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# Estate Planning

Planning for Tomorrow



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# Estate Planning

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## About This Publication

This publication was prepared to be used in conjunction with a television and videotape series titled "Planning for Tomorrow." The numbered chapters follow the sequence of the programs. The publication is designed for use with the series or as a single reference. In using the publication with the television and videotape programs, it may be helpful to read the material before viewing the program and then use the material again for reference after the program.

This publication is designed to acquaint the reader with the considerations, problems, and tools available in estate planning, so that he or she might recognize the need for estate planning, and be able to discuss the situation with the attorney in a more meaningful way; and to assist the reader in developing objectives and goals in estate planning that will provide the greatest satisfaction from property for both the reader and the intended beneficiaries.

This publication is not intended to serve as a complete text for estate planning. The subject is so broad and complex that all details could not be included. The reader should observe that statements made in the publication apply to general situations; solutions to specific problems often depend upon the facts of each case. The author has attempted to indicate this throughout the text. It is recommended that the services of an attorney be obtained when dealing with the legal considerations of estate planning. This publication is not intended to substitute for legal counsel.

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(Chapters follow the sequence of the television/videotape series *Planning for Tomorrow*.)

The words *estate* and *planning* are both broad terms with many meanings. Here, the term estate planning is used to mean developing a plan to transfer all of one's property from one generation to the next or within a generation.

Estate planning often involves the use of a will—and that is an important part. A will, of course, is a document, usually in writing, designating a person's wishes regarding the disposition of property after death. A will becomes effective at death.

But a will is only one part of an estate plan. Other factors should be included in a comprehensive plan including methods of owning property; insurance, its ownership and beneficiary designations; gifts and other transfers of property, both during life and after death.

## Who Should Plan

In a sense, everyone has an estate plan. An individual may have a personal plan, evidenced by a will, that has been developed with the help of an attorney. For those who do not have a personal plan, the State of Iowa provides one. If the general laws of the state regarding distribution of property at death meet your personal objectives, you need do little else.

Chapter 4 explains how property is distributed and minor children are cared for by law when there is no will. But if you feel your objectives will not be met by the general laws, you may want to develop your own plan. In planning, it should be understood how ownership of property can affect what becomes of property at death.

Estate planning often is considered a special concern of the aged, where the probability of death is greater. But younger people, especially young couples with minor children, also have a great deal to gain from planning—and possibly much to lose if they don't plan. While the probability of death is not as great for younger people, the effect of death may be greater in view of the twin problems of care of minor children and management of their property in the event of death of both parents.

For those who own an interest in a family business,

the business plan should be considered along with an estate plan. Since the estate will contain the person's business interests, decisions should be made so both plans fit together reasonably well.

## The Plan

Estate planning should be directed at three levels of concern:

1. What to do with the property if one spouse should die, assuming there are a husband and wife.
2. What to do with the property if both spouses should die. Custody of minor children may be an important question here and a guardian can be nominated in the will. Also, minor children are not considered competent to manage property so a trust, for example, could be a helpful item to include in the parents' wills.
3. What to do with the property if the entire immediate family should die. This may be the first level of concern for single persons who are by themselves the "immediate family." For couples, if there is no estate plan, the order of death may determine which side of the family will receive the property. For example, in an accident where the immediate family is killed, but members die at different times, the property goes to the heirs of the person who dies last. So the order of death may determine whether the property goes to the husband's side of the family or the wife's.

## Objectives of a Plan

Determining the objectives of an estate plan is the most important step. If you can identify and articulate your objectives—what the property is to be used for and for whose benefit—the chances are quite good that a plan can be developed to accomplish your goals. Since there are many ways of transferring property, much flexibility exists. There are a few restrictions on what one can do with property, but most people find these restrictions to be reasonable. A greater concern often is the competition among objectives. Some examples of such competition will be examined later.

Parents' objectives often are to maintain security and dependability of income while both are living,

and for the surviving spouse. Generally, the parents are interested in an equitable distribution of property among children. Finally, most are interested in minimizing estate taxes and estate settlement costs.

There may be some special concerns, however, such as the rights of a surviving spouse who remarries, or management of certain types of property by the survivor.

Another concern in the plan is unforeseen developments, which may require flexibility in future management of property. If a living couple has a child handicapped by disease or injury, a larger share of the family's resources may go into medical expenses and care of that child. Most would agree all the children are receiving fair though unequal treatment. But what if such an event occurs after the death of the parents and the estate plan rigidly calls for equal distribution of property or income among the children? Careful planning may be especially helpful in such situations.

### Objectives of Others

In addition to the parents, other family members may have interests and objectives in an estate plan. Heirs or potential heirs outside the family may have objectives relating to their treatment if they should become investors in the family business by inheritance. Generally, these people have objectives:

- To receive income on their investment, or increase in the value of the assets.
- To be able to sell their interest.
- To participate in management of the family business, which may involve the question of how income is divided.

In some instances, it may be difficult or impossible to accomplish all the stated objectives. Estate planning involves resolution of the competitive ideas advanced by the parents and possibly by other members of the family.

With a family business, it may also be an objective of the parents or heirs to continue the business. Linked to this may be the uncertainty faced by heirs who remain with the parents' family business. It's fairly common for a son to stay with the parents' business 20 or 30 years with the understanding that he would be well taken care of at the parents' deaths, or that he would ultimately receive

the family business. At the death of the parents, the son may find his rights are little greater than those of brothers or sisters who left home 20 or 30 years ago. Again, business and estate plans should be closely tied. For family members who work and invest in the family business, an annual determination of ownership might be planned while the parents live. Sharp declines in land values, in the value of machinery and equipment, and, in some instances, in the value of corporate stock and other assets in the 1980s altered the estate planning problem for many farm families. The effects of economic adversity also affected many nonfarm businesses that serve farmers. For those individuals, estate planning involves several special concerns. Rising asset values in the 1990s have provided additional reasons for developing an estate plan or reviewing one prepared at an earlier time.

