Estate Planning Seminar

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Courtyard Marriott ~ Mankato, MN

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Minnesota Estate Tax Recent Changes, Tips and Traps for the Unwary

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Introduction

- **Minnesota Estate Tax Basics**
- **MN Estate Tax Deductions**
  - Qualified Small Business Deduction
  - Qualified Farm Property Deduction
    - ◊ A Note on Property Taxes
- **MN Estate Tax Quirks**
  - 3-Year Claw-Back Rule
  - Non-Minnesota Assets
  - “Look-Through” Rule
  - No “Portability”
- **Intersection of MN Estate Tax & Federal Tax Considerations**
  - Is avoiding MN Estate Tax Always Worthwhile?
  - How Could the Federal Tax Bill Change Minnesota Estate Tax?

Current Minnesota Estate Tax

- Each estate gets a *subtraction* from estate tax—meaning that only the amount over the “limit” is taxed
  - Today: $2.1 million/person
  - Increases $300,000/year until 2020, when it tops out at $3million/person

Current Minnesota Estate Tax

- **Plus, Qualified Farm Property and/or Small Business Deductions**
  - **Today: $2.9 million/person**
  - **Decreases $300,000/year as the "basic" exclusion increases**

Current Minnesota Estate Tax

- **Takeaway: "Basic" Subtraction + Maximum Qualified Farm Property/Small Business Deduction = Maximum of $5 million can pass free of Estate Tax (married couple can pass $10 million with a little more planning)**
- **Tax Rate: 12-16%, based on the size of the estate**

Current Minnesota Estate Tax

- **Minnesota does not tax (most) lifetime gifts**
  - **Only property passing at death (with one important exception) is subject to tax**

Calculating Minnesota Estate Tax

- As the “basic” subtraction amount changes, the “brackets” for each estate tax rate shift, until final scheme goes into effect in 2020.

Calculating Minnesota Estate Tax

- **Current (2017) Estate Tax Brackets**

Amount of Minnesota Taxable Estate	Tax Rate
< or = $2,100,000	0
>$2,100,000 but < or = $5,100,000	12% of excess over $2,100,000
>$5,100,000 but < or = $7,100,000	$612,000 + 12.8% of excess over $5,100,000
>$7,100,000 but < or = $8,100,000	$868,000 + 13.6% of excess over $7,100,000
>$8,100,000 but < or = $9,100,000	$1,004,000 + 14.4% of excess over $8,100,000
>$9,100,000 but < or = $10,100,000	$1,148,000 + 15.2% of excess over $9,100,000
$10,100,000 or more	$1,300,000 + 16% of excess over $10,100,000

Calculating Minnesota Estate Tax

- **Final (2020) Estate Tax Brackets**

Amount of Minnesota Taxable Estate	Tax Rate
< or = $3,000,000	0
>$3,000,000 but < or = $7,100,000	13% of excess over $3,000,000
>$7,100,000 but < or = $8,100,000	$923,000 + 13.6% of excess over $7,100,000
>$8,100,000 but < or = $9,100,000	$1,059,000 + 14.4% of excess over $8,100,000
>$9,100,000 but < or = $10,100,000	$1,203,000 + 15.2% of excess over $9,100,000
$10,100,000 or more	$1,355,000 + 16% of excess over $10,100,000

Qualified Small Business and Farm Property Deductions

- **In addition to basic subtraction**
- **A single estate can claim both the qualified small business *and* qualified farm property deduction, but combined deduction is limited to $2.9 million (in 2017)**

Qualified Small Business & Farm Property Deductions

- For either deduction, person who acquires the property must be a "qualified heir"
- "Qualified Heir" = "Family Member" of decedent (as defined in IRC Sec. 2032A(e)(2)) OR a <u>trust</u> whose current beneficiaries are all "family members"

Qualified Small Business & Farm Property Deductions

- "Family Member" means Decedent's:
  - ◊ Parents, Grandparents, Great-Grandparents…
  - ◊ Children, Grandchildren, Great-Grandchildren, etc. and their spouses
  - ◊ Step-children, step-grandchildren, etc. and their spouses
  - ◊ Siblings and their spouses
  - ◊ Nieces/nephews, etc. and their spouses

Qualified Small Business Property Deduction

- **Not going to discuss in detail, as it's not particularly useful for planning—more like a consolation prize for dying young**
- **Also, "Small" = gross sales for year preceding death must be $10mm or less**

Qualified Small Business Property Deduction

- **Know that it is out there, but it is <u>not as easy as it looks to</u> use because of <u>material participation requirements</u>**
  - **Particularly: the trade or business must not be a "passive activity" under IRC 496(c) during year preceding decedent's death or the three years after death; the decedent or spouse must have materially participated in the t/b in the year prior to the decedent's death; and a family member must materially participate in the three years after death**
  - **NOTE: "Material participation" does <u>NOT</u> include substitute forms of material participation (i.e., retired person or surviving spouse) allowed under IRC § 469(h)(3)**

Qualified Small Business Property Deduction

- **Takeaway—to get Qualified Small Business Property Deduction, you have to "die with your boots on"**

Qualified Small Business Property Deduction Requirements

- Included in the federal adjusted taxable estate
- An asset of a trade or business, or an ownership interest in a business entity engaged in a trade or business
- T/B not a "passive activity" under IRC 496(c) during year preceding decedent's death
- Decedent or decedent's spouse materially participated in trade/business during that year
- Business's gross annual sales for that year ≤$10,000,000
- Not cash, a cash equivalent, publicly traded security, or an asset not used in the operation of the trade or business
- Decedent owned the property for three years before his or her death
- A family member materially participates in the trade/business for three years after the decedent's death, and the trade or business is not a passive activity during those years.
- Estate and qualified heir elect deduction, and qualified heir agrees to pay recapture tax if he or a family member fail to use the property in a trade or business for subsequent three years

Qualified Farm Property Deduction

- Much easier to get than the Small Business Deduction, but still difficult for many operations
- Only available for MN agricultural land

Qualified Farm Property Deduction

- **Qualifying Property must be:**
  - Included in the federal adjusted taxable estate
  - Agricultural land owned by a person or entity OK under Corporate Farm Law
  - In the 3 years preceding decedent's death, property was classified as:
    - ◊ Class 2a property under section 273.13, subd. 23, and
    - ◊ Agricultural homestead, agricultural relative homestead, or special agricultural homestead under section 273.124
      - NOTE: Not as easy as it looks!

Qualified Farm Property Deduction (continued)

- Decedent owned the land for 3 years before his or her death (including property deemed "owned" by the decedent under IRC §§ 2036 [transfer with retained life estate], 2037 [transfer taking effect at death], or 2038 [revocable transfers]), and includes indirect ownership of land via an entity.
- Land remains classified as Class 2a property for property tax purposes for three years following the date of death.
- Estate and qualified heir elect deduction, and qualified heir agrees to pay recapture tax if land fails to stay Class 2a for following 3 years

A Few Notes on Property Tax Classifications

- Property has to be "Class 2a" and "Ag Homestead"
- You can't necessarily tell from your Property Tax Statement
  - Very roughly speaking, "class 2a" means tillable acres, livestock buildings (but NOT pasture), grain bins/machine sheds
  - Plan ahead to save headaches later on: if a property tax statement says anything other than "AG HMSTD," ask Assessor what the notation means and whether the additional classification is really necessary

A Few Notes on Property Tax Classifications (continued)

- You may be able to keep Ag Homestead classification if you move off the farm…but it's complicated
  - You must remain a MN Resident, no matter what

A Few Notes on Property Tax Classifications (continued)

- **OK if you move directly from the farm into <u>assisted living or a nursing home</u>, no matter where it's located in MN**
- **OK if you move to town and a qualifying relative moves into your house, <u>if that relative doesn't claim a separate Ag Homestead</u>**
- **OK if you live within 4 cities and townships of the land; a relative who lives within 4 cities and townships <u>actively farms</u> the land; <u>and that relative doesn't claim a separate Ag Homestead</u>**

A Few Notes on Property Tax Classifications (continued)

- You may be able to keep Ag Homestead classification if you put your farmland in an entity (LLC, Partnership, LP/LLP/LLLP, Corporation), but
  - It's complicated
  - Every county interprets the rules differently
  - MN Revenue interprets the rules <u>extraordinarily narrowly</u>—so asking the County to go up the chain of command to reconsider often ends badly

Minnesota Estate Tax Quirks: Three-Year "Claw-Back"

- Minnesota does not have a gift tax.
- However, all gifts made within 3 years of the decedent's death and after June 30, 2013, are taxed as part of the decedent's estate.

Minnesota Estate Tax Quirks: Three-Year "Claw-Back" (continued)

- **Doesn't matter whether gift was made in contemplation of death/for purposes of avoiding estate tax**
- **Annual exclusion gifts ($14,000/person/year) don't count**

Minnesota Estate Tax Quirks: Three-Year "Claw-Back" (continued)

Example: Jane gave Bill $200,000 on March 1, 2018. After making this gift, Jane dies with $3,000,000 in assets.

