Key Elements of an Estate Plan:
An Overview

Authors:
Dr. Norman L. Dalsted and Rodney L. Sharp
Agricultural Economists
Colorado State University

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Washington State University

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Fact Gathering

Estate planning is “information intensive”. If all the relevant data on a family’s situation is not accurately assembled before work begins, there is a high risk that the initial plans and the documents drafted to carry out the plans won’t be exactly right. That can mean expensive re-working. For example, the failure to take into account mineral rights in some states other than Colorado can require converting an estate plan originally carried out through wills into one which is better arranged through revocable living trusts.

To avoid the unnecessary delays and expense, which can be expected whenever work is redone, follow an organized process of data assembly. A sample information form is attached for reference. This is a reasonably complete form, perhaps more detailed than would be necessary for some families. But something like this background information should be put together prior to a meeting with a financial planner or attorney.

Objectives and Issues

Writing clear objectives is important to the success of your planning. Also in writing, identify issues that will have to be dealt with in the estate plan.

Here is a list of **objectives** that many people have in mind when preparing their estate plan:

- Minimize income taxes while alive
- Minimize estate taxes upon death
- Provide protection of assets from claims of potential creditors
- Provide for continuity of the family business
- Provide a fair division of assets among the beneficiaries
- Provide for charitable interests
- Provide liquidity for payment of bills and taxes upon death
- Encourage development of good character on the part of children
- Create a legacy

Issues that can complicate the achievement of goals include:

- Health problems impacting the needs of family members (or selves)
- Poor management skills on the part of spouse or children
- Intra-family distrust or hostility
- Alcohol and drug abuse by beneficiaries
- Risk of divorce
- Citizenship in nations other than the U.S.
- Blended families
- Business failure risk
- Loss of insurability in the future
- Risk of nursing home expenses depleting the family assets
- Ownership of assets in states with high probate costs

Appraisals

Reliable valuations of assets are critical for the success of estate planning transactions. For example, when making gifts to children, you need to know the value of a share of a certain company's stock to calculate the number of shares equal in value to the current annual gift tax exclusion of $12,000. Also, in giving a percentage of a piece of real estate, one needs to know the value of the whole parcel, and whether giving only a portion of it qualifies for any valuation discount. Such information also comes into play in forming partnerships (or limited liability companies), or making installment sales to children, or at the time of death when a federal estate tax return may be necessary.

A. As a general rule, whenever a change of ownership of an asset is to take place, an accurate valuation must be obtained from some source.

B. The degree of effort and cost, which is reasonable to devote to an appraisal under any of these circumstances, should be discussed with the estate planner. There should be some relationship to the approximate size of the transaction and the IRS views on the type of transaction intended. Any plan to use valuation discounts should be approached with care, and based on the advice of reputable, experienced advisors and appraisers.

- How should you select an appraiser that is right for your situation? For starters, ask your attorney or accountant. Different people appraise real estate than those who do business valuations. Similarly, certain kinds of real estate can be safely appraised by a Realtor, but for purposes of real estate with special characteristics (say, a farm with an integrated feeding operation) you may want to use an MAI (Member, Appraisal Institute) appraiser with some resources to capitalize income.

- There are roles for accountants or appraisal companies to fill, where the asset being valued is held in an entity, such as a family corporation (rarer these days) or LLC (much more common). Familiarity with the principles of transfer restriction discounts and minority discounts is essential. There is no “rule of thumb” that can be relied on in discounts for gift or estate tax purposes.

Advisors

A team approach to estate planning helps move the process along faster, since there are no advisors who have all the knowledge or experience in the many areas involved in a successful plan. Especially if the estate is large and/or complex. Investment objectives, income tax strategies, techniques of entity formation, and the psychology of eliciting family support for the elements of a plan can all be important in a given situation. Members of the team will vary with the situation, but usually include the family accountant, a lawyer with training in estate planning, trust company representatives, financial planners, and appraisers. Family business consultants, university faculty, and life insurance agents can also bring a lot of resources into the picture. And most of those who are in any of these fields can help identify others to serve on the team.

A. It is now required (and was always a good idea anyway) for attorneys in Colorado to explain in writing the basis for legal costs before beginning work. This is reassuring for many clients – we all want to know what we are getting into before making a commitment to hire someone. In nearly all cases, the benefits of legal counsel will more than justify the costs. For example, basic estate planning wills for a family with $2.5 million in assets can save estate taxes on $500,000, which would otherwise be $230,000. A half hour consultation might cost $100, but it may save a family from the common mistake of transferring a parent’s home to one child during their lifetime to “avoid probate”, or “keep it out of the government’s hands if Dad goes into a nursing home”. Even using a lawyer to review a simple real estate transaction might, save tens of thousands of dollars in future litigation costs.

B. The fees for standard wills with all the necessary support documents, but without any federal estate tax planning features can run between $400-500 for a married couple. If tax planning trusts in the wills are indicated, the costs would only be about $200-300 more. And if living trusts included, the total costs for the couple might range from $1,000 to $1,500. Factors, such as those listed in the “Issues” part of this outline, would require more time and small corresponding increases in costs. These figures are not intended to do more than suggest the range of costs one might expect from attorneys, and will vary from firm to firm. The documents normally included would be the wills themselves (or trusts, if that is the chosen format), powers of attorney for financial matters, powers of attorney for health care matters, personal property memoranda, transfer documents (such as deeds), and beneficiary forms for retirement plans.

2. OPTIMUM MARITAL DEDUCTION

A good strategy for married couples owning more than $2.0 million dollars worth of assets is to avoid both joint tenancy and simple wills that leave all of the property owned by each to the other. Why? Because that leaves the survivor with only one "exemption equivalent" to cover the federal estate taxes due on his or her death. Every individual has the equivalent of a $2,000,000 lifetime exemption beginning in 2006. This will go up to $3,500,000 in 2009. The estate tax is scheduled to expire on January 1, 2010, but it is scheduled to be restored (with only a $1 million exemption) on January 1, 2011.

A. Part of the strategy requires establishing trusts for the benefit of the survivor in the wills or living trusts each person should have. Such trusts, commonly managed by the survivor (as trustee) are called by many names:

(1) Family trust
(2) Credit shelter trust
(3) Bypass trust
(4) Exemption equivalent trust
(5) Non-marital trust
(6) "B" trust (in the traditional A-B wills)

B. All these trusts have one thing in common—although all the benefits of the trust go to the survivor during his or her lifetime, on the survivor's death, the remaining assets pass estate tax-free to the persons named as remainder beneficiaries. These are usually the family's children.

C. The illustrations that follow show the tax savings of this strategy. Since the top marginal estate tax bracket rate is now 46%, savings of $695,000 will be available to married taxpayers who have done wills with proper tax provisions.

D. Note that the manner in which assets pass to the survivor outright on the first death is not relevant in calculating the estate taxes. Unless assets are directed into the type of trust described above, they will be taxed in the survivor's estate later on. Joint tenancy may save a few hundred dollars in probate costs, at huge tax costs later on. Similarly, life insurance that passes to the survivor avoids probate, but ruins the estate tax savings that may be embodied in the couple's will or trust. As for a living trust, it may be necessary or desirable for any number of reasons. But, unless it provides for the establishment of a proper trust for the survivor on the first death, it is no better than joint tenancy. The format is no tax protection—only the content.

E. Another aspect of optimum marital deduction arrangements to think about is the type of marital gift. Here are the four main options:

- Outright gift of the amount above the exemption
- Right of withdrawal trust for this amount
- Power of appointment trust for this amount
- Qualified terminable interest property trust for this amount

F. All are treated the same for tax purposes. The surviving spouse has less control over the disposition of the remaining trust assets (on his or her subsequent death) as you go down the list of options.

3. TITLE / DEED OWNERSHIP TRANSFER OF ESTATE

Sole Proprietorships

Most farms in the United States are organized as sole proprietorships. Under this structure the farmer is the sole owner, has legal title to the property, and is self employed. Management decisions are solely under the control of the farmer. Resources for the operation are limited to that available to the sole proprietor. With this organizational structure, personal and business assets of the owner are jointly at risk in the operation. Liability is not limited to only that which is invested in the business. The farmer has total liability for all payments or actions, whether incurred personally or through the farm business. If a farmer were sued for a farm accident, their home and personal assets may also be in jeopardy. This is a risky situation for a farm business that may be a part-time venture. Especially, if a substantial amount of personal assets are involved.

Sole proprietorship is the simplest form of business organization as far as start-up and record-keeping are concerned, but it has its disadvantages. Sole proprietorship has been described as a hindrance to estate planning, farm transfer, and farm efficiency. However, if the farm operation will cease upon the death of the sole proprietor, it is the simplest structure to liquidate. Alternative organizational structures should be considered if “continuity of life” of the business is a concern.

Joint Tenancy

A joint tenancy is a form of shared ownership, with the key feature being the "right of survivorship". This means that while the joint tenants equally share ownership during their lifetimes, when one joint tenant dies, his or her interest is extinguished, leaving the surviving joint tenant(s) with sole ownership.

