CFAES

PLANNING FOR THE FUTURE OF YOUR FARM

Legal tools and strategies for farm transition and estate planning

THE OHIO STATE UNIVERSITY EXTENSION

THE PLANNING FOR THE FUTURE OF YOUR FARM BULLETIN SERIES

Farming takes planning. A lot of planning. Whether for next year's crop, expanding a herd, buying land, constructing buildings, starting a new venture, or upgrading equipment, farmers are nearly always engaged in planning to keep the farm on track. But farm transition planning—that is, planning for what happens to a farm business and its family from one generation to the next—is a whole different kind of planning. And it's one type of planning farmers often avoid.

Farm transition planning can be challenging and uncomfortable, perhaps because it involves dealing with death, uncertainty, and difficult family situations. But like planning for the next year of production, farm transition planning is critical to a farm's success. With good planning, a farm family can protect farm assets, implement family and business goals, and ensure a smooth transition of a viable operation to the next generation. It's the kind of planning that can pay off big.

Our **Planning for the Future of Your Farm** law bulletin series can help with this important planning need. In this series, we explain the legal tools used for planning and present strategies that can address a family's goals. The entire set of bulletins in this series is in the Estate & Transition Planning Library on the Farm Office website at **farmoffice.osu.edu.** We cover these same topics in our popular **Planning for the Future of Your Farm Workshop** offered online and in person each winter. Check the Farm Office website at farmoffice.osu.edu for workshop dates. Reading the series and attending our workshop are two important first steps that can lead to creating a plan for the future of your farm.

The authors of the *Planning for the Future of Your Farm* Series are **Robert Moore and Peggy Kirk Hall**, Attorneys with OSU's Agricultural & Resource Law Program, **Evin Bachelor and Kelly Moore**, attorneys with Wright & Moore Law Co. LPA, and Law Fellows from the National Agricultural Law Center. We hope you will find the series helpful in your efforts to plan for the future of your farm.

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PLANNING FOR THE FUTURE OF YOUR FARM

Legal tools and strategies for farm transition and estate planning

FARM TRANSITION AND ESTATE TRANSITION PLANNING: WHAT IT IS AND WHAT TO EXPECT

Pick up a farm magazine and it's likely to have an article about estate planning. An internet search will yield hundreds of references to passing on the family farm, protecting a farm's legacy, and bringing the next generation into the operation. We focus a lot of attention today on farm transition and estate planning. That's because good planning carries critical consequences for the future of agriculture.

WHAT IS FARM TRANSITION AND ESTATE PLANNING?

Farming is both a unique way of living and a unique way of making a living. It is common for farmers to hope to pass this unique heritage on to future generations. "Farm estate planning" uses legal tools to ensure that the next generation receives farm assets after farm owners retire or pass on. But farmers often want to bring their heirs into the farming operation before passing those assets on. The term "farm transition planning" refers to using many tools to prepare for and transfer the farming operation to heirs, including estate planning and business planning tools. Whether your goals are to pass on land and assets, hand the farm business down to future generations, or both, learning about farm transition and estate planning will help you accomplish those goals.

THE FARM TRANSITION AND ESTATE PLANNING PROCESS

The farm transition and estate planning process begins with **identifying goals** for the future of the farm and the farm family. We frequently hear from farmers whose primary goals are to keep farmland in the family and prepare the next generation of managers. Or perhaps a farmer aims to retire, address special issues with children, or plan for long term health care. Whatever the goals may be, healthy **family communication** and **conflict management** are often necessary to accomplish this important first step of identifying goals.

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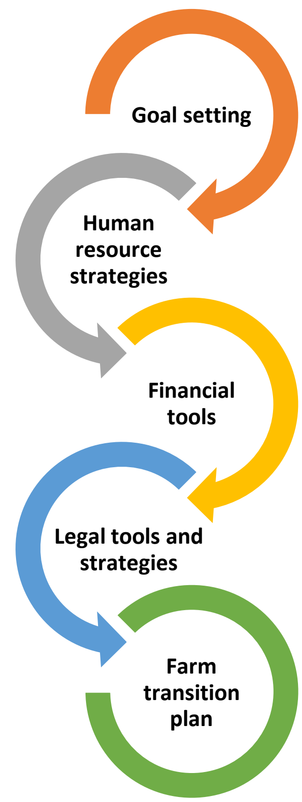
The next step in the farm transition planning process requires **selecting strategies** to implement established goals. Strategies will likely be necessary in several different areas:

- **Human resource** strategies to identify, prepare and train the next generation of the farm business managers.
- **Financial** tools to aid in funding and implementing goals, such as insurance and retirement plans.
- **Legal** strategies and tools for effective asset protection and transfer, such as estate planning and business planning instruments.

The legal tools and strategies component of farm transition planning is the focus of our Planning for the Future of the Farm bulletin series. Some of the legal tools we explain are traditional instruments often used in estate planning, like wills and trusts. But other legal tools can be useful for a farm transition plan, such as business entities, operating agreements, leases, and gifting strategies. These legal tools work together with human resource strategies and financial tools to implement a farm's goals. Putting the legal plan in place is the final step in the farm transition planning process.

The Farm Transition Planning Process



PUTTING A LEGAL PLAN TOGETHER

1. Choose an attorney. The legal side of farm transition planning starts with choosing your attorney. Word-of-mouth is one way to identify a good agricultural attorney with expertise in farm transition and estate planning, or check with organizations like Extension, the state or local bar association, or the American Agricultural Law Association. Ask for an initial consultation and meet an attorney before committing to representation. Several factors can aid in selecting the right attorney: competence, personal comfort, and costs.

- Look for an attorney with **competence** in estate and business planning—composed of both legal knowledge and practical experience. But don't stop there-- it's also very important that the attorney is competent with **agriculture** and experienced in working with farm clients. Farm businesses are different than other types of businesses. An attorney who knows farming will have insight into the laws, tools and strategies that apply to farm situations. Be wary of an attorney who has never worked with farm clients and knows little about agriculture.
- **Personal comfort** with an attorney is essential. It can ensure open communication and make it easier to share necessary information about finances, assets, business plans, and family issues and dynamics. Discomfort can lead to misunderstandings, withholding of critical information, and plans that don't align with a family's goals.
- **Costs** can vary. It is completely acceptable to request an estimate of legal fees. Don't be afraid to ask what the entire plan, from start to finish, will cost.

2. Expect to have two or more meetings with an attorney. The first meeting is typically for reviewing goals and information but might also involve discussing strategies and options. Additional meetings could involve reviewing tools and strategies and executing legal documents.

3. Prepare for the first meeting*.* Advance preparation can help the first meeting move more efficiently and effectively. An attorney might let you know in advance of information to gather before the first meeting. Also consider these tips:

- **Write it down.** Write out your goals for the farm business and farm assets. Also include information about the family, its special needs, and its dynamics. Consider details an attorney may need to know about the farm and the family, like who has "sweat equity" in the business, siblings who don't get along, children with problems managing finances, big purchases coming up, and who wants to be involved in the farm—this and similar information will help with developing a plan that addresses future issues.
- **Compile asset and personal information**. Gather all asset information such as deeds, account numbers and balances, and beneficiary designations, along with personal information on you and your family members. OSU Extension offers a helpful document, *Getting Your Farm and Family Affairs in Order,* that can aid in organizing the information. Doing so before meeting with your attorney can save time and the costs of having your attorney track down the information.
- **Organize financial information**. Use the information gathered in step two to prepare a simple balance sheet showing farm assets, non-farm assets, debts, and net worth. Full disclosure of your financial situation is necessary to developing a plan that addresses financial challenges and opportunities and is another way to save on the costs of paying your attorney to compile the information.

4. You may need your other advisors, too. Communication among all your professional advisors may be necessary to ensure all strategies align with one another. You may need to check in with financial advisors, accountants, insurance agents, and other professionals you rely upon.

SPEAKING THE FARM TRANSITION LANGUAGE: COMMON TERMS

Farm transition planning uses many legal terms, and familiarization with the terms should help you through the process. Here are definitions to common terms you may encounter along the way.

Advance directive. A legal document that gives instruction on a person's health care wishes, such as a living will and health care power of attorney.	***Irrevocable trust.*** A trust that cannot be changed or cancelled by the person who executed the trust.
Basis and step-up in basis. The basis is the value of an inherited asset for tax purposes. A step-up in basis is an adjustment of basis to the asset's fair market value at the time of the death that triggers the inheritance.	***Joint tenancy.*** Ownership of real property jointly by two or more parties, either as joint tenants with rights of survivorship or as tenants in common.
Beneficiary. A person designated to receive proceeds from an asset such as an account, insurance policy, or trust upon the death of the owner of the asset.	***Living trust.*** A trust created during a person's lifetime to manage assets before and after the person's death. A living trust can be revocable or irrevocable.
Business entity or structure. An organization formed to conduct business, such as sole proprietorships, partnerships, corporations, cooperatives, and limited liability companies.	***Living will.*** A legal document stating a person's wishes for medical treatment and life-sustaining measures if the person is at the end of life and unable to communicate.
Capital gains tax. A tax on the increase in the value of an asset between the time it is bought and the time it is sold.	***LLC, Limited Liability Company.*** A business entity that can protect its owners from personal responsibility for business debts and liabilities with pass-through taxation.
Deed. A written document that transfers title to real property to a new owner.	***Long-term care insurance.*** Insurance coverage for long-term services and support not covered by health insurance, such as nursing home or custodial care.
End-of-life directive. A written legal document with instructions for end-of-life medical decisions if a person is unable to make decisions at that time.	***Operating agreement.*** A document that governs the internal operations of a limited liability company and is binding on all members of the limited liability company.

Estate. All of the real and personal property a person owns at death.	***Payable on death account.*** An account set up to be directly transferred to a beneficiary upon the death of the account holder, without going through probate.
Estate administration. The process of collecting assets, paying debts, and distributing the property of a person after the person's death.	***Probate.*** A court process to administer a person's estate by paying all claims, expenses, and taxes, and distributing remaining property to heirs.
Federal estate tax. A tax on the portion of a person's estate that exceeds the federal estate tax exemption amount.	***Revocable trust.*** A trust that can be changed or cancelled by the person who executed it prior to that person's death.
Federal estate tax exemption. An amount of assets in an estate that are exempt from the federal estate tax, as determined by Congress and adjusted annually.	***Survivorship deed.*** A deed that transfers the title to a joint owner's share of jointly owned real property upon death to the surviving joint owners.
Financial power of attorney. A legal document that appoints someone to make financial decisions for a person if the person is unable to manage their finances.	***Tenancy in common.*** A form of joint ownership of real property that allows a joint owner to transfer their share of property to a person other than a joint tenant.
Gifting. Giving cash or assets to a beneficiary during the giver's lifetime rather than after death, which can reduce the value of the giver's estate and the possibility of estate taxes at death.	***Transfer on death affidavit.*** A written instrument that establishes a direct transfer of real property to a designated beneficiary upon the death of the owner without going through probate administration.
Health care power of attorney. A legal document that allows an individual to empower another person to make important medical decisions on their behalf when they cannot do so themselves.	***Trust.*** A legal instrument that holds assets and appoints a trustee to oversee and distribute assets according to the terms of the trust.
Intestacy. Dying without a will, which results in the deceased's assets being subject to probate and distributed according to the state's intestacy law.	***Trust administration.*** The process of managing the assets within a trust according to the terms of the trust.

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THE FINANCIAL POWER OF ATTORNEY

We can't always take care of our own financial and personal affairs. Whether due to medical issues, mental incapacity, schedule conflicts, or other unexpected circumstances, we sometimes need someone else to handle those needs. A Financial Power of Attorney (POA) is a legal instrument that can help in those times. It allows you as the "**principal**" to name an "**agent**" to perform duties such as managing your bank accounts, finances, and investments, signing your tax returns, or handling a specific business matter. It's a flexible legal document that you and your attorney can tailor to address different needs at different times. In this bulletin, we explain how financial POAs can be helpful to your situation and how they work.

HOW A FINANCIAL POWER OF ATTORNEY CAN HELP YOU

It gives you control. If you don't have a POA and become incapacitated, a court may have to appoint a legal guardian to act for you. The person the court selects as your guardian may be a person you wouldn't want to be involved in your affairs. With a Financial POA, you have control over who deals with your financial matters, and you can define the scope of that agent's authority.

It creates consistency. Authorizing someone to step in when you cannot avoids disruptions and keeps your finances and affairs running efficiently and smoothly.

It provides certainty. Third parties often want or require proof that someone has the legal authority to handle someone else's finances and dealings so that they don't end up in the middle of a fraud or theft situation. A Financial POA provides that proof to the parties you deal with.

THE UNIFORM POWER OF ATTORNEY ACT AND OHIO'S STATUTORY FORM

Many states, like Ohio, have adopted the **Uniform Power of Attorney Act**, a model law that provides default rules for POAs and standardizes requirements across states that adopt the law. The

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law aims to deter financial abuse by an "agent" appointed in a POA, especially for elderly and disabled persons. Ohio's POA Act outlines general powers of agents and includes a list of powers that a POA *does not grant* an agent unless specifically stated. These "prohibited powers" that must be stated in the POA includes power to:

- Create a trust for the principal or make changes to an existing trust
- Give away the principal's property
- Create or change rights of survivorship
- Change beneficiary designations
- Let others act in place of the named agent
- Waive the principal's right to be a beneficiary of a joint and survivor annuity, including a survivor benefit under a retirement plan.

OBTAINING, EXECUTING, AND RECORDING A POA

It is possible to prepare your own Financial POA using a state's standard form; Ohio provides an example of a POA in its statue. But you should consider **consulting an attorney** for your POA. An attorney can help you decide when you need a POA, address issues unique to your situation, help you decide what types of authority to grant an agent, and determine when the authority begins and ends. Typically, an attorney can draft a Financial POA quickly with minimal legal fees, making it well worth the investment to have a tailored document that protects you and meets your needs.

For proper execution, a person (the "principal") must sign the POA, or if unable to sign, may direct another individual to sign for the principal while in the principal's presence. Acknowledgement by a notary public or local official is the final step in the POA execution process.

If a POA is for the conveyance, mortgage, or lease of an interest in real property, it must be **recorded** in the county recorder's office where the property is located *prior to* recording of the deed, mortgage, interest, or lease. A revocation of a recorded POA must also be recorded in the same county recorder's office where the recording occurred.

GENERAL VERSUS LIMITED POAs

The two main types of Financial POAs differ according to the powers granted to the agent. A general POA grants the most authority while a limited POA limits authority to specific actions or assets.

A **general POA** typically gives the agent authority to do all things necessary to manage assets held by the principal. Examples of powers typically given by a general POA include:

- Buy, sell, lease, mortgage, and give away real and personal property.
- Contract in any manner with any person on behalf of the principal.
- Operate, buy, sell, enlarge, reduce, or terminate an ownership interest in a business.
- Open, close, invest in, and make withdrawals from an investment or bank account.
- Buy, sell, exchange, assign, settle, and exercise commodity futures contracts.
- Buy, cancel, collect, and change beneficiaries on a life insurance policy.
- Litigate for any money or other thing of value owed to the principal.
- Sign, acknowledge, seal, deliver, file, or record any instrument on behalf of the principal.
- Engage, pay, or discharge an attorney, accountant, investment manager, or other advisor.

A **limited POA** grants an agent the authority to act *only* for a specific purpose, during a certain period, or for particular assets. A limited POA will specify actions an agent may take on behalf of a principal and clarifies that the agent has no authority to act beyond that limited scope of authority. For example, a principal selling real estate might execute a limited POA that gives an agent authority to sign the deed for the principal on the day of the real estate closing. The agent does not have authority to act for the principal on any other matter or at any other time.

THE AGENT'S FIDICUARY DUTIES, LIABILITY, AND COMPENSATION

An agent has "fiduciary" responsibilities when performing under a Financial POA, which means the agent must act in accordance with the principal's best interest, in good faith, and only within the scope of the authority granted by the POA. Ohio law details the specific level of competence, care, and diligence required by an agent, as well as duties for maintaining records of receipts and disbursements and cooperating with the principal's Health Care POA to carry out health care needs, if applicable. Ohio law also states that an agent who violates the agent's duties can be financially liable for the violations. On the other hand, an agent who acts in good faith is not liable to the principal's beneficiaries or liable if the principal's property declines in value. Unless a POA states otherwise, the law states that an agent is entitled to compensation and reimbursement of expenses for performing duties, if costs are reasonable.

WHEN POA AUTHORITY STARTS AND ENDS

There are different approaches to setting the times for starting and ending a Financial POA, and it can be quite beneficial to review the options with your attorney before making decisions.

The start of POA authority. When exactly can an agent begin dealing with matters authorized by the POA? This is a very important provision of the POA to discuss with an attorney because the document will be effective immediately *unless* stated otherwise. It's typical for a principal to sign a Financial POA because the need exists at the current time, such as when a farm business owner needs an agent to assist with immediate business matters. But a second option is for a Financial POA to **"spring"** into effect only when triggered by a certain event. This type of POA can be difficult, as third parties might question whether the triggering event has occurred. For example, if a Financial POA is only effective in the event of a medical emergency, a bank might require the agent to offer proof of the medical emergency. For this reason, Ohio law allows a principal to authorize a person, such as the principal's doctor, to make a written statement that the triggering event has occurred, providing the proof necessary to confirm that the POA is valid.

Durability and incapacity. Ohio's Uniform POA Act law states that unless provided otherwise by the principal, a POA is **"durable."** This means that the Financial POA remains in effect if a principal becomes incapacitated. In the above example of a Financial POA triggered by a medical emergency, the POA would continue beyond the emergency if the principal is incapacitated by the emergency. The law provides a definition of "incapacity," which is an inability to manage property or business affairs for because a person is impaired in the ability to receive and evaluate information or make or communicate decisions, even with technological assistance, or because a person is missing, detained, or outside the United States and unable to return.

A principal may authorize someone to determine when the principal is incapacitated, or the law allows a physician or psychologist to establish incapacity and permits an attorney, judge, or government official to determine if a principal is missing, detained or unable to be in the United States.

The end of POA authority. It is also necessary to clarify when POA authority ends, or Ohio law will establish its end. If a POA states that it is not "durable," the agent's authority ends if the principal becomes incapacitated. For all POAs, the law states that an agent's authority ends if the principal dies, when the purpose of the POA is accomplished, or if the agent dies, resigns, or becomes incapacitated. A principal can change or terminate the agent's authority at any time if the principal has mental capacity. Giving notice that a POA has ended to financial institutions can ensure the agent no longer acts for the principal. Note that if the POA grants powers to convey interests in property and has been recorded, the revocation must also be recorded in the same county recorder's office.

CHOOSING AND COMMUNICATING WITH AN AGENT

Appointing someone to handle your financial and business affairs is a serious matter and exposes you to risk, regardless of how well you know the person. Choose carefully, appointing a person who will adhere to the fiduciary responsibilities the appointment requires. You can also reduce your risk by communicating the terms of the POA and your needs and wishes to your agent. Proper forethought can ensure that the POA helps you through those times when you need another to act on your behalf.

REFERENCES

Uniform Power of Attorney Act, Ohio Revised Code Sections 1337.21 to 1337.64,
https://codes.ohio.gov/ohio-revised-code/chapter-1337

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THE HEALTH CARE POWER OF ATTORNEY AND ADVANCE DIRECTIVES

Health care decisions like deciding whether to have a medical procedure, remain on life support, or donate body organs are challenging, but what if you are incapacitated and unable to make those decisions? Or what if you have wishes for your funeral and burial that you want carried out? There are several legal documents that can address these needs. Ohio law allows you to use a Health Care Power of Attorney, Living Will Declaration, Anatomical Gifts Declaration, Donor Registration, and Statement of Funeral Arrangements to give "advance directives" about your health care and death arrangements. These are important documents that ease burdens for both you and your loved ones.

THE HEALTH CARE POWER OF ATTORNEY

A Health Care Power of Attorney (POA) is a legal document that gives the person you appoint—your "agent"—the power to determine your health care needs. Ohio law provides that, unless you express otherwise in the POA, your agent may make health care decisions to the same extent you could if you were able to do so. For example, your agent could set up appointments, choose treatment, communicate with your doctors, or decide where to obtain long term care. The Health Care POA may also include special instructions about "life support" that authorize your agent to refuse artificial or technology supplied nutrition or hydration if you are in a permanently unconscious state. Alternatively, you may have a separate Living Will Declaration that further addresses end-of-life care, discussed below. Under Ohio law, a Health Care POA begins only if your doctor determines that you have lost the "capacity" to make informed health care decisions. You may revoke or change your Health Care POA prior to death, and it extinguishes upon death.

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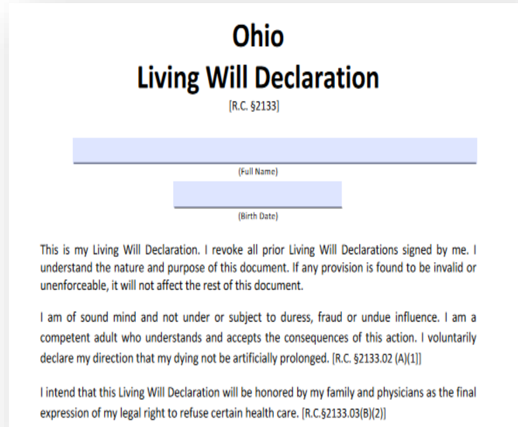
THE LIVING WILL DECLARATION


Ohio
Living Will Declaration
[R.C. §2133]

(Full Name)

(Birth Date)

This is my Living Will Declaration. I revoke all prior Living Will Declarations signed by me. I understand the nature and purpose of this document. If any provision is found to be invalid or unenforceable, it will not affect the rest of this document.

I am of sound mind and not under or subject to duress, fraud or undue influence. I am a competent adult who understands and accepts the consequences of this action. I voluntarily declare my direction that my dying not be artificially prolonged. [R.C. §2133.02 (A)(1)]

I intend that this Living Will Declaration will be honored by my family and physicians as the final expression of my legal right to refuse certain health care. [R.C.§2133.03(B)(2)]

You may determine your end-of-life care through a Living Will Declaration. The declaration directs your doctor to provide only comfort and pain management care and allow you to die naturally if you are in a terminal condition or a permanently unconscious state. Your doctor is not to administer life-sustaining treatment, CPR, artificially or technologically supplied nutrition or hydration, or take any actions that postpone your death. The declaration also authorizes your doctor to issue a "Do Not Resuscitate Order."

According to Ohio's Rights of the Terminally Ill Act, a Living Will Declaration is valid only if you are either in a terminal condition, which means an irreversible, incurable, and untreatable condition from which there is no recovery and death is likely to occur without life-sustaining equipment, or in a permanently unconscious state, which means an irreversible condition in which you are permanently unaware of yourself or your surroundings. Two doctors must examine you and agree that you are in a terminal condition or permanently unconscious state. A Living Will Declaration also directs the attending doctor to make reasonable efforts to notify at least one of three contact persons listed in the document of the determination.

ANATOMICAL GIFTS DECLARATION AND DONOR REGISTRY

Gifting body organs and tissues is also a difficult end-of-life decision to leave to your loved ones. A few options are available to make your decision known in advance and relieve stress and discord among your survivors. If you wish to make gifts of body organs and tissues, it's possible to do so in the Living Will Declaration or Health Care Power of Attorney documents explained above. Ohio and all other states also maintain a separate "donor registry system" that makes your wishes known in a medical emergency. The Ohio Bureau of Motor Vehicles oversees the registration, allowing for immediate recognition on your driver's license that you authorize donations of body organs or tissues.

DISPOSITION OF REMAINS, FUNERAL ARRANGEMENTS AND BURIAL OR CREMATION

Ohio law allows you to appoint a person who can determine what happens to your body after your death, referred to as the "right of disposition." The appointment may grant a person the right to arrange for anatomical gifts, determine the location, manner, and condition of your funeral, and make burial, cremation, and similar decisions. You may also identify the source of funds to be used to pay for arrangements. Ohio law states that a person who acts according to the appointment cannot be held liable for following your preferences. Many courts and organizations provide a form for this type of appointment.

COMMUNICATE YOUR PLANS

Let others know about your Health Care Power of Attorney and advance directives so that the documents are used if a medical or end-of-life situation arises. Give copies to those you've appointed as agents and to your doctors, attorney, and religious advisor, and keep copies with your other important records. Discuss your decisions with family and close friends. Not knowing what you would want can create stress at a very difficult time, and communicating your wishes in advance will likely reduce that stress. Even if others don't agree with your decisions, sharing them beforehand could minimize the potential of conflict, misunderstandings, or a legal battle among family members.

RESOURCES AND REFERENCES

Ohio Revised Code Chapter 1337, Power of Attorney
https://codes.ohio.gov/ohio-revised-code/chapter-1337

Ohio Revised Code Section 2108.70, Assignment of rights regarding disposition of remains
https://codes.ohio.gov/ohio-revised-code/section-2108.70

Ohio Revised Code Chapter 2133, Uniform Rights of the Terminally Ill Act
https://codes.ohio.gov/ohio-revised-code/chapter-2133

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WILLS AND WILL-BASED FARM TRANSITION PLANS

Your will, or "last will and testament," is one way for you to determine what happens to your property after your death. A will is a necessary part of a farm transition or estate plan, but how it is used can vary widely. Some plans may need only a will in conjunction with a few simple tools—we refer to these as "will-based plans." Other plans, however, may be more complex and require additional legal tools. We explain wills and their role in farm transition planning in this bulletin.

WILLS SERVE MANY PURPOSES

The "reading of the will" after someone dies can be a dramatic event, with family members wondering what the will says and who gets what. Distributing property is just one purpose of a will, however. A will can have several helpful purposes, explained here.

Determining where property goes*.* A will transfers property after death according to a person's wishes. The terms of a will can be quite specific about how property passes. It can include restrictions and conditions tailored to the deceased person's wishes and can "disinherit" heirs that otherwise would receive property if the person did not have a will. A will can also include alternative plans in the event of changed conditions and circumstances.

Minimizing the probate process. A will sends clear directions to the probate court. Without a will, the court would otherwise have to determine how property should pass according to law. And as we explain later, a will can direct property to an existing trust and reduce the need to transfer it through the probate process. Both actions can reduce the time spent in probate, as well as the costs.

Choosing who administers the estate. A person can appoint an **administrator** to help settle the person's estate. The administrator, also called an executor or personal representative, will help resolve the deceased person's financial affairs and carry out the directives in the will. It is an important role, so it's critical to choose an executor carefully.

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Naming guardians*.* One critical role a will can play is to address who will care for dependents such as minor children and incompetent adults upon the death of their caretakers. Parents or other persons with dependents may nominate a guardian in the will, and the court will review that nomination when appointing a legal guardian. The will may also specify whether the guardian is to manage the dependent's personal needs, property, or both.

