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Succession Planning Strategies For Family Farms

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Farm Succession Planning

- Family Farms are an important part of our economy.
- Succession Planning is about preserving an agricultural legacy and the maintain for family.
- Family Farms are more than a business. Many have been in the family for generations.
- Like all businesses, succession planning for Family Farms is not easy.

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What are Family Farmer/Rancher Goals?

- Family Farmers/Ranchers know they need to do something:
  - ***Continue/Preserve/Monetize Farm***
  - ***Treat children fairly***
  - ***Achieve Family Harmony***
  - ***Avoid Taxes and Cost***

- Many have experienced the poor planning of their own parents or have witnessed other farms fall apart.

- Farmers still delay.

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Without Proper Planning – Family Farms have Increased Risk

- Assets are exposed to creditors/divorce
- Liquidation of assets because of poor succession planning/tax payments
- Failure to train next generation
- Family Disharmony

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What Happens if There is No Plan?

- Probate
- Guardianships and Conservatorship for Minors
- Added Taxes and Costs
- Business Passes to the Wrong Successors – **No Succession Plan**
- Family Conflict – Destroys relationships and the Business

A Proper Estate/Succession Plan

- Avoids Probate – Assets are in Trust
- Assets are protected from Divorce/Creditors
- Provides Certainty
  - Third parties know who is in charge
- Avoids Guardianships and Conservatorship for Minors/Disabled Parents
- Reduces Taxes and Costs
- Farm Operation Passes to the Correct Successors
- Reduces Opportunity for Family Conflict

Tax Rules

Transfer Tax System

- We live in a country with a 40% transfer tax.
- We are taxed on the privilege of passing wealth.
  - During life – it's a gift tax
  - At death – it's an estate tax

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Available Tools

1. Annual exclusion gifts
   - $15,000 per person ($30,000 if married)
2. Unlimited marital deduction
3. Gift tax and estate tax exemptions
   - $11,580,000 per person (indexed to inflation)*
4. Generation-skipping transfer (GST) tax exemption
   - $11,580,000 per person (indexed to inflation)*

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But it is Temporary…

- Through December 31, 2025
- The $11,580,000 estate tax exemption is scheduled to reset to $5,000,000 (indexed to inflation) on January 1, 2026
- Election in November

Multi-Step Approach

Step 1 - Core Estate Planning Documents

- -Revocable Trust (with GST planning)
- -Pour-Over Will
- -Durable Power of Attorney
- -Living Will / Health Care Directive

Step 2 – Determine Structure / Entities/ Operations

- -Form Entities (LLC, LPs) Recapitalize corporations
- -Fractionalize real estate

Step 3 – Techniques for Succession Plan

- -IDIT
- -ILIT
- -BIDIT
- -GRAT

Step 4 – Other Considerations

- -Charitable Planning
  - *CRTs
  - *CLTs
  - *Private foundations
  - *Private Operating Foundation
- -Exemption Planning
- -Family Meetings/ Communication

Step 1

Core Documents

Core Estate Planning

- Whether a client is worth $2 or $2 billion, we start with core documents.
- This is especially true when the client owns a farm/ranch/ag business.
  - Who makes decisions?
  - Who receives the assets?
- Core documents include:
  - Revocable Trust
  - Pour-Over Will
  - Financial Durable Power of Attorney
  - Durable Power of Attorney for Health Care & Living Will

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Will = Probate

- Probate
- What must be probated?
  - Anything titled in client's name individually
  - E.g. – farmland, equipment, bank accounts, personal property
- How do we avoid probate?
  - Don't have client own anything in his/her individual name at death.
  - Transfer title to client's revocable trust during his/her lifetime.