- Wills should be checked carefully to be certain that property division remains acceptable. A will provision leaving "all of my real property" to one heir and "all of my personal property" to another may not produce acceptable results if land values have fallen — or risen — and the personal property is all in certificates of deposit that have maintained their value.
- Options given, such as by will, to authorize designated heirs to purchase property should be reviewed for continued acceptability of the option price.
- Special attention should be given to will and trust provisions directing that indebtedness be paid and the assets to pass free of the claims of creditors. Such provisions may no longer be feasible.
- Individuals should consider carefully the impact of death on the ability to meet debt obligations. **Liquidity for purposes of paying debts of the deceased has taken on increased significance.**
- Special care should be taken to review whether property should be valued at the alternate valuation date (up to six months after death) for federal estate tax purposes. The alternate valuation date is discussed in Chapter 10.
- With the decline in the value of many business assets, the percentage eligibility tests for special use valuation of land, the family-owned business exclusion, installment payment of federal estate tax, and corporate stock redemption after death should be carefully reviewed. These tests are discussed in Chapters 10 and 15.

As indicated in the introduction, estate planning deals with property. To deal with property effectively, it is important to know what property is, how it is classified, and how it may be owned. Ownership is particularly important because the method of ownership may dictate how property is transferred and how it is taxed upon the death of the owner.

## What Is Property?

There are two broad classifications of property—real property and personal property. Real property includes land and whatever is built on the land or attached to it. It includes buildings, fences, tile lines, and mineral rights, for example.

Personal property is broken down into tangible items and intangibles. Tangible personal property includes such things as machinery, livestock, inventory items, stored grain, household goods, and automobiles. Intangible personal property includes such assets as bank accounts, stocks, bonds, and insurance policies.

## How Is Property Owned?

There are two elements in ownership. One deals with the degree of interest or control of the property. The other deals with relationships of owners when more than one person has a present interest in the property.

If one were able to own property with total control of it—to use it as the person pleases—the individual would have absolute ownership. But absolute ownership does not exist since some rights of ownership are reserved to others besides the owner.

There are three major interests in property that are retained by state or local government. The first right retained by government is the right of eminent domain. For example, the state could take a farm from the owner if it were needed for a roadway, park, or some other public use. The state must compensate the owner for the value of land taken. The process is also known as condemnation.

A second right of the state and county is to tax your property.

The state and county can also regulate use of property through zoning or land use controls. These are examples of the “police power” over property. Basically, a property owner is restricted in using property in ways that might damage a neighbor. Likewise, that property owner has the protection from being damaged by a neighbor’s use of property through this governmental power.

In some states, these rights of the public interest are being expanded to limit or deny uses of property that damage the environment.

Thus, at least three rights to property are reserved to others. So the nearest thing to absolute ownership is known as a fee simple. With property held in fee simple, the owner has the right to sell it, pass it to others at death, mortgage it, lease it, manage it, and receive the income from it.

## Other Ways of Owning Property

Property can be transferred from one person to another with all the rights that fee simple allows. But the transfer can be made with fewer rights to the property, where the owner voluntarily divides the rights of ownership. This makes property ownership more flexible and may allow people to accomplish the objectives of an estate plan more easily.

For example, a widow might own a farm in fee simple. She might decide that she would like to give her children by will something less than fee simple ownership. She may want to give the farm to her children for as long as they live and then have it go to someone else, perhaps to grandchildren or someone on her side of the family. The children are “life tenants” and have a “life estate.”

Under such a plan, the children receive an interest in the farm for the rest of their lives upon the death of the mother. They have the right to the income from the farm and can collect rent or government

payments from it. But they cannot sell it or mortgage it without permission of those holding other interests in the property. Basically, the children have the right to manage the property and take the income from it.

The life tenant or tenants also have the duty to pay property taxes, to pay interest on any mortgage, and to keep the property in a reasonable state of maintenance.

At the death of the children, the property then goes to those holding the "remainder" interest designated by the mother's plan. Those with a remainder interest generally must approve any sale or mortgage of the property while it is being used by the person or persons with the life estate.

One variation involving use of the life estate is to establish a life tenancy, but with no remainder interest designated. In this instance, property reverts back to whomever established the life tenancy or their heirs after death of the life tenant.

Some complications can develop when leases are made by the life tenant. For instance, consider a farm that a man left in life tenancy to his wife. She rents the farm out under a usual farm lease. In the past, when the life tenant died, the farm lease was terminated that day. That often was unfair to the farm tenant. Initially to correct this problem, the tenant was given the right to come on the premises and to harvest crops after death of the life tenant.

The Iowa legislature has strengthened farm tenant protection with a law that continues farm leases until the next March 1 if the life tenant dies. If the death of the life tenant occurs after September 1—the usual date for giving notice to terminate a lease—the lease continues for the next crop year with the same terms and conditions except possibly for an adjustment to the rent if unreasonably low.

Consequently, with farm leases involved, holders of the remainder interest may not be able to obtain complete possession of property immediately upon the death of the life tenant.