It is important to note, however, that creditors’ claims against the deceased tenant's estate may, under certain circumstances, be satisfied by the portion of ownership previously owned by the deceased, but now owned by the survivor or survivors. In other words, the deceased's liabilities can sometimes remain attached to the property.

This form of ownership is common between husband and wife, and parent and child and in any other situation where parties want absolute ownership to immediately pass to the survivor. For bank and brokerage accounts held in this fashion, the acronym JTWROS is commonly appended to the account name as evidence of the owners' intent.

In order to create this type joint ownership, the party or parties seeking to create it must use specific language indicating that intent. For example, if Norm wishes to convey property for Dennis and Rod to share as joint tenants with right of survivorship, Norm must state in the deed that the property is being conveyed "to Dennis and Rod as joint tenants with right of survivorship, and not as tenants in common."

Joint tenancy can have adverse estate, gift, and income tax consequences, however. A joint tenant has no control of post-death disposition of jointly-held property, and jointly-held property may be particularly vulnerable to loss in the event of divorce. The ramifications of a joint tenancy should be carefully examined prior to its creation, and in some cases, existing joint tenancy ownerships could beneficially be terminated.

In conclusion, property is often held in joint tenancy ownership (especially by married couples) because it is easy to set up, convenient, avoids probate and the difficulties of passing title to property at death of one of the tenants. However, spouses and others should consider the potentially adverse gift and estate tax consequences associated with joint tenancy ownership as well as significant non-tax disadvantages. The creator of a joint tenancy loses control over the ultimate disposition of the joint tenancy property after his or her death. These factors should be carefully evaluated before joint tenancies are created; in some cases, existing joint tenancy ownerships probably should be terminated.

Tenancy in Common

Tenancy in Common is a way two or more people can own property together. Each can leave his or her interest upon death to beneficiaries of his choosing instead of to the other owners, as is required with joint tenancy. In some states, two people are presumed to own property as tenants in common unless they've agreed otherwise in writing. Tenants in common can be between two or more persons who are related or who are unrelated. Husbands and wives can hold title as tenants in common.

Ownership can be held in equal shares or unequal shares. For example, Jeff could hold 50% ownership, Sue 25%, Mary 15%, and Tom 10%.

Upon death, the interest of the deceased co-tenant will pass to the co-tenant's heirs. If Tom died, Jeff would still hold 50%, Sue would own 25%, Mary 15 % but Tom's 10% would pass to whomever he designated in his will.

The primary advantages of a Tenancy in Common arrangement are 1) ease of identification, 2) due diligence by the sponsor, 3) no management responsibilities, 4) diversification and sizable returns on investment, 5) easy financing, and 5) non-recourse loans.

The primary disadvantages of a Tenancy in Common arrangement are 1) fear of recharacterization, 2) liquidation and difficulty of finding an exit strategy, 3) volatility and risk factors, 4) due diligence still required, 5) forced sale, 6) bankruptcy, 7) fears of foreclosure, 8) liability, 9) death, 10) divorce, and 11) limited number of investors.

Like most investments, there are both pros and cons associated with Tenancy in Commons. The weighing of the many factors of the offering, sponsor, and most importantly, the investor's circumstances is extremely important. Tenancy in Common arrangements will not be appropriate for everyone, but will be attractive and a good solution for others.

4. GENERAL USE OF TRUSTS

Irrevocable Trusts (ILITs)

In sizing up options for use of a donor's annual gift tax exclusions, the irrevocable life insurance trust (ILIT) often looks pretty good. Annual transfers of cash to a trustee are made, and the trustee then purchases a life insurance policy on the life of the donor (or the donor and his or her spouse). Why would this be of benefit?

a) The value of the life insurance collected on the insured's death is not subject to estate tax.

The trust fund is a source of liquidity to pay estate taxes on the other assets of the donor's estate.

By use of rights of withdrawal given the beneficiaries, the donor gets an annual exclusion to cover the contributions.

Even if the donor dies soon after the trust is set up, there will be enough cash to pay estate taxes. This wouldn't be the case if other investments were made with the contributions.

b) In order to get these benefits, certain rules must be followed. The donor must not be a trustee. The donor must not retain any rights to income or principal distributions from the trust. And, for good measure, the donor should not contribute an existing policy to the trust. If he or she dies within 3 years from making such a gift, the proceeds will be included in his or her taxable estate.

These trusts are a good alternative to giving the children annual cash gifts and telling them to buy a policy on the donor's life. The donor, through the trustee, has more control of the situation. No judgment creditor of a child can get his hands on the policy or any divorcing spouse of a child. The trustee is less likely to "forget" to pay the premium with the annual gift. And the trust agreement is a means of providing alternative disposition of the proceeds if a child dies before the donor.

For donors who have no foreseeable need for life insurance if only one of them dies, a purchase of joint life insurance should be considered. It is far less expensive than single life coverage. And if the couple has proper tax-planning wills or living trusts, there should be no need for payment of estate taxes until both are deceased.

In order to obtain the annual exclusion for gifts into the trust, the donor normally specifies that the beneficiaries (who otherwise receive no principal distributions from the trust until the donor dies) have an annual right of withdrawal from the trust. This right is equal to the annual gifts, divided by the number of beneficiaries, up to the annual exclusion, currently $12,000. If the right is not exercised in the 30-45 days provided, the gift of cash remains in the trust. This allows the trustee to apply the gift on the annual insurance premiums due.

Revocable Living Trusts

A revocable living trust is a legal arrangement by which legal title to property is transferred from personal ownership into the legal ownership of the trust. The revocable living trust is just what the name implies: a trust that can be changed or terminated at any time during the individual's life.

The person creating the trust is called the grantor, settler, or trustor. The grantor must actually change the title of ownership for each asset that will be placed in the trust from his or her name to that of the trust. All too often individuals go to the expense of setting up a trust but fail to change the title of assets. Only assets that are solely owned can be placed in the trust. That is, assets held as joint tenants with right of survivorship (non-probate assets) cannot be owned by the trust unless the joint ownership is severed.

The trustee manages the assets according to the directions of the trust document for beneficiaries identified in the trust agreement. The trustee can be the person setting up the trust (the grantor), a family member, friend, a corporate entity (such as a bank or trust company), or a combination of these. As the trustee, the grantor can maintain full control of the trust until his or her death or incapacity. When the grantor dies or becomes incompetent, legally incapacitated, or resigns, a successor trustee identified in the trust agreement takes over. The successor trustee has legal responsibility for administering the trust prudently and for the beneficiaries. The trustee keeps the beneficiaries reasonably informed. Naming more than one successor trustee is advisable in the event the first successor dies or becomes incapacitated. The successor trustee should be some one you trust and someone with financial management expertise.

The trust agreement is a legal document that contains instructions to the trustee regarding (1) management of the trust assets, (2) who is to receive distributions from the trust, and (3) what happens to the trust if the person creating the trust becomes incompetent or dies. The trust agreement provides instructions for the termination of the trust and the distribution of assets to the beneficiaries. The trustee can do only what the trust agreement specifies.

Beneficiaries of the trust are named by the grantor and can be the individual who formed the trust, friends, family members, and charities such as religious organizations, colleges, universities, or hospitals. To determine whether or not a living trust would fit into your financial planning goals, consider the advantages and disadvantages of a living trust.

Advantages - A living trust is an effective tool for handling your financial affairs if you become incompetent. In the trust agreement, you may name yourself as trustee and also name a successor trustee. The successor trustee handles your financial affairs if you are unable to do so. The trust agreement tells how and who is to determine that you are incompetent and gives directions for the management of financial affairs, which the successor trustee must follow. A successor trustee can deal only with finances. A successor trustee does not have the power to make your health care decisions.

A living trust avoids probate. Assets held in a living trust do not go through probate. The trustee already has legal title to the trust assets and can transfer title, without probate, to the beneficiaries named in the trust agreement. In addition to avoiding the time and expense of probate, the use of a living trust may reduce the risk of a will being contested, and provides privacy of your financial affairs at death.

Disadvantages - Cost. It costs more and takes more time to set up and fund a living trust than it does to prepare a will. Fees usually must be paid to the trustee if you cease to be your own trustee.

There are no significant tax advantages to a revocable living trust. For death-tax purposes, you own the property in the trust and at your death it is included in your taxable estate.

5. THE ECONOMICS OF LIFETIME GIFTS

Income Shifting

One advantage of making lifetime gifts is that the maker of the gift (donor) is usually in a higher income tax bracket than the recipient (donee). If a gift of 100 shares of stock is made in January, and the dividends for the stockholder are $1000 for the year, the savings in income taxes can easily be $160 for that year (the difference between the federal income taxes on, say, a donor in the 31 % bracket, and a child in the 15% bracket). For a taxpayer who can do without the foregone income, that can amount to considerable savings over the balance of the donor's life. This is especially true where the donor has a long life expectancy, and the income would only have compounded in his/her estate anyway.