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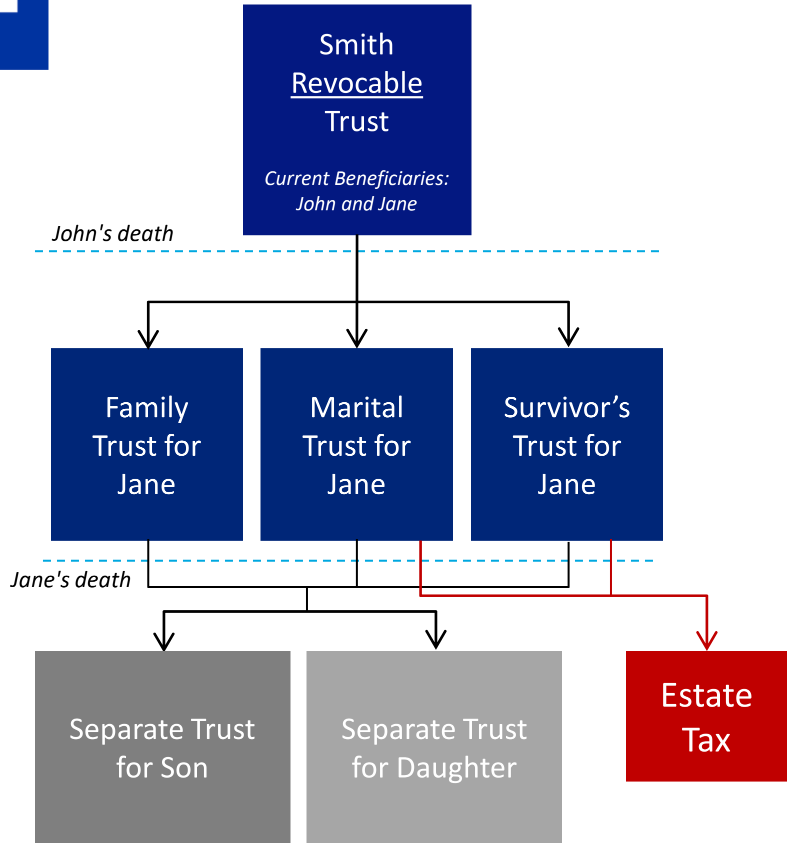
Smith Revocable Trust (assumes John predeceases Jane)



- Grantor: Person who sets up the trust
- Trustee: Person in charge of trust
- Beneficiary: Person who benefits from trust

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Benefits of a Revocable Trust

- Avoids Probate
- Can provide surviving spouse, children and more remote descendants creditor, divorce, and estate tax protection
- Names an individual to make decisions over the assets
    - Who makes decisions about farm/ operations
- Allows for division of farm assets fairly – maybe not equally

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Power of GST Planning

	Without GST Planning	With GST Planning	
Mom & Dad's death	$2,000,000	$2,000,000	
Estate Tax	$0	$0	Assumes $11.58 million dollar exemption and 40% tax rate
Net to Children	$2,000,000	$2,000,000	
Children's death	$20,571,436	$20,571,436	Assumes assets grew @ 6% for 40 years
Estate Tax	$3,668,574	$0	Assumes $11.58 million dollar exemption and 40% tax rate
Net to Grandchildren	$16,902,862	$20,571,436	
Grandchildren's death	$173,858,071	$211,591,988	Assumes assets grew @ 6% for 40 years
Estate Tax	$64,983,228	$0	Assumes $11.58 million dollar exemption and 40% tax rate
Net to Great Grandchildren	$108,874,843	$211,591,988	

Pour-Over Will

- A Pour-Over Will provides that any assets that are not placed in the revocable trust during lifetime are "poured" into the trust at death.
- This ensures that all of the assets pass under the terms of the revocable trust.
- A Pour-Over Will also
  - Appoints a personal representative to handle probate estate administration
  - Names guardians for any minor children

Financial Power of Attorney

- Durable Powers of Attorney for Finances enable clients to plan for periods of incapacity.
- Assets may be managed and legal decisions may be made – all without the potentially significant cost, delay, and expense of lifetime probate proceedings.
- Two Types:
  - Springing (only effective upon incapacity)
  - Immediate (effective immediately)

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Durable Power of Attorney for Health Care and Living Will

- A Durable Power of Attorney for Health Care and Living Will permits health care decisions to be made in the event of incapacity.
- Additionally, these documents expresses an intent regarding what actions should or should not be taken if someone has an incurable or terminal condition.

