals. To do that the Trust may provide incentives in the form of rewards to promote positive behaviors by beneficiaries such as for:

- Continuing formal education
- Living healthy lifestyles
- Making good career choices

The need to maintain control

While farmers and ranchers may find providing for future generations attractive they may also be hesitant to make large gifts because of the loss of control of their money and the inability to access it if it is subsequently needed by them. This is a natural reflection of peoples' desire to want it all by seeking flexibility, control and guarantees in their planning. In that regard, the Family Trust may be designed to provide an opportunity for gifting while maintaining access to the Trust's principal and income. This could be done, for example, by giving a family member a special power of appointment to direct the trustee to make distributions to other family members who could make the funds indirectly available to the farmer or rancher. Here it should be noted that there cannot be a "done deal" where the farmer or rancher is assured that they can get trust funds for the asking. Rather, it would be at the discretion of any family member who received funds to make them available to the farmer or rancher. Alternatively, the Trustee could be given the power to make loans to the farmer or rancher. If the loans are interest bearing, properly documented and secured the life insurance death proceeds from the coverage on the farmer or rancher should not be included in their gross estate for federal estate tax purposes.

Long Term Care

Sources estimate that 50% of Americans will need some type of long term care during their lifetime.[3] Yet, only 10% of Americans over the age of 65 have purchased any type of long term care protection.[4] The seriousness of this predicament to those in the farming and ranching community should be considered in the context that Medicare is only a temporary solution (100 day maximum), health insurance is not going to pay LTC needs, and Medicaid is only a solution for people with virtually no assets. In the latter regard, some 49% of the people relying on Medicaid gave away their assets intending to avoid paying their own long-term care expenses so that they could leave more to their heirs. The passage of the Deficit Reduction Act of 2005, however, made that much more difficult for seniors since the look back period is now 5 years for all transfers. (Further, the beginning date for the penalty period is the later of the date the person enters a nursing home or the date the person applies to Medicaid.) The way this works is that the value of the asset that was transferred is divided by the monthly cost of the nursing home and the applicant becomes ineligible for Medicaid for however many months that asset would have paid for long term care (the penalty period). For example, if the farmer or rancher gives away property worth $300,000 and the monthly cost of care is $3,000 the farmer or rancher will be ineligible for Medicaid for 100 months. [5] Note that, as previously indicated, for purposes of the look-back period only transfers of property that occur within 60 months of the date of the Medicaid application are considered for purposes of this penalty.

While "Medicaid Planning" has become a more often used tactic, there are issues to be concerned about before a senior thinks about disposing of assets to impoverish themselves to qualify for Medicaid. Some of the downsides in that respect include the fact that:

- If the nursing home resident is married, the "spousal impoverishment" provisions limit what a non-confined spouse may keep.
- If a farmer or rancher gives property away and things go badly they may find themselves asking their children for what used to be theirs.
- There are income limitations for the spouse in need of care and Social Security and pension benefits count toward that limit and cannot be hidden.
- While Medicaid may pay the bill for nursing home care the individual may not get to live where they wish.

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[3] Mature Market Institute, Market Survey of Long Term Care Costs, October 2011.
[4] What to Know About Long-Term Care and Medicaid – The Wealth Channel – 2011.
[5] Farm & Ranch Estate Planning: An Introduction, Joe M Hawbaker, Hawbaker Law Office, Omaha, NE.

- Since Medicaid pays a negotiated rate many facilities prefer to take private pay individuals first and that leaves the Medicaid patient with fewer choices on where they can stay.

Due to the above disadvantages associated with counting on Medicaid to cover the cost of long-term care farmers and ranchers should consider obtaining long- term care coverage. In fact, the government has encouraged this through the Pension Protection Act of 2006 that allows for the tax free exchange from life insurance, annuities or endowment policies to a stand-alone long-term care policy.

Alternatively, a long-term care rider can be added to a life insurance policy at purchase to provide funds for the insured should they need long-term care. However, in the event no long term care is ever needed, the insured has a death benefit to leave to their heirs.

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