Transfer of Appreciation

Another advantage of making lifetime gifts is that any growth in appreciation of the transferred asset escapes gift or estate taxation. A transfer of a rental house now worth $100,000 may use up some of the donor's exemption. But if the property had been kept until the donor died, it may have appreciated to $150,000 (as well as generating a lot of income that the donor may not have needed). And the estate taxes on the date of death value would be a lot higher than on the date of the intended gift.

Formerly, the Internal Revenue Service (IRS) would occasionally try to recapture the tax on this appreciation, by re-valuing the lifetime gift when the estate tax return for the donor was eventually filed. The law provides that the value becomes final for all purposes when the time limit for I.R.S. to contest the gift tax return for the transfer has expired.

Care must be used in selecting gifts for transfer, as values can go down as well as up. And the gift of assets with a low income tax basis (i.e., cost of purchase, as adjusted for depreciation or improvements) must be done with care. The donee of such property receives a "substitute" basis equal to that of the donor. This means that if the donee sells the asset, he or she is likely to have capital gains income realized on the sale. Had the donor given the asset to the donee in his or her will, the donee would receive a "step-up" basis, equal to the fair market value on the date of the donor's death. Having said this, it should be kept in mind that the effective capital gains income tax rates are lower than the beginning estate tax rates. Only in the case of a donor who is not likely to have a large enough estate to pay estate taxes will it normally be better to keep an asset to pass on in one's will than to make a lifetime gift.

Lower Effective Rates

This advantage applies to gifts made which aren't covered by either the donor's annual exclusion (currently $12,000 to each donee each year) or the donor's applicable credit amount (formerly called a "unified credit"). On these gifts, taxes are payable-on or before April 15 of the year following the year in which the gift is completed. The payment is made with the U.S. Gift Tax Return, form 709 that is due on such date.

What is the advantage of making such gifts and paying a gift tax during one's lifetime? The gift tax is paid by the donor out of his or her other assets. Therefore, when the donor dies later on, the amount of such payment is not present in the estate to be taxed. Contrast this with the gift through the donor's will or living trust. There is an estate tax on the amount of assets that will be used to pay the taxes on the rest of the donor's estate. The result? If a donor (having used up his applicable credit amount on other gifts) has $1,337,600 left and gives away the maximum amount that he can while retaining enough to pay the gift taxes, he can give $1,000,000 to his beneficiary. If the same donor retains the $1,337,600 in his estate, the estate taxes will be $465,213. The beneficiary will receive $127,613 less with the after-death gift.

Currently, however, lifetime taxable gifts should be done cautiously, if at all. The rapid increase in the amount of estate tax exemption is a strong reason to hold on to assets, and transfer them at death to one's beneficiaries.

6. TAX FAVORED OPTIONS FOR GIFTS

Annual Exclusion Gifts

One of the most familiar and still most-useful provisions of the gift tax law is the allowance of annual gifts of currently up to $12,000 to each beneficiary of a donor each year. There is no tax on such gifts, and no need to report the gift to the IRS. Such gifts may be made in cash or in just about any other kind of property.

Because of the power of compounding, a regular program of such transfers over a number of years can sometimes be the only estate planning option needed to maintain a person's estate in an acceptable size range... but it is seldom enough to address the problem of an estate that is well over the exemption equivalent amount (because of the uncertainty of how long the donor will live, and just how many gifts he or she will be able to make to reduce the estate for tax purposes).

A frequent issue in carrying out these gifts is completing them for tax purposes within the calendar year. Generally, all the steps must be taken for the donor to irrevocably part with "dominion and control" in order for the gift to be treated within the year. Delivery of a check on December 31 may not be enough, if a stop-payment order could still be made.

Lifetime Exemption Gifts

After making sure that the foreseeable needs of the donor won't be placed at risk, a transfer of assets worth the gift tax exemption amount ($1.0 million) could be considered. A report of the transfer to the IRS on Form 709 is required. This step is potentially helpful, especially when the donor may not have many

beneficiaries to whom annual exclusion transfer may be made. For farm or ranch families, the phenomenon of low return on equity is familiar. Gifts of assets with high estate tax value may often be made without seriously impairing income to live on.
For husbands and wives, the opportunity to make this kind of gift can make transfers of substantial assets possible, without incurring any tax payments out of pocket. For land transfers, a qualified appraisal is vital before the deed of conveyance is done.

There is no requirement that a transfer of more than the annual exclusion amount to a beneficiary use up the entire exemption equivalent amount. Part can be used one year (say, a $200,000 gift) and the rest in succeeding years. The IRS form 709 shows previous transfers, and aggregates them for purposes of determining when you have used up your applicable credit amount.
This technique can certainly be combined with other options, such as establishing a limited liability limited partnership to "leverage" the use of your applicable amount (by use of discounts for limited transfer rights and voting rights normally accorded to the limited partners).

Charitable Gifts

An outright gift from a donor to a qualified, tax-exempt charitable organization (such as the Colorado State University Foundation) in the donor's will or trust is exempt from federal estate taxes. More accurately, the assets given are reportable in the estate, but there is a charitable deduction for the full value. The result? The total taxes on the remaining estate are much lower.

How can one do even better than this, if a charitable gift is part of your overall plan anyway? Consider making the gift at death out of assets that would otherwise produce income taxes to another beneficiary, such as a child. Examples would be Individual Retirement Account benefits, tax-deferred annuities, and §401(k) plan benefits. By designating the first $25,000 of such assets to go to your favorite charity, you direct them to an organization that will not have to pay income taxes on the benefits, anyway. That frees up the identical amount in your will (applicable to probate assets) that can go to your non-charitable beneficiaries. A warning, though - this is a situational matter. If one has a surviving spouse who can do a tax free rollover to his or her own IRA, and if this spouse has a good life expectancy, it may be preferable to make the proceeds payable to the spouse, to maximize the amount of assets he or she can hold in a tax-exempt account before being required to start drawing down on them.

Under the federal Pension Protection Act of 2006, a retirement account owner who is 70 ½ or older can make charitable gifts out of his or her account, up to $100,000, with favorable income tax consequences. Also, the owner can designate his or her children as beneficiaries, and they can do tax-free rollovers, which was only available for surviving spouses under previous law.

If a person has sufficient funds, he or she can make a lifetime charitable gift, to get the charitable income tax deduction, as well as removing the gifted asset from one's estate for estate tax purposes. This can be impractical if it is important to retain the asset until it is clear it will not be needed for the owner's use during their lifetime. But in the case of a deathbed illness where there is time to consider such matters, a gift like this can be an important estate planning option. To avoid doubling up on charitable gifts inadvertently, one should provide in the will or trust that charitable gifts made at the time of death under the document should be reduced by gifts made by the donor to such organization during his or her lifetime- or passing to the organization through beneficiary designations under life insurance policies or retirement plan beneficiary designations.

For example: "Upon my death, my personal representative shall distribute $100,000 to a qualified charitable organization, less the amount (if any) of assets which pass to this organization by reason of my death outside my will, and, further, less the amount (if any) of gifts to this organization I may have made to it after the date of this Will (disregarding any contributions under $100 in value). This gift is to be used for such tax-exempt purposes of the organization as the governing body considers best."

Payment of Tuition Expenses

In addition to the annual gift exclusion, a donor can make what is called a "qualified transfer" without gift taxes. There are provisions for paying tuition to an educational organization for an individual, in unlimited amounts, that many grandparents may be interested in. Also, payments of costs of medical care for a donee may be made without gift taxes. Note that such payments must be made directly to the educational institution, or the medical care provider, and not as a reimbursement to the donee.

Perspective on Charitable Gifts

A final word on charitable gifts. Don't assume these are only for the very wealthy. Assuming that the family beneficiaries are pretty well self-sufficient, and will in any event inherit enough other assets to be comfortable, a person may well be in a position to make a real impact on other people or charities with a small part of his or her estate.

7. GIFTS WITH RETAINED BENEFITS (Split Interest Gifts)

Charitable Retained Interest Trusts

This is an option for those who would consider selling their farm or ranch property.

An outright charitable gift isn't for everyone. First, there may be children who would be partially disinherited by the amount of the gift, when this would be a material factor. Second, the donor(s) may not feel secure in parting with the asset for fear that some development in their lives may make the income from remaining assets insufficient for their needs.

For once, the tax code comes to the rescue. Under IRC §664, a donor can establish an irrevocable living trust for a charity, and reserve the right to receive income from the trust during his lifetime. There is a calculation of the amount of the charitable income tax deduction. It is based on the value of the initial contribution (requiring a qualified appraisal for assets such as real estate and a closely held business), and the value of the income rights specified by the donor in the trust agreement. The younger the beneficiary, the less the income tax deduction (the charity will have to wait longer to get its distribution). The higher the payments specified by the donor in the trust agreement, the lower the deduction (the actuarially calculated value of these rights will be higher, of course, and they are deducted from the initial contribution to determine the available deduction). An interest rate factor for the month of the gift plays a role, too.

