Farm Succession Planning: Fair Does Not Mean Equal, but Boy is it Hard to Talk About

July 21, 2020
Estate & Succession Planning for the Family Farm
Indiana Agricultural Law Foundation
Polly J. Dobbs, Esq.

DOBBS LEGAL GROUP, LLC

1

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Speaker introduction

Polly Dobbs, Esq. Owner,

Dobbs Legal Group LLC (Peru, IN)

- Estate planning attorney passionate about helping farm families create holistic plans
- Raised on a farm, left to do the city thing, thrilled to be back home raising the next generation on my family's farm
- Conducts regular seminars and publishes written materials about succession of the family farm
- polly@dobbslegal.com (765) 470-7090

DOBBS LEGAL GROUP, LLC

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Fair Does Not Mean Equal

Common Mistake: "I want to treat all my kids exactly the same."

NO

Your Kids are Different – it's OK to Treat them Differently!

Change your mindset!

DOBBS LEGAL GROUP, LLC

3

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Avoid Tenants in Common:

- Equal tenants in common ownership ~~may~~ ***will*** set the stage for a family feud
  - Partition actions can allow <u>one</u> tenant in common to trigger a court ordered auction, no matter how <u>small</u> an interest he or she owns
  - Step up in cost basis at death makes heirs eager to sell for no capital gains

The Do Nothing Plan

- No, if you ignore this, it won't go away.
- Sweetheart Will: All to spouse… then he remarries, then what!?
- The kids will just work it out….um, no.
- Be responsible for your legacy.

The Say Nothing Plan

- Planning in secrecy is a bad idea. Entitlement may be brewing at the next generation.
- Take a poll – not a vote -It's not a democracy.
- Once you decide what's fair – tell everyone – no surprises!
- "No Contest" clauses are a cop out
- "It's easier to talk to your kids about sex than about farmland transition" … said one Iowa farmer.

HOW DO I START A FARM SUCCESSION PLAN?

- No "one size fits all" solution
- Start with a checklist (see handout)
- Accurate Personal Financial Statement is home base
  - Fair market value, not cost basis or book value after depreciation, or low ball conservative estimate
  - How are things titled – individual, joint, POD/TOD.
    - Need the deeds!
  - Face value of life insurance, not cash value
  - Current beneficiaries of retirement accounts, annuities, life insurance
- Re-evaluate as needed

DOBBS LEGAL GROUP, LLC

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Threshold Issue

<u>Is Co-Ownership at Next Generation Best?</u>

- Should your children be in business together?
- Do you have a child in mind as a management successor?
- Can they get along well enough to split the cash rent?
- Could they get along if a professional farm manager was involved?

<u>If not – pursue a different plan</u>

DOBBS LEGAL GROUP, LLC

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Ideas & Strategies – Divide it up

- ✓ Direct ownership of different tracts of land to different children, which they wholly own *instead of* co-owning the whole as TICs.
- ✓ Can still do this if land is owned by an Limited Liability Entity ("LLE") by including instructions to dissolve LLE at death and distribute different ground to different children.
- ✓ May add a "hook" on the deeds subjecting sale of land to a right of first refusal in siblings, cousins, neighbor
- ✓ All land (or ownership in land-holding LLE) could go to farming child, identifying different assets for other beneficiaries.

DOBBS LEGAL GROUP, LLC

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Ideas & Strategies – Divide it up

- ✓ Are there sufficient assets to pull this off?
  - Summer lake house
  - Winter beach condo
  - Securities accounts
- ✓ Could there be with life insurance benefits to provide liquidity to balance things out? You might not want to own the insurance yourself.
  - Irrevocable Life Insurance Trust ("ILIT")
  - Direct ownership by children

DOBBS LEGAL GROUP, LLC

10

TRUSTS

- ✓ If you have young children you need a trust.
- ✓ Trusts help grown children with dependency problems, trouble handing money, bad marriages, or if you just don't want children to receive inheritance in a large lump sum.
- ✓ Trusts are helpful for blended families.
- ✓ Beneficiaries receive distributions of the Trust's income and perhaps principal on terms you set.
- ✓ Provides control of ultimate ownership where one child doesn't have children.

DOBBS LEGAL GROUP, LLC

11

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Ideas & Strategies – Dynasty Trusts

- ✓ Keep the farm in trust (with some seed money) for your children's lifetimes – They never truly own it but receive its income. Provides asset protection.
- ✓ Prevent land from being included in children's gross estate for tax purposes.
  - ✓ (allocation of GST tax exemption – tricky).
- ✓ You pick the trustee who'll have control, and you dictate continued management or sale of the farm in the trust agreement.
- ✓ Address cash rent if Trustee or a Beneficiary will be farming!