- **If Jane died after March 1, 2021, no MN Estate Tax is owed (Jane's MN taxable estate = $3,000,000)**

Minnesota Estate Tax Quirks: Three-Year "Claw-Back" (continued)

– If Jane died on or before March 1, 2021, her Estate owes $26,000 tax

(Jane's MN taxable estate = $3,000,000 + $200,000 gift made within 3 years of death)

Minnesota Estate Tax Quirks: Non-Minnesota Property

- **Basic Rule: Minnesota only taxes property "located" in Minnesota under most legal definitions**

Minnesota Estate Tax Quirks: Non-Minnesota Property (continued)

- Basic Rule: MN Estate Tax Applies to:
  - MN real property, regardless of whether owner is an MN resident
  - Tangible personal property located in MN, regardless of whether owner is an MN resident
  - Intangibles owned by MN residents

Minnesota Estate Tax Quirks: Non-Minnesota Property (continued)

- **Unless all property is "located" in Minnesota, the estate does not get the full benefit of the "basic" subtraction Minnesota Estate Tax**
  - **Tax is based on the ratio of the deceased's Minnesota property versus their total gross estate.**

Minnesota Estate Tax Quirks: Non-Minnesota Property (continued)

- **Example: Zelda owns $1 million in Minnesota real estate, $750,000 in cash and a $500,000 home in Arizona**

Minnesota Estate Tax Quirks: Non-Minnesota Property (continued)

- If Zelda dies a resident of Minnesota:
  - ◊ Total Estate = $2.25MM
  - ◊ MN property = $1.75MM (land + cash)
  - ◊ AZ property = $500K (house)
  - ◊ MN vs. Total Estate = ~75%
  - ◊ MN Estate Tax = $14,000

Minnesota Estate Tax Quirks: Non-Minnesota Property (continued)

- If Zelda dies a resident of Arizona:
  - ◊ Total Estate = $2.25MM
  - ◊ MN property = $1.0MM (land)
  - ◊ AZ property = $1.25MM (cash + house)
  - ◊ MN vs. Total Estate = ~45%
  - ◊ MN Estate Tax = $8,000

Minnesota Estate Tax Quirks: The “Look-Through” Rules

- Remember: Intangible personal property is located wherever the decedent resides
  - Solution for non-residents: turn real estate into intangible property by putting it in an LLC or Partnership???

Minnesota Estate Tax Quirks: The "Look Through" Rules (continued)

- **The Twist: Pass through-entities (LLC, S-Corp, Partnership, Trust), which are normally treated as intangibles, are disregarded when determining where property is located for estate tax purposes**

Minnesota Estate Tax Quirks: The "Look Through" Rules (continued)

- This means that a non-MN resident will be subject to MN estate tax if he owns an interest in property located in MN, even if he only owns the property indirectly via ownership interest in an LLC, Trust, or other entity.
- Publicly-traded entities are exempt from the look-through rule

Minnesota Estate Tax Quirks: The "Look Through" Rules (continued)

- **The Takeaway: If you can't take it with you when you move out of state, "it" is almost certainly subject to MN Estate Tax, no matter where you live.**

Minnesota Estate Tax Quirks: No "Portability"

- Federal Estate Tax has "Portability" or "Deceased Spouse Unused Exclusion" (DSUE)
  - If a spouse dies and does not use their full Federal Estate Tax exemption, the surviving spouse can use the leftover portion on his/her Estate Tax Return if a simple election is made on the first spouse's death
  - Remember: there is no Estate Tax on transfers between spouses

Minnesota Estate Tax Quirks: No “Portability” (continued)

- Example: Ann and Bob have a combined net worth of $8 million. Ann owns $3 million and Bob owns $5 million. They have simple Wills leaving everything to the surviving spouse on the first spouse’s death, and everything to their children on the second spouse’s death.

Minnesota Estate Tax Quirks: No "Portability" (continued)

- If Ann dies first, her PR can made the "Portability" election on her Federal Estate Tax Return to give all of her Federal Estate Tax Exemption (today, ~$5.5MM) to Bob.

Minnesota Estate Tax Quirks: No "Portability" (continued)

– At Bob's death, he will have his own exemption (at least $5.5 MM), plus Ann's exemption (~$5.5MM), so there will be plenty of exemption to pass their entire $8MM combined net worth to their children with no Federal Estate Tax.

Minnesota Estate Tax Quirks: No "Portability" (continued)

- **Result of Portability:**
  - Married couples in with "mid-size" estates (more than one exemption, but less than two) can have very simple estate plans without incurring Federal Estate Tax
  - Estate plans can be designed so there is a step-up in basis on <u>all</u> of the couple's property on the second death.

Minnesota Estate Tax Quirks: No "Portability" (continued)

- Minnesota does <u>not</u> permit portability between spouses.
- Minnesota "basic" subtraction and small business/farm property deductions are "use it or lose it" on each spouse's death.

Minnesota Estate Tax Quirks: No "Portability" (continued)

- Result: Couples with "mid-size" estates (over $3MM but under $6MM, or those that need to use the small business or farm property deductions) require more complicated estate plans so that not all property passes outright to the surviving spouse on the first spouse's death.
  - Credit Shelter Trust (a/k/a "Bypass Trust")

Minnesota Estate Tax Quirks: No "Portability" (continued)

- **Result of Credit Shelter Trust or other estate plan with less than all property passing outright to the surviving spouse:**
  - **The property that bypassed the surviving spouse's estate does not get a second step-up in basis on the surviving spouse's death.**

Intersection of Minnesota Estate Tax and Federal Income & Capital Gains Tax: Or Is Gifting Always Worth It?

- Income tax (and if you're lucky, it's capital gains) applies to all transfers except for (1) gifts, (2) transfers made at death, or (3) transfers that meet a special exception in the income tax code
- *How much* capital gains tax is owed depends on the transferor's <u>basis</u> in the property:
  - Remember: Sale proceeds – Adjusted Basis = Taxable Income

Federal Income & Capital Gains Tax: Or Is Gifting Land Always Worth It?

- **Lifetime Gifts:**
  - Pros: Avoid MN Estate Tax on property altogether (if gift made at least 3 years before death) and avoid Federal Estate Tax on appreciation in value of asset from date of gift to date of death
  - Cons: Donee receives carry over basis (and potentially significant capital gains on sale)
- **Transfer at Death**
  - Pros: Donee receives step-up in basis, which can eliminate or greatly reduce capital gains on sale
  - Cons: MN & Federal Estate Tax liability

Basis: Lifetime Gifts vs. Transfers on Death

How You Got the Property	Your Basis	What that Means
Purchase	Cost Basis	Purchase Price
Lifetime Gift	Carry Over Basis	Donor's Basis becomes Your Basis
Transfer Upon Death (includes gifts of property with retained life estate)	Stepped-Up Basis	Fair Market Value of the Property as of Transferor's Date of Death

- **Remember: Seller pays tax on the difference between the sale price and the property's adjusted basis**
- **Sale Price – Adjusted Basis = Taxable Gain**

Long-Term Capital Gains Rates 2017

Tax Rate on Ordinary Income	Corresponding Capital Gains Tax Rate
10%	0%
15%	0%
25%	15%
28%	15%
33%	15%
35%	15%
39.6%	20%

Federal Income & Capital Gains Tax: Or Is Gifting Land Always Worth It?

- Example: Fred's Old Farm
- Assume nothing qualifies for the Farm Property Deduction
- Assume Son is Married Filing Jointly and has $75,500 other income of sale

Fred's Basis	Date of Death Value (1/1/2018)	Sale Price	Fred's Estate (if Old Farm Not Included)	Fred's Estate (if Old Farm Included)	Son's Tax Brackets
$200,000	$1,000,000	$1,010,000	$2,000,000	$3,000,000	25% (15% cap. gains) Federal

Minnesota Estate Tax vs. Capital Gains Tax

- **If Fred gifts Son the property (without the gift being recaptured) such that it is not subject to Minnesota Estate Tax…**

Minnesota Estate Tax Liability	Son's Capital Gains Tax on Sale
$0	$1,010,000 - $200,000 basis = $810,000 First $391,450 x 15% Plus Remaining 418,550 x 20% = **$142,427 Federal Cap. Gains Tax** $810,000 x 9.85% = **$79,785 Minnesota Income Tax** = $222,212 total Fed/MN Income Tax
=$222,212 Overall Tax	

Minnesota Estate Tax vs. Capital Gains Tax (continued)

- **If Fred keeps the property, Fred's Estate pays the Minnesota Estate Tax, and Son gets a stepped-up basis…**

Minnesota Estate Tax Liability	Son's Capital Gains Tax on Sale
$900,000 x 12%= **$108,000 Minnesota Estate Tax**	$1,010,000 - $1,000,000 basis = $10,000 $10,000 x 15% = **$1,500 Federal Cap. Gains Tax** $10,000 x 7.05% = **$705 Minnesota Income Tax** = $2,205 total Fed/MN Income Tax
=$110,205 Overall Tax	

Federal Income & Capital Gains Tax: Or Is Gifting Land Always Worth It?

- Takeaways:
  - If your estate is not large enough so that Federal Estate Tax is an issue, it may make sense to pay a little Minnesota Estate Tax on low-basis property to save a lot of Federal & MN Income Tax
  - When deciding whether to gift property, consider:
    - ◊ What is its adjusted basis?
    - ◊ Are your heirs likely to sell this property after you are gone?