Step 2

Determine Structure / Entities/ Operations/ Discount the Estate

Assets and Structure

- Need to protect assets from creditors and divorce.
- Important to separate the assets to determine how to structure, protect and transfer.
  - Land
  - Operations
  - Equipment
  - Employees
- Need to provide firewalls around the property and implement plan for succession.

Discounting - Fair Market Value

- The estate tax is imposed on the fair market value of what someone owns at death.
- Look for ways to argue what a client owns is worth less by using Discounting techniques.
  - Lack of Marketability
  - Lack of Control
- Placing high value assets in an entity could provide both protection and discounts.

Three Key Techniques for Discounting

- Fractionalize ownership
- Recapitalize ownership into voting & non-voting
- Form entities - FLPs/LLCs

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Recapitalize Business Entities

- Recapitalize business entities into 10% voting and 90% non-voting interests .
- Take advantage of minority interest and lack of marketability discounts.
- Give away or sell a substantial interest in the entity and retain current level of control.

Recapitalize Business Entities Cont.

- Voting interests may carry a valuation premium; however, owning a non-controlling interest in the company may negate this premium.

- Fractionalizing voting interests after the recapitalization may allow you to further mitigate the effect of such premium or obtain further discounts.

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Type of Entities

Type of Entities

- Family Limited Partnership (“FLP”)
- General Partnership (“GP”)
- Limited Liability Company (“LLC”)
- Corporations
  - “C” or “S”

Structuring the Operations is Very Important

- Land should be separated from the Operations.
  - Form an LLC/FLP.

- Analyze the Operational Entity and determine how to structure properly to minimize exposure.

- Determine if Equipment/Vehicles need to be separated from the other assets.

Risks with Entities

Inclusion

- Retain control: IRS could argue the FLP’s/LLC’s assets are includible.
- Need business purpose

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Advantages with Entities

- Obtain creditor and liability protection.
- Create opportunity for significant transfer tax savings due to valuation discounts.
- Reduce the Risk of Inclusion.

Other Considerations with Entity Structure

- **Operating Entity**
  - General Partnership with SMLLC
  - LLC Electing as an S corp
- FSA – Important to contact
  - Must have a farming operation
- Small Partnership Election
- 179 Election
- Respecting the Entity - Clients must comply with annual items.

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Structuring the Operating Agreement is Also Important

- Put Option to allow members to sell a small percentage to the LLC
  - Provides a mechanism for liquidity
- Voting/Nonvoting interest/Manager-Managed
- Cash Rent Option
- Buy-Sell provisions

