



# Ag Business Management

*Informing farm families and ag businesses about management issues.*

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## Estate Planning Principles

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### Introduction:

Estate planning is the process of controlling your assets during your life as well as after your death. Your estate plan should focus on three objectives. Those objectives are: 1) to ensure that your assets will provide you with the necessary income and resources upon which to live, 2) to ensure that upon your death, your assets go to the people and/or organizations you intended, and 3) to minimize your estate tax, fees, and any associated court costs.

Estate planning encompasses many components. Your Will or trust must be adapted or changed to meet your objectives. Property ownership must be examined and tailored to your plan. Life insurance amounts, policy ownership, and beneficiaries must be reviewed. Family income requirements must be matched with projected income. Other items include treatment of heirs, passing on a business, power-of-attorney, health care directive with a HIPPA designation, disability planning, tax planning, personal representative or trustee selection, and estate administration cost savings.

Estate planning is an ongoing process. As tax laws change and as life situations change, reviewing your estate plan is crucial.

### Who Needs An Estate Plan?

Many people feel that estate planning is for the elderly or the rich or is not something they want to discuss because it focuses on death. No one knows what the future holds and so it is important that everyone have a plan.

For the young married couple with minor aged children, it is crucial to designate guardians for those children in the event both parents are killed. If the both parents are killed and no provision for guardianship has been made, the courts will appoint a guardian for the minor children. For the person who thinks they do not have enough

money to worry about estate planning but have lots of life insurance, their death can create an estate tax problem. A person who is injured in an accident and suddenly is not capable of making their own medical and financial decisions, can name an individual who will make those decisions on their behalf. The bottom line is that estate planning is important for everyone.

### Property Ownership:

Property in Minnesota can be held in several ways. The method chosen depends upon the individual's estate plan and how they wish their property to transfer to their heirs. Following is a list and description of the ways property can be held.

Sole Ownership is the simplest form of ownership. One person owns the property. Upon their death, the property passes via their Will through the probate process or through their trust. If they have no Will, state law dictates how assets are transferred to the designated heirs. With sole ownership, heirs receive a step up in basis on asset value upon the decedent's death.

Tenancy In Common allows two or more people to own property together. Upon the death of any tenant, the decedent's portion of the property does not go to the survivor. That property passes via the decedent's Will, through their trust or via state law. At the time of death, the value of the decedent's portion of the property is included in his/her estate. It is subject to the probate process if the decedent has a Will, not if they have a trust. The heirs receive a step up in basis on only that portion of the asset owned by the decedent.

Joint Tenancy Ownership is ownership between two or more people. They own the property together and upon the death of one joint tenant, the surviving joint tenant or tenants receive the decedent's property automatically regardless of what the decedent's Will or trust says. To

create joint tenancy, specific wording is necessary on the ownership documents. Typical wording is “John Doe and Mary Doe, as joint tenants with rights of survivorship, not as tenants in common” for assets placed into joint tenancy established after December 31, 1976.

Upon the death of one joint tenant, his/her portion of the property is included in their estate for estate valuation purposes. Joint tenancy property is not subject to the probate process upon the first death, but may be upon the second death. This is a complex area of tax law so check with your attorney.

**Note:** The State of Minnesota may now recover value of joint tenancy property where Medicaid/Medical Assistance payments have been made to either joint tenant. There may be exceptions so consult with an attorney who practices in the area of elder law.

Ownership by Contract allows insurance contracts, investment accounts, bank accounts, and trusts to designate owners or beneficiaries upon the occurrence of a stated event such as the death of the owner. This method of ownership is not subject to the probate process and the asset is not subject to the decedent’s Will or trust. The accounts are titled as Payable on Death (POA) or Transferrable on Death (TOD). With regard to deeds, there is a new provision whereby a deed can be titled Transferrable on Death Deed (TODD).

Life Estates are another method of transferring property. A Granted Life Estate is another form of ownership. It is usually done through a Will or living trust. A person can hold title to property as a life tenant or as a remainderman. For example, if a husband passes land to his children, but with a life estate (life use) to his wife, the children are the remaindermen and the wife is the life tenant. The wife receives all income from the property and must manage, maintain and pay all property expenses on it during her lifetime. Upon her death, the property passes outright to the children without being included in her estate. The property would receive a stepped up basis (valued at fair market value) on the date of the death of the husband.

A Retained Life Estate occurs when a living person gifts an asset they own to their heirs while at the same time they retain a life estate or lifetime use of the property until their death.

**Example:** A mother might gift her personal residence or farmland to her children. She reserves the right to live in the house or receive income from the farm as long as she lives. Upon her death the property passes completely to the children. It would be included in her estate and receive a stepped up basis upon her death.

**Note:** there have been recent changes in Minnesota law regarding life estates. If put into place **after** August 1, 2003, the assets of the life estate are subject to claim by the State of Minnesota if any Medicaid/Medical Assistance payments are involved. Creating a life estate

no longer protects assets from that process. Consult an elder law attorney for assistance with this issue.