Minnesota Estate Tax Quirks: IRC 2032 and 2032A Valuation Availability

- Federal Section 2032 Alternate Valuation Date = Estate can elect to be valued as of 6 months after decedent's death, rather than on decedent's date of death
- Federal Section 2032A Special Use Valuation = Permits use of different valuation approach to reduce estate tax value of farmland (and technically other real estate) in certain estates

Minnesota Estate Tax Quirks: IRC 2032 and 2032A Valuation Availability

- Section 2032 and 2032A valuations not available to Minnesota Estates unless Estate also has to file a Federal Estate Tax Return
- Outcome: "Mid-sized" estates (over MN limit but under $5.49 million Federal limit) not able to take advantage of Section 2032 or 2032A

Federal Tax Bill's Effect on Minnesota Estate Tax

- **House Bill:**
  - Increase Federal Estate Tax exemption for 5 years, then eliminate Estate Tax
- **Senate Bill:**
  - Double Federal Estate Tax Exemption to ~$11MM/person
- **Result: Eliminates ability to take 2032 or 2032A elections for Minnesota Estates under $11MM (or for all Minnesota Estates)**

Farm Transition Case Study

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Family Facts

- Dad – Age 64, (farmed entire life)
- Mom – Age 57, (farmed entire life)
- Live on 4th generation farm property
- Children
  - Daughter - Age 30, lives in another state, not active in farming
    - ◊ Married
    - ◊ No children
  - Son – Age 33, farms with dad
    - ◊ Married (spouse is citizen of foreign country)
    - ◊ Two children (ages 1 & 3)

Family Facts

- Family members have worked with a consultant helping align
  - Family member goals & concerns
    - ◊ Dad & Mom want to stay in area
      - Currently live at farm site
      - Relocate to town – son to live on site
    - ◊ Succession/Estate plan to support lifestyle
    - ◊ Family harmony between Son & Daughter is important to Dad & Mom
    - ◊ Estate division may not be equal Dad & Mom are OK with this as well as non farm daughter
    - ◊ Succession plan for farm management in place
      - Confidence in Son

Key Facts

- ◊ Preserve Farmland – <u>Key</u> Element
- – Do they need all entities currently in place to accomplish their business objectives?
- – Mom & Dad want to get farmland rents and other net cash flow from Land Co.
- – Land & Equipment Co – should they divide?
  - ◊ Son & Daughter
- – Mom has health issues
- – Preparation for possible changes in both income and estate tax
- – Liability risk with General partnership
  - ◊ Multiple entities?

Dad & Mom Summary Net Worth

	Dad	Mom	Joint
IRA Accounts	$ 100,000	$ 45,000	
Personal Assets	$ 300,000	$ 300,000	
Entities			
Land Co		$3,000,000	
Farm Partnership ([3])	$ 800,000	$ 800,000	
Land Partnership ([1])	$ 300,000		
Hog LLC	$ 100,000		
Farmland			
Parcel A	$2,200,000		
Parcel B	$1,500,000		
Parcel C	$2,200,000		
Parcel D	$ 730,000		
Insurance (death benefit)			
Dad's Life	$ 600,000		
Mom's Life	_________	$ 63,000	
Total Estimated Value	$8,900,000	$4,200,000	
Debt ([2])	$(1,000,000)	_________	
Net Estimated Value	$7,900,000	$4,200,000	

([1]) With third party partners

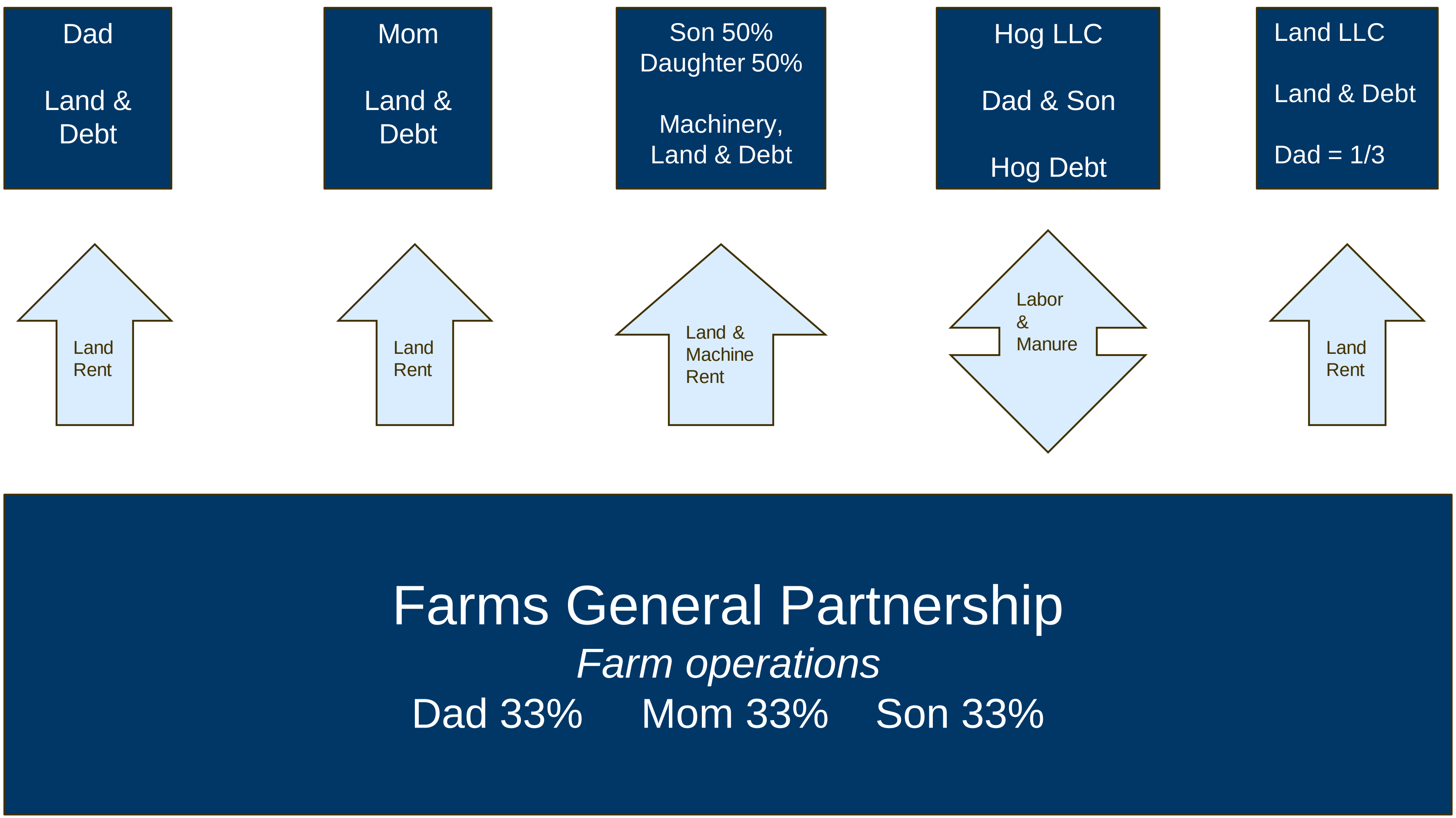
([2]) Includes loan from Land Co

([3]) Directed

Farm Operation Summary

- General
  - Farm in General Partnership Legal Structure
    - ◊ Owned 1/3 each by Dad, Mom and Son
    - ◊ Grain farm operation
    - ◊ Cash basis
    - ◊ Owns bins & tile
    - ◊ Leases both farmland & equipment
    - ◊ Farm about 5500 Acres (some leased from third parties)
      - Beans and corn
  - Buy/Sell provisions in place in Partnership Agreement
  - Revenue $4.0 -$5.0 million

Farm Operation Diagram Now



Land & Equipment Entity

Son 50%

Daughter 50%

Land & Equipment Corporation

Dad is President

Land & Equipment Entity

- C Corporation
- Owns a Bin site & buildings – FMV $1,100,000
- Owns Farm land – FMV $1,600,000
- Equipment – FMV $2,000,000
  - No cost basis (fully depreciated)
- Lease Income
  - Land, building & bin site $100,000
  - Equipment $323,000
  - Depreciation expense $300,000
- Access to cash flow loans to family members - $244,000

Land Company

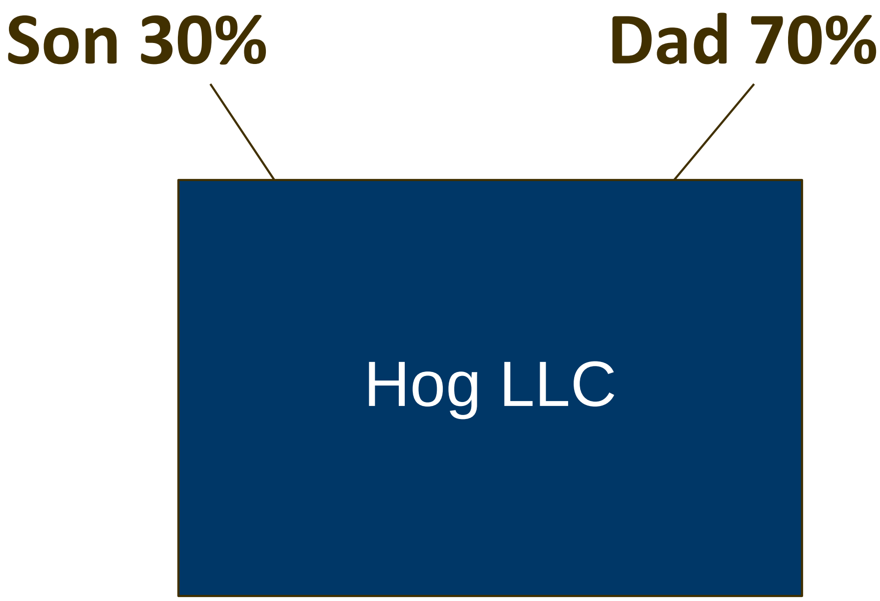
Mom 100%

Land Co
C Corporation

Land Company

- C Corporation
- Farmland & bin site – FMV $3,300,000
- Annual Rental income - $70,000
- Miscellaneous other investments
- Access to excess cash flow - loans to Dad total of $400,000 (mom owns the stock)
- Book retained earnings (equity) about $1,000,000