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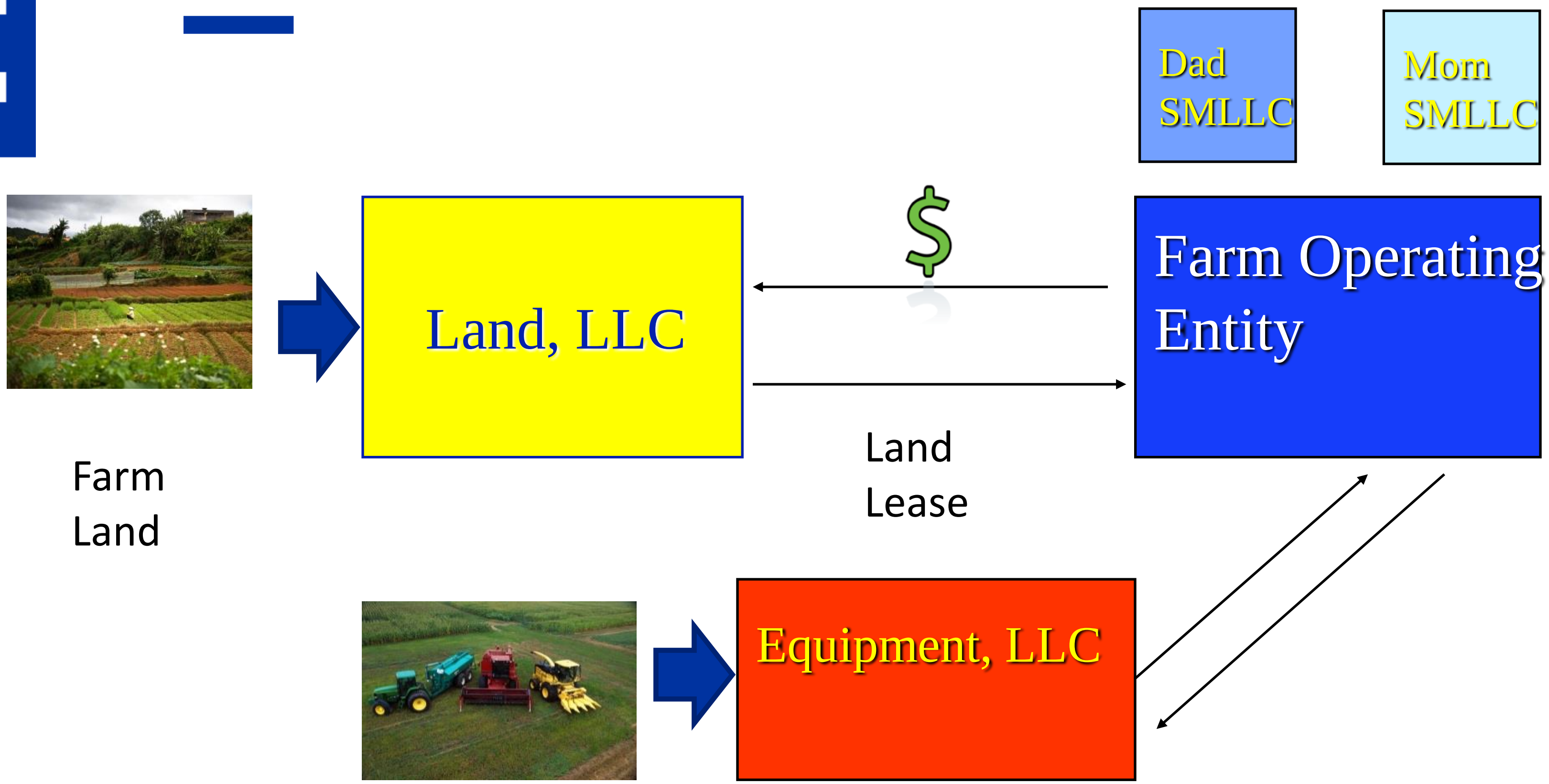
Tripod Approach



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Step 3

Techniques to Transfer Assets & Provide Liquidity

Typical Goals for Succession Planning

- Protect the farm / ranch from creditors / divorce.
- Ensure on-farm family is able to continue operations.
- Minimize taxes.

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SUCCESSION "MUST DOs"

- Implement "Core Documents".
- Don't Transfer an interest "outright" to a child until you know all the consequences.
- Anticipate/Minimize the "Flashpoints".
- Utilize the sophisticated planning tools available:
  - IDGTs/BIDITs
  - Structure designs
  - Use exemption while exemption is $11.58 million.

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Intentionally Defective Grantor Trusts (IDGT)

- What is an IDGT?
  - An IDGT is an irrevocable trust that effectively removes assets from the grantor's gross estate.
  - An IDGT seeks to take advantage of the differences between the estate tax inclusion rules of IRC Sections 2036-2042 and the grantor trust income tax rules of IRC Sections 671-678.
  - For income tax purposes, the trust is "defective", and the grantor is taxed on the trust's income.
  - The IDGT's income and appreciation accumulates inside the trust gift and GST tax free.