You control ultimate disposition

DOBBS LEGAL GROUP, LLC

12

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

What about your spouse?

- ✓ Those in a second (or third…) marriage with children from a first marriage can use a marital trust to preserve assets for children while providing lifetime support to surviving spouse.
- ✓ Provides protection ~~if~~ when spouse remarries.
- ✓ Unlimited marital deduction for gift and estate tax is powerful.
- ✓ Strike the proper balance between spouse & children.

DOBBS LEGAL GROUP, LLC

13

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Careful with Blended Families

- Dad died, step mom sold farm
  (or step mom redid her plan)
  - Of course she did
  - If Dad wanted to protect the farm for ultimate ownership by his natural children, he should have used a marital trust or otherwise avoided outright distribution of the farm to step mom
  - Step Mom may be easily swayed by her children, or by her next spouse or his children

DOBBS LEGAL GROUP, LLC

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Why Farmers *really* need prenups

- Prenuptial agreements for children of farm families should be considered a standard part of a farm succession plan.
- Trusts can only provide so much divorce protection, depending on a lot of factors, including how much control the beneficiary has.
- Ultimate discretion is given to the judge in the divorce proceeding.
- Buy-Sell provisions are nice, but other owners may have to buy back interests to keep an ex out
- Spouses have right to elect assets at death, which can be waived in a Prenup.
- Prenups for subsequent marriages in golden years are a must!

DOBBS LEGAL GROUP, LLC

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Separate Land and Operations

- ✓ Treat assets differently during lifetime to make them easier to pass at death
- ✓ Survey and split off operations from bare land: machinery, equipment, trucks, bins, dryer, shop, barns, pasture
- ✓ Direct who gets these assets through lifetime sales or gifts or at death

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Separate Land and Operations

- ✓ Include operations in share of farm successor child - either "off the top," or so farm kid gets less of other stuff
- ✓ Offer operations for sale to non-related successor
- ✓ Hold land in trust to be available to a farm successor until retirement, then distribute to grandchildren?
- ✓ Have land in entity, which all kids inherit with rules attached, keeping land available to successor

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Strategies – First Right of Refusal

- ✓ During lifetime: Landowner can "sell" first right of refusal to anyone. It is important that consideration is given (ex: $100) to make the contract valid.
- ✓ Then the first right should be recorded in the chain of title.
- ✓ At death: deeds distributing different tracts of land to different heirs can include ROFR language
- ✓ The farm cannot be sold without first being offered to the holder of the first right.
- ✓ * Operators - ask all your Landlords for this!

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Strategies – Right to Purchase

- ✓ At death: You can leave the farm (or interests in LLE that owns the farm) equally to all children
- ✓ Require the off-farm children to offer their interests for sale to the on-farm child, and giving the on-farm the option to purchase same.
- ✓ Certain kids don't ever have a right to own land, but get cash. Are you OK with this?
- ✓ Simple strategy - avoids problems in future generations when ownership is fractionalized among cousins.

First Rights – Where They're Found

The document granting the first right can be any of the following:

- ✓ Last Will and Testament
- ✓ Trust Agreement
- ✓ Freestanding Contract (recorded if addressing real property)
- ✓ Articles of Organization or Operating Agreement if LLC
- ✓ Articles of Incorporation or By-laws if Corporation
- ✓ Partnership Agreement
- ✓ Separate "Buy-Sell" for any entity- careful of inconsistencies

Don't Botch the Details

The document granting the first right must clearly identify:

- ✓ The purchase price
  - Match bona fide offer that's on the table
  - Appraisal – who selects? average?
  - "Sweetheart deal" – ok but TELL ALL
  - What liabilities will be considered?
    - *If C Corp. will Built In Gains Tax Liability be reflected?
  - Will valuation discounts be applied?
  - CPA should walk all owners through the formula showing the current value per share, and have everyone sign off agreeing
    - in annual minutes
    - Attach a sample as an exhibit to the Buy-Sell

First Rights - the details

The document granting the first right must clearly identify:

- ✓ Payment terms
  - Cash – lump sum
  - % down with delivery of low-interest * Promissory Note for the balance due

Applicable Federal Rate, Long Term Inst., July, 2020 = 1.17%
Current WSJ Prime Rate = 3.25%

First Rights- Fund With Insurance?