WHAT IF YOU DON'T HAVE A WILL?

Every state in the U.S. has an "intestacy law" or "statute of descent and distribution" that steps in when a person dies without a will and directs distribution of the person's property. As with other states, Ohio's intestacy law makes assumptions that the deceased would choose to give property to family members. The law establishes an order of preference that gives a surviving spouse first priority, then children of the deceased and their children. If there is no spouse or children, the law looks next to parents, then to other family members. The State of Ohio receives the property if there are no family members. Ohio law also gives the probate court authority to appoint an administrator to assist with settling the estate of a person who dies without a will.

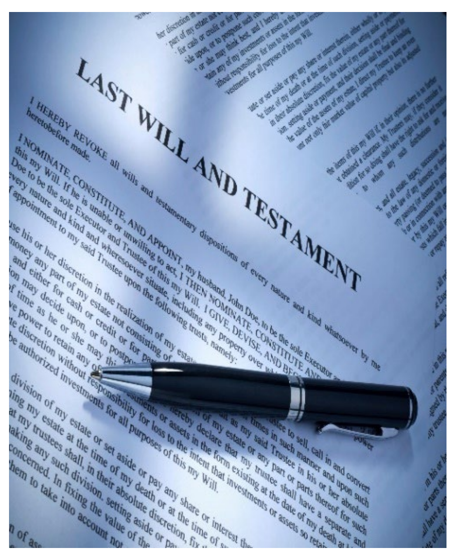
THE FORMALITIES OF MAKING A WILL

Requirements for making a will are straightforward but failing to meet them can result in a will being declared invalid. A person must be 18 years or older to make a will and be of "sound mind and memory" and "not under restraint." These terms mean that a person must know what he or she is doing and that making the will is a free and voluntary act. A will must be in writing, although it need not be typed, and the person making the will must sign it or if unable to do so, direct someone else to sign in their presence. Two or more witnesses must acknowledge that the person made and signed the will and must also sign the will in the presence of the person making the will.

Many "fill-in-the-blank" wills are freely available, but we advise working with an attorney to develop a will. Doing so will ensure not only that the legal requirements for making the will are satisfied, but more importantly that the will properly fits with the farm transition plan.

DIFFERENT TYPES OF WILLS

How a will distributes property can vary. A will can direct property to an identified party, send property to an established trust, or order a trust to be set up to receive the property. Here's an explanation of these three different types of wills:



A **simple will** directs all property to a surviving spouse or if the spouse is pre-deceased, then to the children. A simple will might also make specific bequests of property, name an executor, and appoint a guardian for minor children. The "simple" name for this type of will means that it does not involve a trust, making it less complex than wills that do. Some call this type of will a "sweetheart" will, because the plan is to leave all or most of the property to the deceased's sweetheart. The sweetheart then determines the fate of the property at his or her death.

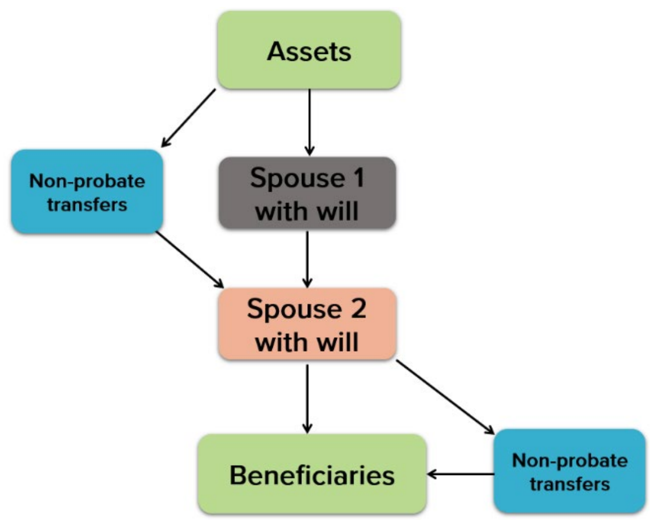
A **pour over will** transfers property to a "living trust" that was created prior to death. The assets "pour over" into the trust at death and the trust provisions then control what happens to the assets. This type of will is an important part of a trust-based plan and ensures that all property goes directly into the pre-existing trust rather than through the probate process.

A **complex will** directs the creation of a trust after death, referred to as a "testamentary trust." A testamentary trust might be simpler than a "living trust" and might only arise if certain conditions exist at death. For example, a simple testamentary trust could direct assets into a trust to support minor children if both parents pass. The trust only arises if the children are minors and both parents are deceased. Because a will creates the trust, the probate court would oversee administration of the trust by the trustee named in the will.

A WILL-BASED FARM TRANSITION PLAN

A plan can use a simple will to pass assets from one spouse to the next and then on to heirs. Other tools might be involved in the plan, such as transfer on death accounts, which we explain in our bulletin *Legal Tools for Avoiding Probate*. But the plan doesn't require the use of a trust. We refer to this approach as a **"will-based plan."** The illustration to the right shows how a will-based plan combined with non-probate tools can transfer farm assets to the intended beneficiaries. This approach can be sufficient for many people, but most often doesn't work well to address the complexities and assets of farm families and transitioning farm businesses.

A simple will-based plan



DO YOU ALSO NEED A TRUST?

Can you accomplish your plans for the future with a will-based plan? Or do you need a trust-based plan that uses a trust to help carry out the transition of your farm and assets? Those are "it depends" questions, as several factors come into play. The complexity of your situation is probably the critical factor that could lead you to a trust-based plan rather than a will-based plan. For example, if you have heirs with special needs, want to place certain conditions on heirs receiving property, need to address details ensuring transition of the farm to a specific heir, or are worried about federal estate taxes, a will-based plan may not be able to address your needs.

Likewise, you might prefer a trust because you want to avoid probate court involvement and have a trustee in charge of administering your affairs. You may also prefer to place details in a trust because of the privacy it offers in comparison to a will, which becomes an accessible public record when it goes through probate. Finally, legal fees are a factor. While a trust-based plan will likely cost more to create at the outset, it can keep assets out of probate and save on probate fees. A will-based plan is probably less expensive to create but could result in higher costs if assets must transfer through the probate process.

In the chart below, we outline how different factors play out in will-based versus trust-based plans. Discussing the factors with family and an attorney can be helpful. To learn more about trusts and using a trust-based plan in farm transition planning, see our other bulletin in this series, *Using Trusts in Farm Transition Planning*.

Comparing a will-based plan with a trust-based plan

Factor	Will-based plan	Trust-based Plan
Complexity of situation	Simple	Complex
Concerns about heirs	Little or none	Some or significant
Remarriage concerns	Little or none	Some or significant
Transition of operation	Little or none	Some or significant
Estate taxes	Little or none	Need to maximize savings
Probate	Don't mind; judge is in charge	Want to avoid; trustee is in charge
Privacy	Not important	Important
Cost	Less at outset; maybe more later	More at outset; maybe less later

UPDATING A WILL

How often should you update your will? It's important to be aware of circumstances that can trigger the need to review and update your will. Major life events are the most common triggers, including:

- Marriage, remarriage, or divorce in the family
- Birth of a child or grandchild
- Death of a spouse or beneficiary
- Change in health status
- Inheritance or other income that affects the value of your estate
- Moving to a different state
- Estate or tax law changes

WORKING WITH AN ATTORNEY

Many "fill-in-the-blank" wills exist but be wary of the one-size-fits-all approach they offer. An attorney plays an important role in developing a will that not only expresses your wishes but also addresses contingencies, considers the estate and tax laws that govern your estate, and fits the will into the overall farm transition plan. See our resources on choosing an attorney and talk with friends and family to find an attorney who will help you with the important task of creating a will that can carry out your plans for the future.

REFERENCES

Ohio Revised Code Section 2105.06, Descent and distribution
https://codes.ohio.gov/ohio-revised-code/chapter-2105
Ohio Revised Code Chapter 2107, Wills
https://codes.ohio.gov/ohio-revised-code/chapter-2107

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LEGAL TOOLS FOR AVOIDING PROBATE

The probate process serves the important purpose of administering a deceased person's estate. During probate, assets are accounted for, outstanding debts are paid, and property is distributed to heirs and beneficiaries, all with the oversight of the probate court. However, the probate process can be time consuming, costly, and open to public records. If these disadvantages of probate are a concern to you, note that there are other ways to distribute most your property to beneficiaries without going through probate. The law in Ohio allows you to make advance plans for transferring certain types of property outside of the probate process. In this bulletin, we begin by examining the costs of probate and then explain legal tools that allow you to avoid probate while guaranteeing that your assets transfer as you intend.

THE COSTS OF PROBATE

There can be time, privacy, and financial costs to sending farm assets through probate. In Ohio, it can take six months to a year or more for an estate to complete the probate process. Trying to continue a farm while its assets are tied up in probate for an uncertain amount of time can hinder a farming operation. Additionally, because a probate court oversees an estate going through probate, estate records are public records. Many consider this lack of privacy an additional cost of probate.

Of perhaps the most concern, however, are the financial costs for sending a farm estate through probate. The attorney that handles an estate can charge legal fees that are usually a percentage of the value of estate assets that go through probate. To limit the fees, Ohio law allows a county to set maximum probate fees attorneys can charge in the county. Even so, because farms tend to be "land rich," these legal fees can add up and amount to a significant cost. **Consider the example on the following page.**

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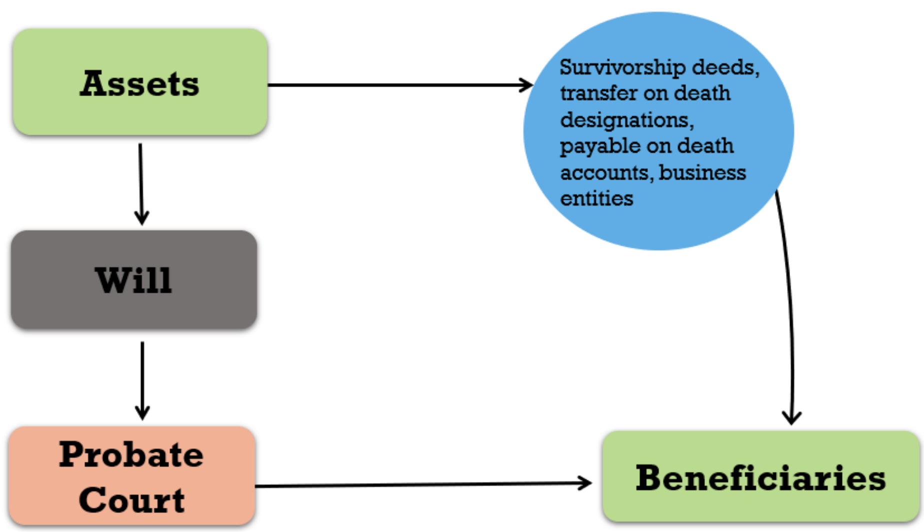
A county in Ohio sets the maximum fees an attorney may charge an estate in probate as:
For personal property including proceeds of real estate sold:
6% on the first $3,000
4% between $3,001 and $15,000
2% on the balance
For real property transferred but not sold:
2% on the first $10,000
1% on the balance
For all other property transferred: 2% of the property value

Joe dies owning farmland valued at $500,000. The attorney could charge Joe's estate $5,100 in fees to transfer the farmland to his beneficiary.

AVOIDING PROBATE

Fortunately, there are several legal tools that can keep a farm parcel like Joe's and many other farm assets out of probate, reducing not just the financial costs but also the time and privacy costs of transferring assets through the probate process. Survivorship deeds, transfer on death designations, payable on death accounts, trusts, and business entities are the most common of these tools. We discuss trusts in another bulletin in the *Planning for the Future of Your Farm* series. The other tools, explained below, send assets directly to the intended beneficiaries rather than transferring through the estate administration process in probate court. The illustration below shows how the tools can keep assets out of probate court.



SURVIVORSHIP DEEDS

Ohio law allows co-owners of real property to pass their share of the property to the surviving co-owner(s) upon death through a survivorship deed, also referred to as a "joint tenancy with survivorship rights." This type of deed is common in a marital situation, where the spouses own equal shares in the property and each becomes the sole owner if the other spouse passes away first.

A survivorship deed is useful for other joint ownership situations in addition to marriage, whenever the owners want to ensure that their share goes only to the other co-owners upon death.

The process for establishing a survivorship deed is simple. The property deed must contain language expressing the intent of the joint owners to have survivorship rights. The language signals that the property is to transfer automatically upon death of a co-owner, making it unnecessary for the property to go through probate to accomplish a transfer of ownership. **Consider this example:**

> John and Jane are married and own farmland. The deed to the farmland states "to John and Jane Doe for their joint lives, remainder to the survivor of them." This language indicates an intent for the property to pass to the surviving spouse if the other spouse dies. Upon John's death, the property automatically vests with Jane, who becomes the sole owner of the property. The property does not have to go through the probate process to transfer to Jane.

TRANSFER ON DEATH AFFIDAVIT

Another instrument for designating a transfer of real property upon an owner's death is the "transfer on death designation affidavit." This affidavit allows property to pass to one or more designated beneficiaries if the owner dies. The process is simple but requires a few forms and steps. First, the owner must complete the affidavit and file it with the recorder in the county where the land is located. Then, upon the owner's death, the designated beneficiary must complete an affidavit of confirmation and present it to the county auditor and county recorder along with a verified death certificate for the deceased owner. Once the county recorder files the affidavit of confirmation, the beneficiary holds title to the deceased owner's share of the designated property.

TRANSFER ON DEATH DESIGNATION AFFIDAVIT
[RC 5302.22]

STATE of OHIO
COUNTY of ______________

____, owner, with a marital status of________________, now owner of record of the following real property located at ____ as recorded at Instrument No. ____________________________of __________ County deed records, with the following legal description:

Title of record to the above property is held by owner(s) as follows:
____ Sole owner
____ Tenant(s) in common
____ Tenant(s) in survivorship
____ Tenant(s) by the entireties

Hereby designates the following as transfer on death beneficiary to receive the owner's title to that property upon the death of the owner:
____.

VEHICLES

Ohio law also allows motor vehicles, boat, campers, and mobile homes to transfer outside of probate with a transfer on death designation made by completing and filing a Transfer on Death Beneficiary Designation (form BMV 3811) at the county clerk of courts title office. The beneficiary may be an individual, corporation, organization, trust, or other legal entity.

There is a special rule for automobiles owned by a deceased spouse that did not include a transfer on death designation. Upon the death of a married person who owned at least one automobile at the time of death, the surviving spouse may transfer an unlimited number of vehicles valued up to $65,000 and one boat and one outboard motor by taking a death certificate to the title office and completing a Surviving Spouse Affidavit (form BMV 3773). It is important to note that the deceased spouse provision only applies to automobiles used "as a method of conveyance." Grain trucks, trailers and other commercial vehicles are typically not permitted to transfer using this method.

PAYABLE ON DEATH ACCOUNTS

Farmers may have several other types of accounts that can pass automatically to identified beneficiaries. Checking accounts, savings accounts, stocks and bonds, IRAs, life insurance policies, and similar types of accounts can pass outside of probate if designated by the owner as "payable on death." The institution that holds the account requires an owner to complete the institution's forms to make a payable on death designation. As with transfer on death affidavits, the institution will require the named beneficiary to provide a certified copy of the owner's death certificate before transferring the account to the named beneficiary, and the account need not go through the probate process. Institutions often ask for beneficiary designations when a person opens an account, but owners may forget about these designations or fail to change them as circumstances change. For these reasons, it is good practice to review and update your payable on death designations regularly.

BUSINESS ENTITIES

The many advantages of using business entities are well known but avoiding probate is an often-overlooked attribute of business entities. Ohio law allows business entity ownership to be transferred outside of probate by making a transfer on death designation. This is most commonly done with ownership certificates or within the operating agreement. Upon the death of the owner, the ownership is transferred to the designated beneficiary with a simple transfer business document.
Consider the following example:

> Andy and Betty own XYZ Farms LLC. Andy wishes for his ownership to transfer to Betty upon his death. To avoid probate, Andy and Betty create ownership certificates for the LLC. Andy's certificate is titled "Andy, transfer on death, to Betty". This simple certificate with this simple phrase causes Andy's ownership to pass to Betty outside of probate.

Business entity ownership certificates can be relatively simple and are often drafted by the attorney setting up the entity. The certificates do not need to be recorded; they remain private business documents. Existing entities without certificates can create new certificates for a transfer on death designations. Upon establishing a new entity, certificates should be drafted to allow for a transfer on death designation.

NON-TITLED ASSETS

As the above discussion shows, Ohio law allows titled assets to avoid probate rather easily. However, farms have many untitled assets such as machinery, equipment, livestock, crops, and grain. These assets can be made non-probate, but it will require either a trust or a business entity.

The non-titled assets can be transferred to a trust then distributed to beneficiaries without the need of probate. In a similar manner, non-titled assets can be transferred into a business entity and the entity ownership certificates made to include a transfer on death designation. If neither a trust nor business entity is used, the non-titled assets will likely need to pass through probate upon the death of the owner.

REVIEWING YOUR NON-PROBATE TRANSFER OPTIONS

It's surprising to learn how much of an estate can transfer to beneficiaries without going through the probate process. Whether you need a simple or complex transition and estate plan, these tools will likely contribute to your plan. Review your assets and their transfer options with your attorney to see how these tools can help you plan for the future of your farm.

REFERENCES

Ohio Revised Code Section 5302.20, Survivorship tenancy
https://codes.ohio.gov/ohio-revised-code/section-5302.20
Ohio Revised Code Section 5302.22, Transfer on death deed form
https://codes.ohio.gov/ohio-revised-code/section-5302.22
Ohio Revised Code Section 2106.18, Transfer of vehicle by surviving spouse
https://codes.ohio.gov/ohio-revised-code/section-2106.18
Ohio Revised Code Section 2106.18, Transfer on death designation for business entities
https://codes.ohio.gov/ohio-revised-code/section-1709.05

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PLANNING FOR THE FUTURE OF YOUR FARM

Legal tools and strategies for farm transition and estate planning

GIFTING ASSETS PRIOR TO DEATH

Gifting assets before your death may seem like an obvious strategy for those who want to transfer assets to their heirs. If you don't need the assets, why not transfer them now rather than after your death? It's true that gifting can be a good strategy for transferring assets, but gifting can have tax implications and transferring the same assets through an estate plan may be a better strategy. In this bulletin, we discuss how gifting works, gifts and taxes, and when it is advantageous to incorporate gifting into a farm transition plan.

WHAT IS A GIFT?

According to the Internal Revenue Service (IRS), a gift is property transferred to another without receiving the full value of the property in return. Just about any asset can be a gift. Cash is the most common gift but many farm families also gift machinery, livestock, grain, and land.

MAKING A GIFT

The process for making a gift depends upon the asset being gifted. Some assets can only be gifted by executing documents while other assets can be gifted by simply handing the asset over to the person receiving the gift. Here is a list of commonly gifted assets and how they are gifted:

- **Real estate.** May only be transferred with properly executed deeds.
- **Financial accounts**. Transfer forms must be completed with the financial institution.
- **Vehicles and trailers.** Title must be transferred, and a new title issued by the county Clerk of Courts title office. Note that some smaller trailers may not have titles.
- **Machinery, equipment, livestock, and grain**. These assets do not have titles, so they are transferred by giving possession of the asset to the giftee.
- **Cash.** Direct transfer of funds to the giftee.

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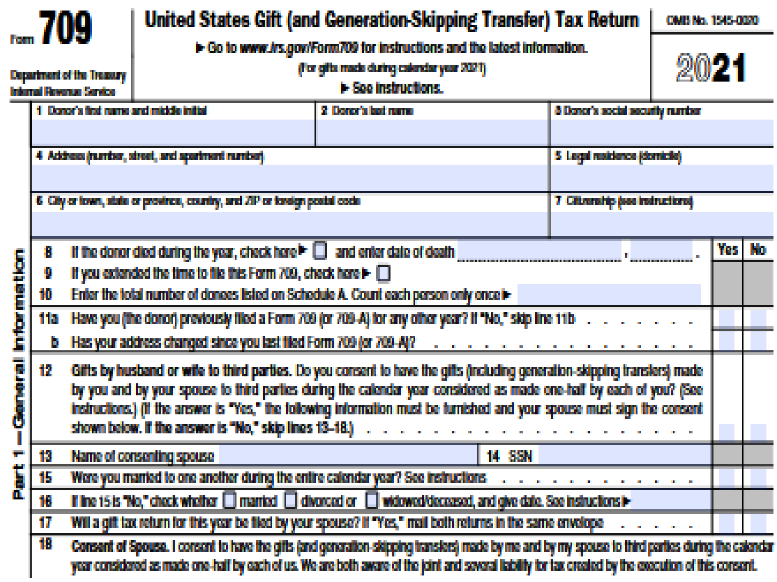
Regardless of what type of asset is gifted and how it transfers, it is good to keep a **written record** of the gift. Documenting the gift is important to avoid misunderstandings about what asset was gifted and helpful if there is an IRS audit. The written record should include a description of the gifted asset, the value of the gift, who is receiving the gift, and the date of the gift. For cash, consider using a check as further record of the gift. The person receiving the gift should also date and sign documentation to confirm that they have accepted the gift.

GIFTS AND TAXES

The gift tax. The federal government and many states assess a tax on gifts, but Ohio does not have a gift tax. The federal gift tax was developed to prevent individuals from avoiding federal estate taxes by gifting away significant assets prior to death. For this reason, it is the <u>giver</u> of a gift who is responsible for paying the gift tax. The gift tax begins at 18% on the first $10,000 and increases by 2% every additional $10,000, to 40% on gifts over $1 million. A giver uses IRS Form 709, pictured here, to document a gift that may be subject to gift tax.


Form 709
Department of the Treasury
Internal Revenue Service
United States Gift (and Generation-Skipping Transfer) Tax Return
▶ Go to www.irs.gov/Form709 for instructions and the latest information.
(For gifts made during calendar year 2021)
▶ See instructions.
OMB No. 1545-0020
2021

Part 1—General Information

1 Donor's first name and middle initial	2 Donor's last name	3 Donor's social security number
4 Address (number, street, and apartment number)		5 Legal residence (domicile)
6 City or town, state or province, country, and ZIP or foreign postal code		7 Citizenship (see instructions)

		Yes	No
8	If the donor died during the year, check here ▶ ☐ and enter date of death ______, ______.		
9	If you extended the time to file this Form 709, check here ▶ ☐		
10	Enter the total number of donees listed on Schedule A. Count each person only once ▶		
11a	Have you (the donor) previously filed a Form 709 (or 709-A) for any other year? If "No," skip line 11b		
b	Has your address changed since you last filed Form 709 (or 709-A)?		
12	Gifts by husband or wife to third parties. Do you consent to have the gifts (including generation-skipping transfers) made by you and by your spouse to third parties during the calendar year considered as made one-half by each of you? (See instructions.) (If the answer is "Yes," the following information must be furnished and your spouse must sign the consent shown below. If the answer is "No," skip lines 13–18.)		
13	Name of consenting spouse — 14 SSN		
15	Were you married to one another during the entire calendar year? See instructions		
16	If line 15 is "No," check whether ☐ married ☐ divorced or ☐ widowed/deceased, and give date. See instructions ▶		
17	Will a gift tax return for this year be filed by your spouse? If "Yes," mail both returns in the same envelope		
18	Consent of Spouse. I consent to have the gifts (and generation-skipping transfers) made by me and by my spouse to third parties during the calendar year considered as made one-half by each of us. We are both aware of the joint and several liability for tax created by the execution of this consent.		

Exceptions to the gift tax. The good news is that federal law grants many exceptions from the gift tax. A gift to a spouse or a political or charitable organization is not subject to the tax, nor is tuition or medical expenses paid for another. Additionally, federal law allows a certain value of gifted assets to pass free of gift taxes, referred to as the "annual exclusion." Gifts in excess of the annual exclusion may also be given tax free if they count toward the "lifetime exemption" from estate tax. Here's how these two types of gifts work:

1. **Annual exclusion gift.** The annual exclusion gift is truly a "free gift." A person may gift up to $16,000 annually to an unlimited number of people. These annual exclusion gifts have no gift or estate tax implications. Neither the person who gives or the person who receives the gift is subject to a tax. As an example, a person can gift $1 million tax free by giving the annual exclusion gift of $16,000 to 63 different individuals. Note that federal law indexes the annual exclusion gift amount and occasionally increases it by $1,000 as it did in 2022, when it increased from $15,000 to the current $16,000.

2. **Lifetime exemption gift.** Many people are surprised to learn that large gifts can also be free from gift tax by counting toward a person's lifetime exemption from federal estate tax. The lifetime exemption is the amount of wealth a person can have at death that is not subject to federal estate taxes, as determined by Congress and indexed and increased each year. For 2022, the amount is $12.06 million but in 2026, the current federal estate tax law is set to sunset and the exemption will be reduced by one-half.

Federal law allows the lifetime exemption to be "used up" during a person's lifetime. The amount of a gift that exceeds the $16,000 annual exclusion can reduce the giver's lifetime estate tax exemption by that amount when they die. If not, the amount of a gift over $16,000 can be subject to gift tax rates that start at 18% and increase to 40% on gifts over $1 million. People often choose to avoid the gift tax and reduce their lifetime exemption when making gifts over the annual exclusion amount.

The best way to explain these two important gift tax exceptions may be by using examples. **Consider the following examples**:

Example 1. John's net worth is $10 million at death and his lifetime exemption is $12.06 million. John's estate owes no estate taxes because his net worth is less than his lifetime exemption.

Example 2. John gives a single gift of $1 million to Daughter while alive and counts it toward his lifetime exemption. John's net worth at death is $10 million. The gift to Daughter was $984,000 over the $16,000 annual exclusion, which reduces his $12.06 million lifetime exemption by that amount to $11.076 million. John's net worth of $10 million at death is still less than his remaining lifetime exemption, so his estate will owe no estate taxes. The $1 million gift to Daughter was essentially a free gift because his net worth remained under the lifetime exemption.

Example 3. Same scenario as Scenario 2, but John dies with a net worth of $12 million. After the gift to Daughter, John's remaining estate tax exemption is $11.076 million. Now his net worth exceeds his remaining lifetime exemption by $924,000, so John's estate will owe federal estate taxes on that amount. John's large gift in this scenario had federal estate tax implications. Had he given Daughter the $1 million in smaller gifts to Daughter and her family over the years, John could have reduced the amount of

EFFECT OF GIFTING ON TAX BASIS

An asset's tax basis is generally the purchase price or its value when inherited, less depreciation taken. For example, a tractor purchased for $100,000 with $60,000 depreciation taken has a tax basis of $40,000 remaining.