Most states have not acted to continue farm leases beyond the death of the life tenant, as in Iowa. In these states, the interests of farm tenants can be protected from premature termination of the lease

if all interests are held in trust and the trustee signs the lease or if holders of all interests—life estate and remainder—have signed the lease.

## Co-Ownership

If two or more people own the same piece of property there is co-ownership. The property might be a farm, home, bank account, or automobile, for example. The property might be owned by husband and wife, father and son, two brothers, or even two or more unrelated people.

Fee simples, life estates, or remainders concern mainly the degree of rights to the property. Co-ownership involves the relationships between owners when more than one person holds title to property at the same time. Co-ownership is important in estate planning because the method of co-ownership may determine who eventually owns the property as well as the amount of tax due at death of one of the owners.

There are two widely used types of co-ownership—tenancy in common and joint tenancy.

## Tenancy in Common

Tenancy in common is the least used of the two forms of co-ownership. This may be due to misunderstandings about tenancy in common and joint tenancy.

Tenancy in common involves undivided ownership interests. For example, consider a 160-acre tract of land owned in tenancy in common by A and B. It is not correct to state that A owns one-half or 80 acres, and B the other 80 acres. The two owners hold undivided interests in the entire 160 acres.

Together A and B can sell the property, mortgage it, lease it, manage it, and divide the income from it. If one of the owners wants to terminate the arrangement, they can agree to sell the property and divide the proceeds. Or they can simply divide the property into two parts so that each takes a specified part. With the division, they exchange deeds dividing the property and taking it out of co-ownership.

Should one owner desire to terminate the arrangement and the other refuses to sell or divide, the owner desiring to end the co-ownership relationship may, if necessary, go to court to request an order for partition and sale. The court can require

that the property be sold and the proceeds divided, or that the property be split into parts, if that can be done fairly.

It is not necessary that each of the parties owns equal interests in co-ownership. One can own a three-fourths interest and the other one-fourth, for example. If the deed or other document of title reads "A and B," the interest is presumed to be equal. Otherwise, the amount of interest each owner has in the property must be specified.

Tenancy in common is not limited to husbands and wives. It may be used by other family members or even unrelated parties. Nor is tenancy in common limited to two parties. There may be any number of co-owners.

In the case of tenancy in common, when one owner dies, that person's interest in the property goes to the heirs under state law if the person has no will.

If the individual has a will, the deceased's ownership interest passes under the will to designated beneficiaries. The heir or will beneficiary then owns the undivided interest in the property with the living co-owner. The same rights of co-ownership continue, including the availability of partition and sale.

For purposes of figuring death taxes and estate settlement costs, the actual percentage of interest owned is included in the deceased's estate—one-half the value, if that is the interest of the deceased.

To determine the type of co-ownership involved, it is necessary to examine the document of title, deed, or stock certificate. Typically, the word "and" as in "John Doe and Mary Doe" creates tenancy in common. For most cases, "John Doe or Mary Doe" also creates tenancy in common. In a few specific instances, the word "or" creates joint tenancy.



Joint tenancy is the other system of co-ownership in addition to tenancy in common and has been the more popular form of co-ownership. Its popularity may have been because many people believed it to be the best type of co-ownership. But that may not be a correct assumption. Whether joint tenancy is best depends on individual circumstances.

With joint tenancy, as with tenancy in common, two or more people own property together. Each has an undivided interest in the property. Each has the right to request a court order for partition and sale if he or she wants to terminate the arrangement.

The major difference between joint tenancy and tenancy in common becomes clear at the death of one of the owners. With joint tenancy, there is a right of survivorship that controls disposition. When property is held in joint tenancy and one of the owners dies, the property goes to the other owner. The survivor takes all. An ordinary will does not affect the disposition of property in joint tenancy at the death of the first joint tenant. When property is held in joint tenancy, there is a "built-in" will operating on the death of a joint tenant.

Iowa law doesn't favor joint tenancy. All else being equal, tenancy in common is favored. Therefore, the creation of joint tenancy requires specific language. The words typically creating joint tenancy for land are: "John Doe and Mary Doe as joint tenants with right of survivorship and not as tenants in common." Bank accounts may read "John Doe and Mary Doe or the survivor of them." Earlier it was indicated that the word "or" may create joint tenancy with right of survivorship in certain situations. One such instance is U.S. Government savings bonds. That is a specific instance. Generally, the word "or" does not create joint tenancy.

When using joint tenancy, you should be willing to accept any possible order of death of the joint tenants. Usually, older people are expected to die first, or husbands to die before wives. When the expected sequence of death occurs, objectives of an

estate plan using joint tenancy may be met. But what if the unexpected occurs?

Consider a father-son situation, where the son had been in business with the father with the business assets held in joint tenancy. The basic intent was that the mother would be taken care of with insurance, so the business would go to the son who was employed there.

But the son, who had a wife and four children, was killed in an automobile accident. His interest in the property passed to the father, which left the son's widow and children in a difficult situation with few assets.

Another factor, in addition to order of death, is the accessibility of the property at death. In the case of land, it usually isn't critical if it's tied up in probate for a year or so after death. But in the case of a bank account or an automobile, it may be inconvenient for the survivor not to have access to these items after death. Joint tenancy assures immediate access for these two items. But the best arrangement depends on your individual situation and should be decided by you in consultation with your attorney.

With the bank account in joint tenancy, the survivor can continue to use the account after the death of one owner. With an automobile in joint tenancy, the survivor can take a copy of the death certificate, the certificate of title, and a small fee to the county treasurer's office and obtain title to the auto immediately after death. It is advisable to consult your insurance agent to be certain that the auto insurance policy remains valid with the change of title.