Hog Operation



Hog LLC

- Started about 10 years ago
- Owns hog facility
  - Cost $2,000,000
- Debt real estate & hog loan $1,500,000
- Book equity ($300,000)

Estate Today

Dad and Mom

Current Estate

- Farm Partnership
- Hog LLC
- Home
- Farm Land
- Land Co. Land & Debt
- Land P's & Debt
- Other Investments
  Cash & Notes
  Personal Property
  Life Insurance

Estate Plan vs. Farm Operations

Estate	Operations
Farmland	Operating Entity
Life Insurance	Machinery
Non-Farm Investments	Home Site
Home	Grain Bins
Personal Effects	Grain Inventory
	Debt

Farm Family Discussion Issues and Planning Opportunities

- **Alignment of Family Goals and addressing family concerns**
  - **Farm Land**
    - ◊ **Access to farm land rental income cash flow – major source of retirement income for Mom & Dad**
    - ◊ **Protect Farm land to keep in family**
      - **Farm Land Dad owns separately (4 large parcels FMV $6.6 million)**
        - **Contribute to Partnership Land Holding Company FLP) – Recommendation # 1**
        - **Consider 50% ownership of Land FLP for dad and mom**
          - Dad gifts to mom 50% interest – unlimited marital transfer
      - **Land Inc.- Consider S election to access land rent cash flow- Recommendation # 2**

Farm Family Discussion and Planning Opportunities (continued)

- ◊ **Amend Dad and Mom's estate documents to leave an interest in FLP to both son and daughter at death –Recommendation # 3**
  - **Terms of Dad's current will says**
    - **Separately owned Farmland**
      - 3 parcels - A, B & D
        - Specific bequest to Daughter
      - 1 parcel - C
        - Specific bequest to Son
  - **Problem with terms is daughter can decide to take farmland and either rent or sell to third parties at her own will**

– **Life Insurance**

- ◊ **Current policies transferred by gift to an Irrevocable Life Insurance Trust (ILIT). Consider other insurance on Son or additional insurance on Mom and Dad. Recommendation # 4**

Farm Family Discussion Issues and Planning Opportunities

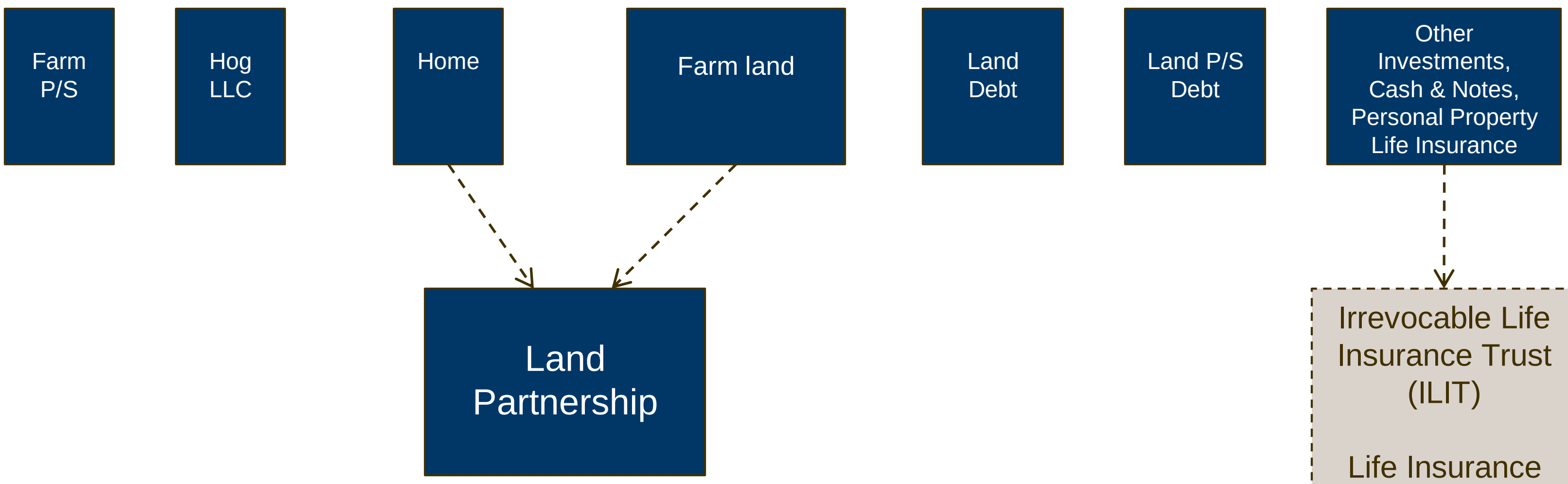
- Land & Equipment Co
  - Goals
    - ◊ Succession plan for farming operation to Son
    - ◊ Help equalize estate split with daughter
    - ◊ Get daughter cash flow now if possible to promote family harmony with Son and daughter.
    - ◊ Split entity to separate farmland and equipment as land is a legacy (estate) asset and equipment is an "operations" asset
    - ◊ Recommendation # 5 elect S corporation or alternatively purchase Daughter's interest in entity for cash and a note.
- Risk Management
  - Consider restructure of ownership in General Partnership to protect individual owners from risks passing through partnership entity to them Recommendation # 6

Recommendation #1

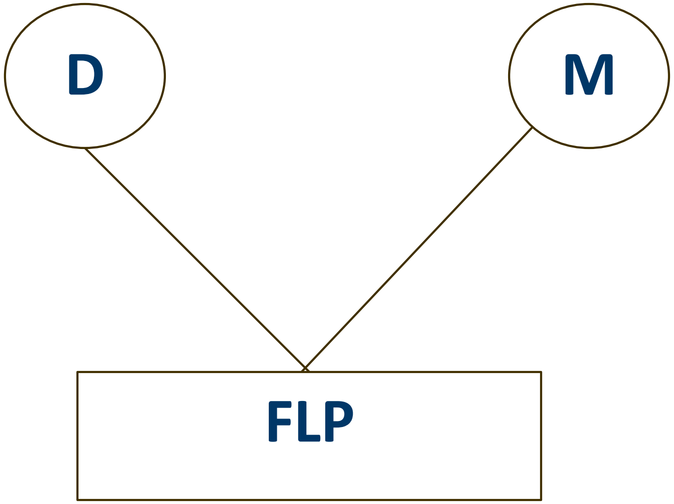
- Set up a new FLP entity to own Dad's separately owned farmland
  - Purpose
    - ◊ Entity to manage farmland and provide long term goal of keeping farmland in family
      - Cash flow to Dad & Mom during retirement
      - Facilitates ability to give fractional interest to children & grandchildren
      - Partnership / Limited Liability Company allows
        - Cost basis step up of land at death of Dad & Mom
        - Special use valuation of a farmland owned by entity
        - Allows for nonfarm daughter to own a all or a portion of the farm without control
      - Is home site good asset to be owned by this partnership?

Recommendations # 1 & # 4

Suggested Actions

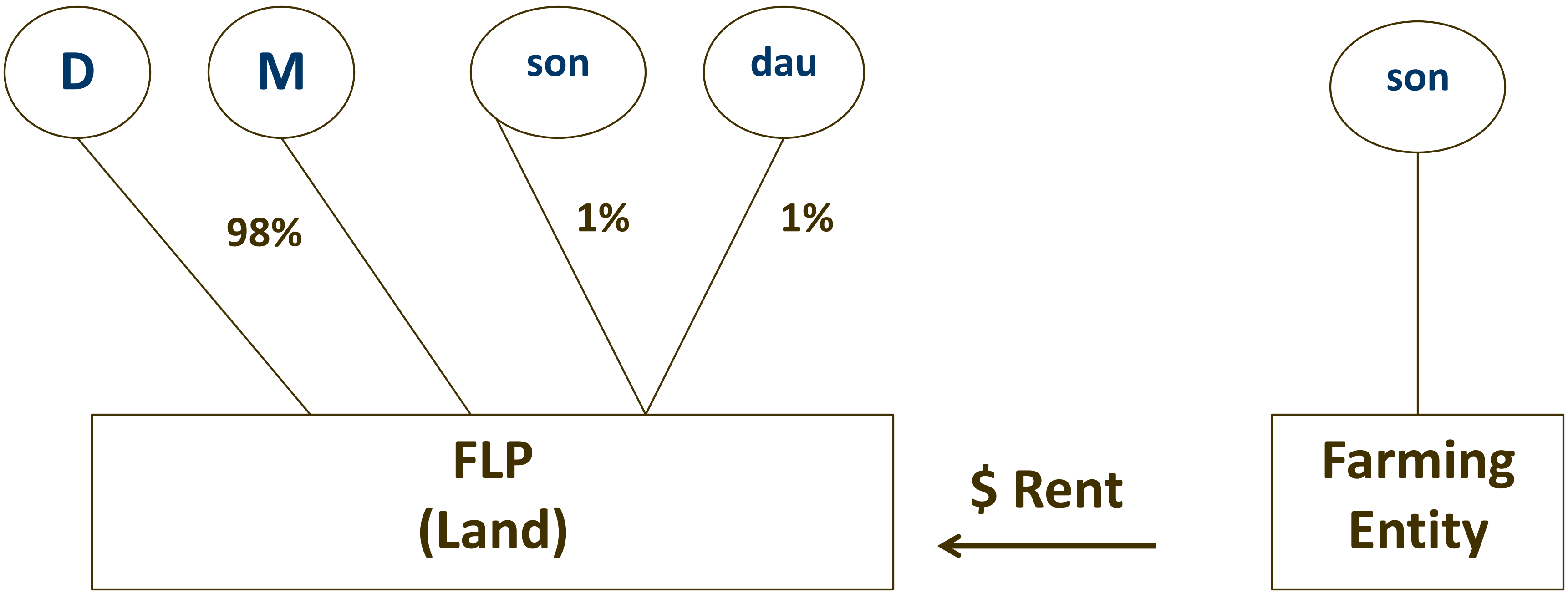


Family Limited Partnership (FLP)