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IDGTs

- Assets of the IDIT should not be subject to creditor or divorce claims of a beneficiary.
- Designed to:
  - receive gifts from the grantor
  - borrow funds from the grantor
  - purchase assets from the grantor
- GRATs versus IDGTs

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IDGTs

- Turning Off Grantor Trust Status
  - Grantor can release the grantor trust triggers.
  - A trust protector can re-grant them.
  - Toggling?

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IDGTs

- Reimbursing Grantor for Income Taxes Paid
  - A discretionary tax reimbursement clause is permissible. See Revenue Ruling 2004-64.
  - However, there must be no express or implied understanding between the grantor and the trustee that the trustee will exercise its discretion in favor of the grantor.
  - And state law must not subject the trust property to the claims of the grantor's creditors. Otherwise, inclusion will result under IRC Sec. 2036.

IDGT

- GST considerations
  - As long as the grantor allocates his or her generation-skipping tax (“GST”) exemption to gifts to the IDGT, the trust assets will be exempt from the GST tax.
  - GST exemption need not be applied to the sale transaction.

Power of GST Planning

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Sale to IDGT Strategy

Sale to IDGT Strategy

- Why an installment sale to an IDGT works:
  - No capital gains tax on sale. Rev. Rul. 85-13.
  - Freezes value of appreciation on assets sold at the AFR.
  - Particularly effective in low interest environment.
  - Interest payments not taxable to grantor.
  - Tax burn - Payment of IDGT's income taxes by grantor leaves more assets in the IDGT – gift tax free. Rev. Rul. 2004-64.
  - Back end-loading (i.e., interest only with a balloon payment).
  - Valuation Discounts increase effectiveness.

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Sale to IDGT Strategy

- Disadvantages to an IDGT sale:
  - Requires 10% seed funding.
  - Note is taxable in grantor's estate (unless SCIN is used).
  - Potential cash flow problems for grantor by paying IDGT's income taxes.
  - Likely no step-up in basis at grantor's death.
  - Possible gift and estate tax exposure (under IRC Section 2036) if IDGT has insufficient equity.

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Sale to IDGT Strategy

- Funding the IDGT prior to sale
  - Amount of seed funds
    - The "seed fund" reduces the risk that the sale will be treated as a transfer with a retained interest by the grantor under IRC Section 2036.
    - In PLR 9535026, the IRS ruled that IRC Sections 2701, 2702 and 2036(a) did not apply if the note retained by the grantor was bona fide debt.

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Sale to IDGT Strategy

- Funding the IDGT prior to sale (cont.)
  - In *Sharon Karmazin*, Tax Court Docket No. 2127-03, the IRS challenged an IDGT sale on the basis that IRC Code Sections 2701 and 2702 applied, but later dropped both arguments.
  - In *Karmazin*, the trust had 10% seed money. The case was settled out of court with the only adjustment being a reduction of the valuation discount from 42% to 37%.

Sale to IDGT Strategy

- Funding the IDGT prior to sale (cont.)
  - A personal guarantee by the IDGT beneficiaries assists in substantiating that the sale to the IDGT is at arm's length.
  - However, a beneficiary giving a guarantee may be treated as making a contribution to the IDGT, which could cause the IDGT not to be considered a grantor trust with respect to the original grantor.
  - Consider a third-party guarantee and pay a reasonable guarantee fee.

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Sale to IDGT Strategy

- Sale Agreement / Note
  - Should have 10% equity or personal guarantee (Fidelity-Philadelphia).
  - The note is typically structured to provide annual payments of interest only with a balloon payment at the end of the term.
    - Farms need liquidity so a longer term is typically used.
  - Interest at AFR (Frazee).
  - Allows prepayment provision.