There is a contrary argument on placing a motor vehicle in joint tenancy. With a vehicle in joint tenancy, both owners are liable for damages in an accident. In some situations, where one owner may be a poor driver, or there is some type of high risk, co-ownership might be avoided to limit liability to one person.

In most cases, owners of vehicles protect themselves through automobile liability insurance. But



owners should be aware of liability implications, especially if there are unusual circumstances.

## Simplified Estate Settlement

One of the reasons joint tenancy may be so popular is that it is believed to simplify estate settlement at the death of the first to die. And it is useful in modest estates. But there are some problems.

First, one's estate may be modest at the time one takes title to property. But property values may inflate, life insurance may be added and other assets acquired—and the estate one day may no longer be so modest. As estates grow larger, the advantages of simplified estate settlement are soon overshadowed because of the tax traps of joint tenancy. The tax implications of joint tenancy are covered in more detail in Chapter 11.

However, for those with estates of less than \$500,000 to \$600,000, who are relatively sure their estates will not grow much more, and who accept the order of death with the survivor taking all the property, joint tenancy may simplify estate settlement and not create unacceptable death tax results. The amount of property may be as high as \$600,000 in 1997, \$625,000 in 1998, without creating federal estate tax liability. The size of estate that may create state death tax concerns depends upon the facts of the situation.

## Purpose of Settlement

There is no law that requires estates to be settled. There may be a penalty for failing to pay taxes due in relation to an estate, but none for not settling the estate. Estates are settled for three reasons. If none of these applies, then the estate need not be settled.

- The first reason to settle an estate is to determine who gets the property. This is one reason for the probate process of an estate, handled under the supervision of the court to determine formally who is entitled to the decedent's property. However, if all property is in joint tenancy, disposition of the property is already determined, so there is no need for settlement for this reason.
- The second reason for settling an estate is to get good or clear title to property. Usually, this is a matter of showing that creditors of the decedent were paid and there are no claims against the decedent or the property.

The estate settlement process gives creditors an opportunity to present their claims. If they fail to make their claims during the allowed time, the claims are no longer valid. Without estate settlement, the claims could remain against the property for a period of time and the new owners may be liable for the debt.

The situation with joint tenancy property differs, however. In most states, including Iowa, creditors of a deceased joint tenant cannot make claims against the property that passes to the surviving joint tenant unless the survivor was specifically obligated.

Despite concerns about abuse of this situation, there have been relatively few problems. Only about half a dozen states in the nation allow creditors of a deceased joint tenant to make claims against property of the surviving joint tenant.

Since Iowa does not permit that, the second reason for settling an estate is not applicable if all property is in joint tenancy. In Iowa, unsecured creditors are cut off in joint tenancy and cannot reach the property to satisfy the decedent's obligations unless the survivor was obligated specifically.

- The third reason to settle an estate is to pay taxes. That cannot be avoided. However, if that is the only reason for estate settlement, all that needs to be done is to prepare and file an inventory of property owned, value the property, and pay the federal estate and state inheritance taxes, if any, or to obtain clearance from the tax agencies if no taxes are due. There's a short form procedure to obtain necessary tax clearances. These procedures are less time consuming and usually less expensive than a full probate of the estate. So in certain circumstances, property in joint tenancy can be a benefit.

Finally, joint tenancy assures that property will pass to the surviving joint tenant. For those without a will, it may assure that the surviving spouse receives the property. But placing property in joint tenancy does not substitute for a will beyond the first level of concern, which is death of the first spouse or joint tenant. Joint tenancy is a helpful substitute for a will in some situations up to this point. But joint tenancy goes no further and says nothing about disposition of property should both joint owners die or should the entire immediate family die.

When a person dies without a will, it is said that the person died intestate. State law specifies how the property is distributed among the heirs.

If you die without a will, usually a member of the family begins the estate settlement process. Certain individuals have priority rights to begin estate settlement. Usually the surviving spouse has the right for a period of time, and then the children have an exclusive right following the right of the spouse to initiate estate settlement proceedings as noted in Chapter 6.

Typically, a family member asks an attorney to petition the court to open the estate and appoint an administrator. The person who manages the estate during settlement when there is no will is called an administrator.

The court usually directs the administrator to post a bond and publish a newspaper notice so creditors and the public know the estate is open and that claims may be presented. At present, Iowa law allows creditors four months to present their claims. Those who owe money to the decedent also can make payments to the estate.

The administrator manages the property, collects the assets after death, safeguards and maintains the property, sells the assets at the proper time, pays the creditors during the settlement process and pays the taxes. The latter includes the final income tax return for the decedent, possibly filed with the decedent's spouse. There also are the income tax returns for the estate, both state and federal; the state inheritance tax return and the federal estate tax return; plus property taxes that may be due during settlement.

The administrator also prepares a final report, indicating to the court how the property has been disposed of, what claims have been paid, and what taxes have been paid. After approval of the final report, property is distributed to the heirs who are entitled to receive it under state law.

The rules on distribution of property by law can best be illustrated by examples. These examples are based on Iowa law that applies to permanent

residents of the state at the time of death.

First, if you die leaving no will, no spouse, and no children, but with a surviving mother and father, the parents share the estate equally. If one parent had died earlier, then the surviving parent receives the entire estate.

