Saving the Family Forest for Future Generations

through Tax Planning and Business Entities

By Robert A. Tufts, Rebecca J. Barlow, and John S. Kush

Why do you own land? Surveys of small-scale, private landowners in the South, especially those who own less than 100 acres, indicate that passing the family forest to the next generation was the highest priority. They want to improve the land value for future generations, but are concerned about protecting their investment. Two barriers to meeting their objectives are estate taxes and fragmentation of ownership.

A recent Congressional Research Service Report (R42959) states that the estate tax will affect less than 0.2 percent of decedents over the next decade. Also, about 65 farm estates and about 94 estates with half their assets in small business (with owners who expect their heirs to continue in the business) are projected to be subject to the estate tax

The larger problem may be fragmentation. For example, a father owned 500 acres and had five sons. If he gives each of those sons an equal share, then each son has 100 acres. If each of those children has five children and the parents treat them equally, then each grandchild will own 20 acres. In two generations, a working 500-acre farm has been reduced to 25 twenty-acre lots that are not practical to manage for income.

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Taxes

The recently-passed American Taxpayer Relief Act of 2012 has made permanent (at least until Congress changes its mind) the transfer tax system that has been in a state of flux for the past twelve years. The gift and estate taxes have been reunified with an applicable exclusion amount of $5 million indexed for inflation and a maximum tax rate of 40 percent. With indexing, the applicable exclusion amount for 2012 was $5.12 million and the amount for 2013 is $5.25 million. Since Congress also made *portability* permanent (the opportunity for a surviving spouse to use a decedent spouse's unused applicable exclusion amount), if filed correctly, the surviving spouse has access to the "Deceased Spousal Unused Exclusion." Therefore, an individual could leave everything to a surviving spouse and pay no estate tax by using the unlimited marital deduction. Then the surviving spouse could transfer the first $10.5 million (in 2013) to children and grandchildren tax-free. This is not the estate plan we recommend.

For an individual with assets greater than $10.5 million there are several estate planning techniques that can be used to transfer assets either tax-free or at a discount to children and grandchildren, as well as options to pay some of the tax in installments.

Estate tax planning is essentially a gifting program where assets are transferred to younger generations for reduced or no gift taxes. By transferring assets *during life*, any future appreciation and income are excluded from the decedent's estate. Although it is generally not appropriate to make taxable transfers during life, the effective gift tax rate is lower because gift tax is paid on the amount the donee receives (tax exclusive), versus an estate where the tax is collected on the value before the transfer (tax inclusive). For example, if an individual wanted to transfer a tract of land worth $1 million to his children during life, he would need $400,000 to pay the tax owed on the transfer ($1 million gift times 40 percent tax rate). However, the individual's estate would need $666,667 in cash to pay the estate tax for the children to receive the property ($1,666,667 times 40 percent equals $666,667 leaving the $1 million property).

To make the decision a little more complicated, you have to consider your investment or "basis" in the assets transferred. The donee [recipient of gift while the donor is still living] takes the donor's basis (plus tax paid on the appreciation §1015), but the devisee [recipient of gift by a will] gets a change in basis to the fair market value on the date of transfer (§1014). Suppose the $1 million asset had a basis of $600,000. Then the donee's basis would be $760,000 ($600,000 donor's basis plus $160,000 tax paid on the appreciation) while the devisee's basis would be $1 million. With a 15 percent long-term capital gains rate, the donee would have a built-in capital gain tax of $36,000 and the devisee would have none. Overall, the lifetime taxable transfer would save $230,667 of federal tax.

The first step in tax planning for an estate is to make use of **tax-free gifts**. A parent can make unlimited transfers for a grandchild's tuition (in most states, college tuition is a support obligation of a parent and not a gift). A parent could also pay medical expenses of children and grandchildren, including insurance premiums, as tax-free transfers. In both cases, tuition and medical, the payment has to be made to the provider and not given to the child/grandchild (§2503(e)). A parent can also make annual exclusion transfers tax-free (§2503(b)) as long as the gift constitutes a present interest. The current amount is $14,000 per donee per year. If parents had two married children with four grandchildren, they could transfer $224,000 tax-free this year (two children, two spouses, and four grandchildren equals 8 times $14,000 each for husband and wife).

The second step is to transfer ownership of **life insurance** policies. Most insurers make the insured the owner of the policy. Under §2042, life insurance proceeds on policies owned by the decedent are included in his estate. If the insured has an estate tax issue, the children or grandchildren should be the beneficiaries of the life insurance, and an Irrevocable Life Insurance Trust (ILIT) should probably own the policy.

If steps one and two have not eliminated the estate tax liability, the individual should make lifetime transfers preferably using **split-interest techniques** (trusts) or business entities. When interest rates are low, as now, a grantor retained annuity trust (GRAT), private annuity, and perhaps a charitable lead annuity trust (CLAT) are appropriate.