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Valuation Agreement

- Use a value definition clause, e.g. the value equal to x amount.
- Make it clear that the value is *as finally determined for Federal Estate and Gift Tax purposes*. Nelson v Commissioner, T.C. Memo 2020-81.
  - 10 magic words per Nelson.
- The gift/sale should be reported using the same language reflected in the transfer document.
- An independent written appraisal of the asset being sold to the IDGT should be obtained.

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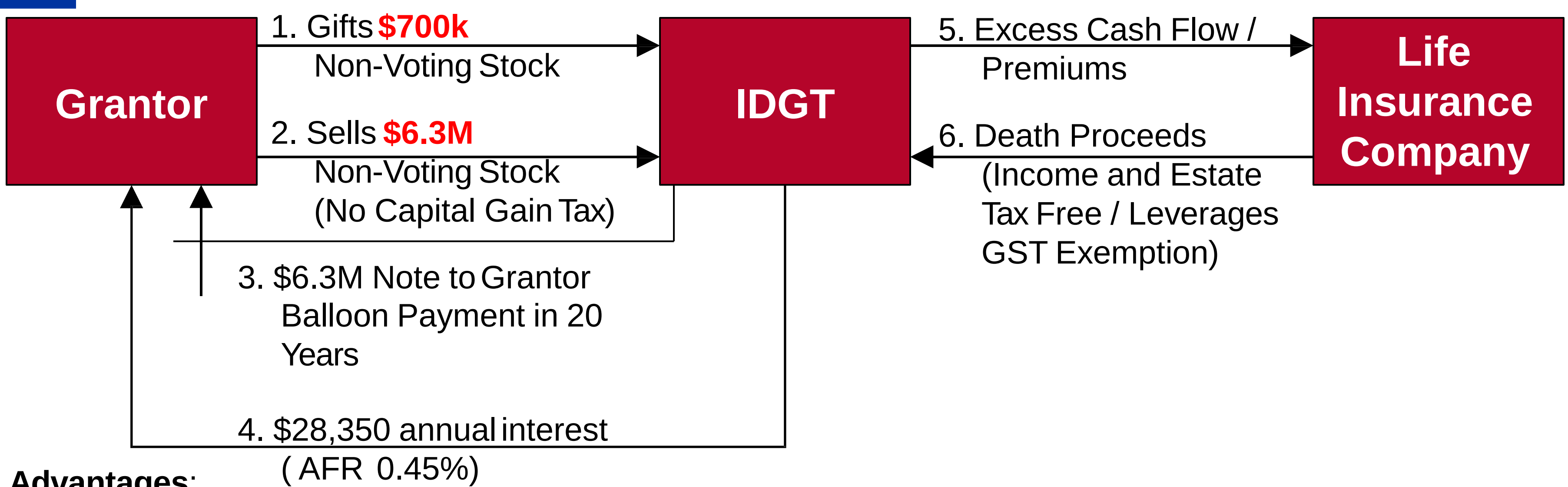
Sale to IDGT Diagram



Advantages:

- 30% discount for lack of control and lack of marketability.
- Freeze asset value
- Tax burn: Grantor’s estate reduced by the income taxes paid on behalf of the trust.
- The trust property escapes estate taxation for as long as permitted under state law.
- IDGT can purchase a life insurance policy on Grantor’s life without triggering the transfer for value rule; and IDGT is an eligible Subchapter S shareholder.

Cases Impacting Sale to IDGT Strategy

Cases Impacting Sale to IDGT Strategy

- *Trombetta*
- *Woelbing* (two companion cases)

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Cases Impacting Sale to IDGT Strategy

- *Trombetta*
  - Decedent transferred mortgaged rental properties to annuity trust; value of transferred property exceeded value of reserved annuity payments; decedent's children guaranteed annuity; decedent as Trustee with ½ of vote; Trustees authorized to distribute excess income to decedent.
  - Implied understandings; no negotiation; decedent on both sides of transaction; decedent benefited from trust payments on mortgage; no legitimate business reasons for transaction.