If both parents had died before you, the parents are resurrected, theoretically, and the estate goes through their hands to their descendants, who would be your brothers and sisters. If you were an only child, or there were no survivors, the property goes back up the family tree—splitting the estate between your mother's parents and your father's parents. If all the grandparents are living, they share equally in the estate. If any one member of one of the pairs is deceased, the survivor receives the share for the pair. If neither of the pair lives, your estate is distributed to their descendants, your uncles and aunts, or to their descendants if the uncles and aunts are not living.

If no heirs are found, the property is divided among your great grandparents, or distributed to their descendants. The process continues back through previous generations. If no heirs can be found, the estate goes to your spouse, heirs of the spouse if deceased, or heirs of predeceased spouses.

If all possibilities are exhausted and no heirs are found, the property returns (escheats) to the State of Iowa.

## A More Typical Situation

A more typical situation would be where you leave a mother and father surviving and also a spouse, but no children. The surviving spouse receives any life insurance proceeds where he or she is named beneficiary and any joint tenancy property if he or she is the surviving joint tenant. In addition, the spouse in this instance receives all of the rest of the decedent's property.

## Where There are Children

Now suppose you die leaving a spouse and children, and no will. If the surviving issue are all the

issue (descendants) of the surviving spouse, the surviving spouse receives all of the decedent's property.

In the event some of the decedent's issue are not the issue of the surviving spouse, the surviving spouse receives a fixed minimum amount of the estate. A surviving spouse would receive one-half of the real property, all personal property exempt from execution, and one-half of other personal property after debts are paid. Personal property exempt from execution includes items that cannot be taken by creditors. If the total amount passing to the surviving spouse is not at least \$50,000, the surviving spouse would get enough property to total that amount if the estate is more than \$50,000. If the estate is \$50,000 or less, the surviving spouse would receive all the property. If the estate exceeds \$50,000, the spouse would get a portion as indicated and the issue the rest. The interest of a wife in a husband's estate is the same as the interest of a husband in the wife's estate. The shares are divided equally among the issue. If there are four individuals who are children of the decedent, for example, but one is not an issue of the surviving spouse, each would receive 25 percent of what does not pass to the surviving spouse.

**Example:** Grandmother died without a will leaving her husband and four children born to her and her husband. Her property, which totaled \$300,000 in value, would pass to her husband.

**Example:** Father died without a will leaving \$200,000 in bank accounts. He was survived by his second wife and by three children of that marriage and one child by an earlier marriage. His wife would receive \$100,000 (one-half) with the remaining amount passing to the four children (\$25,000 each).

**Example:** Mother died without a will, survived only by her husband. Her property, valued at \$500,000, would all pass to the surviving spouse.

The spouse has some other options, also. The spouse can elect to have the homestead included in his or her share of the property. Often the spouse can determine the exact property he or she is to receive. The spouse also can elect to occupy the

homestead (take a life estate) instead of his or her interest in the real property.

## Disadvantages

One of the disadvantages of death intestate is that the method of property distribution is rigid and inflexible. Often the distribution of property is not as the decedent would have wanted. But unless his or her desires are reflected in a will or in some other legal way, the rules apply, regardless of the person's intent.

Another disadvantage, where the principal asset is a family business or farm, is that the business can be placed in jeopardy when both husband and wife die. For instance, if one son had remained with the family business with the assurance that he would be taken care of at the death of his parents, the property is still divided among all children equally on the death of the parents if there is no will. After the death of both parents, the farm or business would then be owned in tenancy in common by all children—some of whom may be wealthy because of an education paid from family funds earlier. If one of the sons or daughters wants his or her equity for any reason, he or she can go to court and probably obtain an order for partition and sale. Once the process is started, others may decide to ask for their interest at the same time.

A child operating the business may try to borrow money to pay off the other owners. But the child owning only a small share of the total business may not be in a strong position for borrowing. It may be possible to sell enough business assets to pay off the others, but this may drop the operation below an efficient level. The other choice is for the child to sell his or her interest, also.

A further disadvantage of death intestate occurs if children are minors. This may require that a conservator be appointed to look after their interests. This involves red tape, inconvenience, and extra expense.

A final disadvantage is that an administrator may be required to post a bond to assure that the interests of the heirs are protected while the estate is being settled. This is an expense that can be saved if a person makes a will and asks the court not to require the estate representative—an executor, in the case of a will—to post a bond.

A person making a will is a testator. At death, it is said the person with a will died testate.

## Who Can Make a Will?

Making a will is a privilege you have to dispose of your property after death. It is to be a voluntary act. The will should represent careful and calculated judgment of what you would like done with your property after death.

To make a will, you must be of full age and of sound mind. Full age means that you must be either 18 or married. If you are 17 and single, you don't have a right to make a will. But if you are 17 and married or have been married, a valid will can be made.

A person cannot be forced to make a will. A will is not valid if it is made while under someone's undue influence.

Wills must be in writing in Iowa and signed by the testator. The signature must be witnessed by at least two disinterested witnesses. Witnesses are there to assure that the person making the will appears to be of sound mind, appears to be of age, and isn't being forced or influenced to make the will.

A holographic will, written by the individual and signed and dated, but without witnesses, is not a valid will if made in Iowa.

If a will is valid where it is written, it is generally valid anywhere. It is advisable to have such a will checked, however, for it is interpreted under the laws of the state of permanent residence at death and the laws of other states in which real property is owned at death.

## What Is Soundness of Mind?

A person who is not of sound mind cannot make a valid will. The question of soundness of mind probably occurs most often in the case of a second marriage, where a surviving spouse remarries and makes a new will leaving all the property to the new spouse.