- Land

Family Ltd. Partnership



Family Ltd. Partnership

- Define Son as having first right to lease and define terms
  - Written lease terms
    - ◊ Time frame for land availability
    - ◊ Rent Example: 95% of county extension lease rates
    - ◊ Rent safety valve if farm economics become difficult
    - ◊ Define right of Son to purchase land parcels from partnership (e.g., appraisal mechanism; seller-financed terms)
    - ◊ Define trigger events for daughter to sell some or all of her interest in entity
- Consider specific designation of voting units
  - Example: 3 voting units: Dad, Mom and Son.
  - At second parent's death, 1 unit to Son. & 1 to daughter
  - Son has control, but daughter to monitor compliance with FLP document

Family Ltd. Partnership

<u>**Avoiding family conflict:**</u>

- **Thorough communication at formation about Dad & Mom's objectives**
- **Emotional and financial buy-in by each child**
- **Consider use of consultant to sort out conflicting objectives of children/misconceptions/hidden heartburn**
  - **Private interviews; feedback to Dad & Mom**

FLP Advantages

- Facilitates gifts
  - Annual exclusion of $14,000 ($15,000 in 2018)
  - Discounts for minority and lack of marketability
- Most units non-voting (to allow management control to selected partners)
  - Centralized management
- Triggering events defined and terms for buy-out of a daughter's interests
  - After Mom and Dad's passing – basis step to FMV
  - Discount if early exit (e.g. 80%-90% of appraised value)
  - Specify pmt. terms (long term /low interest rate to preserve entity cash flow)

FLP Advantages

- **Include binding mediation/arbitration language if disputes arise**
- **Design of FLP document forces family communication pre-death**
  - **Require each child to invest cash at formation to force legal and emotional buy-in to the operating agreement**
- **Require super-majority to liquidate the partnership/distribute land**

FLP Disadvantages

- Fees
  - Legal costs of document drafting/planning
  - Appraisal fee for land valuation
  - Appraisal fee for discount valuation
- IRS valuation disputes
- Annual partnership tax return
  - Separate checking account
- Proper allocations of any cash distributions each year

Recommendation # 2

- Elect S Corporation – Land, Inc.
  - Purpose of S Election
    - ◊ Ability to pass future rental income through to Mom with one level of taxation
      - Rents – Farmland & bin site
      - Entity could other investments – pass through
    - ◊ Farmland has appreciated substantially
    - ◊ Issue
      - Accumulated earnings & profits (AE&P) = $1,000,000
      - S rules say if
      - S corporation has AE&P
      - S corporation has "net passive income"
      - S corporation passive income > 25% of gross receipts
      - S corporation has taxable income
      - Passive income tax assessed – highest corporate tax rate 35%
      - S election automatically terminated in 3 years

Recommendation # 2

- **Elect S Corporation – Land, Inc.**
  - **Possible Solution(s)**
    - ◊ **Cleanse Land Inc. of Accumulated E&P**
      - **Pay taxable dividend to Mom**
        - 15% federal rate
        - 8% State rate
      - **Estimated tax cost ≈ $230,000**
      - **Easy to do – expensive short term tax-wise**
    - ◊ **Restructure land rental income to "active" business income**
      - **Share crop arrangement**
        - Financial risks shifted to landlord
          - Risk of expenses
          - Risk of no income
        - Material participation by Mom

Recommendation # 2

- Elect S Corporation – Land, Inc.
  - Long term benefit
    - ◊ Ability to access cash flow
  - CAUTION – S corporation still has AE&P
    - ◊ Consider plan to payout AE&P each year to reduce amount to zero
  - Mom and Dad to use future income from this land to supplement/support during retirement

Recommendation #3

- **Redo Dad and Mom's wills or other estate dispositive documents**
  - Remove specific bequests for three land parcels to Daughter
  - Remove specific bequest for one land parcel to son
  - Set up specific bequests of new FLP land entity to Daughter & Son – 50/50
    - ◊ Controlling interest to Son ?
    - ◊ All land to be held in the family land entity
  - Consider changing beneficiary designation of retirement accounts to Daughter
  - Ensure Land Inc. ownership is divided 50/50 to Daughter & Son
  - Ensure outside Land LLC goes to Daughter
    - ◊ Is this a good idea?
    - ◊ Other owners what does the buy sell agreement say with respect to Dad's death?
  - Residue split 50/50 Daughter & Son net of any charitable bequests

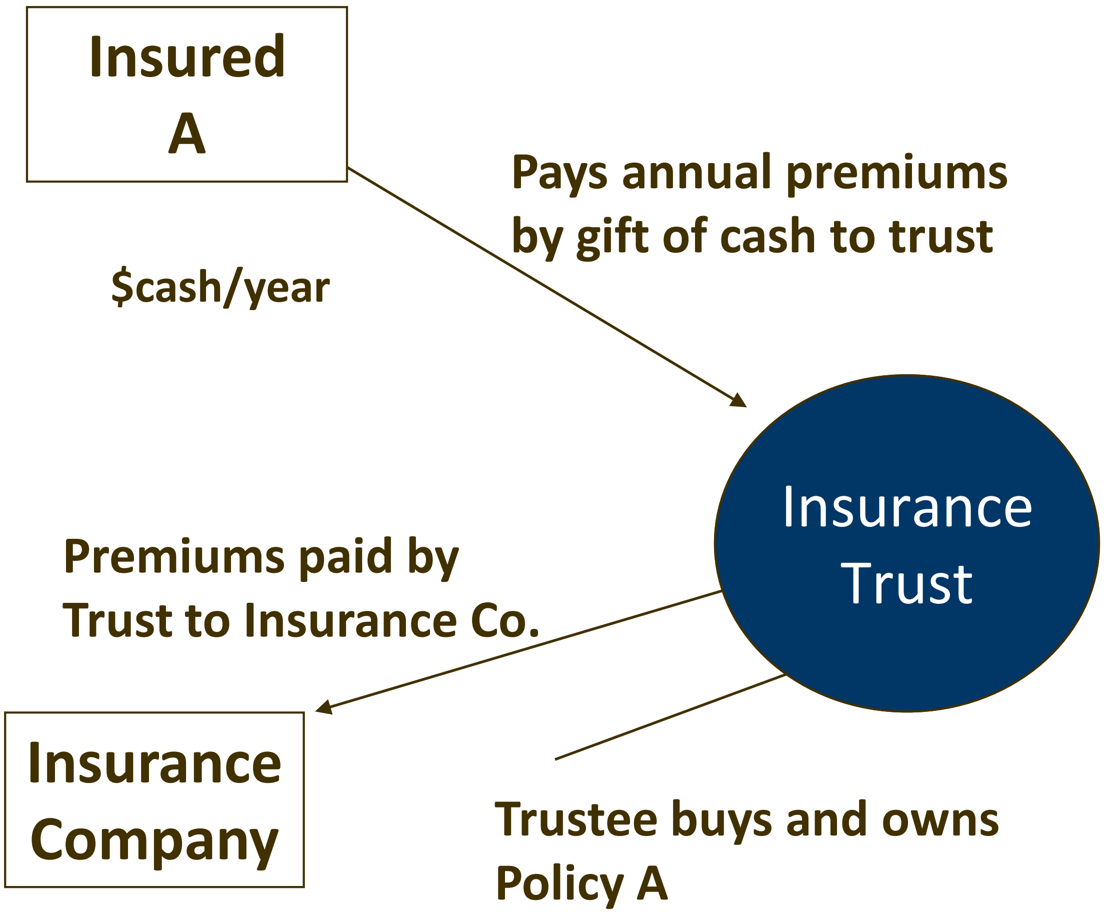
Recommendation #4

- **Establish separate irrevocable trust to own life insurance**
  - Purpose:
    - ◊ Remove life insurance death benefit from estate tax
      - Current tax exposure 40% rate of benefit or about $265,000 estate tax cost
    - ◊ Allows Mom to have additional access to cash flow/income from death benefit invested if needed
    - ◊ Provides liquidity to pay any estate tax
    - ◊ Provides funds for Son to use to buy out sister/daughter from entity ownership i.e. Land and Equipment entity
    - ◊ Can provide balance of estate for nonfarm heir, if necessary
  - Should additional insurance be added?
    - ◊ Second to die?