Split-interest techniques are more tax efficient than outright gifts. For a GRAT, an individual transfers property to an irrevocable trust and takes an annuity interest for a fixed number of years, leaving a remainder interest to a beneficiary. The beneficiary's interest is a taxable gift. Because the remainder interest does not mature for some years, the value of the interest is discounted (actuarially valued), based on the number of years and the current rate set by the IRS (the 7520 rate which is 120 percent of the mid-term applicable federal rate rounded to the nearest 0.2 percent). As an example, a 15-year, $1 million GRAT with a $50,000 annuity and a 1.4 percent 7520 rate (March 2013) would result in a remainder interest of $327,724. If the $1 million could be invested at an average return of 5 percent over the next 15 years, there would still be $1 million in the GRAT for the children. In other words, the grantor would use $327,724 of applicable exclusion amount (the amount available in 2013 for lifetime gifts is $5.25 million), so he did not pay any gift tax. He would receive $750,000 over the next 15 years, and at the end of 15 years his children would receive $1 million tax free. If the grantor does not live for the 15-year term, the technique does not work, but the grantor can pick any term keeping in mind that the longer the term the greater the benefit. It is also possible to adjust the annuity payment to create a zero-gift GRAT.

Business entities are also used to make discounted gifts. When a business owner transfers an interest to children, there are discounts available for minority interests and lack of marketability. Because the minority owner has little voice in partnership operations, cannot obtain a pro rata share by compelling liquidation, cannot obtain the value of his interest by redeeming it, cannot transfer his management rights, cannot compel distributions, and must pay taxes on his allocable share, he cannot sell his interest for the value of his fractional share. The actual discount should be determined by a qualified appraiser, but discounts of 35 percent are not uncommon. The discount for a business entity is a frequently litigated issue, but the discount for a split-interest transfer is statutorily set.

If a farm or business entity engaged in an active trade or business constitutes 35 percent or more of a decedent's estate, the estate may qualify for §6166 treatment. Section 6166 entitles the estate to a five-year deferral of the tax on the business entity, and then allows the estate to pay the tax in ten annual installments. In addition, tax owed on the first $1.39 million (for 2012) of business assets accumulates interest at only 2 percent.

Business Entity or Trust

Management of the family forest is a typical problem for second- and third-generation owners. As the number of owners increases, it becomes difficult to agree on management objectives. A trust or business entity can be used to equally benefit the children and grandchildren, while vesting the management powers in one or more individuals.

The typical business entities used for estate planning are limited liability companies managed by managers and limited partnerships or more recently, limited liability limited partnerships. These entities allow one or more individuals, usually parents, to manage the business while gifting interests to children and grandchildren. Even though the children have an ownership interest in the business, they do not have any management rights. Other advantages of the business entity are limited liability, creditor protection, perpetual life, avoidance of ancillary probate, ease of gifting fractional interests, avoidance of partition sales, and no income tax at the entity level. It can also provide a succession plan. The children/grandchildren would receive income in proportion to their ownership interest, thus shifting income to younger generations. One disadvantage is that after the parents are gone, the children probably control the business and have the right to liquidate it.

A trust is an alternative to the business entity. A trust is an agreement between the grantor who funds the trust and sets the distribution criteria, and a trustee who has legal title to the assets but must follow the distribution criteria established by the grantor. The beneficiaries have what is called equitable title in the trust assets, and the trustee distributes trust assets for the benefit of the beneficiaries. Although many grantors utilize "corporate" trustees (typically the trust department at a bank), a trustee can be any competent individual, such as an attorney, an accountant, or even two or three of the beneficiaries. The typical trust set up as an estate plan rather than for tax planning would be a *revocable* trust with the parents as grantors and trustees, and the children and grandchildren as beneficiaries. The trust would become *irrevocable* upon the death of the grantors, and the successor trustees would assume ownership of the trust assets. The trustees would manage the family forest for the benefit of the beneficiaries.

The life of a trust is governed by the state's rule against perpetuities, but several states have abolished the rule against perpetuities and a trust in those states can have a perpetual life. The traditional rule against perpetuities allowed a trust to last for a life in being (child or grandchild) plus 21 years (Georgia); however, in Alabama and Florida, a trust that holds real property can last for 360 years. Even so, it is probably not practical for a parent to try to control property beyond three or four generations.

The trust would have many of the same advantages as a business entity – limited liability, creditor protection, etc. However, the major advantage of the trust is the inability of the children to thwart the parents' intent, because they cannot change the terms of the trust as they could with a business entity. That also means there is no flexibility with the trust as there would be for a business entity.

Conclusion

It is possible to save the family forest with a little planning. It is important that you consider all of your goals when making any land management decision. For many, tax planning can save all but the largest land holdings from being lost to estate taxes. Using a trust or business entity to own the family forest can provide a long-term management plan and prevent it from being sold in a partition sale. Before making any decisions, you should consult a professional advisor.

For more information and workshops on this and similar topics, visit the Alabama Cooperative Extension System website at **www.aces.edu/gwcal/month.php**.

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