Generally, a person is considered to be of sound mind if he or she knows the nature and extent of his or her property interests (what is owned); and if he or she knows the "natural objects of their bounty"—spouse, children, and grandchildren, for example.

## Can You Disinherit a Spouse?

Generally, a spouse cannot be disinherited unless the spouse is willing to abide by the share of property left under the will and that interest is minimal or nonexistent. A spouse can "elect to take against" the will. A spouse electing to take against the will is entitled to receive one-third of the real property, one-third of the personal property, and the personal property exempt from execution by creditors. The remainder of the property would be distributed as nearly as possible in the manner specified in the will if the surviving spouse elects to take against the will.

An arrangement that can be used to avoid conflicts over estates by keeping the estates of spouses separate is the antenuptial agreement. Such an agreement must be signed before marriage. Generally, the parties agree they will not inherit from the estate of the other. Antenuptial agreements are used most often in instances of remarriage. Antenuptial agreements are not valid in all states, but are so in Iowa.

A child can be disinherited rather easily, merely by failing to mention the child in the will. It is not necessary to give the child a dollar, as is commonly believed. However, one class of children is an exception to the disinheritance rule. These are children born after a will is made. If a will is made and children are born later, these children are eligible to take a share of the estate as if there had never been a will. If one wishes to disinherit after-born children, it can be done by including a suitable statement in the will. Young people may want to specify that after-born children are to inherit in the same manner as other children.

These subtle rules—unknown to most people—are some of the reasons homemade wills are often unwise. This is added justification for seeking legal counsel in having a will prepared.

### **Are There Other Restrictions in Making a Will?**

You cannot go against public policy in making a will. There must be some redeeming social or economic purpose served by the provisions of the will. If there is disagreement over whether a will distributes property in a manner that has redeeming social or economic value, the court makes the decision. Wasteful disposition of funds or exorbitant amounts left to pets are the types of bequests that pose questions of redeeming value.

With these limitations on disposition of property, there still remains a great amount of latitude in disposing of property by will.

### **Are There Other Purposes Served by a Will?**

In addition to determining how property is to be distributed, a will allows you to designate the executor of your estate—the person to manage it. You can ask the court not to require the executor to post a bond, which saves costs. Likewise, a will enables you to nominate the guardian of minor children.

You actually only nominate a guardian. The court makes the appointment. But in most cases the court follows your wishes. Generally, only in cases where the nominee is dead, ill, bankrupt, alcoholic, or for some other reason not suitable to serve, will the court appoint someone else.

A person nominated as guardian may decline to serve. Therefore, it is advisable to check informally with those you nominate before the names are included in the will.

Generally, only one copy of the will is executed

(signed). Unsigned copies may be kept for reference. The executed copy of the will should be stored in a secure place. The attorney who draws your will may provide a storage service. The will also may be stored in your safe or safe deposit box. And the Clerk of the District Court in your county also has a service of providing free storage of wills. Wills left with the Clerk of the Court for storage do not become a matter of public record until the estate is opened.

There is little problem in keeping wills in a safe deposit box in Iowa. If the will is stored there, usually the attorney for the estate and a family member can obtain it from the bank. It is true that neither a member of the family nor anyone else has assured access to the safe deposit box, for access to the box is limited at the death of any of the lessees. The bank denies access until the box has been inventoried for tax purposes. But the banker usually will open the box and give the will, and possibly insurance policies, to responsible representatives of the family.

It is not advisable to place burial instructions in the safe deposit box, however. Such instructions may not be found until after burial. The same applies to documents willing your body or parts of it to a medical school or donor bank.

### **A Caution**

It generally is not effective to fill out deeds to your property during life, deeding property to intended recipients at death with the deed retained until your death. This has been tried by persons who hoped to save taxes, attorney's fees, and estate settlement costs. But the action often is contested and the courts generally rule that a deed cannot be used to dispose of property at death—that requires a will. A deed may fail to meet the requirements of a will because of an insufficient number of witnesses. Moreover, a deed, to be effective, must be delivered in order to transfer ownership.

When a person dies, the estate—property, debts, and obligations—is subject to settlement or probate. It is not necessary that all estates be probated. Estates go through probate only if it is necessary.

## Why Probate?

There are three basic reasons for probating an estate—to determine who is to receive the property; to settle the decedent's debts; and to pay taxes, as explained in Chapter 3.

In a small estate, it may not be necessary to go through the full probate procedure, depending on the type of property and how it is owned. If most or all of the property is held in joint tenancy, it may be possible to use “short-form” probate on the death of the first joint tenant. Joint tenancy already determines who gets the property—it goes to the surviving joint tenant. And the creditors of the deceased joint tenant may not follow the property into the hands of the surviving joint tenant, unless the surviving tenant was bound by the obligation. This eliminates the reason for a full probate proceeding. Therefore, the only step that may be required is to value the property and pay taxes. That procedure is known as short-form probate. Short-form probate also may be possible if the property was held in a revocable living trust at death.

But short-form probate through joint tenancy may not be an advantage in all instances. Once an estate reaches a certain size, the total taxes over both deaths may be greater with all property in joint tenancy, so that increased taxes may outweigh the advantages of short-form probate.

## The Probate Procedure

The procedures of probating an estate are similar whether or not a person dies with a will. The initial steps are much the same. The will affects especially the final step in the probate process—determining who receives the property.

## Without a Will

When a person dies without a will, the surviving

spouse has an exclusive right for 20 days to begin estate settlement. Children have 10 more days after that, and then creditors and anyone with an interest in the estate may start the process.