The tax basis of an asset has significant tax implications. The higher the tax basis, the more depreciation can be taken and the less taxes owed when sold. Using the above example, if the tractor is sold for $70,000, the $40,000 tax basis is not taxed, only the $30,000 gain (sale price – tax basis) is taxed. The higher the tax basis, the less taxes are upon sale.

As noted above, the tax basis is usually established at time of purchase or inheritance. This is known as a "step-up" in tax basis because the tax basis is stepped-up to either the purchase price upon purchase or the fair market value upon death of the owner. This step-up in tax basis is particularly important when an asset is inherited because **when an asset is gifted, a step-up in basis does not occur**. For estates with no estate tax liability, an inherited asset with no estate tax also receives a full stepped-up tax basis. The person inheriting can re-depreciate the asset or sell the asset and pay no taxes on the sale, if sold for no more than the stepped-up tax basis. **Consider another example**:

> Bill inherited the tractor above from his father's estate. Prior to his father's death, the tractor had a tax basis of $40,000. The tractor appraised for $80,000 at the time of father's death, so Bill receives the tractor with a stepped-up tax basis of $80,000. Bill can either depreciate the tractor and offset $80,000 of income or sell the tractor for $80,000 and pay no tax on the sale. If Bill's father would have gifted the tractor to Bill during life, Bill would have received it with the lower $40,000 basis. From a tax perspective, Bill was better off inheriting the tractor rather than being gifted the tractor.

As these examples show, there can be negative consequences to gifting assets. Before gifting an asset, be sure to analyze all the tax implications of the gift. You may find that passing the asset by updating your estate plan is a better strategy for your heirs.

USING GIFTING STRATEGIES IN A FARM TRANSITION AND ESTATE PLAN

While gifting is not always the best tax strategy for farm transition plans, there are times when its advantages outweigh the loss of a step-up in tax basis. Gifting can be, and often is, an important part of a plan. The following scenarios illustrate situations where gifting can be a good option:

Transferring a depreciating asset. Sometimes the older generation owns machinery, equipment, livestock, or other assets that will lose value over time. Owning these types of assets also carries with them some degree of liability exposure. If an owner does not need income from the assets, it can make sense to transfer the assets now rather than upon death. In this situation, transferring the assets during life to remove the challenges of ownership outweighs the lost step-up in tax basis.

Gifting appreciating assets. For people who are close to or over the estate tax exemption, gifting appreciating assets can be a good strategy. If the asset is gifted now, the future appreciation of the asset is transferred out of the giver's estate. For example, a farm is gifted that is worth $1 million today but is expected to have a significant increase in value. When the value of the farm doubles, the additional $1 million in appreciation occurs in the giftee's estate rather than the giver's estate. The gift causes a loss of a stepped-up tax basis, but it is probably well worth it to avoid a 40% estate tax on the $1 million appreciation.

REVIEW GIFTING WITH YOUR LEGAL AND TAX PROFESSIONALS

Gifting can be a good tool to help build a farm transition plan, but sometimes it should be left in the toolbox. Be sure to have a discussion with your attorney and tax advisor before making any significant gifts. A thorough analysis can reveal tax implications for both you and the person receiving the gift.

REFERENCES

26 U.S. Code Subtitle B Chapter 12, Gift tax
https://www.law.cornell.edu/uscode/text/26/subtitle-B

26 U.S. Code Subtitle A Chapter 11, Estate tax
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PLANNING FOR THE FUTURE OF YOUR FARM

Legal tools and strategies for farm transition and estate planning

USING TRUSTS IN FARM TRANSITION PLANNING

Maybe you've asked the question, "should I have a trust?" It's a common question for farm families who are planning for the future of the farm. Trusts have become quite popular, with good reason. Trusts can be useful tools for keeping farmland in the family, avoiding probate, holding assets for minors, and more. But while a trust may have many applications and benefits, it may not always be the right solution for your farm transition goals. A careful analysis with your attorney and professional advisors is the best way to determine whether you need a trust. This bulletin offers explanations of trusts and illustrates roles they can play in farm transition planning.

WHAT EXACTLY IS A TRUST?

A trust is one of several tools that holds and transfers assets. Think of a trust as a container. You can place your assets in the container at any time—during life, immediately upon death, and after death. You can create terms and conditions in the trust. Then the assets are distributed out of the trust by the trustee according to the terms and conditions.

To help understand how a trust works**, consider the following example:**

> Andy establishes a trust for his land and includes the following provision: "Upon my death, my son Bill shall have the option to purchase the land. The purchase price shall be 75% of the land's appraised value. My trustee shall provide Bill written notice of his option to purchase the land within 60 days of my death. The purchase proceeds shall be distributed to all my children equally."

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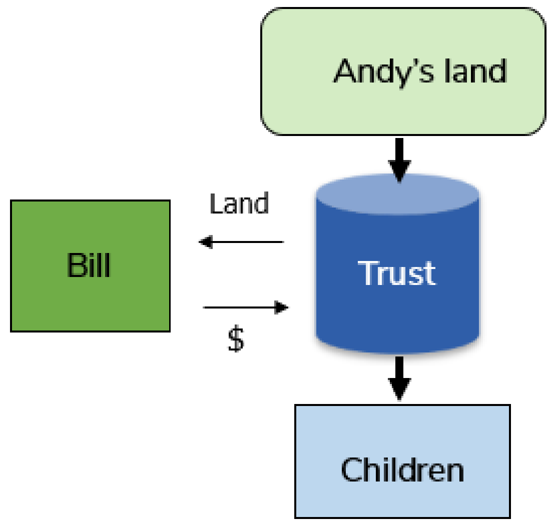
In this example, after Andy's death, his assets will be held in his trust and eventually distributed to out to his beneficiaries. While the assets are in the trust, the trustee will administer the terms and conditions of the trust as established by Andy prior to his death. Here's how the trust could play out:

1. The land goes into Andy's trust upon his death.
2. The Trustee provides Bill written notice that he has the option to purchase the land at 75% of appraised value.
3. Bill elects to buy the land and pays the purchase price to the trust.
4. The trustee distributes the purchase proceeds to all of Andy's children.



As the example shows, the trust is the container that holds Andy's assets. While the assets are in the trust, conditions can be placed on the assets which the trustee must enforce. Ultimately, after the conditions of the trust have been met, the assets flow out of the trust to the trust beneficiaries.

There are essentially no limits to the type and number of conditions that can be placed on assets as they flow through a trust. The conditions in the trust can be very simple, such as giving a beneficiary the right to buy an asset, to very complex, such as holding assets in the trust for multiple generations with restrictions on how the assets can be used. One of the key benefits of a trust is the flexibility it provides for planning because conditions can vary so widely.

HOW LONG ARE ASSETS HELD IN TRUST?

How long it takes from the time assets go into a trust until they leave the trust depends on a trust's conditions and purposes. Sometimes assets transfer through the trust within a few days, weeks, or months. Other times, assets may remain in a trust many years before being distributed.

Assets held in the trust only a short period of time may be assets needed by the next generation to continue farming. Holding assets such as machinery and livestock in trust may impede the ability of the next generation farmer to effectively operate the farm. **Consider the example on the following page:**

George is a farmer who owns farm machinery. Mary is George's daughter and the successor to the farming operation. George's trust provides that all farm machinery is to be distributed outright to Mary. George dies just as planting season is starting and Mary needs to use the machinery. The trustee distributes the machinery to Mary immediately so that Mary's farming operation is not interrupted.

As this example shows, it is possible for some assets to be held in trust only a few days. Because the machinery is to go directly to Mary with no additional conditions, the trustee is free to distribute out the machinery very quickly.

We pointed out above that assets can also stay in a trust for many years. Often, real estate is the most common asset to be held in trust for a long period. Farmers will sometimes require their land be held in a trust for an entire generation to keep the farmland available to future generations. **Consider the following example:**

George's land has been in his family for five generations. He does not want the land sold until his grandchildren have a chance to farm it. He establishes a trust with the following provision: "All of my farmland shall be held in trust for the benefit of my children. While the farmland is held in trust, my daughter Mary shall have the option to lease the land. Upon the death of all my children, the farmland shall be distributed to my grandchildren. At the time of distribution, any of my grandchildren who are actively farming shall have the option to lease the land."

In this example, the farmland will be held in trust for the lifetimes of George's children. Perhaps the land is held in trust for as long as 50 years. This is a perfectly acceptable way to use a trust.

As this discussion demonstrates, trusts can be used to hold assets just long enough to transfer them to a beneficiary or to hold assets for many years to meet the goals of the grantor. When considering the use of a trust, the amount of time that the assets will be required to be held in trust is an important consideration.

TRUSTS AND PROBATE AVOIDANCE

A primary characteristic of a trust is probate avoidance. Probate is a time-consuming process. It can take months or longer to administer an estate through probate, but a trust continues to operate without having to wait on probate. Probate can also be expensive.

As we discuss in our other bulletin in this series, *Legal Tools for Avoiding Probate*, we can avoid probate of titled assets without the use of a trust with payable-on-death or transfer-on-death designations. These assets include financial accounts, life insurance, vehicles, and real estate. But non-titled assets such as equipment, crops, grain, and livestock can only avoid probate by using a trust. Farms with substantial amounts of these non-titled assets can keep those assets out of probate by using a trust. **Consider the two scenarios in the following example**:

> *Scenario 1.* Jane owns a large inventory of farm machinery. For her estate plan, she has a simple will leaving the farm machinery to her children. When she dies, the machinery will be subject to probate. It will likely take several months, at a minimum, to complete the probate process to transfer the machinery to the children. Additionally, considerable legal fees will be required to file the appropriate forms with the probate court.
>
> *Scenario 2*. Jane elects to have a trust for her estate plan. When Jane dies, the machinery will be in her trust. Jane's trustee can distribute the machinery to Jane's children at any time after Jane's death. Other than perhaps a simple document recognizing the children's receipt of the machinery, the machinery can pass to the children with little effort and in a short amount of time.
>
> This example highlights the probate-avoiding benefits of a trust. For farm operations with large inventories of machinery, livestock, grain, crops and other non-titled assets, trusts will usually save significant time and legal fees by avoiding the probate process.

DO YOU NEED A TRUST?

A trust is not necessary for every situation; sometimes a simple will is adequate. Several factors can help with deciding if the benefits of a trust outweigh the extra costs and complexities of a trust. The following are a few of the more important factors to consider when making this decision.

1. **Complexity of plan**

Generally, the more complicated the plan the more likely a trust is the better option. Remember that assets that are subject to a will are also subject to probate court oversight. While probate courts provide an important service and do a good job of administering many estates, the probate process is also well known for being laborious and time consuming. Administering a complicated plan through a will and probate can get bogged down very quickly.

A trust is not subject to probate oversight. The trustee administers the trust with the oversight of only the beneficiaries. The administration of assets through a trust can often be done much more efficiently and quickly than probate. Trust administration does not have all the constraints and formality of probate. **Consider the following examples**:

> *Example 1.* Mike's goal is to have his farmland go to his three children equally with no additional conditions. A trust is likely not needed as the distribution plan is simple and straightforward.

Example 2. Mike would like all three of his children to benefit from his farmland. However, he wants his son Nick to have the option to purchase the other children's ownership interests. He also wants to set the purchase price at 80% of the appraised value and give Nick 10 years to pay for the land at the lowest allowable interest rate. A trust is likely the better option for this scenario because of the complexity involved with Nick's option to purchase. While this scenario could be done through probate, it would take much longer and likely incur significant legal fees. Instead, by using the trust, the trustee obtains an appraisal, makes the offer to Nick and collects the sale proceeds – all without the need to involve the probate court.

The more complex the estate plan becomes, the more likely a trust is the better option. Wills are the better option for people with simple plans, but most farmers do not have simple plans. Farmers often include options to purchase, leases, rights of first refusals, and many other complicated components in their plans. For many farmers, a trust will be the better option for their estate plan.

1. Transition of operation

One of the primary concerns of many farmers is the transition of the farming operation to the next generation. Trusts can allow the farming operation to flow to the next generation farmer quickly and efficiently. This quick and efficient transition can help ensure that the farming operation remains viable and profitable for the successor farmer. **Consider the following example:**

Linda owns a herd of beef cattle. Her intention is for her two children to inherit the cattle. Linda knows the cattle should be sold upon her death since her children have no interest in the cattle and have never helped with the cattle. Linda dies unexpectedly a week before her cows are to start calving.

Scenario 1. Linda dies with only a simple will that leaves everything to her children. Before the cattle can be sold, Linda's estate must be opened in probate court and an executor must be appointed by the court. Then, the executor must receive permission from the court to sell the cows. This process could take several weeks and in the meantime, the cattle have likely started to calve and there is no one to take care of the cattle or the new calves.

Scenario 2. Linda had set up a trust before her death which holds the cattle. Upon Linda's death, the trustee is able to immediately find a buyer and sell the cattle. All the cattle are sold to another beef operation before they begin calving.

This example shows how a trust can provide a better transition of the farming operation. In the first scenario the probate court was required to be involved, which could hold up the transition. In the second scenario the trustee had the authority to sell the cattle immediately upon Linda's death. The independence enjoyed by the trustee allows decisions to be made faster and actions to be taken quicker–both important to a smooth transition of the farming operation.

3. Concerns about heirs

Most people want to leave an inheritance to their heirs to help improve their lives and the lives of future generations. But sometimes, there may be concerns that the heir may not be able to manage the inheritance left to them or that it may be lost to frivolous spending or creditors. A trust can help ensure that an inheritance will be protected from mismanagement or loss.

A trust strategy uses a trustee to manage an heir's funds. The trustee can provide the heir with income and/or principal from the trust and can also limit the resources available to the heir to be sure it is not wasted. The assets can be held in trust until certain conditions are met, for a certain period, or for the life of the heir. **Consider the following example:**

> Nancy wants to leave her farmland to her two children, Paul and Oscar. Paul has never been able to manage his finances and spends every dollar that is available to him. Nancy is concerned that if Paul inherits the land he will immediately sell it to get money to spend on things he does not need. Nancy wants Paul's children to be able to enjoy and benefit from the land someday.
>
> Nancy establishes a trust. Upon her death, Paul's share of the land will be held in trust for the remainder of his life. Oscar, who is responsible and good with money, will be the trustee of Paul's trust. Oscar will manage the land on behalf of Paul and will release only the income generated from the land annually to Paul. The trust instructs Oscar not to sell the land and upon Paul's death, to distribute the land to Paul's children.

When facing a scenario in which the heir should not receive the assets directly, a trust is an excellent means to protect the assets. This strategy can be used to protect assets from issues that heirs may have such as drug/alcohol abuse, gambling, creditors, lawsuits, bankruptcies, spending problems, and marriage problems. Wills, conversely, provide limited options to protect assets for heirs.

4. Estate taxes

In the last decade, federal estate taxes have become less of a problem for farmers because the federal estate tax exemption has steadily increased. And many states, like Ohio, no longer have estate taxes. This means only a small fraction of farm families face the prospect of paying estate taxes. However, for those farm families who do face estate taxes, trusts are a near necessity.

A discussion on the intricacies and complexities of estate taxes and trusts is beyond the scope of this publication. However, it can safely be said that trusts provide opportunities to reduce estate taxes that cannot be accomplished by a will alone. This estate tax savings benefit is mostly applicable to married people because assets can be held in trust at the death of the first spouse. For unmarried people, trusts do little to reduce estate tax liability and thus a will may be an adequate solution.

5. **Privacy**

The process of probate is overseen by a probate court and all filings and information are open to public access. For some people, the idea of having information about their will, assets, and heirs be publicly available is not a big concern. For others, privacy is a priority.

Trusts can maintain privacy. Because a trust is a private document and only the trustee and beneficiaries are entitled to see it, a person's assets, beneficiaries, and distribution plan remains completely private. For individuals who wish their estate information to be private, a trust is a better option than a will.

6. **Legal fees**

Generally, trusts are more complex legal documents than wills and usually cost more in legal fees, although costs vary greatly from one attorney to another. However, the attorney and probate fees for implementing a will-based plan can be several times more than the costs to administer a trust-based plan. Before engaging an attorney to draft a will or a trust, be sure to understand what the total costs will be as this is an important factor in deciding between a will or trust.

OTHER BENEFICIAL CHARACTERISTICS OF A TRUST

There can be other benefits of incorporating a trust into your farm transition plan. We explain these additional benefits and considerations below. If any of these are important to your goals for the future of your farm, consider using a trust to accomplish those goals.

Control after death. A trust allows you to continue to control the assets after your death through the terms of the trust. For example, the trust could hold farmland after death and not allow that farmland to be sold for 50 years or more.

Planning for second marriages. In a blended family involving a second marriage after the loss of a first spouse, a trust can provide income and support for your second spouse if you pass away while keeping farm assets in your family. If your second spouse later remarries after your death, the trust could direct the assets to go to your children, whether from the first or second marriage, and the assets won't end up in your second spouse's new family. This strategy can keep farmland and other farm assets in your family in a second marriage situation.

Restrictions for minors. A trust can include provisions requiring your children to meet certain age requirements before they receive income from an asset or the asset itself.

Provide for heirs with special needs. Much like a trust can provide for a surviving spouse, a trust can manage funds and assets for loved ones with special needs like a handicap or disability who might not be able to care for themselves after you pass away. Appointing a trustee to manage the assets and income for your beneficiary gives you the assurance that your loved one will have the funds and care needed to live a comfortable life.

Giving to charities. In addition to providing for loved ones, you can also use a trust to support your passions. You can establish a charitable trust that names certain charities, or you can describe causes or issues you want to support with the trust assets.

GIVE CAREFUL CONSIDERATION TO TRUSTS

Trusts are valuable tools for farm transition planning. However, trusts are not necessary for every plan. Consider the benefits of a trust to determine if it is the best asset transfer tool for you. Your estate planning attorney can help guide you through the process.

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PLANNING FOR THE FUTURE OF YOUR FARM

Legal tools and strategies for farm transition and estate planning

USING BUSINESS ENTITIES IN FARM TRANSITION PLANNING

A formal business entity can be a valuable tool in farm transition planning. Many attorneys advise forming a formal business entity to limit liability and manage taxes, but an increasing number of agricultural attorneys have found that business entities are excellent tools for transitioning the farming operation to the next generation. We explain business entities and how they can be used in farm transition and estate planning in this bulletin.

BUSINESS ENTITY BASICS

The farm business can be an informal structure, such as a sole proprietorship, or can be formally organized, such as a corporation or limited liability company. Each type of entity has its own set of liability protections, tax issues, ownership transfer processes, and other characteristics.

Sole proprietorships and general partnerships. Sole proprietorships and general partnerships are the simplest business entities, and according to the U.S. Census of Agriculture, the majority of U.S. farms are one of these two types. They are business entities that generally require no filing of paperwork with a state. While the details may vary from state-to-state, the characteristics of these types of entities are fairly consistent nationwide. They afford no liability protection to the owners because any liabilities of the business are also the personal liabilities of the owner, and taxes are assessed directly to the sole proprietors or the partners at individual tax rates.

By default, if there is no formal business entity, an individual who owns lands, equipment, and other goods to make a profit will own those assets as a **sole proprietor**. The sole proprietor is the business, and the business is the sole proprietor. The business has no existence beyond the sole proprietor, so when the proprietor dies, the business ends and the assets are divided up through the proprietor's estate. A sole proprietorship has limited usefulness in a transition plan because entities that are separate from the owners are best suited for farm transition planning.

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If two or more people own land, equipment, and other goods to make a profit with no formal business entity, then they own the business as general partners in a **partnership**. A partnership may or may not have a formal written partnership agreement. In either event, Ohio's Uniform Partnership Act provides laws that govern partnerships in Ohio and provides default rules if the partners haven't addressed them in a partnership agreement. In the eyes of the law, a partnership is a "person" and can own assets and conduct business as a person would. Partnerships are typically more flexible and less formal than corporations. A partnership may and often does continue after the death of a partner. For these reasons, a partnership can be an effective component of a farm transition plan.

The simplicity of sole proprietorships and general partnerships come with the tradeoff of **no liability protection**. The sole proprietor is personally responsible for any liability of the business because there is no separation between the proprietor and the business. In a general partnership, all partners can be personally liable for any losses, debts, or mistakes related to the business and the other general partners. For example, if one partner signs a contract for the partnership, the other partners are bound to and personally liable for the contract.

Corporations. A corporation is an organized business entity with a separate legal status from its owners. Corporations have the right to buy and sell property, carry debts, enter into contracts, and more. This is why we hear the phrase "corporations are people." Shareholders own the corporation and typically elect a board of directors who in turn select officers to run the day-to-day operations of the corporation. Shareholders have limited liability and are only liable for losses up to their investment in shares.

State laws governing corporations can be rather complex and burdensome. The shareholders and board of directors must hold annual meetings and keep detailed records of meetings and activities. Corporations are typically governed by majority rule, such that the owners of 51% of voting stock decide how the corporation operates.

There are two primary types of corporations: C-corps and S-corps.

1. **C-corps** are taxed directly, but shareholders are also taxed on any dividend they receive, which results in double taxation. When people think of a corporation, they often think of C-corps.
2. **S-corps** are a sub-set of corporations with special rules. People often refer to these as closely held corporations because they may have no more than 100 shareholders and have pass through taxation. S-corps may not have corporate shareholders and can only issue one class of stock.

Limited liability companies. A limited liability company (LLC) combines features of partnerships and corporations, and many attorneys describe the LLC as the best of both worlds. Like a corporation, an LLC is an organized business entity that has a legal status separate from its owners with personal liability protection for the owners. Like a partnership, owners of an LLC can create flexibility in how the LLC is governed. For taxation, LLCs may choose to be taxed directly like a C-corporation or to pass taxes to the members as in a partnership or S-corporation.

LLCs are the entity of choice for most new farm businesses, for many reasons. We discuss the usefulness of LLCs in transition planning in the rest of this bulletin, but be aware that there are times when a partnership or corporation may be a better choice than an LLC. The concepts we discuss below can apply similarly to partnerships and corporations.

USING THE LLC FOR FARM TRANSITION PLANNING

LLCs allow for considerable creativity when designing a farm transition plan. Here are several roles an LLC can play in carrying out the goals of a farm transition and estate plan.

1. Protecting farmland

No asset is more important to a farmer than the land. An LLC can protect the land for future generations by preventing any one family member from forcing the sale of the land and making it difficult to transfer land unless the family collectively agrees to do so. But leaving land to family members outright to own jointly exposes family land to risk**.** That's because Ohio's **partition law** allows a co-owner of land to ask the court to sell the land and divide sale proceeds among the owners. A co-owner can seek partition regardless of what share they own, as can successor owners and creditors. With partition rights, the original co-owners and their spouses, heirs, and creditors all have the ability jeopardize the goal of keeping land in the family.

An LLC removes the risk of partition. Ohio law grants partition rights only to co-owners of land, not to co-owners of an LLC. When land is placed in an LLC, partition rights are extinguished because the LLC owns the land rather than the individuals co-owning the land. The owners of the LLC do not have the ability to use the partition law to force the sale of the land. **Consider the following examples!**

*Example 1***.** Mom and Dad want to leave their farmland to their three children. They have a simple will that gives all the land to the three children as co-owners. After the parents die, Arthur, one of the children, decides that he would rather have money than continue to own the land. The other two children are unable or unwilling to buy Arthur out at his asking price, so Arthur files a partition action. The court orders the land to be sold at a Sheriff's sale and the sale proceeds to be divided among the three children. The family no longer owns the land.

Example 2. As above, Arthur is a co-owner of the land given by Mom and Dad to the three children. Arthur gets into financial trouble and must sell his one-third of the land to pay his creditors. Arthur files for a partition so that he can receive his value of the land in cash to pay the creditors. The family no longer owns the land.

Example 3. Mom and Dad put their land in an LLC. Their three children inherit the LLC. Now, when Arthur wants to sell, he does not have partition rights. Arthur is an owner of the LLC, not a direct owner of the land. The only way Arthur can cash out is if one of the other owners agree to purchase his ownership. If Arthur gets in financial trouble, his creditors do not have partition rights and cannot force the sale of the land. At most, the creditors are only entitled to Arthur's share of the profits from the LLC. The family continues to own the land.

2. Discounting value

An LLC can be used to decrease the value of assets. This is important when a person's net worth exceeds the federal estate tax exemption. All wealth exceeding the federal estate tax exemption is taxed at 40%, so it is important to make all efforts to minimize the negative effect the estate tax can have on the goal of transitioning the farm to the next generation.

An LLC can decrease net worth with a concept called **discounting**. Essentially, the value of the ownership in a closely held company is discounted to be less than the value of the assets in the company. This is due to minority ownership, shared management, and transfer restrictions of the LLC ownership, all factors that reduce values. Discounts can be as high as 30-40%, which can minimize the risk of estate taxes being assessed on farm assets. **Consider this example**:

> Mom and Dad own a farm and their net worth exceeds the federal estate tax exemption by $1 million, so their heirs will owe $400,000 in estate taxes upon their death.
>
> Mom and Dad own 500 acres of land valued at $5 million. They put the land in an LLC, and each holds 50% ownership in the LLC. They also set up the LLC so that a decision requires a majority vote and ownership interests can only be transferred to direct family members. Neither Mom nor Dad have majority ownership or control, and each is limited as to whom they can transfer their ownership – all important factors to obtaining a discount.
>
> Let's assume a 35% discount applies to Mom and Dad's LLC ownership interest because the discounting factors exist. Now, instead of owning land valued at $5 million, they co-own an LLC worth $3.25 million. Mom and Dad have reduced their net worth by $1.75 million by placing their land in the LLC. They have given up little to receive a significant reduction in the value of their estate.

3. Designating management

An LLC can also designate the future managers of the farming operation or its assets. Not all beneficiaries of a transition plan may be qualified or willing to manage the farm's assets, or maybe the beneficiaries don't get along well and wouldn't make joint asset management decisions easily. An LLC can address these issues by determining who will have management and decision-making authority. **Consider this example:**

> Mom and Dad want their three children to jointly inherit their farmland. Two children live out-of-state and have never been involved with the farm while the third child lives locally and has been involved. Mom and Dad's transition plan transfers the land to an LLC, makes the children owners of the LLC, and designates the local child to be the manager of the LLC.
>
> The management provisions help ensure that the land will be managed properly and the out-of-state children's unfamiliarity with the land will not cause disruptions or poor decision making.

4. **Removing the need for a trust**

Many farm transition plans include a trust as the primary estate planning document, as we explain in other bulletins in this series. Using a trust can avoid probate and include terms and conditions for the distribution of assets at death. But in some cases, an LLC can negate the need for a trust. Like a trust, an LLC can avoid probate and contain ownership restrictions, management responsibilities and other terms and conditions. An LLC may also save time and legal fees. An LLC can replace a trust, or sometimes LLCs and trusts are used in combination in a transition plan. Before assuming that you need a trust, explore the possibility of using business entities instead. **Consider this example**:

Mom and Dad want their children land to inherit their farmland. They don't want the land sold outside of the family and want one specific child to manage the land. Instead of a trust, Mom and Dad establish an LLC with their required terms and conditions and make ownership of the LLC "transfer on death" to their children. The children inherit the LLC without going through probate and are subject to the transfer and management terms of the LLC. Mom and Dad accomplished their transition plan without the use of a trust.