Many options are worth looking at. The payout rate must be at least five percent a year (5%), based either on the initial fair market value of the assets (annuity trust) or based on the annually determined fair market value of the trust assets (unitrust). There are upper limits, too.

The donors may be trustees of charitable remainder trusts (CRTs), or institutions may be chosen. There are limits on the powers of a donor-trustee to be observed. These are designed to prevent the donor from controlling the payments due under the established percentage payout provisions by valuing the assets arbitrarily.

The identity of the charities to receive the trust assets upon the death of the donor can be changed, even after the trust is signed. This does require that the beneficiaries to be named be public charities.

The payment of the specified amounts can be effectively deferred, by electing to use a formula allowing the trustee to pay you the stated percent due each year, or the actual income, whichever is less. Further, the donor can require that any deficiencies in payments for years when actual income is less than the stated percentage will be made up in years when actual income exceeds the stated payout rate.

A. Annuity Trusts

   This version of a CRT provides a fixed payment amount, and so it is favored by those desiring security of income. Once it is established, no additional contributions may be made to a Charitable Remainder Annuity Trust (CRAT).

B. Unitrusts

   This version of a CRT allows the dollars paid out to float with the fair market value of the assets, as these change from year to year. This trust appeals to younger donors or those with sufficient income from other sources to take some risks. Additional contributions to this trust can be made after its original establishment.

- Charitable Retained Interest

The advantages of the CRT include the following:

- Current income tax deduction
- Estate tax deduction on donor's death
- Sale of assets from the trust with no capital gains tax
- Tax free accumulation of income in the trust
- Absence of requirements applicable to retirement plans

The ability to generate more income from an appreciated asset from a CRT than would be the case with a sale and reinvestment of the after-tax proceeds is important. The donor, if he or she qualifies for life insurance, can use some of the extra income to pay life insurance premiums on policies on his or her life. And if these policies are held in an irrevocable trust, they escape estate taxes. So what? Well, these proceeds can be given to the donor's children, effectively restoring the value of the CRT assets that go to the charity on the donor's death!

Grantor Retained Annuity Trusts

These are also irrevocable trusts, set up like CRTs in many respects. The value of this estate plan option is they allow a valuable asset to be given to one's non-charitable beneficiaries (children) at a relatively modest cost. The "cost" is measured by how much of one's lifetime applicable credit amount is used in covering the value to the children of the remainder interest. This value is the actuarially calculated value of the right to receive the trust assets on the specified termination date of the retained income interest. If the interest factor used in valuing the interests of the donor and the remainder is high, then the gift tax cost of setting up the trust is high.

If the donor dies before the specified termination date, little is lost except the expenses of establishing the trust, and the chance to do something else with the assets placed in the trust. And if the trust ends with the assets being distributed to the donor's children, the property may well have appreciated in the meantime. So, a $100,000 asset may be transferred at a gift tax cost of $80,000, in the example of a 60 year old person making a gift into trust for 5 years, and reserving a 5% payment in an annuity, if the applicable federal rate for the month of gift is 8%. To partly offset this benefit, however, there is no annual exclusion for the gift.

Qualified Personal Residence Trusts

A special kind of grantor retained interest trust may be used to transfer a donor's personal residence. Instead of a specified income payment from the trust, the donor reserves the right to live in the house for a specified term (such as 15 years). At the end of this term, the trust asset goes to the named beneficiaries, usually his or her children. The reason for doing this? Again, the efficient use of the donor's applicable credit amount. If a $250,000 house is transferred into trust, and a sufficient time reserved for the donor to live in the house, the value of the remainder interest can be a small fraction of the value of the house. For example, if the applicable federal rate for the gift is 7.6% and the term of the trust is 10 years, the gift made by a 65 year old donor is only 35% of the value of the house, or about $87,500. Note that there is no annual exclusion available to offset this taxable gift, so part of the donor's lifetime credit must be used.

The trust must contain a provision converting it to a grantor retained annuity trust (GRAT) if the house is sold during the term of the trust and no replacement bought. That is, the donor would get income distributions from the invested proceeds at a specified rate during the rest of the term of the trust. Normally, a replacement house would be purchased if the original house were sold by the trustee.

If the donor unexpectedly dies before the trust period ends, the house will be included in the donor's estate for tax purposes. Care should be used to select a term for the trust that will provide the benefits you're after, without being too aggressive.

8. GIFTS OF LIFE INSURANCE

Gifts of Existing Insurance

As with any gift, the transfer of an existing life insurance policy should not be made if the potential donor might need the policy for his or her own use. For example, there may be a large cash value buildup that could be drawn down to provide retirement income. Or, the policy may be necessary to pledge as collateral for an operating loan.

When it does make sense for the owner of the insurance policy to give it away (to remove the proceeds on the insured's life from the owner's estate for estate-tax purposes, typically), there are a few points to consider. Importantly, if the donor-insured dies within three years from the time the policy is given away, the proceeds will be included in the donor's estate anyway. That's one reason cash gifts are usually made into ILITs, so that the trustee can buy a new policy, which won't be includable in the insured's estate if the policy is purchased within three years from the date of setting the trust up.

Another consideration is valuing the policy for gift-tax purposes. Normally, this would be the cash surrender value, plus unearned premium, which is the interpolated terminal reserve value. But if the donor is uninsurable due to medical problems on the date of transfer, even if he or she survives more than three years after the date of the gift, the value of the policy for gift tax purposes may be far higher than the cash surrender value.

If a gift of an existing policy having a large cash value would otherwise generate gift taxes, it would be wise for the owner to borrow against the policy to reduce the cash value, and then make the gift. In most circumstances, this will not have adverse gift- or income-tax consequences to either the donor or, the donee, although each transfer should be evaluated carefully with a tax adviser before it is made.

Cost Sharing In Premiums

"Split dollar funding" allows you to divide up the responsibility for paying premiums on a life insurance policy, and to divide up the benefits from policy ownership as well. This is occasionally useful in estate planning.

The two primary reasons for different parties to share the cost of insurance premiums are to fund business buy-out agreements and to minimize the gift-tax costs of setting up irrevocable life insurance trusts. The subject of buy-sell agreements, or other business buy-out arrangements, is outside the scope of this outline. But, typically, ordinary life insurance policies (i.e., those having an investment factor, as opposed to term insurance policies) are jointly purchased by a corporation and a shareholder. The corporation pays for the investment portion of the policy, and the shareholder pays for the costs of the pure insurance protection. When the insured dies, the corporation gets repaid its costs through the years. The shareholder receives the "pure insurance" part of the proceeds. These are used to buy the shares owned by the insured from the estate of the insured. Result? A young family member can afford to buy life insurance on his father, so that when Dad dies, his shares are bought by the son, and Mom has the cash to live on (in the tax-planning trust Dad set up for her).

In a large estate for a donor having few children, split-dollar funding can be very helpful. One party, such as a corporation in which the donor is an owner, or the donor's wife, pays the investment portion of the premium, and the donor makes contributions into the ILIT of the pure insurance part of the premium payment. When the donor-insured dies, the party which contributed part of the premium gets repaid the cumulative amount of these payments, and the rest of the policy (which in most cases is the bulk of the proceeds) goes into the insurance trust. This keeps the annual contributions into the trust at a level covered by the donor's available annual exclusions for gift-tax purposes. For example, with a donor having only one child, and wishing to make annual life insurance premium payments of $30,000.00, if the donor contributed all of the costs of the insurance premium payments into the trust, $20,000.00 per year would not be covered by the donor's annual exclusion. But if the donor's company can pay a substantial part of the premium, so that the donor only needs to contribute, say, $10,000.00 per year in to the trust, the whole plan works better for gift-tax purposes.

Partnership Ownership of Policies

Because of what many people perceive as complex requirements for holding life insurance policies in an irrevocable trust, in some situations it may be useful to own life insurance policies in a partnership, in which the insured is a partner. Where an insurance policy has a large cash value, for example, instead of borrowing against the cash value and putting the policy in a trust, it may be preferable to put the entire policy into a partnership, and only give away fractional interests in the partnership to family members over the years. The downside of this arrangement is that the proportionate part of the policy proceeds equal to the deceased partner's interest in the partnership will be included in the deceased partner's estate. That's not so good. But at least it avoids using up part of the insured-partner's estate tax exemption amount to cover the value of the transferred policy in excess of the annual exclusions available.

For example, Colorado's partnership law would not recognize a partnership that only held life insurance policies. Since a partnership is an association of one or more parties to carry on a business for profit, the ownership of life insurance might not meet the state law test for actually conducting a business. If a partnership can own any other asset, or conduct any other business, such as facilitating a buy-sell agreement, then the partnership should be valid, and the estate tax benefits would follow.