Usually a member of the family asks an attorney to file a petition with the district court, asking the court to open the estate and appoint an administrator so the estate can be settled, debts paid, and property distributed. The administrator becomes the manager of the estate.

After the administrator is appointed, he or she arranges publication of a legal notice in a general circulation newspaper indicating the estate has been opened and notifying creditors that they may present their claims. The estate remains open for at least four months.

## With a Will

If there is a will, the first step is for an interested person to petition the court to open the estate and appoint the executor. There are penalties for suppressing a will. If a will is not presented to the court, even though one exists, it is presumed that the person died without one and the property is distributed according to law as though the person died intestate.

Where there is a will, one of the early steps is proving the will. The usual manner of doing this is to call the witnesses to court or ask for a sworn statement from the witnesses, if they are alive, or show the validity of their signatures otherwise. A will may be self-proved at the time of its execution or later by notarized statement by the testator and the witnesses. A self-proved will may be admitted to probate without testimony of witnesses. Objections to the validity of the will may be made and a trial may be necessary to determine if the will is valid.

After the executor is officially appointed, a notice in a general circulation newspaper is used to notify the public of the appointment of the executor so creditors may present claims. Again, the estate is open for at least four months.

## Either With or Without a Will

The executor or administrator has the estate inventoried and presents a list of all property of the decedent and an appraisal of its value. The state or federal government may require that property such as land that is not subject to objective valuation be appraised.

Property is listed at fair market value. Land may eventually be listed at special use value or "use" value for federal estate tax purposes. Special use value is discussed in Chapter 10.

Though some property cannot be used to pay debts (that exempt from execution), it is included in the inventory, as is property held in joint tenancy. Certain property transferred before death may also be included in the inventory for tax purposes under certain circumstances.

The primary task of the executor or administrator is to collect, preserve, manage, and distribute all the property of the decedent. After setting apart exempt property to the surviving spouse, the executor or administrator pays expenses, debts, taxes, and any allowance made by the court to the spouse and minor children.

Claims by creditors are presented for payment. Disallowed claims may be submitted to the court and a hearing held to consider the claim. Or the claim, under certain circumstances, may be submitted to a jury. If claims are not filed within four months after notice is given, claims may be barred and hence not collectable.

Obligations of the estate are paid by the executor or administrator out of assets specified in the will or in accordance with state law.

When all debts, claims, and taxes have been paid, the executor then distributes the property to persons named in the will. If there is no will, property is distributed in accordance with state law.

The executor or administrator may make reports to the court on the progress of settling the estate. When ready for final distribution of property, the estate representative makes a final report to the court. The report to the court shows the list of property and what was done with it. Again, any interested person may object to the final settlement at this time. If the report is approved, distribution of any remaining property is made and the estate is closed.

However, the file on the estate remains in the county courthouse and is available to anyone who might need to consult it later. Sometimes, for income tax purposes, it may be necessary to go to the file to determine values placed on assets.

## Special Procedure for Small Estates

Where the estate subject to state inheritance tax of a person does not exceed \$50,000, and a spouse or children or both survive, a special simplified estate settlement procedure is available. The simplified procedure is available for those with estates subject to tax of \$15,000 or less if a parent (but not a spouse or child) survives and for those with estates subject to tax of \$10,000 or less if someone survives within the fourth degree of consanguinity to the decedent. Under the simplified procedure, a member of the family agrees to be personally liable for the decedent's debts. An inventory still must be filed.

# Considerations in Holding or Disposing of Property

# 7

An important concern in estate planning is whether assets should be held until death or whether some or all should be sold during life. There are many factors that need to be taken into account, including taxes.

Generally, income tax liability is of less concern if assets are held until death. Certain assets, such as a home or land, especially farm land or corporate stocks, may have large gains or profits. Consequently, there could be a sizable income tax liability if such items were sold during life.

Income tax liability is also a concern—but for a different reason—if property has a large potential loss. The loss may disappear at death as explained below.

Income tax liability on property is thus a major factor in the decision to hold or sell. Government savings bonds, money market certificates, or certificates of deposit, on the other hand, may have little, if any, gain or loss. Some bonds or investments have accrued interest that could create income tax liability if sold or redeemed, making this an important element.

From an income tax viewpoint, it is generally more advantageous to sell those assets with less gain (or a loss) and retain those with major gains if some property is to be disposed of during life.

## Change of Form

A second major factor in deciding whether to sell or retain assets is whether the change in the form of capital is desirable. For instance, if most of the family wealth is in land, is it preferable to sell the land and buy a different form of asset such as a fixed principal obligation (government savings bonds, for example)?

Would you feel as comfortable owning corporate stocks or bonds, as you do holding land? Confidence in the asset or in the pattern of various holdings can be important and may grow more important in old age.

## Inflation

Closely related to the form of the asset is the concern about inflation. For example, if property is sold during life and invested in a fixed principal asset such as bonds, then inflation may erode the real value of the bonds over the years. Some assets, on the other hand, may change with inflationary pressure and increase in value.

## Capping an Estate

A final element to consider is whether it's desirable to cap or freeze an estate. There is considerable interest in capping or freezing an estate to prevent it from continuing to grow and to increase federal estate tax or state inheritance tax liability.

An estate can be capped, for example, by selling assets and buying a fixed principal investment. It's also possible to cap an estate by shifting to a corporation and taking preferred stock in exchange for property, or forming a partnership with fixed principal capital interests. But there are some disadvantages. If the estate is capped and inflation continues, you may find after 10 to 20 years that there is insufficient capital to support the owners of the estate in later years.