5. **Balancing assets between heirs**

LLCs can also be used to balance assets between farming heirs and non-farm heirs. For farm families, it can be difficult to provide a fair inheritance to non-farm heirs without including at least some farm assets. Farm assets, such as land, can be put into an LLC. Then, the non-farm heirs are provided ownership in the LLC, perhaps even a majority. The farming heir is provided at least a small percentage of ownership and may have the ability to prevent the sale of the land or have an option to buy out the non-farm heirs. LLCs can provide non-farm heirs ownership of farm assets without the risk of those assets leaving the farm. **Consider this example:**

Mom and Dad own a farm business that includes machinery, livestock, and land. They have three children–Bill, Chris, and David. Only Bill is involved with the farm and will continue it after Mom and Dad's deaths. Like most farmers, Mom and Dad's wealth is almost entirely wrapped up in the farm. If Bill were to inherit all the farm assets, little value would be left for the inheritance of Chris and David. However, if Chris and David were to inherit two-thirds of the farm assets, it could jeopardize Bill's ability to continue a viable farming operation.

Mom and Dad establish an estate plan where Bill will inherit all the machinery and livestock. They form an LLC for the land and grant ownership shares to Bill, Chris, and David, with Chris and David receiving a larger share to offset the machinery and livestock Bill received. The LLC names Bill as the Manager and allows the land to be leased back to Bill.

In this scenario, the land LLC allows Chris and David to inherit farm assets without being able to interfere with Bill's farming operation. Chris and David will receive their share of the land rent, but Bill will retain control over the land. This strategy provides farm assets to non-farm heirs while leaving control of the farm with the farming heir.

FORMING A BUSINESS ENTITY

The internet is full of advice and fill-in-the-blank forms for forming a business entity. It's a decision that requires more than an internet search, however. Your attorney is a necessary resource not just for selecting an entity that carries out your goals, but for designing your entity so that it does what you want it to do. An attorney can tailor the legal documents for your business entity to your goals, ensuring that they contain the appropriate provisions and mechanisms to achieve those goals.

Choosing the right business entity for you, your family, and your farm is an important step in the farm transition planning process. An LLC is one type of entity that can help protect farmland, minimize estate tax risk, designate management authority, and keep assets out of probate. If any of these goals are in your farm transition plan, be sure to review them with an attorney who can help you design the entity that fits your plan for the future of your farm.

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AUTHORS OF THE PLANNING FOR THE FUTURE OF YOUR FARM SERIES

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PLANNING FOR THE FUTURE OF YOUR FARM

Legal tools and strategies for farm transition and estate planning

STRATEGIES FOR TREATING HEIRS EQUITABLY

Farm families often have children who have stayed on the farm and helped with the farm and operation. Should parents treat these children differently in estate and transition plans than they treat children who have left the farm? Is it fair to favor the on-farm children in your estate plan? Or should parents treat all children equally, despite their differing contributions to the farm? These questions raise the "equal versus equitable" decision many farm families face. It's not an easy one. In this bulletin, we present questions that can help a family work through the "equal versus equitable" debate. We also offer strategies on how to create an "equitable" plan if an equal inheritance is not the best solution for a farm situation.

"EQUAL" VERSUS "EQUITABLE" INHERITANCE

It's common for parents to assume that an "equal" division of assets among their heirs is fair. But it's also common for an equal division to raise issues of unfairness and cause problems for a farming operation. That's because a farm family's most valuable assets are usually the farm assets—its land, buildings, equipment, livestock, and crops—and an equal division of those assets could jeopardize the ability of heirs to continue farming. For example, some children may want to capitalize on their inheritance and sell their share of inherited farmland out of the family, making it difficult or even impossible for other heirs to have a viable farming operation. Additionally, an equal shares division may not reward heirs who've contributed sweat equity over the years, often adding value to the farm for the benefit of heirs who did not contribute to the farm.

An "equitable" approach might be a better solution for a farm family. An equitable approach recognizes that an equal division may not be fair or in the best interest of the farm and family. It operates on the belief that heirs are not automatically entitled to an equal share of the farm assets. Instead, parents may need to allocate assets fairly to accomplish their goals for the farm and family. For families with the common goals of protecting family land and ensuring a viable farming operation into the future, an equitable approach may be necessary.

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WEIGHING EQUAL VERSUS EQUITABLE APPROACHES

Whether to take an equal or equitable approach to inheritance can be a difficult decision. If you're trying to determine which approach is best for your farm and family, the following questions can help you weigh important factors that may lead you to an answer.

What are your goals for the farm? This is a good time to review what you're trying to accomplish for the future, such as leaving wealth for your heirs, protecting family land, or passing on a viable farming operation. Consider how each approach could affect those goals. Would an equal division of assets among your heirs help or hinder your goals? Is an equitable approach necessary to achieving your goals? You might be surprised to learn that taking either an equal or an equitable approach can significantly impact whether you can accomplish your goals.

Are your experiences getting in the way? We sometimes find in farm families that decisions of past generations can affect the emotions and decisions of current generations. For example, if your parents were not fair in how they handled their estate, you may feel you must be fair. Or maybe your grandparents' decision to equally divide up the farm assets ended the family farming operation and deprived you of the opportunity to farm. Consider how your own past experiences play into your situation and be aware that they might affect your judgment now.

Do any heirs want to continue the farm? If no one in the family cares whether the farm continues after you're gone, perhaps an equal division of assets is the appropriate approach. But do you know for certain if any heirs want the farm to continue? Have you discussed the issue with your heirs—including children and grandchildren? If you have raised the issue and know there are heirs who want the farm to continue, consider the next question.

Who wants to be involved with the farm in the future? The answer to this question can be very important, especially if you have several heirs. If all of your heirs want to remain involved in the farm in the future, an equal division may allow for that. But if there is a split between heirs who do and do not want to be involved in the farm, an equitable division may be necessary to protect the land and the farming operation.

Who has helped with the farm? Have all your heirs helped equally on the farm, or have some contributed more than others? Is there a child or a grandchild who willingly volunteers time to care for the land, maintain equipment, plant and harvest, or make capital improvements? Those who've helped have likely increased the farm's worth through their "sweat equity," making the assets more valuable for those who will inherit them. Do you want to consider contributions of sweat equity when dividing the farm assets?

Do you have farm and non-farm assets? Non-farm assets such as life insurance, savings accounts, other real estate, and retirement plans can help balance asset division between non-farm and farming heirs. Can you accomplish your goals by giving non-farm assets to heirs who do not want to be involved in the farm while giving farm assets to those who do? If not, are there opportunities to increase your non-farm assets? It may be helpful to consider investment strategies and generate non-farm assets.

Do some heirs need more inheritance than others? Not all equity issues are tied to farming issues. If you have an heir with special needs or limited income earning capacity, you may want to provide additional resources to meet their needs. An equal approach would likely not allow for special treatment. We address this issue in our bulletin in this series, *Strategies for Addressing Special Family Needs*.

Have you already given more to some children than others? Have you bought a new car for an heir, put another through college, given an heir farm equipment, or made similar contributions to an heir? Do you want to treat an heir who has received more during your life equally upon your death, or do you want to take lifetime gifts into consideration in your final estate plan?

STRATEGIES FOR CREATING AN EQUITABLE PLAN

Developing an equitable plan might require a bit more thought than a plan that equally divides assets among heirs. Many strategies can help with an equitable plan, however, as we discuss below.

1. Assign farm assets to on-farm heirs and non-farm assets to off-farm heirs

Use non-farm assets such as cash, investments, and life insurance for your off-farm heirs. This can allow you to give farm assets to those who want to continue the farm. **Consider this example:**

> Farmland, farm equipment and checking account goes to Child One, who wants to continue the farm. Savings and investment accounts go to Child Two, along with a life insurance policy to help balance asset distribution.

2. Include an option to purchase farmland or farm assets

When you know or expect that one or more heirs wants to own the farm, consider giving them the option to buy out the interests of the other heirs if they want and can do so. The non-farm heirs would then receive sale proceeds rather than assets. This approach is often used for land but can also work with other assets. **Consider this example:**

> Fred and Wilma know their child Sam wants to own the farm. They give Sam the option to buy the farmland at a specified price and require that the proceeds be distributed among all of their children. If Sam does not exercise the option, all children will receive an equal share of the farmland.

3. Include a right of first refusal on farmland and/or farm assets

A right of first refusal is like an option to purchase, but the heir's right to purchase arises if there is an attempted sale of the asset. Often, this comes into play when an heir who receives land wants to turn around and sell the land, but other heirs want the land to remain in the family. An heir that holds a right of refusal would have the first right to purchase the land before anyone else, and the other heir would still receive the proceeds from selling the land. **Consider the example on the following page:**

> "I leave the Smith Farm to my daughter Jane. However, prior to distribution, my Trustee shall provide a Right of First Refusal to my son John that gives him the first opportunity to buy the Smith Farm in the event Jane intends to sell the farm."

4. Include buy out terms for options to purchase and rights of first refusal

You may also set sale and payment terms for assets to ensure that a farming heir is able to make a purchase of farm assets. You could set the purchase price at a fixed dollar amount or use a calculation, such as 75% of the asset's fair market value as determined by appraisal. You can also allow installment payments over a number of years, such as a 10-year repayment, which can also help farming heirs afford the asset purchase while continuing the farm. **Consider this example:**

> "I leave the Smith Farm to my daughter Jane. However, prior to distribution, my Trustee shall offer my son John the right to purchase the Smith Farm. The purchase price shall be 75% of appraised value. John may elect to pay the purchase price in ten annual installments at the lowest allowable interest rate. If John elects to buy the Smith Farm, all sale proceeds shall go to Jane."

5. Name an on-farm heir as the beneficiary of a life insurance policy

Even with an option to purchase or right of first refusal, many farming heirs find it difficult to exercise their rights because of how much farm assets cost. Discounting and the ability to pay over a number of years helps, but sometimes they still need money for the purchase. A life insurance policy can provide an easy, relatively affordable way for an on-farm heir to buy-out off-farm heirs. It offers a way to expand the non-farm assets because the on-farm heir can collect on the policy and put the money toward exercising their options to purchase and rights of first refusal.

6. Calculate the sweat equity of your on-farm heirs

If you have on-farm heirs who have worked full or part time on your operation, you can calculate their contribution to the farm's value. This calculation can be based on the changed value of the farm operation since they started working for you and the proportion of the growth you believe resulted from their efforts. You can include this calculation to boost the on-farm heir's share of the farm equivalent to what they have contributed but have not fully been compensated for. **Consider this example:**

> June has worked on the family farm full-time since she graduated from college. In that time, the farm has increased in value by $1,000,000. Mom and Dad feel that June has contributed about one-half of the labor and management of the farm since she joined. They determine that June has $500,000 of sweat equity in the farm.

7. **Calculate the lost income of your on-farm heirs**

On-farm heirs often receive less money while working for the family farm than they would have received at an off-farm job. This may reflect the fact that they also received lodging, food, and other necessities. Nonetheless, the heir may have lost income that their off-farm siblings were able to earn by working off the farm. You can calculate what an heir might have made in another career and compare that number with how much they've received on the farm. Using the difference, you can boost the heir's share of the estate to an amount equivalent to what they would have made in another career.

8. **Gift assets while you are still alive**

You can begin the process of rebalancing your estate mix between farming assets and non-farming assets by gifting. You can also give a gift of ownership in a business entity. Note that some gifts may be subject to gift taxes. Learn more about gifting in our bulletin in this series, *Gifting Assets Prior to Death.*

9. **Create an LLC with two classes of owners**

With an LLC, you can name the LLC as the owner of farming assets such as land and equipment and designate ownership interests in the LLC to your heirs but create two types of ownership interests. Your farming heirs could be in the class of owners who run the day-to-day operation and control the assets, while off-farm heirs are in the class that only receives income from the LLC. We address LLC strategies further in our bulletin in this series, *Using Business Entities in Farm Transition Planning.*

10. **Use multiple entities**

Another strategy is to have both a land holding LLC and a second operating LLC that holds the equipment, employs the labor, and manages the farm operation. In this model, you can give some or all ownership in the land holding LLC to off-farm heirs and give the on-farm heirs ownership interest in the operating LLC. You can guarantee the on-farm heirs' access to the land with a long-term lease between the land holding LLC and the operating LLC. This strategy allows off-farm heirs to own and benefit from farm assets without interfering with the farming operation given to the on-farm heirs.

MAKING EQUAL VERSUS EQUITABLE DECISIONS

Ultimately, the decision on how to balance your estate and farm transition plan is up to you but it's a decision that can affect your farm and your heirs long into the future. As you weigh your situation and options, you can benefit by seeking input from others. Consider discussing your situation with your attorney and professional advisors, who can help you select the strategies that address your concerns and move your vision forward. Communication with your heirs is important also, as you will need to know whether heirs want to engage in the farming operation after you are gone. Time spent assessing these issues will help ensure that you're planning for the future of your farm.

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STRATEGIES FOR TRANSFERRING EQUIPMENT AND LIVESTOCK

Machinery and livestock can be the most challenging farm assets to transfer to the next generation. That's because transferring these assets during life can have negative tax implications but waiting to transfer them at death can have timing issues for the farming operation. For many farmers, there is no perfect solution. However, there are several strategies that can pass your machinery and livestock to the next generation while addressing your goals for your farm transition situation. In this bulletin, we present these strategies and review the advantages and disadvantages of each.

DETERMINE YOUR GOALS

While land is often a farm's most valuable asset, equipment and livestock are also significant assets on a farm's balance sheet. What are your goals for these assets? Assessing your current situation and determining your goals for transferring equipment or livestock is an important step in planning for the future. Ideally, your equipment and livestock goals will fit well with the other pieces of your farm transition or estate plan.

Consider these questions to help define your goals:

- Do you need income from the assets? If so, when do you need that income?
- Do you want to transfer the assets now to help the next generation?
- Do you want to keep control of the assets until your death or use them to some degree?
- Do you want to reduce your costs and liability risks for the assets?

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STRATEGIES TO IMPLEMENT YOUR GOALS

If you have a good idea of your goals, consider the different strategies that can help you accomplish those goals. Each strategy has advantages and disadvantages and analyzing these factors can help you decide which strategy best fits your goals and your farm transition plan. This can be a cyclical process, where understanding the implications of a strategy might alter your goals for transferring the assets.

1. Outright sale

Selling the assets outright is always an option. The advantages of an outright sale are that it generates income and relieves the owner of liability and the costs of maintenance. Additionally, selling now allows the next generation to use the assets for their current farming operation.

As for disadvantages, selling equipment and livestock means you no longer control that asset. Especially for equipment, you may have to buy, lease, or borrow in the future if you still have need for the equipment. However, the major disadvantage to selling equipment and livestock outright is that it will likely create a significant tax bill if the assets have little or no tax basis. When the assets are sold, there can either be capital gains or depreciation recapture issues. **Consider the following example:**

> Farmer bought a tractor for $100,000 and has taken $90,000 of deprecation on the tractor. Farmer sells the tractor to Daughter for $70,000. Farmer will pay ordinary income tax on $60,000 of depreciation recapture, which is the sale price less the remaining tax basis in the tractor ($70,000 - $10,000 = $60,000).

2. Installment sale

Installment sales provide the benefit of income but instead of generating that income all at once, you receive it through a number of payments over a certain period of time. This period could be months or even years, giving you a steady flow of income. But an installment sale often advantages a buyer because it can help the buyer meet cash flow needs. If you're trying to transition the operation to the next generation, an installment sale is likely to help them be able to purchase the assets.

A disadvantage of an installment sale is that you still run into the problem of depreciation recapture. Even though you receive income over a period of time, the Internal Revenue Service (IRS) considers an installment sale to be complete in the year of you transfer the asset. You must pay all depreciation recapture that first year. Installment sales should be closely scrutinized with a tax professional. Many farmers who make an installment sale without tax advice may be unpleasantly surprised that the recapture is due in year one. **Consider the example on the following page**:

Farmer sells his tractor to Daughter for $100,000, with $25,000 due now and $25,000 due every January 1 for the next three years. Farmer has completely depreciated the tractor so that it has a $0 tax basis. The sale will create $100,000 of depreciation recapture (sale price of $100,000 less remaining tax basis of $0). The IRS treats Farmer as having realized a $100,000 financial gain in the year of the sale. Even though Farmer will not receive the full $100,000 for three years, Farmer must pay the full income tax on the depreciation recapture in year one.

3. Gifting

If you do not need income from your equipment or livestock and there is someone you wish to receive the asset, gifting may be a good strategy. Because you are not gaining financially from the gift, there are no capital gains or depreciation recapture taxes due on the transfers. There may be federal estate tax implications in the future, however. Gifts exceeding the annual gift tax exclusion allowance, currently $16,000 per gift, will either trigger a gift tax or reduce your federal estate tax exemption. Also, the person receiving the gift does not receive a stepped-up tax basis in the asset. For a detailed discussion on the strategies and implications of gifting, see the *Gifting Assets Prior to Death* bulletin in this series.

4. Inheritance

Anther strategy if you do not need income from the asset is to transfer it at death through your estate. This strategy gives you control of the asset until your death, so is useful if you still need the asset. One disadvantage is that you remain responsible for maintenance, repairs, and liability.

There are clear advantages to the heirs who receive equipment and livestock through inheritance—the assets will have a stepped-up tax basis equivalent to the fair market value of the asset at the date of death. By inheriting the asset with a stepped-up basis, the recipient can re-depreciate the asset or sell it right away and pay little or no taxes. **Consider the following examples**:

Scenario 1. Farmer owns a tractor that he had fully depreciated. When Farmer dies, the tractor's fair market value is $100,000. Daughter inherits the tractor. She receives the tractor with a stepped-up tax basis of $100,000. She now has $100,000 she can use for depreciation, or she can sell the tractor for $100,000 and have no tax on the sale since the tax basis and sale are both $100,000 and there is no gain to tax.

Scenario 2. Farmer gifts the tractor to Daughter while he is still alive. Daughter receives the tractor with Farmer's $0 tax basis. She cannot depreciate the tractor and if she sells the tractor, she will pay income tax on the depreciation recapture.

5. Lease-to-own

A lease-to-own agreement appears similar to an installment sale in that the owner receives income from the arrangement over time and the buyer possesses the equipment, but a primary difference between an installment sale and lease-to-own is the tax implications. The tax treatment of a lease-to-own agreement differs from an installment contract in two ways. First, the IRS considers the lease payments that the owner receives to be ordinary income taxable in the year received. Second, the lease payments are fully deductible to the buyer. Another difference is that the purchase in a lease-to-own strategy occurs at the end of the lease term. Instead of having to pay all the depreciation recapture up front, the owner pays these taxes at the end, when the value of the machinery has significantly declined. While the IRS assesses all taxes on the gain from an installment contract in year one, a lease-to-own agreement allows you to spread out the tax burden. **Consider the following example:**

> Farmer owns a tractor valued at $100,000. He leases the tractor to Daughter for seven years for $10,000/year. Farmer also gives an option to Daughter to buy the tractor at the end of the lease. The value of the tractor will be determined at the end of the lease when its value is less.
>
> Farmer will report $10,000 of income for each year of the lease. Farmer will pay depreciation recapture on the sale at the end of the lease, based on the value of the tractor at that time.

There are a few possible disadvantages to a lease-to-own agreement. First, the owner continues to retain ownership of the asset until the term of the lease has ended and the purchase is complete. By continuing to own the asset, the owner retains liability for it. This liability can be limited with liability insurance or an LLC. Second, the owner may still be responsible for maintenance and repair depending upon the terms of the lease arrangement.

Compared to other strategies, a lease-to-own agreement is also a bit more complicated because it requires the preparation of a lease and a later sales contract with a method for determining the purchase price when the lease ends. It is important that the lease be legitimate and charge a reasonable lease rate. Also, the option to purchase the lease asset at the end of the lease must use a reasonable method to determine the value of the asset at the end of the lease. Leases and options that use less than fair market value can be scrutinized and challenged by the IRS.

6. Transfer to a Limited Liability Company

A Limited Liability Company (LLC) can be a useful tool to transfer equipment. In this scenario, the owner transfers the machinery into an LLC. Then, the owner sells a percentage of the LLC each year to the recipient. The sale of the LLC ownership spreads out the potential tax liability and provides some liability protection to the owner. **Consider the following example on the next page:**

Farmer owns several pieces of machinery worth $500,000. He transfers the machinery into an LLC. He then agrees to sell 10% of the LLC each year for the next 10 years to Daughter.

Generally, the sale of the LLC ownership will be subject to capital gains. However, the tax paid on the sale depends on the type of asset in the LLC and other factors. The tax implications of the strategy should be fully explored with a tax professional.

There are two potential disadvantages of this strategy. First is the cost of setting up a new LLC and administration costs of operating an LLC. Second, this strategy causes the owner to become a business partner with the recipient for as many years as the transition takes.

ASSESSING THE STRATEGIES

There are many strategies for transferring ownership of equipment and livestock out of your hands and to the next generation. Using one or a combination of strategies might help you accomplish your goals. Assess each scenario carefully with your professional advisors and heirs to find those strategies that accomplish your goals for planning for the future of your farm.

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FARM TRANSITION PLANNING STRATEGIES FOR SECOND MARRIAGES

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Second marriages present unique challenges for farm transition planning. This is especially true when the second marriage occurs later in life and the spouses have accrued significant assets and/or have children from prior marriages. The spouses in a second marriage obviously want to help provide for each other but may have a competing interest of providing for their children but not necessarily stepchildren. Without good planning, it is possible that farm assets will end up with a spouse or stepchildren who were not involved in the farming operation.

This bulletin will look at the two most common sources of risk to farming operations when a second marriage is involved – death and divorce. While these risks cannot be eliminated, there are strategies to help minimize the risks to ensure, as best we can, that farm assets stay with the farm family. The following is a general discussion of these strategies and how they can be integrated into a farm transition plan.

1. Death of a Second Spouse

Balancing the Need to Provide for Spouse and Children

One of the challenges with second marriages occurs when one or both spouses have children from a prior marriage. The spouses usually intend to provide adequate income to the surviving spouse upon the death of the first spouse to pass away. Also, the spouses will usually want some or all of their assets to ultimately go to their children, not their spouse's children. So, the issue becomes, how to establish a plan to take care of the surviving spouse while ensuring the deceased spouse's assets go to their own children?

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Consider the following example, a typical second marriage, farm transition scenario:

> *Mark and Mindy each have two children from previous marriages. Mark has farmed his entire adult life and built a large farming operation prior to marrying Mindy. Mindy has two children and is not involved in the farming operation. Mark's two children plan to take over the farming operation. If Mark dies before Mindy, he wants to make sure Mindy has adequate income for the rest of her life. However, he wants his assets to be inherited by his children and not Mindy's children.*

Let's first look at what poor planning might look like. If Mark and Mindy do not have an estate plan or a simple estate plan where everything goes to the surviving spouse then to the children, Mindy's children could end up with some or all of Mark's assets. In this scenario, if Mark dies first, all of his assets will go to Mindy. At that point, Mindy will have total control of the assets and could sell them all or leave them all to her children. For second marriages, no plan or a simple plan is usually not adequate to meet the goals of a farm transition plan.

Trusts Can Provide Options

The better plan is to use a trust. A trust can hold the deceased spouse's assets for the surviving spouse's life, thus providing income. Then, at the surviving spouse's death, the assets are distributed to the deceased spouse's children. The surviving spouse never has ownership of the deceased spouse's trust assets, so the assets are never in danger of ending up with the surviving spouse's children.

Continuing the previous example, Mark establishes a trust with the following terms:

> *"Upon my death, my farm assets shall be held in trust for the life of Mindy. While held in trust for Mindy, my Trustee shall distribute all income to Mindy. Upon the death of Mindy, my Trustee shall distribute the assets to my children."*

These trust provisions will meet Mark's goals of providing for Mindy while ensuring that his children eventually inherit his assets.

Sometimes we may want some assets to go directly to the deceased spouse's children at death and some to be held in trust. This is quite common for farm plans. When children will be taking over the farming operation, we may not want to tie up the operating assets in trust but instead have those go directly to the farming children. To implement this plan, the trust may have provisions similar to the following:

> *"Upon my death, my Trustee shall distribute all my farm machinery, grain, crops and other farm operating assets to my children. The remainder of my assets, including my farmland, shall be held in trust for Mindy. While held in trust for Mindy, my Trustee shall distribute all income to Mindy. My Trustee shall offer to lease the farmland to my children for 80% of the county cash rent average. Upon the death of Mindy, my Trustee shall distribute all remaining trust assets to my children."*

These trust provisions allow the farming operation to be inherited directly by Mark's children, allowing a seamless transfer of the farming operation. The farmland is held in trust and leased by the children. The rental income from the farmland is provided to Mindy for the remainder of her life.

A third variation provides some assets outright to the children, some assets outright to the surviving spouse and some assets held in trust. This type of plan might be used when the spouses wish for some assets to go directly to the surviving spouse, without being held in trust. This is often done with cash or other financial accounts to provide immediate and freely available money to the surviving spouse. Trust provisions reflecting this type of plan may be as follows:

> *"Upon my death, my Trustee shall distribute all my farm machinery, grain, crops and other farm operating assets to my children. My Trustee shall distribute my First National Bank account and Acme Financial Account to Mindy, outright and free of trust. The remainder of my assets, including my farmland, shall be held in trust for Mindy. While held in trust for Mindy, my Trustee shall distribute all income to Mindy. My Trustee shall offer to lease the farmland to my children for 80% of the county cash rent average. Upon the death of Mindy, my Trustee shall distribute all remaining trust assets to my children."*

These trust provisions provide cash to Mindy for which she has immediate access and control. The farm assets continue to go directly to the children so that they can continue the farming operation and the farmland is held in trust to provide income for Mindy.

A trust can be designed with a great deal of flexibility and creativity. The surviving spouse can be provided with adequate income while protecting the assets for the deceased spouse's children. A simple transition plan or no plan at all can result in some or all the deceased spouse's assets being inherited by the surviving spouse's children. Trusts are often an important component of a farm transition plan for second marriage scenarios.

2. Divorce

In the divorce process, assets are divided among the soon-to-be ex-spouses. Sometimes the division of assets can be done in a cooperative manner and sometimes the division of assets is contentious and ultimately decided by court order. In either case, dividing assets for a divorce is stressful and unpleasant. Before entering a second marriage, a prenuptial agreement should be considered. For spouses who are already married, postnuptial agreements are also an option.