Since at least some portion of partnership assets would be taxed in the estate of the insured (the policy proceeds must be payable to the partnership, not to any individual, or to the estate of the insured, to avoid inclusion in the estate of the insured for tax purposes), the partnership vehicle doesn't get 100% of the policy proceeds out of the insured's estate. But where there is an existing partnership formed for purposes of, say, operating the family farm, and the senior partners plan to transfer away all but a small percentage of the other assets, holding a life insurance policy in the partnership would be worth considering, in lieu of setting up a separate irrevocable life insurance trust.

9. GIFTS TO GRANDCHILDREN

Annual Exclusion Gifts & Trusts

Transfers to grandchildren currently enjoy the same $12,000.00 per donor per year exemption as transfers to other beneficiaries. But because grandchildren are often minors, an outright gift to them, to hold an asset in their own name can be a poor practice. Troubles can occur once an asset is put into a grandchild's name, whether it is a bank account, a fractional interest in land, or some other property. If the asset is to be sold, a seven-year-old person (for example) obviously does not have the contractual capacity required to join in signing a deed to make the conveyance. What do you do? You set up a conservatorship. A conservatorship is a court order that some property or a person be subject to the legal control of another person or entity. Many jurisdictions use the term “guardianship of a person” to refer to the same legal principle.

A far better idea is to use some other technique to make annual gifts to grandchildren. These can include steps as simple as establishing a Uniform Transfers to Minors Act account for the child, naming a custodian for the account, and making the gift to the designated custodian. If the gift comes from grandparents to a custodial account for the child managed by the parents, there should be no adverse estate- or gift-tax consequences for either if grandparents or parents die before the account terminates (at age 21) and the assets are given to the grandchild outright. But beware of parents setting up Uniform Transfers to Minors Act accounts for their own children. If the parent dies while the account is still in place, the asset will be taxed in the parent’s estate, because the parent retained the right to control the use and enjoyment of an asset for a beneficiary as to whom the parent had a legal duty of support.

Another technique is to establish irrevocable trusts for the benefit of the grandchildren. These are usually one of two types:

Section 2503(c) trust-this is an Internal Revenue Code section that says if certain rules are followed, a transfer into a trust for a grandchild will get the current $12,000.00 annual exclusion, even if it is not a transfer of a “present interest”. It enjoys the same tax treatment as if the asset had been put into a UTMA account, or given to the grandchild outright. But this trust terminates at age 21. Since the grandparent may not want the trust to end that early, a provision is often included allowing the grandchild to elect to continue the trust for a few more years, after the grandchild reaches age 21. Some informal leverage could be applied. For example, grandparents and parents could make it clear that if the grandchild elects not to continue the trust another few years, the grandchild’s inheritance of other assets might well be cut back.

Section 2041 trust-these are trusts under which the grandchild is given a right of withdrawal. This is exercisable within a short period of time after a contribution is made into the trust for the grandchild’s benefit. If the grandchild does not exercise this right of withdrawal, the assets stay in trust for the provided period (usually, until the grandchild reaches age 30, or something like that). The existence of the right of withdrawal, accompanied by proper notice to the grandchild (or his or her guardian or parent, if the grandchild is a minor) is enough to secure the $12,000.00 annual gift tax exclusion.

Note that the use of custodial accounts or trusts can be combined with a third technique described below. In effect, the trustee for the trust agreement, or the custodian for the UTMA account, acts as a stakeholder for the grandchild, under the partnership arrangement described below.

Gifts of partnership interests-grandparents can transfer large assets into a partnership, and then give fractional interests in the partnership to their grandchildren each year. If the grandchildren are minors, these gifts can be made through the UTMA accounts or one of the trust arrangements discussed above. The benefit? Commonly, establishing the partnership first allows the grandparent to retain some partnership control, by being a general partner, and giving away only limited partnership interests. This allows the grandparents to shift some income to the grandchildren, and to reduce the grandparents' estate for tax purposes, while retaining the ability to manage the assets within the partnership, for as long as the grandparents are able and willing.

Generation Skipping Transfer Taxes

A. Rate and Applicability.

Our Congress has pretty well halted the former practice of grandparents setting up a significant part of their estates in a trust for their children, with a provision that, when their children died later on, the assets would go on to the grandchildren. While this arrangement did not save the grandparents any estate taxes, it made it possible to benefit the children, and yet keep the assets out of the children's estate for estate-tax purposes. This, of course, significantly increased the available trust assets for ultimate distribution to the grandchildren.

Now, U.S. citizens enjoy only a $2.0 million one-time exemption from the generation skipping transfer taxes. If one attempts to use the arrangement described above, using assets more than $2.0 million in amount, a tax of 46% is imposed on the excess. This is in addition to any federal estate taxes that might be payable on the transferred assets. Because the combined estate and generation skipping transfer taxes on a really large transfer are prohibitively high, it is unthinkable, in estate planning, to intentionally incur a generation skipping transfer tax.

These generation skipping transfer (GST) taxes apply to trusts which are, from the inception, intended to benefit grandchildren, and to transfers directly to grandchildren. Such transfers are called "direct skips". But the GST tax also applies to "taxable terminations", which are usually transfers in trust for the benefit of children, which terminate and then go to the grandchildren (the arrangement described above). Such taxes must also be paid on "taxable distributions", which are discretionary distributions by a trustee to grandchildren out of a trust which is primarily intended for children.

B. Exemption.

Careful use of the lifetime $2.0 million exemption must be made. Certain transfers actually don't even count against the lifetime exemption. For example, outright gifts to grandchildren which are covered by the current annual exclusion amount of $12,000.00 don't count. Payment of tuition costs under §2503(e) don't count. A transfer in trust, accompanied by a right of withdrawal on the part of the beneficiary, qualifies for the $12,000.00 annual exclusion, but not as an exception to the GST tax. Part of one's lifetime exemption must be applied to such transfers into a trust. This is done by filing a gift tax return form on which the transfer is reported, and part of the $2.0 million exemption is allocated to this transfer.

There are automatic allocation rules that are intended to benefit taxpayers, which may help. In general, these rules cover inadvertent generation skipping transfers, such as when a trust is set up for the benefit of one's children until they reach age 50 but then (unexpectedly) the trust terminates and goes to grandchildren because one's child died in a car accident. It is safe to say that these automatic allocation rules are generally helpful. However, that is not always the case, and the best practice in estate planning is to carefully identify when a generation skipping transfer may occur, and to allocate the exemption on an intentional basis.

C. Maximizing Use of Exemption.
When transferring assets into a trust which will be held for a long period, the hope is that the assets will be invested wisely and appreciate in value. Rather than "spending" the GST exemption when the trust terminates and assets are distributed to grandchildren, why not allocate the exemption when the trust is funded, before the appreciation occurs? This is certainly legitimate.

To a great extent, the automatic allocation rules mentioned above may do this "early" GST exemption allocation. Still, it's best to consult an accountant or attorney whenever a transfer in trust occurs, due to death of a party or lifetime gift, about this issue.

10. INSTALLMENT SALES

Related Party Rules

Because of the generally low interest rates now applicable to mortgages and other commercial transactions, and because land values are appreciating in Colorado, sales of assets between parents and children is a good way to fix the value of the land in the parents' estate for estate tax purposes. Generally, the increase in the value of the real estate will be greater than the cumulative amount of interest paid on the note. Since the interest payments, in the aggregate, tend to replenish the estate of the seller, there would be little value in this technique unless the value of the land appreciated significantly after the sale took place.

If an installment method sale is done, care must be taken with respect to the depreciable portion of a farm or ranch, such as outbuildings. There is a rule that prevents installment reporting of gains when a sale is categorized as a sale to a "related person". This is a deceptive rule, because it sounds like it applies to a sale to family members. Actually, it applies to a sale to corporations or partnerships or other entities in which the seller has a substantial interest. These rules require immediate recognition of the gains on the sale to such entities, even though the promissory note received in the transaction calls for payment over a period of time. This can be a rude shock. A sale outright to another family member does not run afoul of these rules. Care should be taken to consult your professional adviser before a sale of a farm or ranch property as a means of freezing the value of the estate. Such a technique, by the way, is considered a freeze, since the value of the note does not increase over time-the balance at date of death is the taxable portion for the parents' estate.

If a transaction between parents and children qualifies for installment reporting, the interest paid on the note is taxable income. This interest must meet certain tests to avoid the "unstated interest" rules, which impute a certain minimum interest to the deal. Also, the difference between the parents' basis in the property and the sale price is capital gains, a portion of which is recognized each year based on the portion of note payments received during the year as a ratio of the total original amount of the note.

Subsequent Disposition Rules

For income tax purposes, it is important to keep in mind the fact that a subsequent sale of a property by a child may trigger recognition of all the gains on the transfer, if this sale takes place within two years after the first sale. Since most parents anticipate making gifts of some of the note payments due to them, all parties to an installment sale should normally plan on the property being held until several years after the transaction, to give the parents a chance to make additional gifts to the children by forgiving note payments. In no event, however, should there be a prearranged plan to forgive all note payments that makes the transaction a gift from the beginning, and destroys the opportunity to maximize the use of your annual exclusions.