Recommendation # 4

- Should Son or one of the entities he owns purchase additional insurance on mom and dad?
  - Is current insurance coverage adequate ?
  - Are the insurable at a reasonable cost?
  - Which entity would purchase it? Land and Equipment Entity?
  - Cost/benefit ?
  - Source of tax free capital for future sister buyout?
  - Who should pay for life insurance in this situation?
- Should Son buy insurance on his own life to
  - Protect his family's interest in his estate
  - Does mom and dad use insurance on Son to buy out Son's estate?
  - Provide liquidity for family

Irrevocable Life Insurance Trust (ILIT)



Insurance Trust At Death

Insurance Trust

$663,000

Pays death
benefit to Trust

Insurance
Company

Trustee

- Pays out benefit to beneficiaries
- Lends money to estate for expenses
- Buys assets from estate
- Pays income to surviving spouse

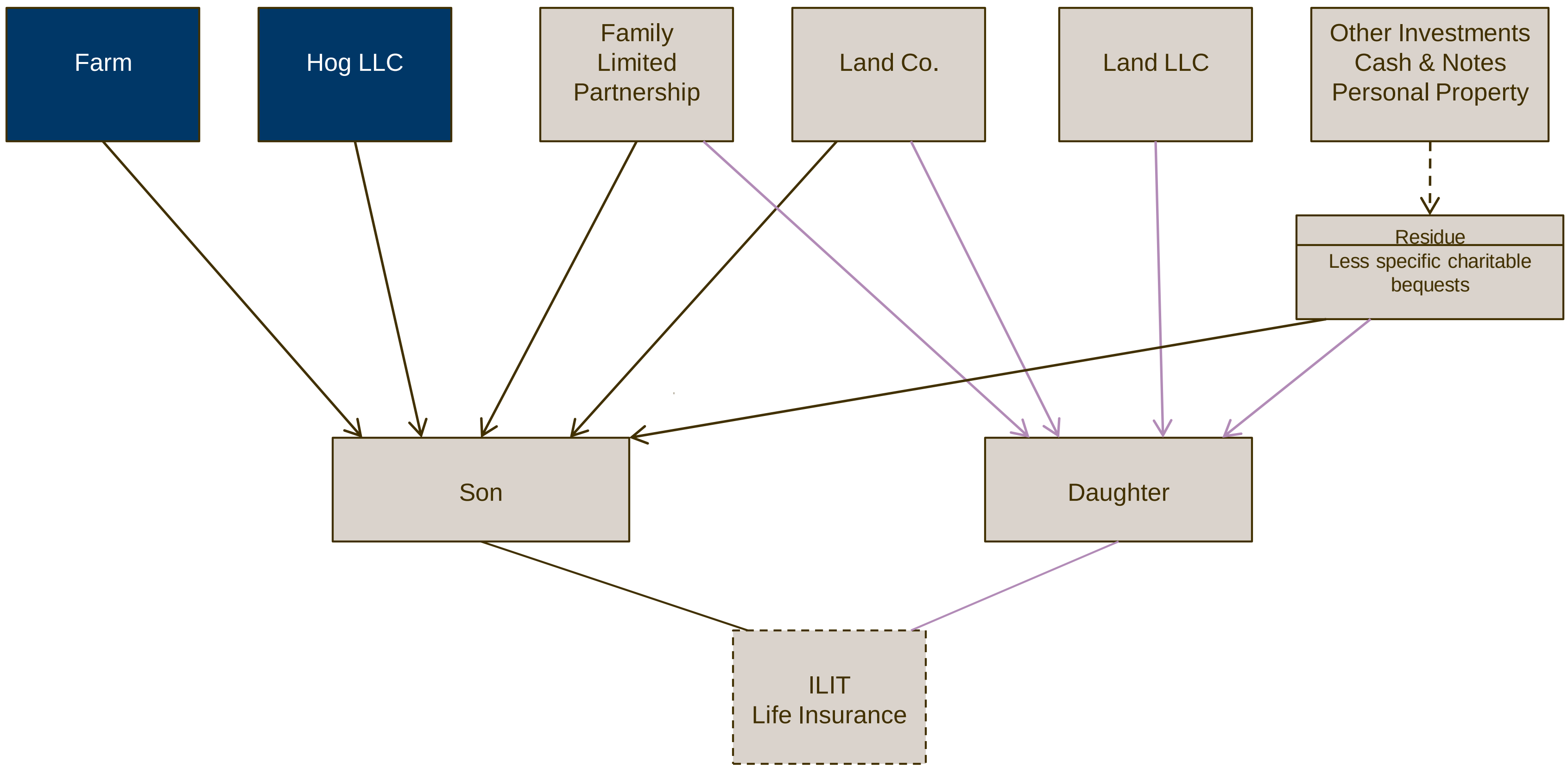
Recommendation #5

- **Land & Equipment Corporation, Inc.**
  - S Election issues
    - ◊ AE&P $700,000
      - Distribute in 2012:
        - 15% federal
        - 8% state
      - Total income tax cost estimated $160,000
    - ◊ Passive income issue
      - Equipment rental passive ($300,000)
      - Difficult to restructure entity to active
  - Redemption of Daughter's stock by Entity
      - Long term note with interest
      - One-half AE&P deemed distributed with redemption
      - Capital gain treatment to daughter
    - ◊ Alternative – Son buys Daughter's stock?

Recommendation # 6

- **Establish risk protection for general partners in Farm Partnership entity**

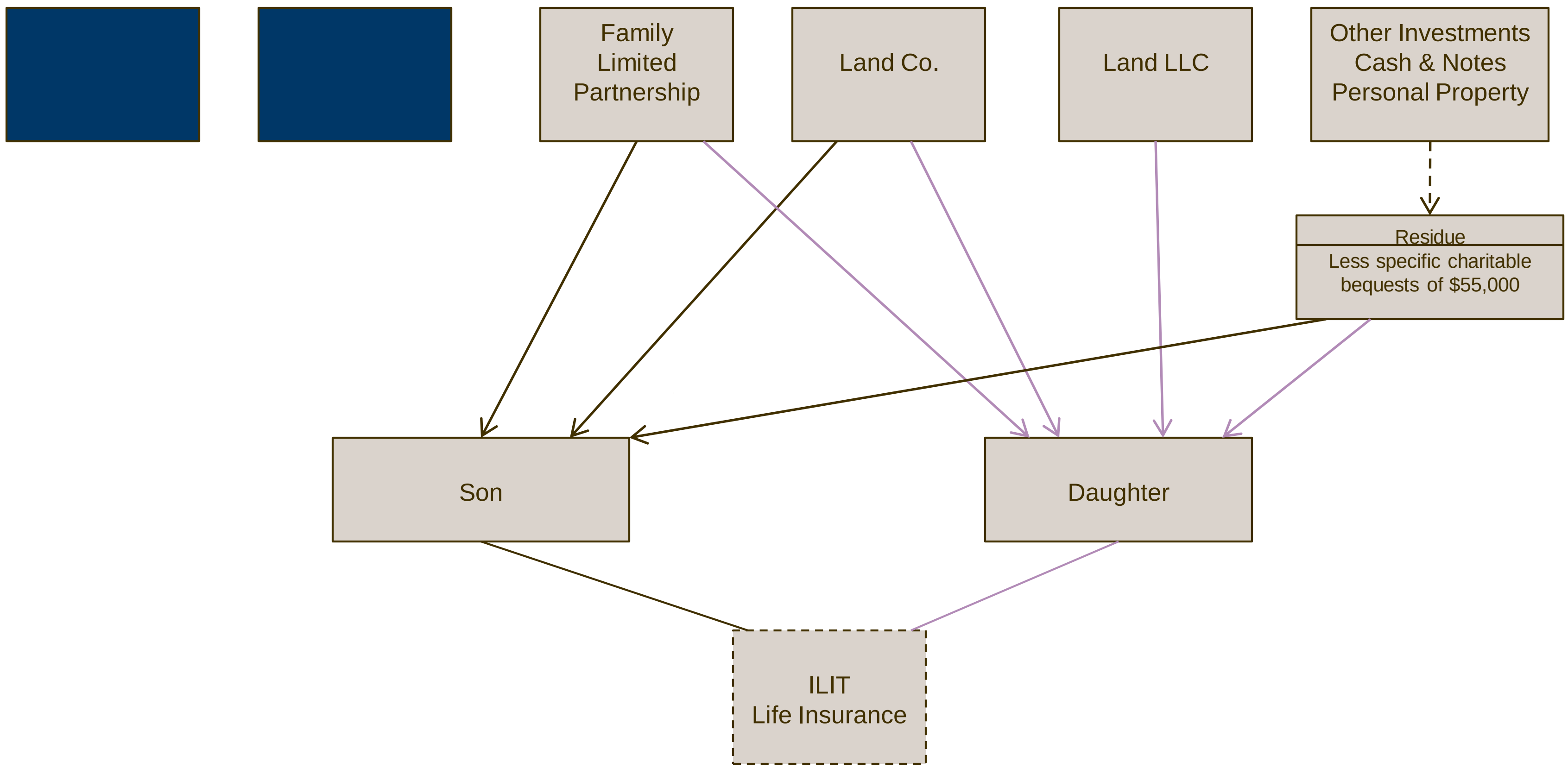
Short Term Results Estate/Operation Plan