Marital Versus Separate Assets

To address the issue of divorce, it is first helpful to know what assets are subject to a divorce. According to Ohio law, marital assets are to be divided "equitably" in the event of a divorce.[1] Equitable does not necessarily mean equal although an equal division of marital assets between the spouses is often the result. Divorces can be especially threatening to farmland because of the "land rich, cash poor" dilemma for farmers. In a farm divorce, it is usually not equitable for one spouse to receive all the farm assets if there are not sufficient non-farm assets for the other spouse. Thus, both spouses may receive farmland in the divorce settlement. Once the farmland is divided, either spouse can sell or transfer the land out of the family.

It is important to note that Ohio law only requires "marital" assets to be divided. Non-marital assets, referred to as "separate" assets, are retained by the spouse who brought the assets to the marriage.

[1] ORC 3105.171(B)

Understanding the difference between a separate asset and a marital asset is critical when attempting to mitigate the risks of divorce.

Separate assets include the following:

- Property acquired by a spouse prior to the date of the marriage.
- Passive income and appreciation from separate property received by a spouse during the marriage.
- An inheritance received by a spouse during the marriage.
- A gift received by a spouse during the marriage.

The above list would seem to make it an easy exercise to determine which assets are marital and which are separate in a divorce situation. However, like many legal issues, the application of the concept is more complicated than it may appear. This is because Ohio law also provides that income or appreciation on separate property can become a marital asset.

Ohio law includes as marital property:

> *"... all income and appreciation on separate property, due to the labor, monetary, or in-kind contribution of either or both of the spouses that occurred during the marriage.[2]"*

So, it is possible for an asset to be partially separate (the initial property) and partially marital (the income and appreciation on the property).

Consider the following example:

> *Andy and Beth are farmers in the process of divorcing. Shortly after they were married, Beth inherited a 100-acre farm from her grandmother. When she inherited the farm, it was valued at $600,000. A few years after inheriting the farm, Andy and Beth's farming operation paid for and installed $80,000 of drainage tile on the farm. The current value of the farm is $1 million.*

In this example, the farm was Beth's separate asset upon inheritance. However, the tile that improved the quality and value of the farm was a result of Andy and Beth's joint farming operation. Andy likely has a valid claim that at least part of the $400,000 increase in value is a marital asset due to the tile installation.

Perhaps Andy further argues that most of the increase in value was due to fertilizer, tillage and other soil improvements made while Andy and Beth farmed the land. It is in Andy's interest to make the $400,000 increase in value a marital asset. Conversely, Beth could argue that the increase was not a result of the marital farming operation but was merely a passive value increase due to market pressure. It is in Beth's interest to argue the $400,000 increase as her separate asset.

[2] ORC 3105.171(A)(6)

As this example illustrates, an asset that is initially a separate asset can become, at least in part, a marital asset. Both Andy and Beth have valid arguments. It is not hard to imagine how much time and legal fees could be spent resolving or litigating the issue in a contentious divorce.

Co-mingling assets can also cause a separate asset to become a marital asset. If the spouse owning the asset voluntarily allows the other spouse to become an owner of the asset, it is likely to become a marital asset. Using the example above, after Beth receives the farm, she adds Andy's name to the deed as co-tenant. Because she voluntarily added Andy to the deed and gave him half ownership, Beth has likely changed the property from a separate to a marital asset.

Another example might be as follows:

> *Beth receives a $100,000 inheritance from her grandmother. Beth deposits the money in a bank account owned by both her and Andy.*

By co-mingling the inherited money with other money owned jointly with Andy, Beth has probably made the $100,000 inheritance a marital asset. If Beth would have deposited the money in an account owned only by her, the inheritance would have remained a separate asset. While co-mingling does not automatically make an asset become marital property, the spouse owning the asset should avoid co-mingling if wanting to keep the asset separate.

Assets acquired during a marriage will almost always be considered marital property. This is true even if one spouse provided little or no contribution towards the acquisition of the asset. Ohio law considers marriage to be a sort of equal partnership regardless of the contribution of the spouses. For example, farmland purchased during the marriage will be a marital asset even if only one spouse operates the farm and the other spouse is not involved with the farmland or farming operation.

Prenuptial and Postnuptial Agreements

A prenuptial agreement can help alleviate issues with marital assets. This type of agreement, entered into prior to marriage, designates what assets each person is bringing to the marriage, what assets will be separate, and what assets will be marital. Especially for people who have accumulated some wealth prior to marriage, a prenuptial agreement is a good option to avoid future disputes regarding the nature of assets in a marriage and potential risks to farmland.

To be valid and enforceable, a prenuptial agreement should:

1. Be in writing and signed by the parties;
2. Be prepared, reviewed, and executed long before the marriage;
3. List each spouse's assets, including values;
4. Be reviewed by separate attorneys representing each spouse.

Prenuptial agreements can become outdated, especially when marriages last many years. A married couple who enters into a prenuptial agreement when they are 25 may have very different assets and goals when they are 65. Until recently, a married couple in Ohio was stuck with their prenuptial agreement regardless of how unfair or obsolete the agreement had become. Recently, legislation was adopted to allow for postnuptial agreements.

A postnuptial agreement is similar to a prenuptial agreement in that it identifies which assets are to remain outside of the marriage and what assets are considered joint, marital assets. A postnuptial agreement is signed sometime after marriage begins. There are no term requirements for a postnuptial agreement – it can be entered into shortly after marriage or many years after marriage.

For a prenuptial agreement to be terminated or amended or for a postnuptial agreement to be valid, the law requires the following:

1. The agreement must be in writing and signed by both spouses;
2. The agreement is entered into freely without fraud, duress, coercion or overreaching;
3. There was full disclosure, or full knowledge, and understanding of the nature, value and extent of the property of both spouses;
4. The terms do not promote or encourage divorce or profiteering from divorce.

For people who are considering getting remarried or for those who are already remarried, a prenuptial or postnuptial agreement should be considered. These agreements can establish how assets are to be divided in the event of a divorce and perhaps relieve some worries regarding farm transition planning. Prenuptial and postnuptial agreements should be drafted in consultation with an attorney.

Summary

Second marriages can have significant consequences to farm transition planning. The optimistic anticipation of being remarried could be somewhat tempered by trepidations of the effect on the future of a farming operation. Through the use of trusts and prenuptial and postnuptial agreements, second marriage risks to the farming operation can be substantially reduced. An attorney familiar with farm transition planning and second marriage issues should be consulted to help establish the best plan for the soon-to-be married couple.

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RETIRING FROM FARMING: CHARITABLE REMAINDER TRUSTS AS A RETIREMENT STRATEGY FOR FARMERS

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One of the primary challenges for a retiring farmer is the large tax burden that retirement may cause. Throughout their farming careers, farmers do a good job of managing income taxes, in part, by delaying sales and prepaying expenses. This strategy works well while the farm is operating but can cause significant tax liability upon retirement. The combination of a large increase in revenue from the sale of assets and little or no expenses to offset the revenue can cause a retiring farmer to be pushed into high tax brackets. It is not unusual for 40% or more of the sale proceeds from a retirement sale to go to taxes. One strategy to reduce income tax liability at retirement is a Charitable Remainder Trust (CRT). A CRT can be an effective way of managing income taxes at retirement, but it is not for everyone.

THE CRT STRATEGY

A CRT is a charitable trust because at least some of the assets in the CRT must eventually pass to a qualified U.S. charitable organization such as a church or 501(c)(3) corporation. This charitable nature of the CRT is central to the CRT strategy. As a charitable trust, the CRT may sell assets without paying tax on the sale. So, instead of the retiring farmer selling assets in their own name, they donate the assets to the CRT and then the CRT sells the assets. The retiring farmer then receives an income stream from the CRT. After a period of time, the income stream stops and the remaining trust assets are contributed to the named charity. The following are the steps of the CRT strategy:

1. Assemble a team of advisors and develop a CRT strategy.
2. Donor establishes a CRT. The trust document declares the income beneficiaries and the charitable beneficiaries.
3. Donor determines the assets to be contributed to the CRT.
4. Donor contributes assets into the CRT, typically grain, machinery and/or livestock.
5. The CRT sells the assets but does not pay tax.
6. The Trustee of the CRT uses the sale proceeds to establish an annuity. The annuity must be designed to provide at least 10% of the sale proceeds to the charity.
7. The annuity pays out to the Donor over a number of years. The Donor pays income tax on the annuity distributions.
8. When the trust is terminated, the charity is paid the remaining assets.

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Consider the following example to help further explain how a CRT strategy works:

> *Farmer decides to retire at the end of the 2023 crop year. After harvesting the 2023 crop, Farmer owns $1 million of grain and $1.5 million of farm equipment. Farmer's accountant tells him that if he sells all the grain and machinery in one year, he will pay around $1 million in taxes. Farmer decides to implement the CRT strategy. He establishes a CRT and names himself and his spouse as the income beneficiaries and the local children's hospital as the charitable beneficiary. Farmer transfers his grain and machinery into the CRT. The CRT sells the grain and machinery and receives $2.5 million in sale proceeds.*
>
> *The CRT establishes an annuity that will pay out $125,000 for the next 20 years. Farmer pays income tax on each $125,000 payment which results in $20,000 of annual income taxes. After 20 years, the trust is terminated, and the children's hospital receives the remaining funds in the CRT.*

As the example shows, the strategy avoids a large, up-front tax payment in the year of the asset sale. Farmer pays taxes on each annual $125,000 payment which allows him to stay in a lower tax bracket. In the example, instead of paying $1 million in taxes in 2023, Farmer spreads the payments out and ultimately pays $400,000 over 20 years.

BUILDING THE TEAM

The first step in the CRT strategy is to develop a team to assist in implementing the CRT. The CRT should be drafted by an attorney familiar with estate planning. Another key member of the team is an accountant. The accountant can assist with calculating potential tax savings of the CRT, address many other tax issues involving the CRT, and file the income tax return for the CRT. Lastly, but perhaps most importantly, a financial advisor should be included on the team. The financial advisor will help determine the type of annuity that should be used and calculate the annual payments to be sure the CRT accommodates the 10% required for the charity.

ESTABLISHING THE TRUST

After the team has met and the decision has been made to implement the CRT strategy, the trust document must be drafted. This document establishes the trust and includes all terms and provisions of the trust. The following are some of the key provisions included in a CRT document:

- The name of the CRT
- The Donor(s)
- The Trustee and any successor Trustees
- The income beneficiary(s)
- The charitable beneficiary(s)
- The legal and tax provisions required to qualify the trust as a CRT

The trust document is likely to be rather long, perhaps as many as 100 pages. The trust is lengthy because many standard boilerplate terms are included as well as many details and contingencies unique to each CRT plan. The Donor and the initial Trustee of the Trust sign the trust document.

THE TRUSTEE

The Trustee manages the CRT. The Trustee can be almost anyone, including the Donor. In most situations, the Donor names themselves or one of the income beneficiaries to serve as Trustee. Contingent Trustees should be identified in the event the primary Trustee is unable to serve. The Trustee will sell the assets on behalf of the trust, establish the financial account for the annuity, distribute the income payments, distribute to the charity, and ensure that a tax return is filed for the CRT.

CONTRIBUTING ASSETS TO THE CRT

After the CRT is established, the assets to be sold can be transferred/donated to the CRT. For untitled assets such as grain, livestock and machinery, the transfer should be documented with an assignment signed and dated by the Donor. For titled assets such as vehicles or real estate, the assets must be titled into the CRT before being sold.

Each asset should be valued at the time of the transfer into the CRT. Commodities such as grain and feeder livestock can use market prices while assets such as machinery and real estate should use appraisals. Establishing the value of the contributed asset is important because the Donor can receive a charitable deduction for the asset's contribution. The amount of the charitable deduction is based on asset value.

ANALYSIS OF ASSETS TO CONTRIBUTE

The Donor can donate nearly any asset to the CRT. Typical assets farmers donate to a CRT include crops, grain, inventory, livestock, and equipment. The best assets to contribute are those that have significant appreciation and/or a low tax basis. These high value, low tax basis assets, the sale of which would normally create significant, immediate tax liability for the owner, can be sold by the CRT without creating tax.

Assets that will not create much, if any, gain or recapture upon sale should probably not be contributed to a CRT. A primary purpose of the CRT is to avoid large tax liability upon the sale of assets. If there is little or no tax liability upon sale, the assets should be kept out of the CRT so that the retiring farmer retains full control over the sale proceeds. It is important to analyze each asset to determine if it is a good candidate for donation to the CRT.

Consider the following example:

> *Farmer owns a green tractor with a current value of $100,000. Farmer has fully depreciated the tractor so that the current tax basis is $0. If Farmer sells the tractor, it will create $100,000 of depreciation recapture taxed at ordinary income tax rates.*
>
> *Farmer also owns a red tractor valued at $100,000. However, Farmer only recently purchased the tractor and it has $90,000 of tax basis. If Farmer sells the red tractor, it will create only $10,000 of depreciation recapture.*

In this example, the green tractor is an excellent asset to transfer to a CRT. If Farmer sells the green tractor, the $100,000 of depreciation recapture will create considerable tax liability, perhaps $40,000 or more. By donating the green tractor to the CRT then the CRT selling it, the CRT pays no tax on the sale of the tractor.

On the other hand, the red tractor will only create perhaps a few thousand dollars of taxes. Farmer may not want to donate this asset to the CRT. The small tax savings likely does not justify tying up the sale proceeds in the CRT for many years. A more prudent course of action is likely to sell the tractor outside of the CRT, pay the small amount of taxes owed upon the sale, and retain full control over the sale proceeds.

DONATING FARMLAND TO THE CRT

While farmland may be donated to the CRT, it rarely is for the following reasons:

1. Farmland can provide a good source of rental income to the retiring farmer without creating much liability;
2. Farmland is relatively easy to manage;
3. Farmland is not a depreciable asset;
4. The farmland is often associated with family heritage so the owner usually desires the land to be passed on to future generations rather than being sold;
5. If held until death, the farmland will receive a stepped-up tax basis.

Consider the following example:

> *Farmer owns $750,000 of machinery which has been fully depreciated. Farmer also owns $2,000,000 of farmland. Farmer decides to donate the machinery to a CRT but retains ownership of the farmland. The farmland is leased to a local farmer for $200/acre.*

In this example, Farmer makes a good decision to donate the machinery to the CRT. The machinery has no tax basis and thus would create significant tax liability if sold by Farmer. Additionally, if Farmer retains the machinery, it will decrease in value over time and create liability exposure to Farmer. Unlike the machinery, Farmer can retain the farmland and earn rental income without the land creating much liability exposure. Also, it is important to Farmer that the farmland be passed along to his children and hopefully his grandchildren. Farmer has made a good decision by keeping ownership of the farmland and not donating it to the CRT.

ASSETS THAT SHOULD NOT BE CONTRIBUTED TO A CRT

There are several types of assets that should not be donated to a CRT. One such asset is S-Corporation stock. While some types of trusts are eligible to own S-Corporation stock, a CRT is not. Transferring S-Corporation stock to a CRT will cause the corporation to be converted from an S-Corporation to a C-Corporation.

Transferring assets subject to debt to a CRT can trigger tax liability. An explanation of the implications of donated debt is complicated and technical and beyond the scope of this bulletin. Before donating any assets with debt to a CRT, be sure to discuss the tax implications with the team's accountant.

Lastly, assets that are already contracted to be sold should probably not be donated to the CRT. The IRS will likely consider these assets already effectively sold and take the position that the only purpose for contributing the asset to the CRT is to avoid tax. The IRS could choose to not consider the transfer of the asset to the CRT a charitable donation and may expect taxes to be paid as if it were sold.

SALE OF THE DONATED ASSETS

The CRT Trustee may sell the assets at public auction, private sale, or consignment. It is in the best interest of the income beneficiaries to sell the assets for as much money as possible. The sale of the assets may only be done by the Trustee but the Donor can obviously provide ideas and suggestions to the Trustee.

The donated assets can be sold to anyone except family members. Selling to family members violates the charitable requirement of the CRT. Because family members cannot buy the assets, the CRT strategy is generally not used when transitioning a farming operation to the next generation. The CRT strategy is best used when the retiring farmer has no heirs to take over the farming operation.

THE CHARITABLE DONATION

When an individual donates assets to a CRT, they may be eligible for an immediate tax deduction for the charitable portion of the gift. The amount of the tax deduction is based on the present value of the remainder interest that will ultimately pass to the named charitable organization at the end of the trust's term. The calculation of the tax deduction takes into account several factors such as the value of the assets donated, the donor's age, the payout rate to the beneficiaries, and the applicable federal interest rate (AFR) at the time of the donation.

The charitable deduction is only available for the amount of tax basis still in ordinary income property such as machinery and livestock. The deduction of long-term capital gain property is based on the fair market value. The tax deduction for donating assets to a CRT is subject to certain income limitations and other rules and regulations. The charitable tax deduction is one of the primary reasons that the Donor's team should include a knowledgeable accountant who can calculate and apply the charitable deduction.

THE INCOME STREAM

As stated previously, the sale proceeds from the donated assets are used to establish an income stream. The Donor's financial advisor calculates the amount of money that can be distributed to the Donor while fulfilling the CRT's obligation to the named charitable beneficiaries. The money is then invested in financial instruments that will provide the required income and charitable donation. The income stream is paid out to the income beneficiary for a stated period of time which cannot exceed 20 years or the life of one or more of the beneficiaries. IRS rules require at least 5% of the trust principal to be paid out each year but limits annual payments to no more than 50% of the trust principal. These rules effectively cause most CRTs to be in effect between two and twenty years.

This step in the CRT process requires a financial advisor familiar with CRTs. The financial advisor determines the best financial product to hold the funds and the amount of funds that can be distributed each year to meet the charitable donation requirement and the designated income payment period. The IRS requires the Donor to be able to show that the type of financial instrument used and the income stream calculations were done in good faith to provide 10% to the identified charitable beneficiaries. Market fluctuations can cause the actual distribution to be more or less than 10% when the CRT terminates. The CRT is not required to actually provide 10% to the charitable beneficiary, what is required is to show that a good faith forecast was made to provide at least 10% to the beneficiary.

Consider the following example:

> *Farmer establishes a CRT for a term of 10 years with initial assets of $1,000,000. Based on current values and projected return on investment, Farmer's financial advisor establishes an annuity that will pay annual income of $91,000 to Farmer with $100,000 remaining to be transferred to the charity at the end of the 10-year term. The return on investment does not do as well as expected and at the end of the 10-year term only $90,000 remains for the charity. If Farmer can show that a good faith effort was made to leave the charity $100,000, the CRT will keep its charitable designation.*

BENEFICIARIES

As stated previously, the trust document identifies the income beneficiaries and the charitable beneficiaries. There can be multiple income beneficiaries concurrently; spouses often are joint beneficiaries. Once established, income beneficiaries may not be changed but the charitable beneficiaries can be changed.

A CRT can include contingent beneficiaries for the income stream. Including a contingent beneficiary helps alleviate the risk of the primary beneficiary dying shortly after the CRT is established, causing almost all of the assets to go to the charity. For example, the Donor may designate themself as the primary beneficiary and their child as the contingent beneficiary. Upon the Donor's death, the income stream will pass to the designated contingent beneficiary for the remainder of the trust term or for the remainder of the contingent beneficiary's life, depending on the terms of the trust.

Consider the following examples:

> *Farmer establishes a CRT for a term of 20 years with himself as the income beneficiary. He names Daughter as the contingent beneficiary. Farmer dies in year 10 of the trust term. Daughter will receive the income for the remaining 10 years of the trust term.*
>
> *Farmer establishes a CRT that will pay out income to him for the remainder of his life. He names Daughter as the contingent beneficiary. Farmer dies after 10 years. Daughter will receive the remaining payments. The 5% minimum payout requirement will likely mean that Daughter will receive payments for another 10 years, not necessarily for the remainder of her life.*

The charitable beneficiary may be any organization qualified under section 170(c) of the Internal Revenue Code. Charitable beneficiaries can include non-profit organizations, churches, veteran's organizations, fire departments and community foundations. Multiple charitable beneficiaries may be named.

TWO TYPES OF CRT

There are two types of CRTs – charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs). The primary differences between the two types are how the income distribution to beneficiaries is determined and if additional contributions can be made. In a CRAT, the income is distributed each year as a fixed amount, and the donor cannot make additional contributions to the CRAT. The fixed income distribution must adhere to the 5% minimum/ 50% maximum distribution rule. The assets are not re-valued each year.

With a CRUT, the income is distributed each year as a fixed percentage, and the donor can make additional contributions to the CRUT. The fixed percentage distribution must be at least 5% and no more than 50% of the fair market value of the assets, valued annually. Because the assets are re-valued each year, the income will likely vary from year to year.

A CRAT tends to be used more when all the assets are sold at one time and the Donor wants to provide a pre-determined income stream to the beneficiaries. A CRUT is used more often when the Donor may want to donate additional assets in the future and may be more inclined to accept the risks and rewards of asset value changes and financial market fluctuations. Deciding upon a CRAT or CRUT must be done prior to establishing the CRT and is an important early discussion for the CRT team.

IRREVOCABILITY

A CRT is an irrevocable trust, which means it generally cannot be amended or changed without the consent of the beneficiaries and a court. State law often requires a court's permission to make material changes to irrevocable trusts. The irrevocable nature of the CRT is its primary disadvantage. Once the CRT is established and funded with assets, the plan is set and cannot be undone except in extraordinary circumstances. For people who wish to keep control of their assets and keep flexibility, a CRT may not be the best strategy.

The irrevocable nature of the CRT does have an advantage. Once the assets are transferred into the CRT, the assets are protected from creditors of the donor. Because the Donor has given up ownership and control of the assets, the Donor's creditors are not entitled to access the trust principal[1]. However, the income payments from the trust to the beneficiaries are not protected and are subject to creditors.

TAXES

The CRT must file both a 1041 Tax Return (Trusts) and an IRS Form 5227 (Split-Interest Trust) annually. Payments from a charitable remainder trust are taxable to the non-charitable beneficiaries and must be reported to them on a Schedule K-1 "Beneficiary's Share of Income, Deductions and Credits." The payments to a non-charitable beneficiary are taxed as distributions of the CRT's income and gains in the following order[2]:

1. **Ordinary income.** Payments are considered ordinary income first to the extent the trust had ordinary income for the year and undistributed ordinary income from prior years. If the trust has enough ordinary income to cover all payments, the entire payments are taxed as ordinary income. Beneficiaries must report payments as ordinary income as reported to them on Schedule K-1.
2. **Capital gains.** Once the trust's ordinary income is exhausted, payments are taxed as capital gains based on the sale or disposition of the trust's capital assets. These payments are taxed as capital gain to the extent of the capital gain of the trust for the current year and any undistributed capital gain income from prior years.

[1] Assets are protected provided they were not donated as part of scheme to avoid creditors. Donation of assets to a CRT can cause disqualification for Medicaid which could subject the donated assets to risk of being spent for long-term care costs.

[2] Internal Revenue Service, https://www.irs.gov/charities-non-profits/charitable-remainder-trusts

3. **Other income.** Once all ordinary income and capital gains in the trust are fully distributed, payments are characterized as other income to the extent of the trust's current year and accumulated other income. This includes tax-exempt income.
4. **Corpus.** After all current-year and accumulated income and gains are fully distributed, payments would lastly be considered corpus or "principal" of the trust not subject to tax.

ILLEGAL USES

Charitable remainder trusts must not be misused to evade taxes or illegally benefit their beneficiaries. By law, a charitable remainder trust may not:[3]

- Inflate the basis of an asset to its market value when the asset was transferred into the trust, instead of recording the asset at carryover basis, or the basis in the hands of the donor, to illegally minimize or eliminate capital gains or ordinary income.
- Omit or fail to account for the sale of any assets of the trust.
- Mischaracterize distributions of ordinary or capital gain income as distributions of corpus.
- Give non-charitable beneficiaries any payment beyond the prescribed annual income payments, called “self-dealing.”
- Transfer the charitable remainder interest of the trust to an organization that isn't a qualified tax-exempt organization.
- Make an upfront cash payment to a charitable beneficiary in lieu of the remainder interest .

By law, charitable trust donors and beneficiaries may not:

- Pay personal expenses with trust funds.
- Borrow from the trust.
- Change the character of payments from the trust from ordinary income or capital gains.
- Use loans, forward sales of assets or other financial schemes to hide capital gains or income in the trust.[4]

EARLY TERMINATION

There are two scenarios in which the Donor or beneficiary may want to terminate the CRT early. The first is the Donor may wish to discontinue receiving income from the CRT. Perhaps the Donor has adequate income from other sources and does not wish to pay tax on the CRT income. In this situation, the beneficiary can transfer their interest in the income stream to the charitable organization. When this occurs, the transfer is considered a gift of a capital asset. Typically, the trust is then terminated under the merger doctrine due to the charity having both the current income stream and future remainder interest.

The second scenario may result if the Donor requires more immediate funds than the stream of income will provide. If the trust document allows, the trust assets may be distributed to the income beneficiary and the charity on a pro rata basis. When this occurs, the transfer is considered a sale of a capital asset, and gain is recognized on the entire proceeds of the sale. This strategy should only be used in rare occasions as the early termination would result in significant tax liability for the Donor.

[3] Internal Revenue Service, https://www.irs.gov/charities-non-profits/charitable-remainder-trusts
[4] Internal Revenue Service, https://www.irs.gov/charities-non-profits/charitable-remainder-trusts

SCHEDULED TERMINATION

The CRT will terminate based upon the terms in the trust. Most CRTs terminate in one of two ways. If the term is measured by the life of the beneficiary, the trust will terminate upon the death of the beneficiary. The remaining trust assets at the time of death are distributed to the charity, a final tax return is filed and the trust is terminated.

If the term of the CRT is a specific number of years, the trust will terminate at the end of the term. All assets remaining at the end of the term are distributed to the charity, a final tax return is filed and the trust is terminated.

ESTATE TAX IMPLICATIONS

If the Donor establishes a charitable remainder trust for his or her life only, the trust assets will be included in his or her gross estate under IRC section 2036. The amount included, however, will "wash out" as an estate tax charitable deduction under IRC section 2055. A surviving spouse's interest in a qualified charitable remainder trust qualifies for the estate tax marital deduction. Note that the marital deduction is lost if there is any non-charitable beneficiary of the trust other than the donor and the donor's spouse.

If the donor names someone other than himself and spouse as the income beneficiary, the trust assets will not be included in the donor's estate. The donor has given up ownership and control of the trust assets and has not retained an interest in the assets. The donation of the assets to the CRT is essentially a completed gift.

TIMELINE

Planning for the CRT should be started well in advance of retirement. It takes significant time to analyze the tax savings, calculate the term and payouts, establish the trust, transfer the assets to the trust, sell the assets, and establish the annuity. Preferably, planning should start at least one year prior to the retirement date. This will allow the team time to analyze, implement and manage the CRT. The CRT strategy can be implemented in a few months if necessary, but decisions and actions must be made quickly and deliberately.