**Probate/Non-Probate Assets:**

The probate process is established to prove that the decedent’s Will is valid, to pay any debts held by the estate, to establish clear title to any assets, and to pay any necessary income or estate taxes. Solely owned property and property owned as tenants-in-common are subject to the probate process. Joint tenancy property, life insurance not owned by the decedent going to beneficiaries other than the estate, and revocable living trust property are not subject to the probate process.

The probate process can be time consuming and costly as well as making the decedent’s estate information public. How property is held will dictate if the probate process applies or not.

**Note:** a Will is the equivalent of a letter to the court system and therefore triggers the probate process. Having a Will does not enable you to by-pass the probate process. The exception is if your total estate value is less than \$50,000 and you own no real estate (in the State of Minnesota). Establishing a RLT does allow you to by-pass the probate process. If one of your goals is to avoid the probate process, you need to construct your estate plan differently utilizing a Revocable Living Trust.

**Federal Gross Estate:**

Estate taxes will be assessed on any estate that exceeds the Applicable Exclusion Exemption. This amount varies by year. The current federal amounts are listed in the following table. **Note:** State of Minnesota amounts, listed later in this document, are less than the federal amounts so plan accordingly.

Federal Estate Tax Exclusion		
Year	Exclusion	Credit
2004-2005	\$1,500,000	\$ 555,800
2006-2008	2,000,000	780,800
2009	3,500,000	1,455,800
2010	-No Tax -Lose “stepped up” basis	No Tax
Gift Tax Exclusion		
Year	Exclusion	Credit
2002-2009	\$1,000,000	\$ 345,800
2010	1,000,000	345,800

For the year 2010 only, the Federal Estate Tax is eliminated. Along with that provision, there is no step up in basis. The step up in basis is replaced with something referred to as Carryover Basis.

Carryover Basis is the lesser of the decedent’s adjusted basis or Fair Market Value increased by: 1- \$3,000,000 if assets are transferred to the surviving spouse or by: 2 - \$1,300,000 plus decedent’s unused capital loss carryover, net operating loss carryover, and any other

built in losses if assets transfer to all other heirs. The personal representative or trustee can make the election of increasing assets with low basis values for this provision. **Note:** this provision is a one year only provision and expires Dec. 31, 2010.

An individual's Federal Gross Estate includes all property held at death. It will include all stocks, bonds, cash, land, machinery and other assets. The assets are valued at fair market value (FMV) as of the date of death or as of six months after the date of death if it is more advantageous for tax reasons.

**Deductions From Federal Gross Estate:**

Certain deductions are allowed against the decedent's gross estate. Those can include debts owed by the decedent, funeral costs, administrative costs, last medical costs, a marital deduction, and charitable contributions, etc.

1) Marital Deduction:

A married person can pass any amount of estate assets to their spouse, free of any estate tax (exception: if spouse is a non-US citizen – limits apply – see your attorney). It is a deduction from the gross estate and is one of the biggest federal estate tax saving devices. The marital deduction is not available to the estates of widows, widowers or other unmarried persons. In a carefully constructed estate plan for a married couple, little or no estate tax is payable upon the first death. Each individual can pass through their estate an amount up to the Applicable Exclusion Exemption to other heirs, with the balance going to their surviving spouse using the marital deduction.

Example: Wife dies in 2009 leaving a total estate of \$3.7 million. If she passes \$1,000,000 to her children and \$2.7 million to her husband, no estate taxes (federal or state-MN) would be paid upon her death. The surviving husband (not remarried) may or may not have an estate tax problem depending upon the value of his estate at the time of his death. Since he has no spouse on which to use a marital deduction, he is limited to the Applicable Exclusion Exemption in effect the year of his death.

2) Charitable Deductions:

The value of any property passing to qualified charities is deductible from the gross estate.

**Federal Estate Tax Calculations (simplified):**

Husband dies in 2009 leaving a gross estate of \$3,900,000. He has estate settlement and other qualifying expenses as listed in the example below. Following is the calculation using these numbers.

Calculation:

Gross Estate	\$3,900,000
Debt	- 100,000
Deductions	- 30,000
Charitable deductions	- 50,000
Marital Deductions	- <u>800,000</u>
Adjusted Taxable Estate	\$2,920,000

Since the taxable estate is under \$3,500,000 (2009 federal exclusion), there is no federal estate tax due.

**Federal Estate Tax Rates:**

For taxable estates over \$3,500,000 (2009), the tax rate is 45%. That rate has changed over time as follows:

2005 – 47%	2006 – 46%
2007 – 45%	2008 – 45%
2009 – 45%	2009 – 45%

In 2010 the estate tax is eliminated and only the gift tax of 35% remains. In 2011, the rules revert back to the 2001 rules if there is no Congressional action taken.