Short Term Results

- Summary of restructuring
  - Operations – Son
  - Family owned Farmland – equal
  - Land LLC – Daughter
  - Other – residue
  - Insurance Trust – equal treatment

Long Term Results



Summary

- Organization of Succession/Estate Plan to
  - Operate business
  - Provide for succession of operations and legacy assets
  - Access cash flow for Dad and Mom
    - ◊ Retirement
    - ◊ Non-farm kids
- Estate Planning Needed
  - Provide for estate liquidity
  - Provide for potential estate tax reduction
- Other

Proposed Tax Legislation

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Firm Results For Midwest Clients

Possible Tax Legislation: The Process

- 9-27-17: Republican leadership issues Framework
- 11-3-17: House Ways & Means Committee releases first draft of legislation: H.R. 1 (425 pp. of statutory changes)
  - 11-3-17: Jt. Tax Comm. explanation (JCX-50-17)-299 pp.
  - 11-6 & 11-9-17: Chair's amendments
- 11-9-17: Senate mark-up
  - Jt. Tax Comm. explanation (JCX-51-17)-253 pp.
  - 11-14-17 Amendments; Jt. Comm. Expl. (JCX-56-17)-99 pp.
  - 11-28-17 Senate Budget committee passes bill 12-11
  - 12-1-17 Senate Amendments
  - 12-2-2017 Full floor of the Senate passes bill 51-49

Possible Tax Legislation: The Process

- Next: Jt. Conf. Committee to reconcile the two bills
  - Then House, Senate votes; President's signature to enact
- Reconciliation (budget allows $1.5 trillion increase in deficit for tax reform in 10-year period)
  - Budget approach allows Senate to pass with majority vote (avoids 60 vote requirement)
  - Byrd rule in Senate requires no deficit spending after 10 yr. budget measurement period

Tax Reform: House Bill (H.R. 1 of 11-3-17)

- **1040 rates: Joint (4 rates)**
  - 12% to $90,000
  - 25% to $260,000
  - 35% to $1 million
  - 39.6% at $1M
  - Phase-out of 12% at AGI above $1 million at $6 per $100
- **Single rates = ½**
  - Exception: 35% starts at $200K; 39.6% @ $500K
- **2017 Comparison- Jt.**
  - 10% to $19K/15% to $76K
  - 25%/28% to $233K
  - 33% to $417K
  - 39.6% at $471K
- **Senate: Joint (7 rates)**
  - 10% to $19K/12% to $77K
  - 22% to $140K/24% -$320K
  - 32% to $400K/35% - $1M
  - 38.5% at $1M

Capital Gains: Preserve Present System

- **Joint**
  - 0% below $77,200
  - 15% to $479,000
  - 20% in excess
- **Single**
  - ½ thresholds of above
  - 20% above $425,800

The system: Ordinary fills the lower brackets first, then capital gains on top. Deductions offset ordinary.

Impact on Farmers

- **Income Tax Rate:**
  - Some relief due to lower tax rates on lower income brackets

Standard Deduction: 2018 Proposals

Standard Deduction

- MFJ = $24,400
- Single = $12,200
- H of H = $18,300

Personal Exemptions

- Repealed

Zero tax amount:	2017	2018 Proposed
Joint	$20,800	$24,400
Single	$10,400	$12,200

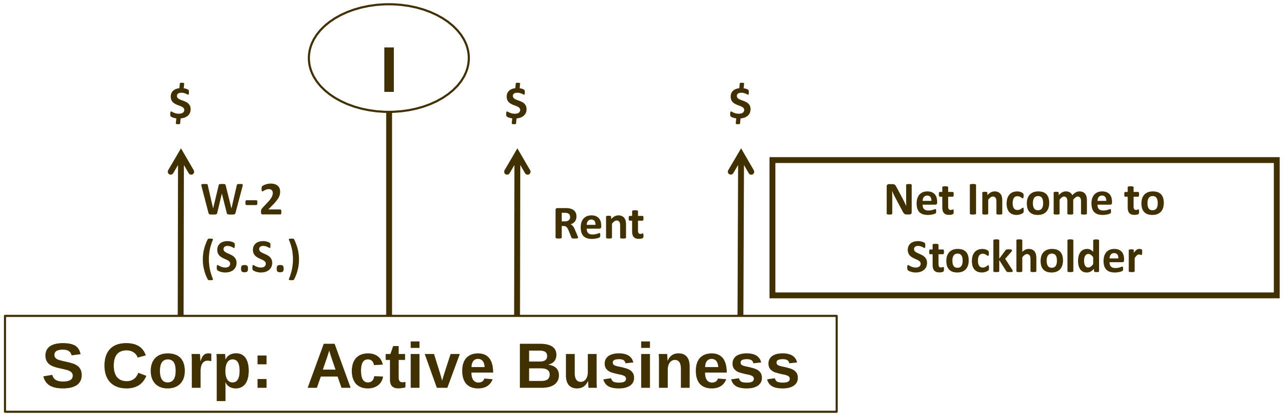
Maximum 25% Business Rate in 1040 (House)

- Passive business income: 100% eligible for cap
  - Not materially participating per Sec. 469 rules
- Active: Applies to 30% of business net income
  - 25% cap on deemed capital portion of business income
  - Personal service = no cap (health, law, acctg., consulting, engineering, etc. – per Sec. 1202 service exclusions)
  - 9% rate (not 12%) on 1st $75K active business income
- But may use alternative rate of return
  - Short term AFR + 7% multiplied by capital investment

Impact of Farmers

- Farm Land Rent – 30% income subject to the 25% cap, 70% subject to ordinary income tax rates.
- For S corps, 30% of K-1 income would be subject to SE.
  - Currently no K-1 income is subject to SE unless Guaranteed Payments.
  - Eliminate S Corps?
- Impact of grouping elections?

Illustration: Categories of Income



- W-2 for services (15.3% FICA taxes)
- Rent - real estate (25% cap on 30% of net income? On all?)
- Pass-thru net income: 25% rate on 30% of net income incl. salary (active participation)
- Pass-thru net of passive investor: All capped at 25% rate

Maximum 25% Business Rate

- Senate approach: 23% (not 17.4%) deduction for the non-wage portion of pass-through business income
- Proprietor, partner or S shareholder limit on deduction: 50% of wages from pass-throughs
  - No limit if T.I. <$500K jt./<$250K single
  - Phase-in wage limit as T.I. $500K-$600K or $250K-$300K
- 23 % deduction N/A to personal service businesses
  - Unless taxable income under $500K jt./$250K single
  - Phase-out 23% over next $100K/$50K of T.I.

Impact on Farmers

- **Although the 23% 17.4% could be a nice deduction, the wage limitation may create an issue for larger operations (taxable income over 250/500)**

Child and Family Tax Credits

- Child credit: Increase from $1,000 to $1,600
  - No change to “qualifying child” definition: < age 17
  - Senate increases to $2,000 and to < age 18
- Plus $300 credit for ea. taxpayer/spouse & dependent not a qualifying child for $1,600 cr.
  - Senate: $500 cr. for ea. dependent not a qualif. child
- Refundable portion = $1,000 as today & indexed
- Phase-out begins at MFJ of $230,000 AGI (up from $110K); Single at $115,000 (up from $75K)
  - Senate: $500K phase-out joint/$250K single

Repeal of nonrefundable credits

- **House: Repeal of four nonrefundable credits**
  - Including adoption credit
  - Credit for elderly or retired and disabled
  - Credit for certain home mortgages
  - Credit for certain electric motor vehicles
- **Senate: None repealed**

Education Credits: Eliminating the Duplicity

- Enhanced American Oppty. Tax Credit (AOTC)
  - First $2,000 = 100% (same)
  - Next $2,000 = 25% (same)
  - Fifth year post-secondary = ½ the rate
  - Up to $1,000 refundable first 4 years; $500 fifth yr.
- Lifetime Learning Credit repealed
- Coverdell Ed. Savings Accts. end; roll to 529 plan

Education Savings: Other Changes

- Elementary and high school expenses up to $10,000/year qualified for 529 plan withdrawals
- Repealed
  - Interest expense on education loans
  - Exclusion for employer-provided ed assistance
  - Exclusion for US savings bond used for higher ed
  - Deduction for qualified tuition and related expenses
  - Exclusion for qualified tuition reduction programs
- Senate: Retain all higher ed tax benefits
  - Senate adopts 529 plan use for elem. & H.S. tuition

Itemized Deductions

- Overall limit/phaseout (Pease): Repeal
- Home mtge. interest: Repeal home equity '18
- Residential acquisition debt: Grandfathered if incurred <u><</u>11-2-17
- For new debt incurred after 11-2-17:
  - Residential acquisition debt limit of $500,000 (was $1M)
  - Deduction only for principal residence debt (Result: No second home residential interest expense)
- Senate retains same $1M debt limit; only removes home equity interest deduction

Itemized Deductions: Taxes

- No itemized deduction for state income or sales taxes
- Allow real property tax up to $10,000
  - Excludes state and local personal property taxes
- Same including retention of $\leq$ $10K real property tax limit
- Strategies <u>if</u> passage likely:
  - Prepay state income tax in 2017
  - Prepay real estate tax if non-deductible in 2018 or higher bracket in 2017