The CRT strategy can be initiated after retirement. However, any assets that will be donated to the CRT must be held until the trust is established. During the time from retirement to implementing the CRT plan, the value of the assets can decrease, and the beneficiaries will miss out on interest.

CONCLUSION

CRTs can be an excellent tool to reduce income taxes for the retiring farmer. A CRT can provide a steady income stream while providing a charitable benefit. However, once the CRT strategy is implemented, it generally cannot be changed. For those farmers who wish to retain control of assets or who may have heirs taking over the farming operation, a CRT is probably not the best option. When considering a CRT strategy, be sure to consult an attorney, tax advisor and financial advisor.

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RETIREMENT FROM FARMING: STRATEGIES FOR TRANSFERRING FARM OPERATING ASSETS

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Retirement means different things to different farmers. For some, retirement is the gradual process of turning over the farming operation to the next generation. For others, retirement may be the immediate sale of operating assets when there is not an heir to take over the farming operation. Regardless of the type of retirement, operating assets will often be transferred. This publication discusses the different strategies to transfer operating assets and the implications of each strategy.

THE TAX ISSUE

Most farmers are aware of the tax bill that is awaiting them upon retirement. This tax liability is primarily attributable to two causes. First, farmers typically delay the sale of grain and other assets into the next tax year. Additionally, inputs may be pre-purchased in the current tax year to help manage income. So, upon retirement, there may be an entire year or more of products to sell with few or no expenses to offset the sale.

Second, and the focus of this article, the sale of operating assets will likely trigger significant taxes. Assets sold at retirement usually include gains taxed at capitals gains rate or depreciation recapture taxed as ordinary income. The extent of the tax liability upon selling operating assets may be underestimated by retiring farmers due to the uniqueness of the situation. While it may not be realistic to avoid all adverse tax consequences, some strategies can be implemented to at least reduce the negative tax impacts on the retiring farmer.

In order to determine the tax liability issues of selling operating assets, it is important to understand the concept of depreciation recapture. At a basic level, depreciation recapture is the mechanism the IRS uses to recoup taxes an individual legitimately avoided by depreciating the value of an asset

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over its lifespan or expensing it upon purchase. The owner is liable for the income generated by the sale of an asset in excess of its tax basis. The sale of these assets, known as IRC Section 1245 assets, often triggers substantial depreciation recapture.

The following two examples are illustrations of how depreciation recapture works.

> **Example 1:** Farmer buys a tractor for $200,000. He has taken $150,000 of depreciation on the tractor. He sells the tractor for $100,000. Farmer will owe ordinary income tax on $50,000, the difference between the sale price and the remaining tax basis after depreciation.
>
> **Example 2: Recapture.** Farmer buys a tractor for $200,000. He elects Section 179 and expenses the entire purchase price in the year of purchase. Farmer then sells the tractor for $100,000. The sale of the tractor will create $100,000 of depreciation recapture taxed at ordinary income tax rates.

CAPITAL GAINS: A LESSER PROBLEM

Some capital gains could also be incurred upon retirement, but capital gains are usually less of an issue than depreciation recapture. For example, a retiring dairy farmer will likely pay capital gains on the sale of the raised cows, rather than depreciation recapture. Generally, capital gains are preferred to depreciation recapture as capital gains tax rates tend to be lower.

While a retiring farmer does usually not sell land, land is worth mentioning. Land does not depreciate so there will not be depreciation recapture. If land is sold for more than its tax basis then capital gains tax will be owed on the gain. However, land improvements such as buildings and bins can be depreciated and thus may be subject to depreciation recapture.

> **Example 3.** Farmer bought a 100-acre farm for $500,000. Farmer paid $450,000 for the land and $50,000 for a general purpose building on the farm. Farmer depreciated the building to a $0 tax basis but could not depreciate the land. Several years later, Farmer sells the farm for $800,000 with $40,000 of the sale price allocated to the barn. Farmer will pay depreciation recapture of $40,000 on the barn. Farmer will also pay capital gains on $310,000, the amount the sale price allocated to the land exceeds the tax basis (purchase price).

STRATEGIES TO TRANSFER ASSETS

There are no perfect solutions for transferring operating assets upon retirement, but there are strategies that can accomplish the farmer's goals and address tax issues. The following discusses seven asset transfer strategies and the advantages and disadvantages of each strategy. Determining the best strategy requires weighing the advantages and disadvantages on a case-by-case basis.

Strategy 1: Gifting

The gifting of assets is the simplest transfer strategy. Gifting works best when the assets are being transferred to a family member and the retiring owner does not need income from the assets. Even large gifts of assets might not cause gift taxes if the amount of the gift is less than the owner's remaining federal estate tax exemption. However, gifting may not be the best tax strategy as there are significant benefits of inheriting assets upon the owner's death rather than receiving them as a gift during the owner's lifetime.

Advantages. The biggest advantage of gifting is the simplicity of the transaction. For most farm operating assets, which are usually untitled, transferring the assets has almost no transactional cost and is quite simple.[1] For example, a tractor can be gifted by simply signing an acknowledgement that includes a description of the asset gifted, the person receiving the gift, the value of the gifted asset and the date transferred. The simplicity of gifting allows for the gift to occur quickly and at any time.

Another advantage of gifting and any similar strategy that transfers ownership is that the liability associated with the property is transferred to the new owner. This allows for the former owner to immediately eliminate their liability for the transferred assets. Strategies that include retaining ownership, such as leasing, cause continuing liability exposure to the owner. For the retiring farmer, the less liability exposure, the better.

Last, gifting can enhance the likelihood of the next generation having a viable farming operation. The fewer assets the next generation farmer must purchase, the more likely they are to have financial viability. Many retiring farmers place a high degree of importance on passing on a viable farming operation to the next generation.

Disadvantages. Gifting includes negative aspects to consider. The obvious drawback is that the owner does not receive any compensation for the asset. Gifting is not a good strategy for those retiring farmers who need to generate income from the sale or lease of assets.

Another disadvantage of gifting is the loss of potential stepped-up tax basis. When someone dies, the assets they owned receive a new, stepped-up tax basis equal to the value of the asset at the time of their death. The person receiving the deceased person's asset can then re-depreciate the asset or sell the asset for little or no gain, and therefore no tax. A stepped-up basis is valuable to the person who receives the asset. With all other things being equal, it is usually better to receive an asset through inheritance than through gifting.

> **Example 4.** Farmer decides it is time to retire and allow Daughter to take over the farming operation. Farmer has adequate retirement income so that he does not need income from his machinery. He owns machinery with a fair market value of $600,000 and no remaining tax basis, so the machinery is fully depreciated. Farmer gifts all the machinery to Daughter.

[1] For titled assets such as trucks, trailers and real estate, title must be transferred to the person receiving the gift before the gift can be completed.

Farmer's gift to Daughter will not cause gift taxes. His federal estate tax exemption will be reduced by $600,000, the current value of the machinery. Daughter will receive no tax basis in the machinery and thus is not permitted to depreciate the assets and if she sells the assets, she will incur depreciation recapture taxes.

Timing is an important factor to consider in the gifting strategy. While it is true gifting assets forfeits the stepped-up tax basis, the retiring farmer may not want to wait until death to transfer the assets. In the above example, if Farmer is 70 years old, he could easily live another 20 years or more. It may not be feasible or desirable to keep the assets until death and gifting may be the best strategy. As stated previously, there is no perfect solution to transferring assets.

Gifting can also be done on a gradual basis. Instead of gifting all the assets at one time, gifts can be made each year until all the assets are transferred. If each annual gift is less than the annual gift exclusion, currently $18,000/year, there are no gift taxes owed and the gift does not reduce the federal estate tax exemption.

For a more detailed and thorough discussion of gifting, see *Gifting Assets Prior to Death*, a law bulletin available at farmoffice.osu.edu.

Strategy 2: Outright Sale

When the owner needs income from operating assets, an outright sale may be the best transfer strategy. An outright sale involves all assets being transferred simultaneously with a payment for the entire sale .Because many operating assets are untitled, an outright sale can be completed rather easily. The owner should sign a bill of sale identifying the property, the purchase price, and date of sale. The buyer provides the funds, and the sale is completed. For any titled assets, the title must be transferred to the buyer to complete the sale.

Advantages. The obvious advantage of a sale is that it creates income. The purchase price can be any amount agreed to by the seller, including discounted purchase prices for family or friends. In a true outright sale, the owner receives the entire purchase price when the equipment is transferred to the buyer.

A second advantage is that the sale transfers title and relieves the seller of the liability of owning the assets. Less machinery and equipment means the retiring farmer has less potential liability. Selling equipment is a good strategy to reduce liability exposure.

Disadvantages. The primary disadvantage of a sale is the tax liability. As discussed previously, selling operating assets will typically trigger significant taxes including depreciation recapture. Taxes can easily consume 40% or more of the sale proceeds. To avoid surprises, it is advisable to have an accountant calculate the taxes that will be incurred with an outright sale.

Another disadvantage with an outright sale is that it can consume much of the next generation's resources and capital. If the next generation purchases the retiring generation's assets, there is less capital available to grow and expand the farming operation.

Strategy 3: Gradual Sale

Instead of an outright sale, assets can be sold gradually, over time. In this strategy, a few items are sold each year until all assets have been transferred. The sales can occur uniformly each year or be adjusted as the seller needs income or the buyer has available resources for purchases.

Advantages. While a gradual sale does not avoid the depreciation recapture issue, it can help keep the seller in a lower tax bracket. Instead of one large sale that can move the seller into higher tax brackets, the sales can be managed to prevent income from reaching the higher tax levels.

A gradual sale is also relatively simple. It is the same process as the outright sale except it is done each year. The seller must determine the assets they wish to sell each year, guided in large part by tax liability and income needs.

Disadvantages. The biggest disadvantage with the gradual sale is that the seller must wait on being paid the full value of the assets and the seller retains ownership of the unsold assets. If the seller needs a large amount of sale proceeds initially, the outright sale may be a better strategy. Also, if the seller does not wish to retain any ownership of the assets, an outright sale may be the better option.

Strategy 4: Installment Sale

According to the IRS, an installment sale is a sale of property where at least one payment will be received after the tax year in which the sale occurs. The terms of an installment sale can vary greatly, and the parties involved have discretion to develop terms that are mutually agreeable. An installment sale spreads the payments over a number of years and may seem like an obvious method to spread out depreciation recapture and capital gains. However, an installment sale is often the worst strategy when selling operating assets. That's because the IRS requires all tax liability due from depreciation recapture to be paid in the year of the sale.[2] Farmers who are not familiar with this rule can find themselves in a difficult situation if they attempt to sell operating assets through an installment sale. The tax due in the first year may exceed the first payment they are to receive.

> **Example 5.** Farmer owns $500,000 of farm machinery and has decided to sell all the machinery at the end of 2024. Farmer sells the machinery to his neighbor and allows the neighbor to pay for the machinery over five years. Farmer is scheduled to receive $100,000 plus interest each year, for five years, beginning December 1, 2025.
>
> While preparing his taxes for the 2024 tax year, Farmer discovers that all the depreciation recapture tax is owed in 2024. The total tax liability is equal to $150,000, significantly more than the first payment. Farmer files his taxes on March 1, 2025, owing $150,000 in depreciation recapture but having received only $100,000 plus interest in payments for the machinery. Farmer must use funds from another source to pay the tax on the sale of the machinery.

[2] Any capital gains can be spread out and are only due as payments are made.

As the above example illustrates, installment sales can cause a significant negative cash flow. Generally, installment sales should be avoided when selling operating assets. Either a gradual sale or a lease/option can spread out the payments without triggering a large, up-front depreciation recapture tax liability.

Advantages. An installment sale does transfer ownership to the buyer so that the seller has no further liability for the sold asset. Also, after the initial depreciation recapture is paid, much of the remaining sale proceeds may have little or no tax liability.

Disadvantages. As stated above, the primary disadvantage is that all depreciation recapture will be due in the first year of sale. Additionally, the seller always accepts the risk that the buyer does not make some or all of the installment payments. This risk can be somewhat reduced by the seller placing a lien on the purchased assets, but a lien cannot eliminate all risk of payment default.

Strategy 5: Lease with Purchase Option

A lease allows payments to be spread over the term of the lease with taxes due upon receipt of each payment, rather than all taxes due up front. The person leasing the machinery can then be given the option to purchase the machinery upon the expiration of the lease. For the retiring farmer who needs income from their machinery, this is a strategy worth exploring.

It is important to make sure this strategy is structured in a way that will not result in a sale classification. The IRS can and does scrutinize lease and option strategies to ensure they are not simply disguised sales. A practical step to help avoid classification as a disguised sale is to have separate documents for the transaction - a lease document and an option document. The following tips can also help to avoid a sale classification:

- Inclusion of a termination clause in the lease;
- The lease term is for less than the remaining economic life of the machinery;
- Lessee is not required to renew the lease for the remaining economic life of the machinery;
- Any option to renew is for more than nominal value; and
- The option to buy at the end of the lease is for more than nominal value.

If the IRS determines a lease with purchase option to be a disguised sale, the sale will trigger depreciation recapture and potentially interest and penalties. To avoid adverse consequences, be sure the transaction is a true lease with an option to purchase at the end of the lease.

The Lease

Advantages. The main advantage of the leasing strategy is that the tax liability is spread out over time. This provides a distinct advantage over an installment sale transaction that forces all depreciation to be recaptured in the year of the sale. Additionally, allowing the lessee to spread out their payments through a lease can help alleviate cash flow strains. The lease payments are a fully deductible expense for the lessee.

Disadvantages. There are three primary disadvantages of the leasing strategy, all related to ownership. First, the retiring farmer must retain ownership of the machinery. The owner could still be liable for any damage or injury that arises from the machinery since they continue to hold ownership of the asset throughout the term of the lease. The liability of ownership can be minimized through insurance, favorable provisions in the lease, and using a formal business entity, but the liability cannot be eliminated entirely.

The second disadvantage is the lessee does not own the machinery during the term of the lease. Thus, the leased assets cannot be used as collateral and are not assets on the lessee's balance sheet. In fact, the lease obligations are a debt that may reduce the lessee's net worth.

Last, it can be challenging to determine lease rates for each year of the lease and to accommodate sales, trades, or additions of machinery. During the term of the lease, the owner may wish to sell a piece of machinery rather than make repairs. Or the owner may wish to trade older machinery for newer machinery. The lease needs to address the possibility of a changing inventory and include a mechanism to adjust the lease rates and other related terms. A pre-established, fixed rental rate will not work well unless the machinery inventory does not change during the term of the lease.

The lease should be drafted in consultation with an attorney. An experienced attorney can provide advice on important terms to include in the lease. A well drafted lease can help defer some of the liability of asset ownership and ensure the lease is flexible and adaptable to any changes in asset inventory.

The Option

Advantages. The Option allows the owner to delay the sale of the machinery for some number of years. At the end of the term of the lease, the machinery will have a lower value and thus create less tax liability for the owner. Also, the option defers depreciation recapture until the option is exercised. The sale of the machinery via the option can create a significant one-time payment to the retiring farmer.

Disadvantages. As stated above, the option does not cause ownership to be transferred until the machinery is purchased after the lease expires. The lessee will make lease payments for several years without gaining any equity. The option agreement should be a separate document from the lease agreement. The purchase price of the machinery must be reasonable and cannot be a de minimus amount, such as $1.

> **Example 6.** Farmer owns machinery valued at $500,000. Daughter is taking over the farm and will require the machinery for her farming operation. Farmer needs income from the machinery but wants to spread out payments over several years to minimize income taxes. Farmer and Daughter agree that Daughter will lease the equipment for seven years paying $40,000 per year. The lease payment will be adjusted for any change in inventory. At the end of the lease, Daughter has the option to purchase the machinery at the then appraised value of the machinery.

This lease and option strategy will allow Farmer to receive $40,000/year in income for seven years. Income tax will be incurred as each payment is received. Daughter can fully deduct the lease payment. At the end of the lease, if Daughter elects to purchase, Farmer will receive an additional payment, but it will likely be significantly less than the original $500,000 value of the machinery.

Gifting Instead of Selling at Lease End

At the end of the lease, the retiring farmer can gift the assets to the lessee. However, this cannot be contracted for or included in the lease. There must be no obligation to gift the machinery at the end of the lease or the transaction will likely be considered a disguised sale. The gifted asset is received by the giftee with no increased tax basis because all previous payments were lease payments, not purchase payments.

> **Example 7.** Continuing the prior example, at the end of the lease Farmer decides he has adequate income and does not need Daughter to purchase the machinery. Farmer gifts the machinery to Daughter. The value of the gift is applied to Farmer's estate tax exemption, so no gift tax is owed. Daughter receives the machinery with $0 tax basis.

Strategy 6: Integrating a Business Entity into the Transfer Plan

Using a business entity such as a limited liability company (LLC)[3] for the transfer of operating assets can have multiple benefits. An LLC can reduce liability exposure, simplify the transfer process, and reduce tax liability. Anyone transferring operating assets should consider incorporating an LLC into the process.

The Process

An LLC must be registered with the appropriate state authority, usually the secretary of state. Then, documents such as an operating agreement and ownership certificates should be drafted. An attorney should assist in establishing the LLC to be sure all benefits and protections are available to the owner(s).[4]

After the LLC is created, all assets intending to be transferred must be assigned to the LLC. Non-titled assets such as machinery, grain, and livestock can be transferred by executing an assignment document. The assignment should include a description of each asset, the value at the time of transfer, and the date of transfer. Titled assets, such as trucks and trailers, can only be moved to the LLC by transferring the title to the LLC.

Caution should be used with assets that carry debt. In some situations when an asset's debt exceeds its tax basis, transferring to an LLC can trigger a taxable event. Be sure to consult with a tax advisor before transferring assets to an LLC to ensure no unexpected tax liabilities arise from the transfer.

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[3] Several different types of entities can be used to transfer assets. LLCs tend to be the entity of choice for new businesses. For more information on business entities, see the *Structuring Your Farm Business* series at farmoffice.osu.edu

[4] For more information on establishing an LLC, see the *Starting, Organizing and Managing an LLC for a Farm Business* bulletin at farmoffice.osu.edu.

After the assets are transferred to the LLC, ownership can then be transferred to the future owner(s). Transferring LLC ownership is simple, often using ownership certificates for the transfer. The certificates identify the current owner, the amount of ownership being transferred, and to whom the ownership is transferred. In addition to the ownership certificate, the value of the ownership being transferred should be documented for tax records.

> **Example 8.** Farmer wants to transfer his farm machinery to Daughter in five, yearly installments. Farmer sets up an LLC and transfers the farm machinery to the LLC. Farmer initially owns 100 ownership units in the LLC. For each of the five years following the establishment of the LLC, Farmer transfers 20 ownership units to Daughter by executing ownership certificates. Farmer also documents the value of the ownership at the time of transfer. After five years, Daughter owns all 100 ownership units in the LLC.
>
> Alternatively, Farmer would like to transfer the entire ownership of the LLC immediately but be paid over five years. Farmer transfers the 100 ownership units and Daughter executes a promissory note agreeing to pay farmer in five annual payments. Daughter owns 100% of the LLC immediately but is able to pay for the purchase over five years.

The sale of LLC ownership is typically treated as a capital sale and thus is subject to capital gains. Therefore, tax is only owed on each payment in the year of the receipt rather than all taxes due in the year of sale. Additionally, the capital gains tax rate may be lower than the income tax rate of depreciation recapture. In some situations, ordinary income tax may be due on some part of the purchase price. Be sure to consult with a tax advisor, as the rules on the sale of LLC ownership can be complicated depending upon the timing and assets held by the LLC.

An LLC can also be used as part of the leasing strategy. Assets can be transferred to an LLC and then leased by the LLC. The LLC will provide at least some liability protection for the owner.

Advantages. Using an LLC has two primary advantages. First, the LLC provides additional liability protection for the owner(s). Second, the sale of the LLC interest is generally treated as capital gains tax which spreads out the tax liability and may keep the income taxed at a lower rate.

Disadvantages. One disadvantage of using an LLC is the set-up costs. Costs to establish an LLC and transfer assets can range from several hundred to several thousand dollars. Another disadvantage is the additional management requirements of an LLC. Each entity must have its own bank account, accounting, and tax return.

Strategy 7: Charitable Remainder Trust

A Charitable Remainder Trust (CRT) can be an excellent strategy for the retiring farmer to sell operating assets without immediate tax liability, receive a long-term flow of income, and make a charitable contribution. The strategy involves establishing a charitable trust, transferring operating assets to the trust, then selling the assets through the trust. Due to the charitable nature of the CRT, no tax is due upon the sale of the assets. The CRT then establishes an annuity for the retiring farmer which generates annual income. At the termination of the CRT, the remaining principal in the CRT is donated to the charitable beneficiary. The CRT strategy is the most complicated strategy and will require the most legal and accounting fees.

A CRT is usually used when there is no farming heir, and the retiring farmer wishes to maximize potential income. For a detailed discussion of the CRT strategy, see the *Charitable Remainder Trusts as a Retirement Strategy for Farmers* bulletin available at farmoffice.osu.edu.

USING A COMBINATION OF STRATEGIES

Sometimes, a combination of strategies can work well. For example, the retiring farmer could gift some of the machinery and sell some of the machinery. A combination of strategies can provide the necessary income to the retiring farmer, minimize tax liability, and allow for a manageable cash flow for the next generation farmer.

> **Example 9**. Farmer determines he needs $200,000 from his machinery to fund his retirement. His machinery is valued at $500,000. Farmer sells one-half of the machinery to Daughter and, after taxes, receives $200,000. Farmer gifts the other one-half of the machinery to Daughter. Daughter is able to obtain a loan for the $200,000 purchase using the $500,000 of equity in the machinery. Farmer has used a combination of sale and gift strategies to transfer the machinery to Daughter.

CONCLUSION

There are several strategies for transferring farm operating assets at retirement. There is no perfect strategy, but each one has advantages and disadvantages. A thorough analysis of the implications on income, taxes, liability risk, and cash flow should be performed before deciding on the preferred strategies. Working with knowledgeable tax and legal counsel can help with the decision-making process and reduce the risk of unwanted or unexpected outcomes.

Find all our **Planning for the Future of Your Farm** resources at https://go.osu.edu/farmplanning

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GIFTING TO REDUCE FEDERAL ESTATE TAXES

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Federal estate taxes are receiving a lot of attention due to the impending potential reduction or "sunsetting" of the federal estate tax exemption in 2026. If Congress does not extend the estate tax exemption or make it permanent before the start of 2026, the exemption will reduce to $5.5 million per person plus an inflation adjustment, which will bring the total exemption to between $7 and $7.5 million in 2026. The current federal estate tax exemption for 2024 is much higher, at $13.61 million per person.

The potential lower federal estate tax exemption in 2026 and after will still be high enough for many farmers to fall under the exemption and not be subject to federal estate taxes. However, some farmers with higher estate values will see themselves move into the federal estate tax bracket in and be subject to federal estate taxes starting in 2026. Farmers in this situation should explore strategies to help reduce their federal estate tax liability.

One such strategy to consider is gifting, or giving away assets that could be subject to federal estate taxes. In some situations, gifting can help reduce federal estate taxes. In other situations, gifting may have little effect on estate taxes and instead have detrimental effects on income tax strategy. This publication discusses the implications of gifting and how gifting may or may not help with federal estate tax liability.

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TWO TYPES OF GIFTS

There are two types of gifts a person can make – the annual exclusion gift and the lifetime credit gift. The Internal Revenue Service (IRS) allows a person to make annual exclusion gifts, which are gifts of up to $18,000 per person made annually to an unlimited number of people. An annual exclusion gift is not taxable to either the person giving the gift (Giftor) or the person receiving the gift (Giftee). It is a free gift. For example, a grandparent can gift $18,000 each to 10 grandchildren for a total of $180,000, and neither the grandparent nor the grandchildren must pay a federal gift tax on the gift.

The second type of gift is the lifetime credit gift. This IRS rule allows a Giftor to make a gift larger than $18,000 and count the gift toward their federal estate tax lifetime credit. That is, a large gift will reduce the federal estate tax exemption available to the Giftor's estate. For example, if Mother gifts a farm valued at $1,018,000 to Daughter, no gift tax is owed when Mother makes the gift but Mother's federal estate tax exemption will reduce from $13,610,000 to $12,610,000 because the gift is $1,000,000 over the $18,000 annual exclusion gift amount.

For a thorough and detailed discussion of the process of gifting and implications of gifting, see the *Gifting Assets Prior to Death* bulletin, available at farmoffice.osu.edu and part of this Planning for the Future of Your Farm series.

GIFTING STRATEGIES THAT CAN HELP WITH FEDERAL ESTATE TAXES

1. **Annual Exclusion Gift Strategies**

One gifting strategy to help reduce federal estate taxes is to use the annual exclusion gift. As stated above, multiple gifts of up to $18,000 can be made without tax to either party. The gifts can be money, shares in a business entity, real estate or almost any other kind of asset, and can be given to any individual. The annual exclusion gift can be an effective strategy for those who have many potential recipients for the gift and/or may be close to or just over the federal estate tax exemption. Consider the following example:

> Grandma has 10 grandchildren. She calculates that she will be about $200,000 over the federal estate tax exemption in 2026. She gifts each grandchild $18,000 in both 2024 and 2025. The gifts allow Grandma to gift a total of $360,000.

These gifts allowed Grandma to move back under the estate tax exemption and avoid federal estate taxes. Neither Grandma nor the grandchildren will pay gift taxes on the gift. As the example shows, using the annual exclusion gift can be an excellent way to reduce or eliminate estate taxes.
The primary limitation to the annual exclusion gift strategy is that it may have limited effect for people who are significantly over the federal estate tax limit. While $18,000 is not a small amount of money to gift, it may be too small to make much of an impact on estate taxes of higher wealth people.

Let's continue the previous example with a change of facts:

> Grandma's net worth will be $2 million over the exemption in 2026.

Even though Grandma can gift $180,000 each year to her grandchildren, it will take 12 years for Grandma to gift away $2 million. Additionally, her net worth will likely increase each year. In fact, the increase in net worth may outpace what she is able to gift each year. While annual gifting will always help reduce potential estate taxes, this strategy may only be moderately helpful for higher wealth people.

2. **Lifetime Credit Gift Strategies**

Another strategy is to make large gifts that are more than the $18,000 annual exclusion gift amount. As discussed above, large gifts can be made without paying gift tax. However, the estate tax exemption is reduced by the amount of the gift that exceeds the annual exclusion gift amount. So, lifetime credit gifts are offset dollar-for-dollar by a reduction in the estate tax exemption. However, this strategy can still be effective when gifting assets that are expected to appreciate in value. Gifting these assets keeps the appreciation out of the Giftor's estate. Consider the following example:

> Grandma owns the Smith Farm that sits next to town. It is currently valued at $1 million. She expects commercial development pressure to cause the value of the Smith Farm to increase to $3 million in the next few years. Grandma decides to gift the Smith Farm to her grandchildren.