11. DISCLAIMERS AS PLANNING OR REMEDIAL OPTIONS

Wills or Trusts Including Disclaimer Provisions

Estate planning is difficult. The planner tries to minimize estate taxes for his clients, without knowing when the clients would die, what the tax laws might be at the time of death, and what the clients would own. This has been made a more even contest by adoption of state and federal laws allowing beneficiaries to do "disclaimers". A disclaimer is simply a refusal to accept ownership of an interest in property, with the result that the property left to a beneficiary under a will, trust, or other arrangement passes on to someone else. As a practical matter, the beneficiary knows in advance who will get the disclaimed interest once he or she decides to do the disclaimer. So the result is really the same as if the beneficiary had accepted the inheritance, and then turned around and given it to the contingent beneficiary. But we observe the legal fiction that the disclaimer is somehow different from acceptance followed by gift-and treat the person doing the disclaimer as if he or she had really never had any control over the property.

What does this mean? Primarily, a will can be drafted so that the beneficiaries are granted a power to disclaim assets, usually into a trust for the benefit of the disclaiming party (where the beneficiary is your spouse) or to some other beneficiaries, such as the beneficiary's children, to whom the beneficiary would like to see the asset distributed anyway. Then, you wait and see. When the owner of the property dies, the beneficiary knows, at the date of death, what the decedent's property is worth, what the tax laws are at the time, and who will get the property if the beneficiary disclaims it.

Disclaimers can apply to part of an inheritance, or all of it. Disclaimers with respect to any property must be done (to satisfy state and federal law) within nine months after the death of the person who left the beneficiary the interest, or if it is a lifetime gift, then within nine months from the date of the transfer which created the interest for the beneficiary. There are certain exceptions for beneficiaries who are under 21 years of age.

Another condition for doing a valid disclaimer is that the beneficiary must not have accepted any benefits from the property which is being disclaimed, and that the beneficiary not <u>direct</u> who gets the property being disclaimed. It is okay if the property passes to persons of whom the beneficiary approves-but it must be by the direction of the decedent, or other donor who has created the interest in the first place.

Of course, there are rules to follow in carrying out a disclaimer, and these rules are different for real estate than the rules applicable to, for example, joint tenancy bank accounts. Colorado statutes establish these rules pretty clearly, and the federal regulations are also quite detailed. But since there is nine months to take action, advice should be sought from a professional adviser as far as how to do a disclaimer, as well as whether or not one would be helpful in any event.

Correcting the "Joint Tenancy Trap"

For most married couples with an estate over the federal estate tax exemption amount, joint tenancy ownership of property is a tempting convenience (because the retitling after one joint tenant dies is easier than retitling through the probate process). Actually, for these people, joint tenancy is a trap. When all of the assets of a couple pass through joint tenancy to the survivor, the first spouse to die has lost the opportunity to shelter some of his or her assets in a tax-planning trust described earlier.

Because the tax savings can be in the hundreds of thousands of dollars if a couple uses both exemptions from federal estate tax, instead of just the survivor's exemption, joint tenancy titling should be avoided, and assets should be held as tenants in common. But there is some remedial action that can be taken with respect to joint tenancy assets.

A surviving spouse, under final Regulations adopted by the Department of Treasury, can disclaim the survivorship interest to which the surviving joint tenant would succeed upon the death of the first joint tenant to die. In Colorado, the survivorship interest of a joint tenant in real estate is one-half, between married persons. So the surviving joint tenant can disclaim a half-interest in real estate. If the decedent had a will which set up a non-marital deduction trust for the surviving spouse, the disclaimer would allow the asset to fall back into the decedent's estate, and then be shuffled off into the tax-planning trust. On occasion, it may require disclaimers from other beneficiaries of the estate to accomplish this result, but this is a possibility that should always be looked into.

For credit union, bank, and brokerage accounts, the disclaimer by a surviving joint tenant applies to the portion of the account attributable to what the decedent put into it. So, if the wife contributed two-thirds of a brokerage account, and the husband contributed one-third, and the husband dies first, the surviving spouse can at least disclaim the husband's one-third of this account. It is also possible to disclaim qualified retirement plan benefits which have been left to a survivor, life insurance proceeds, and other types of assets.

The problem with most estate plans including a lot of joint tenancy property is that, if very little attention has been paid to how to properly title assets, the will is probably not in very good shape, either. So instead of disclaiming interests which would then pass into a tax-planning trust, the surviving spouse often is faced with disclaiming assets which would go to the children. Since the tax consequences are viewed as less damaging than giving up the right to use and enjoy the assets for the rest of the life of the surviving spouse, a disclaimer in this case would have limited use.

12. FAMILY PARTNERSHIPS AND LLCs

Advantages of Using Entities

Here are a number of reasons owners of family businesses establish legal entities, such as corporations, limited partnerships, and limited liability companies. While there are tax and non-tax differences in how each entity is set up and operated, generally, they all provide some of these benefits:

- Provide asset management for family members who need or want it
- Prevent interests in family property from passing to outsiders as a result of death, divorce, or other reason
- Protect family assets from creditors of a partner
- Avoid ancillary probate in the case of real estate in states other than Colorado

- Control distributions of assets to preserve them for the future benefit of partners

- Facilitate transfers by lifetime gifts

- Avoid liquidation or partition rights by owners of fractional interests in land

- Centralize management, usually in the hands of senior members of the family

Choice of Entity

Corporations are generally not advisable when real estate or other appreciating assets are intended to be held in the entity, because of the difficulties incurred in distributing the land out to the owners without paying a tax at the corporation level, and a tax at the shareholder level on the increased value of the assets. Also, the basis of assets in the corporation isn't stepped up at the death of a shareholder, which is allowed for partnership type entities. There are also some non-tax reasons why corporations are used less now than in earlier decades—the need for annual meetings, the need to observe corporate formalities in operations, and the inflexibility of the law concerning shareholder rights. In most cases, owners looking into the options on business entities will choose to set up a form of limited partnership (LP) or a limited liability company (LLC).

Colorado allows a number of versions of limited partnership, such as "limited liability limited partnership", or "limited partnership association", and others. But the technical differences between them are less important than the characteristics they share. And there are few significant differences for purposes of estate planning for farm and ranch owners between LP's and LLCs. The latter need not be operated for profit purposes, and need only have one member. But most family businesses, by definition, involve more than one person, and are intended to be a business operated for profit. There is thought to be a modest benefit in using LP's when the owners plan to make substantial gifts during lifetime (vs. LLCs), so the LP is often the entity of choice in that application. The benefit arises from the fact that the IRS and the Tax Courts have already gone on record as allowing discounts for gift taxes on LP transfers, but have not (at least not yet) done the same for LLC gifs.

Steps Involved

After working out the details of an LP for the owners and their family with advisors, a filing with the Colorado Secretary of State initiates the process. The chosen name for the entity is reserved, and the names of the main people involved in the business are placed on record. A tax number is obtained from the IRS, and a basic agreement (usually called the LP agreement for an LP, and the operating agreement for an LLC) is signed by all those in the family who will be partners. The owners deed the land and equipment into the LP, and the other family members usually contribute a nominal amount, such as $1000, unless they already own some of the assets of the business. If the children own land prior to establishing the LP, they deed that in at the time of formation.

The LP agreement restricts the younger members from voting on most matters. It also restricts them from giving away or selling their partnership interests. These limitations mean that when the parents later on give their children some of their portion of the partnership, the value of the gifts is reduced from the mathematical value that merely applying the percentage of the gift to the market value of the LP assets would produce. This reduction for calculating the gift taxes is called a discount. It consists of a “market discount” due to lack of transferability, and a “minority discount” due to lack of control. The owners usually retain the voting rights, in the form of general partnership interests. They also own a lot of the limited partnership interests, at the start. It is these non-voting limited partnership interests that they give away, if and when they choose.

Each time gifts are made, of course, it is wise to have the underlying assets of the LP appraised. As a matter of good practice, a one-time appraisal of the <u>business</u> is done at the beginning, by a CPA, or other qualified business valuation expert. This is the opinion that is relied on by the family in determining what discount to use in making gifts. For example, if gifts of minority interests in the LP are entitled to a 25% discount, and the owners wish to make gifts of $22,000 to each of their children, and if the asset values in the LP are $1,000,000, then a gift of 2.933% could be made (instead of a gift of 2.2%). The limited partnership interests remaining in the hands of the owners at their deaths are qualified for similar discounts for estate tax purposes.

Succession

The LP agreement may provide for management succession in the event of the death or retirement of the senior family members. This can take place without changing title to any of the assets in the LP, although the partnership records must be adjusted, and prorated based on income tax filings for the year of death.

For those family members not involved in the business operations, means can be provided to ensure that they are treated fairly by the surviving partners. One of these is a life insurance funded buyout for them, which can often be funded in an affordable manner with second to die coverage. Another protection they can be afforded is the right to require liquidation of the entity, if their rights to distributions of net profits are not being honored. And there are other means of planning for a fair and equitable resolution of the potential conflict between children who are in the business for a living, and those who are not.