Itemized Deductions

- **Personal casualty losses eliminated(prior: >10% of income)**
  - **Special disaster relief legislation unaffected**
- **Gambling loss <u>and expenses</u>: Ltd. to winnings**
- **Charitable: 50%-of-AGI limit to 60%**
  - **Repeal special rule for deduction for 80% of rights to purchase tickets to athletic events**
  - **Adjust $.14 per mile charity rate for inflation**
- **Strategy: Prepay charitable via donor-advised fund (DAF)**
  - **Strategy is applicable in any high-rate year**

Impact on Farmers

- Prepay state income tax in 2017.
- Use commodity gifting to bypass Sch A limitations
- Review your property tax to make sure it is allocated correctly (personal vs. business)

Itemized and Other Deductions

- Tax prep fees nondeductible (prior: >2% of AGI)
  - Senate repeals all misc. itemized subject to 2% floor
- Medical expenses repealed (prior: >10% of AGI)
  - Senate retains this deduction with 7.5% floor ’18-‘19
- Pre- AGI alimony repealed & no income->payee
  - Effective for divorce decrees executed after 2017
  - Senate retains present treatment of alimony
- Moving expenses repealed
- Archer Medical Savings Accounts ded.- repealed
  - Switch to HSA (Senate retains Archer MSA)

Other Deductions – Employees

- Employee business expenses not deductible
  - But allow offset of reimb. expenses
  - Military reservist deduction remains
- Repeal pre-AGI ded. of performing artists
  - Senate: No repeal
- $250 teacher supplies deduction repealed
  - Senate: Increases to $500

Summary: House Itemized Not Repealed

- Real estate taxes limited to $10,000
- Home mortgage interest on principal residence
  - New debt: $500K limit
- Charitable contributions
- Investment interest expense
  - Limited to investment income
- Non-2% miscellaneous

Employer-provided Housing (Sec. 119)

- Cap of $50,000 on exclusion with phase-out
- Not available to ≥5% owners
- Limited to one residence
- Senate: No change to present law

Impact to Farmers

- Farmer's using a C Corp for housing may want to revaluate

Principal Residence Gain Exclusion

- No change in exclusion amt. ($500K jt./$250K s.)
- Own and use 5 of 8 years (instead of 2 of 5 yrs.)
  - Available once every five years (not once every 2)
- Phased-out dollar-for-dollar for AGI > $500,000 jt.
  - $250,000 single
  - Result: Upper income taxpayers taxable on house sales
  - Senate: No phase-out of exclusion for higher income

Other Repeals of Employer Benefits

- Exclusion for employee achievement awards
- Qualified moving expense reimbursement
- Adoption assistance programs
- Senate: Retains all except moving exp. reimb.

Estate, Gift and GST Tax

- Doubled exclusion: $5M to $10M + indexing
  - Deaths in 2017: Present exclusion is $5,490,000
  - Should be $11.2 million for 2018
  - Married couple $ 22.4 million in 2018
- House: Repeal estate tax and GST after 2024
  - Maintain stepped-up basis, however
- Senate does not have repeal
- Gift tax = 35% after repeal
- Retain annual gift tax exclusion ($15K)

Impact to Farmers

- **Increased exclusion would help with transfer of farmland**

ACA Individual Mandate; Alternative Minimum Tax (AMT)

- Repeal of Affordable Care Act (ACA) individual health insurance mandate: 2019
- Senate: Repeal ability to specifically designate stock shares sold, eff. in 2018 – Forces FIFO cost
- Repeal Alternative Minimum Tax (AMT)
- Senate: Retain AMT; increase exemption
  - Exemption approx. $85K to $118K jt./$54K to $76K s.
  - Improve phase-out threshold (jt. $150K to $208K)

ACA Individual Mandate; Alternative Minimum Tax (AMT) cont.

- AMT credit allowed against regular tax AMT refundable credit amount Refundable up to 50% of the excess of AMT credits > regular tax liability for 2019-2021
  - Remainder as refund in 2022
  - Senate: 100% refundable in 2021

Impact to Farmers

- **The repeal of AMT could have significant impact on certain famers. Those that have high capital gains (dairy – cull cows) have been subject to AMT. This would provide significant tax relief.**

Corporate Taxes

- Flat 20% rate
- Personal Service Corporations (PSC) = flat 25%
  - Senate: Same 20% rate for PSCs
- Senate: 20% rate eff. for tax yrs. beginning after 2018, and retains corp. AMT (at current 20%)
- Move from worldwide to territorial, and allow lower rate repatriation of prior foreign earnings

Cost Recovery and Asset Expensing

- **Expense 100% acquired and placed in service > 9-27-17 and before 2023 (only retroactive provision)**
  - Includes new and used
  - Senate: Retains for new only
  - Senate: Drops bonus to 80% in '23, 60% in '24, 40% in '25, 20% in '26
  - Passenger auto cap from $8K to $16K
- **Section 179 to $5 million**
  - Phase-out beginning point is $20 million
  - Senate: $1M Sec. 179 expense; phase-out >$2.5M
  - Senate expands Sec. 179 to roofs, HVAC, sec. systems

Impact on Farmers

- If a farmer is nearing retirement he/she may chose to look at a CRT. Using 179 creates tax issues for CRTs, where as expensing would not. Using expensing vs 179 may result in more favorable deferral opportunities.

Expansion of Cash Method of Accounting

- All businesses with average gross receipts < $25 million permitted to use cash method
  - But account for inventories as non-incidental supplies (hold cost until sold)
  - Exempt 263A (UNICAP), incl. real estate construction
  - May use completed contract method if < 2 yrs.
  - Automatic consent accounting method change
- Senate: Same, but at $15 million gross receipts

Business Interest Expense

- Disallowed: Excess of 30% of business adjusted taxable income
  - Determined without interest expense, interest income, NOL, depreciation, amortization, depletion
  - Determined at tax filer level (1065, 1120-S)
  - Excess carried forward to succeeding five years
- No disallowance for business with average gross receipts ≤$25 million
- Senate: Same, but exempt under $15 million

Other Business Provisions

- Repeal NOL carrybacks
  - One-year carryback for: small businesses with disaster losses; farms
  - Carryforwards: No limit
- NOL C/O allowed to 90% of taxable income
- Carryforwards increased by indexing
- Senate: Allows two-year carryback for farms
  - And limit NOL to 80% of taxable income after 2022
- Senate: Active business loss ltd. to $500K jt./$250K single – at 1040 level – excess C/O

Impact to Farmers

- **The good - NOLs indexed**
- **The bad – only 1 year carryback**

Other Business Changes

- Section 1031 exchanges for only real property
  - Personal prop. exchanges taxable; but asset expensing should offset taxable gains on exchanges
- Sec. 118 non-owner contrib. to capital is taxable
  - Senate: Not included
- Section 199 domestic production deduction is repealed
  - Senate: Not repealed until 2019

Impact to Farmers

- Section 1031 repeal should have little impact on trades – sale creates basis to offset gains.
- Section 199 may have impact on farmers. Cooperatives pass DPAD to patrons. Dairy farmers rely heavily on DPAD. Depending on what is passed, certain farmers could lose a significant deduction.

Disallowance of Entertainment

- No deduction for entertainment
  - Transportation passes and parking fringes disallowed
  - Employee recreation and social events disallowed
  - (i.e., the December holiday party: Nondeductible!)
- Senate: Employer-provided eating facility limited to 50%
  - Also repeals employer deduction for employer-provided on premises meals and employer eating facilities after 2025

Business Credit Repeals

- Employer-provided child care credit
- Rehab credit (20% historic/10% pre-1936 bldg.)
- WOTC (jobs credit)
- Deduction for unused business credit >20 yrs.
- New markets credit (community development. entity)
- Disabled access credit
- FICA tip credit modified to 10% of gross, not 8%
- Senate: Only disallows ded. for unused credits
  - Repeals 10% rehab cr.; 20% cert. historic over 5 yrs.

Potential Ag Programs cut/eliminated

- Farm Price Support Programs – the Commodity Credit Corporation Fund
- Farm Security and Rural Investment Programs – conservation programs for wetlands, grasslands, forest, etc.
- Funds for Strengthen Markets, Income, and Supplies – program encourages exports of ag commodities and products.
- Commodity Assistance Program – provides food donations to help elderly and poor.

Senate Provisions not in House Bill

- Drop farm machinery to 5 yr. recovery (from 7)
  - And repeal required use of 1.5DB
- Decrease building recovery period from 39 to 25 yr.
- 15 yr. real estate categories to 10 yr.
  - Retain eligibility for Sec. 179
- Restaurant prop. (except QIP) to 25 yr. recovery
- Employer cr. - paid family/medical leave (Sec. 45S)
  - 12.5% to 25% sliding credit as pay >50% normal wage
  - Minimum of 2 weeks leave for full-time employees

Impact on Farmers

- Farm machinery from 7 year to 5 year and 200% or 150%DD methods.
- Building (non single purpose ag facilities) go from 39 to 25 years.
- Single purpose ag facilities from 15years to 10 years

Summary

- Broad changes with repeal of narrowly used deductions and fringes
  - Many individual provisions expire 2025, 2026 (budget restrictions)
- Hurdles left to passage: House passed, then Senate passed, then Joint Comm. reconciliation and House and Senate vote again . . .

Questions???

THANK YOU!

This program is not intended to be responsive to any individual situation or concerns as the contents of this presentation are intended for general informational purposes only. Participants are urged not to act upon the information contained in this presentation without first consulting competent legal/tax advice regarding implications of a particular factual situation. Questions and additional information can be submitted to your Gislason & Hunter Attorney or CliftonLarsonAllen Accountant.

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