Grandma can gift the Smith Farm without paying gift taxes. Her federal estate tax exemption will be reduced by $1 million. So, the gift itself does not help her estate tax situation by bringing her under the federal estate tax exemption amount. However, when the Smith Farm increases in value by $2 million, that appreciation in value will be assumed by the grandchildren. Grandma has essentially been able to gift $3 million out of her estate while only using up $1 million of her estate tax exemption.

This strategy may not be the best strategy for assets that will have no or little appreciation. For a non-appreciating asset, the gift just comes off the estate tax exemption and does not help the estate tax situation. Again, large gifts work best with appreciating assets.

Capturing the Higher Lifetime Credit

As stated previously, the current lifetime credit gifting allowance is $13.62 million and could decrease by about one-half in 2026. So, there is an opportunity to make a large gift now and capture the large gift allowance before it might be reduced in 2026. Consider the following example:

> Grandma has a net worth of $20 million. She is concerned she will be over the estate tax exemption limit by $13 million in 2026, resulting in around $5 million of estate taxes. To avoid these taxes, Grandma gifts land valued at $13.62 million to her grandchildren in 2024.

In this scenario, Grandma is able to gift her entire lifetime credit, which reduces her federal estate tax exemption to $0. But, if the estate tax exemption reduces to $7 million in 2026, there will be no "claw back" of her gift. That is, her estate tax exemption will remain at $0 because the IRS does not seek to recoup any of the 2024 gift that exceeds $7 million. So, Grandma is able to gift $13.62 million in 2024 and retains the extra $6.62 million as her exemption even if the federal exemption reduces in 2026. Grandma's net worth is reduced to $6.38 million. She will have no federal estate tax exemption left at her death, so her estate will owe estate taxes on $6.38 million. But that is much better than owing estate taxes on $13.62 million. By making the large $13.62 million gift now, Grandma saved her heirs around $2.6 million in estate taxes.

Obviously, this strategy only works for high wealth individuals. The person must have enough assets to gift more than the full exemption amount and still have adequate assets remaining to support themselves. Most people do not have enough wealth to make this strategy work, but for those who do, it can be very effective.

DISADVANTAGES OF GIFTING

Gifting is not without a few disadvantages. The impact of these disadvantages depends upon an individual's situation, so it's important to consider them before developing a gifting strategy.

1. Loss of Stepped-Up Basis

At death, the assets owned by a deceased person receives a stepped-up tax basis to the fair market value of the asset. The new owners of the assets can re-depreciate the asset or sell them for little or no tax liability. The stepped-up tax basis is a tremendous financial benefit to the new owner. A gifted asset does not receive a stepped-up tax basis at the time of gift. Therefore, gifting an asset eliminates the stepped-up tax basis opportunity. Careful consideration should be given to losing the potential of a stepped-up basis before deciding upon a gifting strategy.

For a thorough and detailed discussion of gifting and stepped-up tax basis, see the Gifting Assets Prior to Death bulletin, available at farmoffice.osu.edu and part of this Planning for the Future of Your Farm series.

2. Loss of Control and Income

A gift is a gift. This means that the person gifting the asset cannot retain any control or ownership. It can be difficult to give up control of assets that took a lifetime to accumulate. Also, retaining any income rights from the gifted property will cause the property to remain in the estate. Gifting should only be done if the income from that property is not required for living needs and the Giftor is willing to relinquish all ownership and control of the asset.

3. Risk of Losing the Property

A nightmare scenario for the Giftor is to see the gifted assets lost due to financial mismanagement or misfortune by the Giftee. Consider the following example:

> Grandma gifts the Smith Farm to granddaughter Julie. Unbeknownst to Grandma, Julie is heavily in debt due to overspending and poor financial management. After Julie receives the Smith Farm, her creditors file suit against her and force her to sell the Smith Farm to pay her debts.

Once Grandma gifts the Smith Farm, she can no longer control it. She cannot protect it from Julie's creditors and the farm may be lost unless Grandma can buy it back. Before making large gifts, it is good practice to have an idea of the financial stability of the person to whom the gift is being made.

One way to overcome this issue is to use an irrevocable trust. The trust holds the assets and distributes income to the beneficiaries. Because the beneficiaries do not legally own the assets in the trust, their personal financial misfortunes cannot affect the assets. Consider the following example:

> Grandma wants to gift the Smith Farm to Julie but knows Julie is not the best at managing money or assets. Grandma establishes an irrevocable trust for Julie. The trust will provide income to Julie for the remainder of Julie's life, and then at her death, the farm will go to Julie's children. Grandma transfers the Smith Farm to the trust and names, Jeff, her son, to be trustee of Julie's trust.

In this scenario, the Smith Farm is not at risk if Julie has financial difficulties. Julie does not own the Smith Farm so her creditors cannot get access to it. The income from the trust may be required to be paid to creditors but the farm itself is safe. Irrevocable trusts can be a good way to make gifts and help protect them from financial problems of the Giftee.

PAYING MEDICAL AND EDUCATION EXPENSES RATHER THAN GIFTING

The IRS does not consider the payment of certain educational and medical expenses to be a gift. Therefore, an unlimited amount of educational and medical expenses can be paid on behalf of someone else without triggering a gift tax or reduction of the estate tax exemption. Paying educational and medical expenses for someone else will help reduce federal estate tax liability.

1. Educational Expenses

There are two important points to remember regarding education expenses. First, the exclusion applies only to tuition payments. Other school-related expenses like books, supplies, and room and board costs are not eligible for this exclusion. Second, the tuition must be paid directly to the institution and cannot go directly to the student.

2. Medical Expenses

Payments that qualify for the medical exclusion are those made directly to a healthcare provider, medical institution, or medical insurance company for another person's benefit. Transportation and lodging costs related to the person's medical care can also be covered, but there are specific rules so it is best to consult with a tax professional. The payments must go directly to the care provider or insurance company, not to the individual receiving care, to avoid being considered a taxable gift.

SEEK LEGAL AND TAX ADVICE

Making gifts, particularly large gifts, have significant legal and tax consequences. Before implementing a gifting plan, be sure to consult with legal and tax advisors to explore all options and understand the implications of different strategies. While gifting may seem like a simple solution to federal estate tax liability, gifting is often complicated and has complex legal and tax consequences that should be carefully considered.

CONCLUSION

Many farmers may be facing estate tax liability in 2026. While there are no easy solutions to avoiding federal estate taxes, there are some gifting strategies that can help reduce or minimize them. But the implications of gifting, both positive and negative, must be carefully analyzed before acting. In many situations, the negative aspects of gifting may be greater than the benefits. Before implementing a gifting strategy, be sure to consult with an attorney and accountant.

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We completed this project with the generous financial support of the **USDA National Agricultural Library** and the **National Agricultural Law Center**, in partnership with **OSU Extension.**

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USING SPOUSAL LIFETIME ACCESS TRUSTS IN ESTATE PLANS

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On January 1, 2026, the federal estate tax exemption will significantly reduce unless Congress takes action to prevent the change. As this deadline nears, estate planning professionals are actively seeking strategies to help clients with high net worth minimize their potential estate taxes. One possible approach is using a Spousal Lifetime Access Trust (SLAT) in an estate plan.

A SLAT allows one spouse to transfer assets into a special type of trust and designate the other spouse as the trust's beneficiary. The beneficiary spouse receives distributions from the SLAT while living, primarily in the form of income. Upon the beneficiary spouse's death, the trust's assets are distributed to other trust beneficiaries tax-free. This strategy can reduce the taxable estate of the donor spouse.

As with any estate planning strategy, a SLAT has both advantages and disadvantages. This publication aims to explain how a SLAT works, its advantages and disadvantages, and situations in which a SLAT may be appropriate. Please note, this information is for educational purposes only and readers should consult with an attorney and tax advisor to determine the best strategy for individual circumstances.

This work is supported by the National Agricultural Library, Agricultural Research Service, U.S. Department of Agriculture. It is provided for educational purposes only, is not legal advice, and is not a substitute for the need to consult with a competent attorney licensed to practice in the appropriate jurisdiction.

WHAT IS A SLAT AND HOW DOES IT WORK?

A SLAT is an irrevocable trust designed as an estate planning tool. It provides spouses with income from assets while removing the assets from their estates.

The following example illustrates a SLAT.

> Example 1. In 2024, Arthur establishes a SLAT with his wife Betty as the beneficiary. Arthur transfers farmland into the SLAT. As the farmland generates income, the income is distributed to Betty as the beneficiary. Betty deposits the income into Betty and Arthur's joint bank account. Arthur is able to use these funds as needed. Upon Betty's death, the trust assets transfer tax free to their heirs, who Arthur named as beneficiaries of the SLAT.

Here are the key components and characteristics of a SLAT:

Irrevocability. A SLAT is irrevocable, meaning that once it is established, it generally cannot be modified or revoked, and the assets transferred into the trust cannot be returned to the donor spouse. This feature is crucial for ensuring the assets are removed from the donor spouse's taxable estate.

Trustee management. The assets within a SLAT are managed by a trustee. The trustee can be the beneficiary spouse, another individual, or multiple people acting as co-trustees. The trustee's role is to manage and oversee the trust's assets, ensuring that they are used in accordance with the trust's terms and the best interests of the beneficiary spouse.

Beneficiary spouse. The beneficiary spouse is entitled to receive distributions from the SLAT during their lifetime. These distributions are typically in the form of income generated by the trust's assets. This setup provides the beneficiary spouse with financial support while keeping the principal of the trust intact and outside the donor spouse's taxable estate.

Distribution to beneficiaries. Upon the death of the beneficiary spouse, the assets remaining in the SLAT are distributed to the named beneficiaries. These distribution beneficiaries are often the couple's children but can be anyone other than the donor spouse. The assets are transferred to these beneficiaries free of estate taxes, offering a significant tax advantage.

IMPACT ON ESTATE TAXES

A Spousal Lifetime Access Trust (SLAT) can significantly reduce estate taxes through two primary mechanisms:

1. **Exclusion from taxable estates.** When assets are transferred to a SLAT, their value is excluded from both the donor spouse's and the beneficiary spouse's taxable estates. This means that any future appreciation of the transferred assets is not subject to estate

taxes for either spouse. By removing these assets from their estates, couples can shield the growth of their wealth from potential estate tax liability.

2. **Pre-exemption reduction transfers.** Large transfers made to a SLAT before the federal estate tax exemption is reduced can also provide significant tax advantages. If the value of the transferred assets exceeds the new, lower exemption amount set for 2026, the excess is not "clawed back" into the estate. This means that the amount exceeding the new exemption is not counted against the estate tax exemption or included in the taxable estate. This strategy is particularly effective for individuals with wealth exceeding the reduced 2026 estate tax exemption threshold.

CONSIDERATIONS FOR EFFECTIVE USE

It's important to understand that gifts exceeding the annual exclusion amount will reduce the donor's lifetime estate tax exemption. Simply transferring assets to a SLAT does not inherently reduce estate taxes. The effectiveness of this strategy hinges on two factors:

1. **Appreciation of transferred assets.** The strategy is most beneficial when the transferred assets are expected to appreciate in value, as this growth will occur outside of the taxable estates.

> Example 2. Arthur transfers a farm into the SLAT valued at $1 million. Over the next 20 years, the farm increases in value to $3 million. At Betty's death, the farm is distributed out to Arthur and Betty's two children.
>
> Upon the transfer of the farm to the SLAT, Arthur's estate tax exemption was reduced by $1 million. But, the additional $2 million in appreciation was captured in the SLAT. Neither Arthur nor Betty's estate will include the $2 million in appreciation.

2. **Exceeding the exemption amount.** The strategy is particularly advantageous for those whose wealth surpasses the new estate tax exemption amount, as it allows for large transfers to be made without being subject to future estate taxes.

> Example 3. Arthur transfers $10 million of farmland into the SLAT in 2024. In 2026, the estate tax exemption is reduced to $7 million. The $3 million in excess of the new exemption amount is not "clawed back" into either Arthur or Betty's estate. Arthur and Betty were able to reduce their combined estates by $3 million.
>
> Note: Arthur's estate tax exemption will be $0 at his death because it was reduced by the amount of the 2024 gift. Betty will have her full estate tax exemption at her death because she did not transfer assets.

ADVANTAGES AND DISADVANTAGES OF THE SLAT STRATEGY

There are three primary advantages to incorporating a SLAT strategy into an estate plan:

1. **Exclusion from estate.** Assets transferred into a SLAT are not included in either spouse's estate. This is particularly beneficial for any appreciation in the value of the assets, ensuring that future growth is not subject to estate taxes.

2. **Lifetime benefits.** The beneficiary spouse can receive income and, in some cases, principal from the trust, providing financial support during their lifetime through discretionary distributions approved by the trustee.

3. **Asset protection.** Assets transferred to an irrevocable trust like a SLAT offer a level of protection from creditors of both spouses, helping safeguard the assets from potential claims.

There are also several disadvantages to using a SLAT strategy:

1. **Irrevocable nature.** Once assets are transferred to a SLAT, the donor spouse cannot reclaim the assets. This permanent loss of control can be a significant drawback for some individuals who prefer flexibility in their estate planning.

2. **Dependency on spousal relationship**. The effectiveness of a SLAT is closely tied to the stability of the marriage. Changes in marital status, such as divorce or the death of a spouse, can impact the donor spouse's ability to benefit indirectly from the trust income.

   Example 4. Betty predeceases Arthur. Because the primary beneficiary of the SLAT has died, the income and assets are now distributed to the contingent beneficiaries. Arthur and Betty's children are the contingent beneficiaries. So, the income is paid to the children. Arthur has lost the indirect benefit from the income.

3. **No step-up in basis.** Heirs do not receive a step-up in tax basis upon inheriting assets from a SLAT. This means that upon the sale of the assets, the beneficiaries may incur significant capital gains taxes. In contrast, assets inherited directly from an individual or through a revocable trust receive a stepped-up tax basis to the fair market value at the time of the original owner's death, potentially reducing capital gains tax liability.

   Example 5. Arthur transferred a farm into the SLAT he inherited from his parents. The tax basis was $1,000/acre when he inherited the farm. When Arthur's children inherit the farm, they will receive the same tax basis and will not receive a stepped-up tax basis. If the children sell the farm for $10,000/acre, they will incur taxes on the $9,000/acre gain.

EFFECT OF THE RECIPROCAL TRUST DOCTRINE

Establishing a SLAT for each spouse can maximize potential estate tax savings. However, if the two SLATs are too similar, the Internal Revenue Service may apply the "reciprocal trust doctrine" and include all the property in the spouses' estates. To avoid this outcome, the trusts must be significantly different from each other. If each spouse is establishing a SLAT, it is important to avoid the reciprocal trust doctrine. Differences can be achieved by:

- Executing the trusts at different times.
- Appointing different trustees or beneficiaries.
- Stipulating different distribution timelines for the assets.

SUMMARY

The Spousal Lifetime Access Trust (SLAT) is a valuable estate planning tool that can help reduce estate taxes, especially in anticipation of the potential reduction in the federal estate tax exemption in 2026. While a SLAT is not suitable for everyone, it can be extremely effective in specific situations, particularly for individuals with highly appreciating assets or those who can gift assets near the current federal estate tax exemption limit.

Implementing a SLAT requires careful planning and close collaboration with legal and tax advisors. As with any complex estate planning strategy, it is crucial to consult with an attorney and accountant experienced in estate tax issues to ensure a SLAT complies with all relevant laws and regulations and aligns with estate planning goals.

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UNDERSTANDING REVOCABLE AND IRREVOCABLE TRUSTS

Robert Moore, Attorney, OSU Agricultural & Resource Law Program

Farm succession planning is a critical need that ensures the seamless transition of farm ownership and management from one generation to the next, preserving the legacy and viability of the farm. Two key tools used for succession planning are revocable and irrevocable trusts. Understanding these two trusts is essential for effective farm succession planning. This bulletin compares the characteristics, advantages and disadvantages of each type of trust and explains how each can enable a farm succession plan.

WHAT IS A TRUST?

A trust is a legal instrument for managing assets. A trust "grantor or settlor" establishes a trust, directs assets into the trust, and appoints a trustee to oversee the trust. The trustee must manage and distribute trust assets and benefits according to the grantor's instructions. Trusts are highly useful tools that can protect assets, provide for heirs, and offer tax advantages to the grantor and beneficiaries.

THE REVOCABLE TRUST

A revocable trust, also known as a "living trust," is a trust the grantor can alter, amend, or revoke at any time during the grantor's lifetime. For this reason, the grantor is often the trustee of the revocable trust.

1. **Characteristics of a revocable trust**
   - **Control.** A grantor who is also the trustee can retain control over the trust and its assets.
   - **Flexibility.** The terms of the trust can be changed as circumstances evolve. The trust can be changed at any time and as many times as needed up until the time of the death of the grantor.
   - **Income.** The grantor can receive income from the trust during their lifetime.
   - **Assets in trust.** The grantor can withdraw or contribute assets to the trust at any time.
   - **Taxation.** The trust's income is typically reported on the grantor's personal tax return.

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2. **Advantages of a revocable trust**
    - **Avoidance of probate.** Upon the grantor's death, the assets in a revocable trust pass directly to the beneficiaries, bypassing the often lengthy and expensive probate process.
    - **Privacy**. Trusts are private documents, whereas wills become public record through probate.
    - **Management during incapacity**. If the grantor becomes incapacitated, the trustee can manage the trust assets without court intervention.
    - **Amendments and asset management.** The trust terms can be changed at any time and assets can be contributed or withdrawn from the trust during the life of the grantor.
    - **Stepped-up tax basis.** All assets in the trust will receive a stepped-up tax basis at the grantor's death resulting in significant tax benefit to the trust beneficiaries.

3. **Disadvantages of a revocable trust**
    - **No tax benefits.** Revocable trusts do not provide tax benefits during the grantor's lifetime. All assets in a revocable trust will be included in the grantor's estate value.
    - **No asset protection.** Assets in a revocable trust are not protected from creditors, including nursing homes, since the grantor retains control.

THE IRREVOCABLE TRUST

An irrevocable trust is a trust that, once established, cannot be altered, amended, or revoked by the grantor, except under specific conditions.

1. **Characteristics of an irrevocable trust**
    - **Loss of control.** The grantor relinquishes control over the assets placed in the trust. The trustee of the trust, which cannot be the grantor, has legal authority of the trust assets.
    - **Permanency.** Most terms of the trust are fixed and cannot be changed, providing certainty and permanency to the plan.
    - **Separate tax entity.** The trust is considered a separate tax entity and may be required to file its own tax return.

2. **Advantages of an irrevocable trust**
    - **Asset protection.** Assets are generally protected from creditors and legal claims.
    - **Tax benefits**. Irrevocable trusts can offer tax advantages, such as reducing estate taxes.
    - **Medicaid planning.** Assets in an irrevocable trust are not counted for Medicaid eligibility, which can be important for long-term care planning.[1]

3. **Disadvantages of an irrevocable trust**
    - **Inflexibility**. Once established, the terms of an irrevocable trust are difficult to change.
    - **Complexity.** Creating and managing an irrevocable trust can be complex and may require professional assistance. The complexity of an irrevocable trust will often result in higher legal fees than a revocable trust.
    - **Loss of control.** The grantor gives up control over the trust assets.

[1] Assets contributed to an irrevocable trust are subject to the 5-year Medicaid lookback rule. See *Long-Term Care and the Farm*, available at farmoffice.osu.edu, for a thorough discussion of Medicaid rules and asset protection.

- **No stepped-up basis.** Some irrevocable trusts do not allow for the assets held in the trust to receive a stepped-up tax basis at the grantor's death. The determination as to whether a stepped-up tax basis is available depends on what benefits or control, if any, the grantor retains. For example, if the grantor retains the income rights from the trust, the trust assets will receive a stepped-up tax basis at death.

USING TRUSTS IN FARM SUCCESSION PLANNING

Revocable and irrevocable trusts can play vital roles in farm transition planning, but the choice of which to use depends upon the situation. Where flexibility and continuity are important, a revocable trust will likely be a better fit for a plan. On the other hand, if protecting assets and minimizing taxes are primary concerns, an irrevocable trust may be the best choice. And a plan might require the use of both types of trusts. Here is a review of the strengths of each type, as well as thoughts on incorporating both trusts into a farm succession plan.

1. Strengths of revocable trusts

- **Management continuity.** A revocable trust allows the current farm owner to maintain control over the farm operations while planning for future succession.
- **Smooth transition**. By transferring farm assets into a revocable trust, the transition to the next generation can be smoother and more organized, avoiding the probate process.
- **Flexibility**. Given the dynamic nature of farming and potential changes in family circumstances, the flexibility of a revocable trust is advantageous. The terms can be adjusted as needed.
- **Incapacity planning.** If the farm owner becomes incapacitated, the successor trustee can seamlessly step in to manage the farm without court intervention.

2. Strengths of irrevocable trusts

- **Asset protection**. Placing farm assets in an irrevocable trust can protect it from creditors and legal claims, ensuring the farm remains in the family.
- **Tax efficiency**. Irrevocable trusts can be structured to minimize estate and gift taxes, preserving more of the farm's value for the next generation.
- **Medicaid planning.** For farm owners concerned about long-term care costs, an irrevocable trust can help shield farm assets when planning for Medicaid eligibility.

3. Strategic use of both trusts

In many cases, using a combination of revocable and irrevocable trusts may be the most effective approach for farm succession planning. Consider these examples that illustrate how and when both trusts can benefit a plan:

- **Initial flexibility**. A farm owner might start with a revocable trust to maintain control and flexibility during their lifetime.
- **Transition to irrevocable trust**. As the farm owner ages or as part of an estate planning strategy, they might transfer certain assets into an irrevocable trust to gain the benefits of asset protection and tax advantages.

- **Layered approach**. Different farm assets might be placed in different types of trusts based on their nature and the family's goals. For instance, operational assets might stay in a revocable trust for flexibility, while land and equipment could be placed in an irrevocable trust for protection and tax benefits.
- **Preservation of family legacy**. Either type of trust can ensure that the farm is preserved and managed according to the grantor's wishes, maintaining the family legacy.

PLANNING PROFESSIONALS CAN TAILOR TRUST PLANS FOR FARM OWNERS

Each farm business and farm family is unique, and so are the trusts that can benefit a family's succession plan. Revocable trusts provide flexibility, control, and ease of management during the grantor's lifetime, making them a valuable tool for initial succession planning stages. On the other hand, irrevocable trusts offer robust asset protection and some tax benefits.

It's important to recognize that "one size" or type of trust doesn't fit every farm situation. That's where knowledgeable professionals come into play. Attorneys, accountants, financial planners, and other professionals who specialize in agricultural succession planning can tailor a trust plan to meet the specific needs and goals of the farm and its owners. Farmers should take care to work closely with farm succession planning professionals to determine whether revocable or irrevocable trusts can help them accomplish their goals to plan for the future of the farm.

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USING LONG-TERM LEASES IN FARM TRANSITION PLANNING

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A common challenge in farm transition planning is dividing assets between farming heirs and non-farming heirs. In an ideal scenario, the farming heirs simply receive the farm assets and the non-farming heirs receive the non-farming assets. However, this approach is usually problematic for two reasons. First, since most of a farmer's wealth is usually made up of farm assets, leaving the farm assets to farming heirs can cause non-farming heirs to be treated unfairly. That is, non-farming heirs could receive less of an inheritance.[1] Second, even though they may not be involved in the farming operation, non-farming heirs might wish to inherit the family farmland for sentimental or business reasons.

These issues present a common dilemma for farmers with on-farm heirs and off-farm heirs. On the one hand, they might want to treat all of their heirs fairly. On the other hand, they might want to protect the farmland base for a farming heir. The use of a long-term lease (LTL) in the farm transition plan is one strategy to help overcome this dilemma. This publication will discuss how an LTL can be used in a farm transition plan and the advantages and disadvantages of this strategy.

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[1] What is considered "fair" treatment of heirs is highly subjective and can vary from family to family. Farm transition plans often provide certain benefits to the farming heirs, such as receiving a larger proportion of the assets or the right to purchase assets on favorable purchase terms.

WHAT IS A LONG-TERM LEASE?

Before discussing how to use an LTL, we need to understand what is meant by LTL. There is no precise definition for an LTL, but for the purposes of this discussion an LTL is a contract between the non-farming heir (as the Landowner) and the farming heir (as the Tenant) that allows the farming heir to lease farmland for an extended period in exchange for rental payments to the non-farming heir. An LTL usually has a term of at least five years and sometimes 40 years or more. An LTL provides stability for the farming heir, allowing for long-term planning and investment in the farming operation.

THE DILEMMA OF DIVIDING ASSETS

Let's further explore the dilemma facing many farmers. Consider the following example:

> Mom and Dad own a farming operation and farmland. They have two children, Andy and Chris. Andy is involved in the farming operation full-time and intends to continue the farm. Chris is not involved in the farming operation but enjoyed growing up on the farm and would like to inherit some of the land. Mom and Dad own $1 million of farmland, $500,000 of farm operating assets and $500,000 of non-farming assets. Mom and Dad recognize Andy's contribution to growing the farm and think a 60/40 split between Andy and Chris is a fair inheritance allocation.

In this typical farm transition scenario, Mom and Dad face a dilemma. If they give Chris only non-farming assets, he will not receive the 40% of their total estate they believe is fair and he will not own any of the farmland. On the other hand, if Chris receives any of the farm assets, Andy's farming operation could be at risk due to Andy not having full control over the farm assets. For example, what if Chris receives some of the land, then leases it to the neighbor or gets into financial problems and is forced to sell the land?

HOW DOES AN LTL SOLVE THE DILEMMA?

An LTL can be designed and incorporated into a farm transition plan to allow non-farming heirs to inherit land without jeopardizing the land base for the farming heir. The LTL gives the farming heir the right to farm the land even though they do not own the land. Let's continue the previous example:

> Mom and Dad want Chris to inherit the Smith Farm and want Andy to be able to farm the land. Mom and Dad establish a trust with the following terms:
> *"Upon our deaths, my Trustee shall execute a 20-year cash lease for the Smith Farm with Andy. My Trustee shall distribute the Smith Farm to Chris subject to this lease. In the event Andy discontinues farming for any reason, Chris may terminate the lease."*

The LTL helps solve Mom and Dad's dilemma. Chris will get the Smith Farm to satisfy Mom and Dad's goal of Chris receiving 40% of their estate while also fulfilling Chris' wish to own farmland. Andy's farming operation is protected by attaching a 20-year lease to the Smith Farm. This strategy meets Mom and Dad's goals for Chris while also making sure all of the farmland will be available to Andy's farming operation.