13. POWER OF ATTORNEY

A power of attorney is a written document in which you (called the principal) appoint someone else (called the agent or attorney-in-fact) to act for you. Your agent can do any legal act you ask your agent to do.

A power of attorney allows you to pick someone you trust to handle your affairs if you cannot do so yourself. It gives you peace of mind, knowing that in an emergency someone you choose will have the authority to act for you. If you don't have a power of attorney and you are suddenly incapacitated, your family may have to go through an expensive and time-consuming court action to appoint a guardian or conservator.

A conventional power of attorney begins when you sign it and continues until you become mentally incapacitated. A durable power of attorney also begins when you sign it, but it stays in effect for your lifetime, unless you cancel it. You must put specific words in the document stating that you want your agent's power to stay in effect even if you become incapacitated. If you want this feature, it's very important that you have these words in your document.

All powers of attorney come to an end at your death. Your agent will have no power to make any decisions after you die.

14. LONG-TERM CARE INSURANCE

Long-term care (LTC) insurance helps provide for the cost of long-term care beyond a predetermined period. Long-term care insurance covers care generally not covered by health insurance, Medicare, or Medicaid. Individuals who require long-term care are generally not sick in the traditional sense, but instead, are unable to perform the basic activities of daily living such as dressing, bathing, eating, toileting, getting in and out of bed or chair, and walking.

Long-term care isn’t necessarily long-term. A person many need care for only a few months to recover from surgery or illness. Age is not a determining factor in needing long-term care. About 40 percent of those receiving long-term care are between the ages of 18 and 64.

The risk of long-term care can be dealt with in three ways:

- Avoid it – hope for the best and try to stay healthy (There are no guarantees).
- Retain it – those with sufficient net worth can self-insure (i.e., 5 years of care @ $80,000 per year = $400,000).
- Transfer it – buy a LTC policy and pay an insurance policy to handle the risk.

People can pay for custodial long-term care in the following four ways:

- Self-insurance – If you plan to use your own assets for LTC, be sure you understand the Medicaid guidelines that affect non-institutionalized spouse. What will happen to your spouse if there are not enough assets to cover these costs? Consult with experts for assistance.
- Medicaid – Medicaid is jointly funded by federal and state governments and managed by the states. Rules differ from state to state. Medicaid covers nursing home for people whose income and assets fall below a certain level. If the person is expected to return home or if there is a non-institutionalized spouse, Medicaid exempts the home and one vehicle if it is needed for medical appointments and other trips. Many states place a lien against the home to repay the state after the patient dies.
- Single premium insurance – One way to pay for long-term-care is to purchase a single premium life insurance policy. The investment is guaranteed to earn a minimum rate of interest. This builds up a cash reserve to cover nursing home or home care. Some policies cover both husband and wife.
- Long-term care insurance – This covers all or part of the needed care. The choice is to spend money on premiums now on the chance it will save you money later. One rule of thumb is to add all the premiums you would pay until age 85. Usually this is less than the cost of one year in a long-term care facility. Be sure you will be able to pay the premiums in the future. If you cannot, you will lose not only your protection, but all the money you already paid into premiums.

Some financial planners recommend LTC insurance. Others say this type of insurance makes them only a best (and expensive) guess. Also policies are full of disclaimers, so you might not get what you need even after paying premiums for years.

15. AFTER-DEATH PLANNING OPTIONS

Paying Estate Taxes in Installments

If the value of a farm or other business owned by a deceased person constitutes at least 35 percent of the value of the estate, the estate can elect to start paying the taxes on it on the date five years after the estate tax return is due (nine months after date of death). If desired, the tax can be paid in ten equal installments, meaning that the last installment would not be due until 14 years and nine months after the date of death. This deferral applies only to the portion of the estate tax assessed on the business. For farms, the farmhouse and other related improvements are treated as being part of the farm, as long as they are contiguous to the farmland. For the first five years, interest is payable, generally at favorable rates, as low as 2 percent on the deferred estate tax attributable to the first $1,120,000 in taxable value of the closely held business interest, and at a reduced rate on the taxes attributable to the balance of such value.

The right to pay in installments is generally available, even if the farming or ranching business is held in a corporation or partnership. Certain rules apply to aggregate the interests of a decedent in a number of closely held businesses, and to determine whether a business with a number of owners in a family qualified as a closely held business. For a partnership, there must be no more than 15 partners or the decedent must own 20 percent or more of the partnership. For a corporation, there must be no more than 15 stockholders, or the decedent must own 20 percent or more of the corporation's voting stock.

Conservation Easement Election

An estate may make an election to create a conservation easement and to exclude, for federal estate tax purposes, up to 40 percent of the value of land which is subjected to a qualified conservation contribution. This is a contribution of a qualified real property interest to a charity for conservation purposes. This election must be made by the estate's personal representative on the estate tax return. It allows tax relief for beneficiaries who know that their parent would have made such a contribution, if only he or she had gotten around to it. Many organizations would be eligible to receive such donations, if they are qualified under IRC §501(c)(3), or other similar laws regarding tax-exempt entities. The purpose for the contribution should be for protection of natural habitat, preservation of open space, preservation of historical structures, or preservation of open space, including open space for farmland and forestland, if this will yield a significant public benefit.

Special Use Election

Under another section of the Internal Revenue Code, designed to preserve farm values from forced liquidation, an estate may be able to lower the value of farm or ranch property for taxation purposes by electing to value the farm property in the estate at its value solely as farm property, instead of at its highest fair market value, which may be for development purposes. In order to make this election, the farm property must constitute at least 50 percent of the value of the estate, and farmland must constitute at least 25 percent of the value of the estate. Also, the property must meet certain conditions (ownership by the decedent for five of the eight years prior to the decedent's death, and material participation by the decedent or a member of his family in operating the farm for at least five of the eight years preceding the owner's death), and the future use must meet certain conditions. That is, the property must pass to "qualified heirs" who would certainly include children, and it must be used by them for at least ten years after the decedent's death. So, if a farm property is going to be sold in any event after a decedent dies, this particular election is of little value (except, perhaps, to minimize the tax payments that must be made, under any installment election, prior to the property being sold). If the farm property is sold within the ten years after the special use election is made, there is a recalculation of the amount of taxes that would have been paid if the farm property had been valued at its fair market value, and taxes paid accordingly.

Under an inflation index that began in 1998, the amount of the tax benefit is limited to a “compression” of the value of no more than $870,000.00 for decedents who die in 2005. In a large estate, this means that the tax benefit could be worth as much as $400,200.00 (being the $870,000.00 compression multiplied by the top marginal bracket of 46 percent).

Alternate Value Election

For any estate, regardless of whether it consists of farm or ranch property, bank accounts, securities, residential rentals, or whatever else might be owned, it may be possible to save estate taxes by an election to calculate these taxes using values six months after the date of death, instead of date-of-death values. For example, if date-of-death values for an estate were $3 million, and six months later they had declined to $2,900,000.00, overall, the estate could elect to use the $2,900,000.00 values. This alternate valuation election is made on the estate tax return, filed nine months after date of death.

Any assets which have been sold between the date a decedent passed away and the alternate valuation date would be valued at their sale price. This election is only available if it would result in reducing the estate taxes and generation skipping taxes. For assets which decline in value just because of the passage of time, such as annuity contracts or promissory notes, the change in value between date of death and alternate valuation date is ignored.

16. IMPORTANCE OF COMMUNICATION

When family business owners were asked: “What issues are of the greatest importance and greatest difficulty to accomplish?” Their two top responses were: 1) resolving conflicts among family members who are in the business together, and 2) formulating a succession plan.

Sensitive issues, such as money, death, and family relations are difficult issues not only to bring up but also to talk about in any depth. It is hard to approach these issues calmly when there are strong feelings about what is important. Most people avoid discussing these subjects because they believe it to be disrespectful and uncomfortable. We don’t want to give the impression that family members might die or we want someone to die.

Relationships between adult children and their parents continue throughout life and last longer today. In addition to increased longevity, these relationships are challenged by life transitions such as changes in residence, job, health, marriage, divorce, and remarriage. Building and maintaining healthy intergenerational relationships can give individuals and families knowledge, respect, and appreciation for one another. Skills of understanding provide a legacy to future generations that will also have to deal with the transitions and stresses of life.

Establishing and maintaining healthy relationships among family members is important and challenging at any age and stage in life. It is important that the generations communicate to make the relationship satisfying rather than strained.

These feelings, both positive and negative are greater during times of transition, such as retirement and death. All generations have a desire for help and support and a contrasting desire for freedom and independence. For example, adult sons struggle with their desire to remain the son and be dependent on his parents but also be the independent husband, father, and businessman.