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Cases Impacting Sale to IDGT Strategy

- Response to *Trombetta.*
  - Independent Trustee
  - 10% cushion funded with “old and cold” assets.
  - Don’t peg payments to IDGT’s income.
  - Observe all formalities.
  - Seller should dispose of all other interest in a closely-held business and give up all contacts as an officer, director or manager.
  - Arm’s-length negotiation with Trustees and beneficiaries represented by separate counsel.

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Cases Impacting Sale to IDGT Strategy

- *Woebling Cases*
  - IRS asserted inclusion under Section 2036 and gift under Section 2702.
  - Facts similar to *Karmazin* case which was settled recognizing validity of sale on terms favorable to estate.
  - Cases have been settled; IRS gave up on Section 2036 and Section 2702 arguments.

BIDIT Planning

- Used by individuals who want control/single/divorced people.
- Dividing trustee role into administrative, investment, distribution and transaction trustees.
- Ideal for Assets that have considerable growth.

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Sale to a BIDIT

- Third party ("G") establishes trust (BIDIT) for the benefit of Seller/Beneficiary and Seller/Beneficiary's descendants.
- G contributes $5,000 to the BIDIT giving Seller/Beneficiary Crummey power.
- BIDIT is a grantor trust as to Seller/Beneficiary under Section 678, even after withdrawal power lapses.
- Seller is Trustee with power to make distributions to beneficiaries for health, support, maintenance or education.
- G's contribution is not in Seller/Beneficiary's estate for federal estate tax purposes.
- Seller/Beneficiary sells assets to BIDIT in exchange for BIDIT's promissory note; sale structured same as a sale to an IDGT.
- Parenthetical exception for a bona fide sale for an adequate and full consideration should avoid inclusion in Seller's estate under Sections 2036 and 2038.

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Provide Liquidity – Irrevocable Life Insurance Trust (“ILIT”)

- Estate Tax Savings
  - The life insurance proceeds payable to an ILIT should not be included in client’s estate for estate tax purposes.
- Management of Policy Proceeds
  - An ILIT provides an excellent mechanism to manage the insurance proceeds for the beneficiaries.

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Provide Liquidity Cont.

- Liquid Wealth to Beneficiaries
  - Estate taxes are due (in cash) nine months after the death of the surviving spouse.
  - Significant life insurance proceeds may be received by an ILIT and can be used to provide a source of liquidity.
    - Funds for farming operations
    - Funds to allocate to off-farm children
- Correlate with Revocable Trust
  - An ILIT can be drafted with provisions to match or complement client's revocable trust.

Step 4

Other Considerations

Charitable Planning

- Assets passing to charity should not be subject to estate taxes.
- There are a number of methods available to effectuate charitable planning:
  - Outright
  - Charitable Remainder Trusts (“CRTs”)
  - Charitable Lead Trusts (“CLTs”)
  - Private Foundations
  - Donor Advised Funds

Planning to use Exemption

- Clients do not believe higher exemptions are here to stay.
- Need to think of options to utilize the exemption.
- Additional Gifting Mechanisms
  - GST IDGTs
  - His/ Her IDGTs / SLATs

Basis Planning

- Assets in irrevocable trusts do not receive step up—so consider asset substitution with grantor trusts (swap of low basis for high basis assets).
- Analyze whether a distribution from an old credit shelter trust back into the survivor's estate makes sense.
- Analyze old credit shelter trusts and see if you can add a contingent general power of appointment by non-judicial settlement or trust protector.

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Income Tax Planning

- **Federal**
  - Roth IRA conversions
  - Converting businesses from S to C and C to S
- **State**
  - NING’s and DING’s
  - Moving non-grantor trusts into states with low/no income tax
  - Flipping the switch in no income tax states

Family Meetings/Purpose Discussions

- Family dynamics
- Family function/dysfunction discussions
- Off-farm / On-farm family

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Thank You!

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