SHOULD YOU USE A LONG-TERM LEASE?

An LTL is an important tool in the farm transition legal toolbox. However, an LTL is not for everyone and might not be an appropriate strategy for some farm transition plans. A careful analysis done on a case-by-case basis can determine if an LTL is appropriate for a particular plan. To help with this analysis, let's look at the advantages and disadvantages of LTLs.

1. Advantages of LTLs

- **Protects land base for farming heir.** An LTL can ensure land is available to the farming heir even if the land is inherited by another family member. Recorded leases typically remain on and "run with the land," so the farming heir is protected even if the land is transferred in the future.
- **Provides income to off-farm heir.** The lease requires the farming heir to pay rent to the non-farming heir. Lease payments are a steady, secure income stream for the non-farming heir.
- **Helps cash flow of farming heir.** As anyone who has recently purchased farmland knows, farmland often has negative cash flow. That is, the debt payments on farmland are usually greater than the income from the land. Leases allow the farming heir to farm the land without the large capital outlay required to buy farmland. Also, the lease payment is a fully deductible expense for the farming heir.
- **Provides certainty.** An LTL allows the farming heir to plan for the future with more certainty. The farming heir can make long-term business and financial plans, which is crucial in agriculture when crop cycles and investments span several years. For the non-farming heir, an LTL guarantees a consistent stream of income, usually with favorable tax treatment.[2]

2. Disadvantages of LTLs

- **Limited options for non-farming heir.** While the non-farming heir will own the land, they have little control over it. The lease intentionally limits the non-farming heir's ability to control the land in favor of allowing the farming heir to use the land for their farming operation. Even though the non-farming heir's name is on the deed, they do not have the same control a typical owner would have over property.

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[2] For income tax purposes, the income from a cash rent lease is considered passive income and thus not subject to Self-Employment taxes. The classification of passive income depends on the terms and conditions of the lease and the role of the landowner in the leasing situation.

- **The land is largely unmarketable while LTL is in effect**. An LTL can makes farmland less marketable. Buyers might not be willing to purchase farmland that has an LTL in place. In fact, the person most likely to be interested in purchasing farmland subject to an LTL is the farming heir. A non-farming heir who wants to sell the farmland they inherited could be disappointed if an LTL limits the land's marketability.
- **Does not contribute to farming heir's equity.** The lease payments the farming heir makes to the non-farming heir does not build land equity for the farming heir. If those same payments were being made to purchase the farm, the farming heir would be creating equity. The farming heir could be frustrated that they are paying for the use of family land without ever receiving the benefit of equity in the land.
- **Farming heir does not have full control.** Similar to the first disadvantage discussed above, the farming heir does not have full control over the leased land. They may be reluctant to make capital improvements to the land such as drainage tile, grain bins and buildings. Leasing land does not allow the farming heir the same opportunities to grow and expand their farming operation as owning the land offers.

WHAT ABOUT THE EVER-CHANGING RENTAL VALUE?

The farmland cash rent market is always changing and factors like commodity prices, input costs and government programs can have significant effects on cash lease rates. Fixing the lease rate for the duration of an LTL will almost assuredly result in the lease rate eventually being unfair to one of the parties. A mechanism to adjust the lease rate can address this issue. A typical provision could allow either party to request the lease rate to be adjusted every few years. If the parties cannot agree on the adjusted lease rate, the lease rate could be established by government or university lease rate data or determined by an independent third-party, such as an appraiser. The following is an example of a lease rate adjustment provision that could be included in an LTL:

> *"Every third year of the lease, either Tenant or Landowner may request a renegotiation of the lease rate. Upon such request, the parties shall attempt to reach a mutually agreeable lease rate. If the parties are unable to agree upon a lease rate, a mutually agreeable third-party shall be hired to determine the fair market cash rent value of the property. The costs of hiring the third-party shall be divided equally between the Tenant and Landowner."*

DISCOUNTING THE LEASE RATE

An LTL can include a discount on the lease rate. The discount is commonly included to prevent the farming heir tenant from having to compete with the highest cash rents. The parents might want the farming heir to pay a fair rent for the land but not necessarily the top rent. For example, let's say Mom and Dad do not want the farming heir to have to compete against high cash rents established in the area. They feel 80% of cash rent provides a fair rental rate to both the farming heir and non-farming heir. The following is an example of a provision that could be included in an LTL:

> *"The lease rate shall be 80% of the fair market cash lease rate for similarly situated farmland. For example, if the fair market cash lease rate for similar farmland is $250/acre, the lease rate shall be $200/acre."*

CONSULT WITH YOUR LEGAL PROFESSIONAL

An LTL can be a valuable tool in the farm transition toolbox by allowing farmland to be transferred to non-farming heirs while keeping the land base available to the farming heir. However, an LTL is not for everyone. As with any strategy, there are both advantages and disadvantages that should be weighed when deciding if an LTL is the appropriate strategy for any given situation. Due to the long-term nature of an LTL, it should be drafted in consultation with legal counsel to be sure that the lease meets the expectations of both parties and has adequate protection for changes in lease rates.

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USING GENERATION SKIPPING TRUSTS TO TRANSFER FARM ASSETS

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Farm transition planning often focuses on passing assets smoothly from one generation to the next, but in some cases, a preferred strategy may be to skip a generation and distribute assets to the following generation. A Generation Skipping Trust (GST) is an estate planning tool that allows a farm owner to do so. A farmer can designate that assets will transfer directly to grandchildren and other younger beneficiaries in the future, while providing financial benefits from the trust to the children during the children's lifetimes.

The GST approach opens more options for the farm transition plan and can help protect family farmland, reduce estate taxes, and safeguard assets from internal mismanagement and creditors. This publication explains the basics of GSTs, when they can be useful, their advantages and disadvantages, and how they may fit into a farm's long-term goals.

WHAT IS A GST?

A GST is a concept applied in a trust rather than a specific type of legal instrument or document. It is a trust arrangement that designates assets to bypass the grantor's children and go directly to the grandchildren or other future generations while maintaining benefits to the children during their lifetimes.

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For example, a GST can explicitly state that assets are not to be inherited by the grantor's children, but instead will go to the grandchildren or great-grandchildren, typically at a specified later date. The trust can allow income from the trust assets, such as rent from farmland in the trust, to be distributed to the children until the grandchildren receive the assets. The trust appoints a trustee to manage the assets and any selling, leasing or reinvesting, until the trustee distributes the assets to the grandchildren.

WHY USE A GST?

We already know that we can use a GST to skip the children's generation. However, to fully understand the strategic use of GSTs in farm transition planning, it is important to consider the specific scenarios in which they offer distinct advantages. While there are many reasons for using GSTs, in the context of farm transition planning, the three main reasons are:

1. Avoiding estate taxes for the children's generation.
2. Protecting assets.
3. Mitigating the impacts of problematic heirs.

1. Avoiding Estate Taxes for the Children's Generation

Although federal estate taxes affect only a small percentage of people, they can have a significant impact on those who must pay them. Due to the continuing increase in farmland values, a disproportionate number of farms may face an estate tax issue. For estates that exceed the federal exemption threshold, the estate tax rate may be as high as 40%. In such cases, the use of a GST can serve as an effective strategy to reduce the estate tax burden across generations.

A GST is especially useful when the children's generation has already accumulated significant wealth. If they inherit additional assets from their parents, it will add to their wealth and subject a greater portion of it to federal estate taxes upon their death. The thought is that if the children are already facing estate tax issues, we should not add to their wealth and trigger even more estate taxes. This strategy allows the family to preserve wealth for future generations while still supporting the children during their lifetimes. Consider the following example:

> Farmer's child Andy has had a successful career and has accumulated assets of $20 million dollars. If Andy inherits Farmer's farmland valued at $5 million, Andy's net worth will increase to $25 million. When Andy dies, he will owe estate taxes of $2 million on the farmland alone ($5 million x 40%). Inheriting the farmland adds to Andy's estate tax issue. Instead, Farmer includes a GST provision in his trust so that the farmland is held in trust for Andy's life. Andy will receive all the rental income from the farmland but will not hold legal title to the farmland. Upon Andy's death, the farmland passes directly to his children (Farmer's grandchildren), bypassing Andy's estate and avoiding the estate tax that would otherwise be incurred.

This example illustrates how the use of a GST can limit the estate tax liability of the children's generation while preserving income streams and ensuring that important assets, such as farmland, remain within the family over multiple generations. When using a GST to avoid estate tax liability in the children's generation, it is important to limit how much control the children have over the GST assets. Careful drafting is required to ensure these plans function properly.

2. Protecting Assets

Protecting farmland and other assets for future generations is a common goal in farm transition planning. A GST helps achieve this by preventing assets from passing directly to the children's generation, thereby shielding the assets from potential loss due to creditors, lawsuits, divorces, or poor financial decisions by the children. Basically, if the children don't own assets, they can't lose them.

A GST can also help when parents are concerned that their children may be tempted to sell key assets, such as farmland, rather than preserve them for future generations. By placing the assets in a GST, the parents retain control over how and when the assets are distributed. Let's explore an example of this concept.

> Farmer wants his farmland to remain in the family for future generations. Farmer's children have no interest in the farmland, and Farmer feels it is likely they will sell the farmland when inherited. Farmer would like his grandchildren to have a chance to own the farmland.
>
> Farmer establishes a GST that holds the farmland for the children's lives and then distributes the farmland to the grandchildren after the children have passed. The children will receive the income from the farmland, but do not have the ability to sell the land and receive the sale proceeds.
>
> In this example, the GST allows Farmer to accomplish his goal of having the grandchildren inherit the farmland. The GST also allows Farmer to provide income to the children for their lives so that they receive at least some financial benefit from the farmland.

This example illustrates how the use of a GST can preserve control over key assets within a family even after a farmer has passed away. It simultaneously ensures that the farmer's children will receive income from those key assets while also ensuring that the farmer's grandchildren will have an opportunity to own those assets in the future.

3. Mitigating the Impacts of Problematic Heirs

One of the more difficult aspects of farm transition planning is dealing with concerns about heirs who may not be capable of responsibly managing an inheritance. A GST can be a useful tool for addressing these situations without completely disinheriting a child. If there are concerns about a child's financial judgment, substance abuse, unstable relationships, or other personal issues, a GST can help ensure that family assets are not lost or misused.

Because the GST does not give ownership of the assets to the children's generation, it removes their ability to sell, squander, or lose the assets through poor decisions or legal problems. The trust can instead provide financial benefit to that child in the form of income. Meanwhile, the trust preserves the principal assets for future generations.

HOW A GST WORKS

A GST usually takes one of two different forms: a standalone trust created specifically for all assets to skip a generation or a provision within a broader trust that applies generation-skipping provisions only to certain assets. Let's look at some examples.

1. **Standalone GST Trust**

Farmer's only significant asset is farmland. He wants to skip his children's generation and have the farmland inherited by his grandchildren. However, he does want his children to receive income from the farmland for their lifetimes.

Farmer establishes the *Farmer's Legacy Generation Skipping Trust*. This trust's sole purpose is to ensure that Farmer's children receive income from the GST and that the grandchildren inherit the farmland upon the death of the children. The trust language may look like the following:

> Upon my death, my assets shall be held in a Generation Skipping Trust. While held in trust, my Trustee shall distribute all net income from my assets to my children, in equal shares, at least annually. Upon the death of my children, my Trustee shall distribute the assets outright, free of trust, to my grandchildren." [1]

The GST with this provision will ensure that Farmer's children will receive the income from the farmland without owning it and the grandchildren will ultimately inherit the farmland. This can help ensure that farmland remains in a family for multiple generations following the death of the current owner.

2. **GST Provision within a Broader Trust**

Farmer owns a variety of assets. For his farmland, he wants to skip his children's generation. For all other assets, he wants his children to inherit. In this situation, Farmer establishes a trust that includes a GST provision but also includes provisions for his other assets. The GST is only one part of the larger trust plan. The trust language may look like the following:

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[1] Examples of trust language in this publication are for illustration purposes only. Actual GST provisions will be more detailed.

> "Upon my death, my Trustee shall place my farmland in a Generation Skipping Trust. While held in trust, my Trustee shall distribute all net income created by my farmland to my children, in equal shares, at least annually. Upon the death of my children, my Trustee shall distribute the GST outright, free of trust, to my grandchildren. My Trustee shall distribute all other assets not held in the GST to my children in equal shares."

The GST provisions within the broader trust allow for customized planning, providing a GST for the farmland but allowing all other assets to be distributed directly to the children. This setup is often used so that operating assets, such as machinery, can be directly inherited by the children while still ensuring that the land will be preserved for the grandchildren.

CHOOSING ASSETS FOR A GST

Determining which assets to place in a GST is a key part of the trust planning process. The following considerations can help guide the selection of appropriate trust assets:

1. **Income-Producing Assets**

Assets that generate steady income are well-suited for a GST, as the income can support the current beneficiaries while preserving the principal for future generations. Examples of such assets include:

- Farmland under lease
- Mineral rights or oil and gas leases
- Investment accounts with dividend or interest income

2. **Appreciating Assets**

Assets expected to increase in value over time can help maximize the long-term benefit of the GST and take advantage of gift and estate tax exemptions. Examples of such assets include:

- Farmland likely to appreciate
- Commercial real estate
- Business interests in a growing enterprise

3. **Legacy or Family-Centered Assets**

GSTs can preserve assets intended to remain in the family, offering long-term protection against creditors, divorce, and unintended sales. Examples of such assets include:

- Family farmland
- Vacation homes or recreational property
- Heirlooms, antiques, or other sentimental items

4. **Assets to Avoid Placing in a GST**

Avoid placing complex or high-maintenance assets in the GST, especially if the trustee may have limited experience. Such assets include:

- Assets with significant debt.
- Assets that require frequent replacement, repair, or operational oversight such as farm machinery and livestock.

TAX LIMITATIONS ON THE AMOUNT THAT CAN BE PLACED IN A GST

The value of assets contributed to a GST reduces the grantor's federal estate tax exemption.[2] Additionally, the grantor's generation-skipping transfer tax exemptions is reduced. The GST transfer tax exemption is a specific allowance that lets the grantor transfer a certain amount of wealth to the "skipped persons" (like grandchildren or great-grandchildren) without triggering a flat 40% federal tax. If the total value of the assets transferred to the GST exceeds the available exemption, the excess amount is subject to the 40% tax. This tax is essentially the same as the tax that would be levied against any estate that exceeds the federal estate tax exemption. This rule is designed to prevent individuals with significant wealth from avoiding estate taxes by transferring large amounts to younger generations through a GST. Consider the following example:

> Farmer has a net worth of $20 million. The federal estate tax exemption and the GST transfer tax exemption are both $15 million. Farmer can transfer up to $15 million to a GST without triggering gift tax or GST tax. If Grantor were to transfer more than $15 million of wealth to the GST, Grantor would owe a 40% tax on the overage.

Although a GST can be an effective way to reduce estate taxes for the children's generation, it does not reduce or eliminate estate taxes for the parents' generation. The federal estate tax exemption limits and the GST tax exemption limits cap the amount of assets that can be transferred to a GST. People whose wealth exceeds these limits may still have estate tax liability. The use of a GST must still account for the overall estate tax exposure of the grantor.

Because of the estate tax exemption limit and GST transfer tax limit, it is critical to consult with legal and tax professionals before establishing a GST. These professionals can help ensure the trust is structured in a way that maximizes tax efficiency while meeting the family's broader transition planning goals.

[2] A gift tax return (Form 709) may be required if assets are transferred to an irrevocable GST trust.

GST TRUST PROVISION STRATEGIES

The specific provisions within the GST can vary to accommodate different goals, concerns the needs of the farmer who creates the trust and the farmer's beneficiaries. Consider the following strategies.

1. **Distributions for Health, Education, Maintenance and Support (HEMS)**

As discussed earlier, the income generated by a GST is typically distributed each year to the children's generation. However, there may be times when a child has additional expenses beyond what the trust income can cover, such as medical treatment or tuition. In such cases, a GST can include language that allows the trustee to distribute part of the trust principal to help cover these needs. The authority to make these distributions is limited and must follow specific rules set by the Internal Revenue Service (IRS). Failure to follow the IRS rules can result in loss of many GST benefits, such as exclusion of the GST assets from the child's estate, meaning they would be included in the children's taxable estates.

To maintain the tax benefits of a GST, the trustee's power to distribute principal must be restricted to certain clearly defined purposes. These purposes are known as ascertainable standards and usually include expenses related to health, education, maintenance and support, or "HEMS." If a beneficiary can show there is a real need in one of the HEMS areas, the trustee may be able to provide additional funds from the trust principal to the beneficiary for the expenses. The trust can also require the trustee to make payments directly to the provider of the goods or services, such as a school or hospital, rather than directly to the beneficiary to ensure the money is used for the intended HEMS purpose.

Consider the following example, which shows how a GST can offer flexibility in times of need, without giving full control of the assets to the children's generation.

> Farmer creates a GST that pays annual income to his children. He includes a provision that allows the trustee to distribute principal to any child who demonstrates a need related to HEMS. After the farmer's death, one of his children, Betty, develops a serious medical condition. Betty's personal resources and the income from the GST are not enough to cover her medical bills. She asks the trustee for help. The trustee reviews her situation and determines that her request qualifies under the health category of the trust provision. To raise the funds, the trustee sells a small parcel of farmland held in the trust and uses the proceeds to pay Betty's medical bills directly to the doctors and hospital.

It is important to understand that a HEMS provision is not required in a GST. The trust can be written to allow only income distributions and prohibit access to the principal under any circumstances., including HEMS Whether or not to include this kind of provision is an important decision to consider with legal advisors when the trust is created.

2. Annual Distributions of Income

Although a GST is not required to distribute income annually, doing so is often the most tax-efficient strategy. That's because income that remains in a GST is taxed at compressed trust income tax rates, which are much higher than individual tax rates. For example, in 2025, any income retained by the trust above $15,650 is taxed at the highest federal rate of 37 percent. Distributing the GST income to beneficiaries annually can avoid the higher trust tax rate, and the beneficiaries who receive the income are likely to be in lower income tax brackets

Keeping the income in the trust may provide some asset protection, but it can come at a steep tax cost. Trust creators should consider this tradeoff when designing the trust and discuss distribution terms with their legal and tax advisors.

3. Different Shares for Different Children

So far, we have discussed GSTs as if they apply to all children equally. However, equal treatment is not required. A trust can be designed to treat each child differently, with GST provisions applied only where they are needed. One child may benefit from having their inheritance held in a GST, while another may be better served by receiving their inheritance outright, outside of the GST structure.

This flexibility allows parents to adapt their farm transition plan to fit each child's unique circumstances. There is no reason to use a GST for a child who does not need asset protection or estate tax planning. In fact, applying GST provisions unnecessarily may add cost and complexity without offering any real benefit. Consider the following example:

> Farmer has three children, Andy, Bo and Christine. Each child's situation is quite different:
>
> - Andy is very wealthy. Any inheritance he receives will likely increase the value of his estate, resulting in higher estate taxes at his death.
> - Bo has a history of addiction and unstable employment. He never seems to have any money and is constantly pursued by creditors.
> - Christine is successful and responsible, but her wealth level is comfortably under the federal estate tax exemption. She is unlikely to face federal estate taxes.
>
> To address these differences, Farmer establishes a revocable trust for his farm transition plan. The trust includes a GST that skips Andy to avoid adding to his estate tax issue and skips Bo to protect his share from mismanagement and creditors while still allowing him to receive annual net income distributions. Farmer's trust does not provide a GST for Christine as it is not needed and will provide no benefit to her. Christine will receive her share of inheritance outright, free of a GST provision.

Using a GST provision differently for different children can also be beneficial to continued farm operation considerations. When combined with long term leases and rights of first refusal, a GST can allow a farmer to treat his children more equally while still protecting the future of the family farming operation. Consider the following example:

Farmer has three children, Amy, Ben, and Chase, with different situations:

- Amy is the farming heir. She currently operates the farm with her parents. She intends to continue the operation after her parents have passed away and hopes to eventually transition the operation to her own children.
- Ben is a successful banker in New York and does not have any kids. While he is not interested in operating the farm, he would like to see some financial benefit from it during his lifetime. His major goal though is to make sure that his sister Amy can continue farming and that the family farming legacy is continued.
- Chase has a history of unstable employment and has asked many times why his parents do not liquidate the farm. If he were to inherit any farmland, his first action would be to sell it to the highest bidder. Chase has two kids, but neither of them are old enough to know if they want to farm yet.

To address these differences, Farmer establishes a revocable trust for his farm transition plan. Amy's share of the assets is distributed directly to her to ensure she can continue operating the farm. Farmer also creates a GST provision for Ben to ensure he gets an annual distribution of net income from his share of the assets. After Ben passes away, his share is to pass to Amy's children as the presumptive farming heirs in the grandchildren's generation. Farmer also includes a GST for Chase's share of the assets, which removes his ability to "cash in" on the value of the farmland while still allowing him to receive net annual income from the assets. At Chase's passing, his share will go to his two children, ensuring that if they wish to farm, those assets are still available to them. This example illustrates how a GST can be used selectively to ensure that farming heirs have access to the assets they need to continue the operation while still providing benefit to the off-farm heirs of the grantor.

Both examples above illustrate how GSTs can be used selectively to address different beneficiaries in different situations. The decision to include a GST should be based on the individual needs and risks associated with each child and the situation, rather than applied as a one-size-fits-all solution.

TRUSTEE SELECTION AND RESPONSIBILITIES

The trustee of a GST plays a critical role, and their selection should be made with careful consideration. The trust document should identify the trustee(s), clearly define both the trustee's responsibilities and, perhaps more importantly, any limitations on their authority. Generally speaking, the lifetime beneficiary of a GST cannot be the sole trustee of their trust without losing some of the GST tax benefits.

1. Selecting the Trustee

The type of trust determines who can serve as trustee. For an irrevocable GST, the grantor should not serve as trustee. To fully benefit from the legal protections and tax advantages of an irrevocable trust, the grantor must relinquish control. For a revocable trust with a GST provision, the grantor can serve as the initial trustee during their lifetime but must name a successor trustee to take over after their death.

A GST trustee should be someone who is organized, dependable, and capable of managing financial and legal responsibilities. Often, adult children are well-suited for the role as they are typically familiar with the trust assets, understand the grantor's goals, and may serve without compensation. If children are unable or unwilling to serve, other trusted family members or friends may be appropriate. Professional trustees such as attorneys or banks are also an option but will charge a fee. Be aware, however, that banks generally prefer managing liquid assets and may not be interested in overseeing land or farm property. If a bank is chosen, confirm that it is willing to manage the specific assets in the trust without requiring liquidation.

It is possible to appoint multiple co-trustees, but doing so requires careful consideration. Co-trustees must be able to communicate and collaborate effectively. Conflict among trustees is a recipe for disaster.

In addition to naming a primary trustee or co-trustees, it is essential to designate successor trustees. A successor will step in if the original trustee dies, resigns, becomes incapacitated, or is otherwise unwilling or unable to serve. If no named trustee or successor is able to serve, the trust may include provisions allowing the beneficiaries or a trust protector[3] to appoint a new trustee.

2. Trustee Responsibilities

The trustee is responsible for managing and protecting the trust assets, a role that varies depending on the nature of those assets. For example, if the trust holds farmland, the trustee will handle expenses such as property taxes and insurance and will collect any rental income. For other asset types, the trustee must ensure expenses are paid and income is collected as appropriate.

[3] A trust protector is an individual or entity appointed to safeguard the interests of beneficiaries and the overall integrity of a trust. The law firm that drafts the trust is often the trust protector.

Another key duty is distributing income to beneficiaries. At the end of each tax year, the trustee must calculate the trust's income, distribute it to the income beneficiaries, and work with an accountant to file any required trust income tax returns and provide beneficiaries with the necessary tax documents.

The trustee may also be responsible for distributing principal, but only if allowed by the trust terms. For example, if a beneficiary requests principal for HEMS, the trustee must evaluate whether the request meets the standards. If so, the trustee must determine how to access or raise funds to fulfill the distribution.

DISADVANTAGES OF A GST

The above information demonstrates that a GST can offer significant benefits in certain scenarios but there can also be disadvantages to using a GST to transfer farm assets. It's important for farm families to weigh these potential disadvantages against the benefits and carefully consider their specific circumstances, goals, and family dynamics before deciding if a GST is the appropriate estate planning tool.

1. **Complexity and Cost**

Establishing and administering a GST is generally more complex and expensive than creating a simple trust or will. The legal and accounting fees associated with drafting and managing a GST can be substantial due to the intricate tax rules and reporting requirements.

2. **Loss of Control**

Once assets are transferred into an irrevocable GST, the grantor relinquishes direct control over those assets. While the grantor can appoint trustees, their ability to directly dictate how the assets are managed or distributed is limited by the terms of the trust. This lack of flexibility can be a concern if circumstances change significantly.

3. **Potential for Family Conflicts**

While designed to benefit future generations, a GST can inadvertently create tension or conflict within the family. The children's generation may feel slighted or "passed over" by the assets being sent directly to their children, potentially leading to resentment or disagreements about the trust's management and distributions. Clear communication and a well-defined trust document are crucial to mitigate this risk.

4. **GST Tax Implications**

While the primary goal is often to avoid estate taxes in the children's generation, the GST tax itself can be a significant consideration. This tax, levied at the highest federal estate tax rate, applies when assets exceeding the federal estate tax exemption are transferred to skip generations.

5. **Administrative Burden**

Managing a GST involves ongoing administrative responsibilities, including tax filings, accounting, and trustee duties. This can be time-consuming and may require the engagement of professional advisors, adding to the overall administrative cost.

6. **Potential for Mismanagement**

The success of a GST heavily relies on the competence and integrity of the trustee. Poor trustee selection or mismanagement of the trust assets can thwart the grantor's intentions.

IS A GST RIGHT FOR YOU?

GSTs offer a flexible and effective tool for farm families seeking to preserve key assets and reduce estate tax burdens across generations. Whether used to avoid estate taxes, protect farmland from liquidation, or safeguard inheritances from potential issues with heirs, a GST can provide long-term stability while still supporting the children's generation through income distributions. Importantly, GSTs can be customized to individual family members' circumstances. However, a GST is not appropriate for everyone, as it is typically beneficial only in unique circumstances involving significant assets and/or multigenerational planning goals. It is important to weigh the benefits of a GST against its disadvantages.

As with any estate planning tool, a GST should be carefully drafted with the guidance of qualified legal and tax advisors. A GST is worth considering when long-term asset preservation and multigenerational planning are top priorities. For farm families looking to protect their legacy and ensure a smooth transition to future generations, the GST may be the right fit.

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