- ✓ Life insurance owned by the right-holder on the life of the landowner would help provide liquidity to accomplish the purchase in a lump sum.
- ✓ May want to require amount of insurance proceeds received to be paid over as the down payment, with a promissory note for balance in excess of insurance amount.

Let's Talk Taxes

- Upon death, up to $11.58 million (as of 1/1/2020) will pass exempt from Federal Estate Tax. A married couple can pass $23.16 million.
- During lifetime, you may give away up to $11.58 million of your assets ($23.16 if married) exempt from Federal Gift Tax, which would reduce the amount of your exemption remaining at death.
- For estates or gifts in excess of this exemption, the maximum tax rate is 40%.

Let’s Talk Taxes, tick tock

- Tax Reform under Tax Cuts and Jobs Act of 2017 (“TCJA”), made major changes to succession planning for farmers.
- Temporary doubling of the transfer tax exemption is set to expire January 1, 2026, reverting back toward the 2017 levels; $5.6 million per person, $11.2 million per married couple.
- Elections in 2020 & 2022 – any law can change at any time!
- Now is the time to act.

DOBBS LEGAL GROUP, LLC 25

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Let’s Talk Taxes, portability election

- A surviving spouse can make a portability election in order to “port” over any unused federal gift/estate tax exclusion amount from the first spouse, if he/she died on or after January 1, 2011.
  – “Deceased Spousal Unused Exclusion Amount” (DSUE) - I.R.C. § 2010(c)(5)(A)
- Election must be made by the estate of the first spouse to die, which requires filing of a Form 706 Federal Estate Tax Return, even if no tax is owed.
- Could be a $11.58M mistake is not elected-get it in writing if surviving spouse declines to elect.

DOBBS LEGAL GROUP, LLC 26

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Let’s Talk Taxes
Annual Exclusions & State Taxes

- Annual gift tax exclusion is $15,000 – to as many individuals as donor wishes, without reducing donor’s $11.58 million estate tax exemption or triggering Gift Tax.
- State inheritance or estate taxes deserve special attention: Connecticut, District of Columbia, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, Oregon, Rhode Island, Vermont, Washington, Iowa, Kentucky, Nebraska, and Pennsylvania.
  – *Indiana repealed 1/1/2013*

DOBBS LEGAL GROUP, LLC 27

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Common Mistake

"I'm doing nothing because I'm worth less than $11.58 million," or the similar reasoning: "Because my wife and I are worth less than $23.16 Million."

1. Taxes are probably not your biggest problem! Family farms are destroyed more often by feuding families than by taxes.

2. Who knows what will happen after 2025? The estate tax exemption reverts to half this level in 2026. Anything could happen between now and then.

3. What's your farm ground really worth today? What are your neighbors selling for? Face value of life insurance <u>counts</u> in gross estate. Maybe you have a lurking tax problem.

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Will the Kids Sell? What's your basis?

✓Lifetime gifts remove appreciating assets from donor's estate resulting in estate tax savings.

✓Lifetime gifts = "Carryover Basis" → Recipient receives your low basis in your land.

✓Inherited assets = "Step up in Basis" → Recipient's basis is equal to fair market value on date of death.

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Will the Kids Sell? What's your basis?

✓Lifetime gifting may <u>not</u> be advisable if there may be a future sale.

✓Careful analysis of Estate Tax vs. Capital Gains Tax is necessary before gifting.

✓In light of new tax laws, higher exemptions, returning gifts previously received to original donor may be best (wait… what!?).

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

How's your Ground Titled? Maximize the Step Up!

✓ Step up in basis to fair market value at date of death is very powerful!

✓ Many farms are owned ½ by husband (or his trust) and ½ by wife (or her trust). That limits the step up in basis for the whole farm at the second death. Re-examine titling!

✓ Old A/B trust planning may have "trapped" an interest in ground in the first deceased spouse's credit shelter trust – may be able to get it out so that it receives a full step up at second death.

DOBBS LEGAL GROUP, LLC

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Dust it off every 5 years

- Plan for now, based on today's circumstances.
- Original plan should allow as much flexibility as possible.
- Review when there's a change in the laws, or a change in circumstances. Adjust if necessary

DOBBS LEGAL GROUP, LLC

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com

Questions?

DOBBS LEGAL GROUP, LLC

52 N. Broadway | Peru, IN 46970 | P: (765) 470-7090 | F: (765) 470-7091 | www.dobbslegal.com