**State Estate Tax:**

In addition to federal estate taxes, there are some states that have estate taxes as well. Most states with estate tax provisions did not raise their exemption amounts to match the federal increase. For Minnesota, the exemption amounts are as follows:

2005 - \$950,000
2006 and beyond - \$1,000,000

For the previous federal tax example, there would be Minnesota estate tax on the remaining \$1,920,000 over the state exclusion amount of \$1,000,000. Minnesota marginal estate tax rates range from a beginning rate of 41% and decline to 9.96%. The Minnesota estate tax on the example would be approximately \$191,232.

Consult with your accountant or attorney regarding the state estate tax issues as they relate to your situation.

**Special Use Valuation (SUV):**

Farmland is one business asset that can be valued not at FMV, but at a Special Use Valuation (SUV) if the estate meets several complex qualifications. SUV usually results in a lower valuation than FMV and may possibly reduce an estate tax obligation.

SUV is calculated by taking the 5 year average land rental rate for comparable land minus the real estate taxes paid, divided by the AgriBank FCB average annual effective interest rate for the state where the decedent lived (rate changes periodically so see your attorney).

Example: land is appraised at \$3,850 (FMV) per acre with real estate taxes of \$20 per acre, average cash rent of \$150 per acre, and the FCB effective interest rate of 6.5 percent (MN). The SUV calculation is as follows:

$$\frac{\$150 \text{ rent} - \$20 \text{ RE tax}}{.065 \text{ FCS interest}} = \frac{\$130}{.065} = \$2,000/\text{acre SUV}$$

Using the SUV on this land could save estate taxes on \$1,850/acre (Note: there are limits on the total dollar amount of reduction – see your attorney or accountant).

**Note: 1)** SUV should not be used on estates that are less than the Applicable Exclusion Exemption for the year in question. Doing so may result in a lower than

necessary tax basis as well as unwanted rental and sale restrictions. **2)** The business must be in compliance with the SUV rules for 10 years or you lose the SUV designation. The recipient must farm the land for 10 years – that means materially participating by farming the land or farming on shares. The person can not rent the land to someone else for cash – that violates the SUV conditions. **3)** With people living longer, this is usually not a viable alternative.

### **Power-of-Attorney (POA):**

An individual (grantor) can grant another individual Power-of-Attorney in the event they are incapable of making decisions due to disability or incapacity. The individual or individuals can manage your assets on your behalf.

### **Power-of-Attorney categories:**

1) Common Law Power of Attorney: powers are specifically listed by the grantor. There are no gifting limits. Can be either general or springing (begin at a specified time). Grantor authorizes powers to be effective immediately or upon disability. Granted powers remain in effect throughout grantor's life or incapacity.

2) Statutory Short Form Power of Attorney: powers are governed by state law and are generally very broad. Powers typically take effect immediately and there is a \$10,000 gifting limit in MN. Powers can be changed at any time by legislative law change.

3) Durable Power-of-Attorney: both Common Law and Statutory Powers-of-Attorney can be durable. Durable means the powers will continue to be affective after disability.

Sometimes a POA alone is not accepted by banks, health care facilities, etc. Generally the reasons are the document is too old, too new, too long, too short, has in it the wrong wordage or missing a phrase we require. The solution to this issue is to: 1) name the same person as your trustee, POA, and guardian. Use a Common Law Durable POA in conjunction with your Revocable Living Trust to avoid guardianship and conservatorship. Include in the package your Health Care Directive with HIPAA authorization and guardian designation.

### **Health Care Directive:**

A Health Care Directive along with a HIPAA authorization and guardianship designation can insure your wishes for health care are honored in the event you are incapacitated. You decide what level of health care you want in a given situation and place those wishes in effect via the Health Care Directive. You can choose a disability panel within a RLT.

The panel can determine if you are disabled and no longer able to make decisions on your own behalf. The panel may include your current physician, a specialist, and family members. Many hospitals and health care providers have information on developing the care directive as well as forms to complete.

Make sure you include HIPAA authorization within your Health Care Directive. Without granting HIPAA authorization to the individuals you want to have access to your health records, health care facilities legally can not release your health care information, not even to your spouse or children.

### **Summary:**

To by-pass the probate process and to have your needs taken care of in the event you become disabled or incapacitated, you need to establish a RLT, Common Law Power-of-Attorney, a Health Care Directive with disability panel with HIPAA and guardianship designation and a pour-over Will. Lifetime trust shares held in a protected trust within the RLT can protect some assets from lawsuit and other adverse actions.

If one spouse places assets in the RLT within the protected trust as lifetime trusts shares, and they die, those assets are protected and held for the remaining spouse's health, education, and maintenance. Parents can use the same process for assets passing to their children.

For more details see the following information sheets in this series: *Estate Planning #3-Establishing a Will and Estate Planning #5-Revocable Living Trusts.*

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