Family farms are much more than a business. The farm is a part of the family and the family is a part of the farm. The two are inseparable. In many family farms, losing the farm would be like losing a family member. There is a culture in agriculture that the land must be passed on from one generation to the next and one of the most stressful farming issues is the transfer of the family farm from one generation to the next

Many researchers assume that operating a farm is like operating any other business: "Agricultural economists have argued that farms are or should be operated exclusively as businesses in which performance is evaluated by profit returned. A 15-year Cornell study of how 33 farm families make decisions concludes that while "farms are indeed operated as businesses ... because production is closely related to the life cycle of the family, the farm, in organization and management, is remarkable, if not unique, among businesses in developed economies".
Another study examined the family satisfaction levels of 242 senior generation farmers and 239 junior generation farmers. They found neither generation is happy with the communication in their two-generation farm family. Items such as handling arguments, fair criticism and family problem solving were ranked low by both groups.

Family members need to know and understand their family attributes, family values and family members' expectations as they relate to the current and future management and ownership of the family farm. People are and will be planning their lives and they need information to make informed decisions.

The lack of effective communication among family members is the root cause of most family business failures. Family Council Meetings and Family Business Meetings provide the all-important communication channels through which the family component is effectively managed.

Family Council Meetings
The Family Council Meetings are intended to provide a communication forum to keep the broader family informed of what is going on in the family business as well as the current and anticipated role of the family in it. These meetings are typically comprised

of the broader family, including spouses, in-laws, children, grand parents, and grand children whether active or non-active in the family business.

Given the potential size and composition of the family council, these meetings are typically held annually or bi-annually and are most effective when they focus on keeping family members informed of the “big picture” issues.

Someone needs to be in charge in scheduling and setting up the family council meetings. This can be any family member, active or non-active, with consideration given to rotating the coordinator among family members

Adequate meeting location – Find a setting for the meeting that can comfortably hold the broader family and organize the meeting room so that it facilitates good communication.

Agenda – The agenda should be tailored to meet the needs of the family at the time of the meeting. Distribute the meeting agenda and any other meeting materials to the participants in advance of the meeting.
Sample Agenda:

- Highlight the history of the family business
- Overview of how the business is performing
- Overview of short-, mid-, and long-range plans for the business
- Discussion of employment and career opportunities for family members
- Review and discussion of business rules and “code of conduct”.
- Questions or concerns about the family farm in keeping with overall objectives of the family council.
- Brief evaluation of the meeting by each of the participants.

Establishing meeting rules are important so participants will know what is expected of them.

Record any decisions reached or agreed upon actions and forward to all family members.

Conduct a brief participant evaluation to obtain feedback on the meeting. Encourage participants who would like to provide further comments in writing or in private to do so.

Family Business Meetings
Unlike the Family Council Meetings, the Family Business Meetings are comprised only of family members who are active in the business.

The purpose of the Family Business Meetings is to provide the active family members with a dedicated communication forum to discuss family issues that impact the management and ownership of the farm. The agenda of the meeting can be primarily business issues or primarily family issues or both. The meetings help family members who are working in the business to deal with the interaction between family and the business. The Family Business Meetings are not intended to replace regular business/management meetings.

An active family member or outside facilitator should be assigned to be responsible for scheduling the Family Business Meetings. This person is responsible for selecting a time and place for the meeting. These meetings should be held on a regular basis until the family component issues are adequately addressed after which time they can be held less frequently or on an as-need basis.

Establishing meeting rules that all participants agree to either before or at the first meeting is a good idea. The participants will also need to decide what should be recorded and to whom the notes will be distributed.

Each family farm is different. Therefore the agenda items for your meetings need to be customized to best serve your family dynamics and attributes. For the first few meetings try to select agenda items that are non-threatening, non-confrontational and not overly sensitive so the participants can see the value of the meetings.

Recognizing and accepting that each person has their own unique personality is important, and if we want to work together effectively we need to make an effort to better understand the different personalities and how they interact.

Barriers to Communication

To communicate effectively you need to understand the processes and skills that make up human communication. The basic skills required are: Questioning, Listening, Explaining, and Reflecting.

Barriers to good communication can be split into two main groups: physical and emotional. Physical barriers, such as speech impediment, poor mental ability, and deafness can be easily identified and allowances can be made when dealing with such people. Emotional barriers, such as perceptions, prejudices, fear, and threats might be less obvious.

Listening is the main skill to resolve these barriers. Active listening seeks to hear what the other person is saying, but to also understand what they are feeling. Empathy is seeking to understand where other people are coming from-what their wants and needs are. This also allows for more productive and constructive dialogue. Empathy is a state of harmony that exists between two people. It is a positive state that encourages better communication and better outcomes.

In addition to the verbal aspect, non-verbal communication is vitally important. Facial expression, posture, orientation, and voice tone all add richness to the message.

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APPENDIX

APPENDIX A. - ESTATE PLANNING INFORMATION FORMS

STATEMENT OF FAMILY

Mailing Address:

Telephone Number(s):

	Husband:	Wife:
Legal Name:	______________________	______________________
Other Common Name(s):	______________________	______________________
Birth Date:	______________________	______________________
Birthplace:	______________________	______________________
U.S. Citizen (circle):	Yes / No	Yes / No
Previous Marriage(s):	Yes / No	Yes / No
(If Yes: Date Dissolved)	______________________	______________________
Child Support	Yes / No	Yes / No
Spousal Maintenance	Yes / No	Yes / No
Names of Other Dependents:	______________________	______________________
	______________________	______________________
	______________________	______________________
	______________________	______________________
Health Concerns:		
Yourself:	______________________	______________________
Children	______________________	______________________
Parents:	______________________	______________________
Business Interests Owned:	______________________	______________________
	______________________	______________________
Any Chapter S Corporations:	Yes / No	Yes / No

Child's Name	Birth Date	Birth Location	City of Residence	Date of Death (if deceased)
1.				
2.				
3.				
4.				
5.				
6.				
7.				
8.				
9.				
10.				

DISTRIBUTION OF RESIDUARY ESTATE

Are any gifts (non-tangibles) to be made to charities or friends in the first estate?

Husband:

Wife:

Are there any gifts to be made to charities or friends in the second estate?

Husband:

Wife:

APPOINTMENT OF FUDUCIARIES

Personal Representative(s):

1) Name: ____

Relationship: ___________________________________

City of Residence: ______________________________

2) Name: ____

Relationship: ___________________________________

City of Residence: ______________________________

3) Name: ____

Relationship: ___________________________________

City of Residence: ______________________________

Trustee(s) (Family Trust, Children Trust, Marital Trust if applicable):

1) Name: ____

Relationship: ___________________________________

City of Residence: ______________________________

Special Concerns:

2) Name: ____

Relationship: ___________________________________

City of Residence: ______________________________

Special Concerns:

3) Name: ____

Relationship: ___________________________________

City of Residence: _______________________________

Special Concerns:

Guardian(s):

1) First Choice:

Name: ____

Relationship: ___________________________________

City of Residence: _______________________________

Special Concerns:

2) Second Choice:

Name: ____

Relationship: ___________________________________

City of Residence: _______________________________

Special Concerns:

POWERS OF ATTORNEY

	Husband:	Wife:
General Agents:		
1) Name:	______________________________	______________________________
Relationship:	______________________________	______________________________
City of Residence:	______________________________	______________________________
2) Name:	______________________________	______________________________
Relationship:	______________________________	______________________________
City of Residence:	______________________________	______________________________
3) Name:	______________________________	______________________________
Relationship:	______________________________	______________________________
City of Residence:	______________________________	______________________________

Who Should Receive Report From the Agent?

Healthcare Agents:

	Husband:	Wife:
1) Name:	______________________________	______________________________
Relationship:	______________________________	______________________________
City of Residence:	______________________________	______________________________
2) Name:	______________________________	______________________________
Relationship:	______________________________	______________________________
City of Residence:	______________________________	______________________________
3) Name:	______________________________	______________________________
Relationship:	______________________________	______________________________
City of Residence:	______________________________	______________________________

Who Should Receive Report From the Agent?

	Husband:	Wife:
Options:		
1) Wish to provide organ donations for transplants:	Yes / No	Yes / No
2) Wish to specify funeral/burial arrangements:	Yes / No	Yes / No

If yes, specify:

BENEFICIARY DESIGNATIONS

	Husband:	**Wife:**
Life Insurance:		
Company Name:	____________________	____________________
Policy Number:	____________________	____________________
Policy Owner	____________________	____________________
Insured:	____________________	____________________
Primary Beneficiary:	____________________	____________________

Retirement Plans:

	Husband:	**Wife**
Company Name:	____________________	____________________
Account Number:	____________________	____________________
Account Owner	____________________	____________________
Primary Beneficiary:	____________________	____________________

NET WORTH

	Husband:	Wife
1) Approximate value of estate (not counting life insurance & retirement plans)	$ ______________	$ ______________
2) Value of life insurance	$ ______________	$ ______________
3) Retirement accounts	$ ______________	$ ______________

Property (especially real property) owned in another state or country:

Property	Value	Titled Held