Also, if an estate were capped and *deflation* occurs, you could end up with a larger relative estate than had the asset values changed with the economy. There are reasons to be cautious in capping an estate in times of economic uncertainty. In addition, depending on how it is accomplished, capping or freezing an estate may create problems of eligibility for special use valuation of land, installment payment of federal estate tax, and, possibly, the family-owned business exclusion.

Federal legislation enacted in 1990 repealed a federal estate tax rule limiting freezes, but imposed detailed federal gift tax rules on property subjected to the freeze.

## Income Tax Basis

To understand the income tax liability on the sale of assets, one must understand the concept of



basis. Simply, basis is that portion of the asset value that has been accounted for in previous tax handling. Often, basis is the cost, but in some instances, basis may differ from cost. There are three rules that help determine how much of the income from the sale of an asset will be subject to income tax liability.

### **Purchased Assets**

The first rule of basis relates to assets that have been purchased during life. For purchased assets, you take the purchase price of the asset, add to that the cost of any improvements made during life and subtract any depreciation claimed. Thus, if property was purchased in 1940 for \$10,000, improvements totalling \$4,000 were made, and \$2,000 worth of depreciation was claimed, the income tax basis would be \$12,000.

If the asset is sold, any amount received greater than the \$12,000 basis is a gain. Except for sales to a related party, any amount received less than the \$12,000 basis would be a loss. For capital losses, the deductibility may be limited to offsetting capital gains plus up to \$3,000 of other income per year (for individuals). The income tax basis is subtracted from the selling price to determine gain or loss.

The basis indicates how much of the selling price will be taxable gain.

### **Assets Acquired by Gift**

The second rule applies to assets acquired by gift. For that type of property, you go back to the giver's or donor's basis. That provides the starting point for your income tax basis. To the donor's basis, you add improvements since the date of the gift, and subtract depreciation taken. You may, in some instances, add part of any gift tax paid onto the basis.

Again consider that property was bought in 1940 for \$10,000, improved by \$4,000, with \$2,000 in depreciation claimed prior to the gift. Let's assume that the property at the time of the gift is really worth \$100,000. The federal gift tax would be based on the \$100,000 fair market value, but the \$12,000 figure still carries over to the new owner as the income tax basis.

If the person receiving the property by gift should sell it a few years later for \$110,000, the income tax liability would be based on the \$110,000 selling price, minus the basis. The basis would be \$12,000 (donor's basis), plus the cost of improvements since the date of the gift, and any gift tax paid attributable to the net appreciation in the property, less depreciation claimed. In effect, the person receiving the property as a gift shoulders the potential income tax liability of the donor.

If the basis is less than the fair market value at the time of the gift, the basis to the donee is the fair market value.

### **Inherited Property**

The third basis rule applies to inherited property. Using the same example, the property with an income tax basis of \$12,000, but worth \$100,000, is held by the owner until death. The difference between the \$12,000 basis and the \$100,000 value is not considered. The new basis becomes \$100,000 for the new owner who inherits the property.

While the federal estate tax and state inheritance tax will likely be based on the \$100,000 fair market value of the property, elimination of income tax on the \$88,000 of gain is a major advantage.

If fair market value at death is less than the basis, the decedent's estate receives a *step down* (rather than a step up) in basis. Thus, if property acquired for \$200,000 (no improvements and no depreciation) had dropped to \$120,000 at death, the potential \$80,000 loss is eliminated.

There is an exception to the general rule of a new income tax basis at death. If appreciated property is given away within one year of death and then inherited back by the donor or the spouse of the donor, or the property is sold and the proceeds are inherited by the donor or spouse of the donor, the property does not receive a new income tax basis at death.

### **Advantages to Holding Assets**

One of the major advantages of holding property until death has just been shown. For those with gains in assets, the advantage of receiving a new income tax basis may overshadow the potential

estate or inheritance tax liability, or at least a significant part of it.

If the property is land, the land held until death may be valued under the special use valuation rules. That is a second major advantage. Special use valuation is discussed in detail in Chapter 10. But special use valuation does not apply to transactions by sale or gift.

Third, business assets held until death may be eligible for the family-owned business exclusion for federal estate tax purposes. Thus, part or all of the business assets may be excluded from the gross estate for federal estate tax purposes. Cash or non-business investments from a sale of business assets before death would not be eligible for the exclusion. The family-owned business exclusion is discussed in Chapter 11.

There is one type of asset that does not receive a new income tax basis at death, however. These are assets that produce "income in respect of decedent." This is a category of income that is so close to being earned income that a new basis is not permitted for the assets involved.

If the decedent has been renting out farmland under a non-material participation crop share lease, the stored crops and growing crops are income in respect of decedent and the gain is not eliminated. Accrued interest on Series E U.S. Savings Bonds is another example that continues to be taxable after death.

Installment sales, or installment contracts for the sale of assets such as land, produce income in respect of decedent, also. Qualified retirement plans including Individual Retirement Accounts and Keogh Plans (for those self-employed) also

produce income in respect of decedent with the benefits subject to income tax to the heirs or beneficiaries.

## Sale of Residence

There are some special tax treatments available on the sale of a residence. These treatments apply to urban residences, or to the sale of the farm residence either as part of the farm or if sold independently.

One provision available to ease the income tax burden on sale of the residence was repealed in 1997; another was modified substantially. The provision that was repealed permitted a homeowner to sell the principal residence, reinvest the proceeds in another principal residence within two years, and postpone paying income tax on the gain. If the new residence cost as much or more than was received on sale of the old residence, all of the gain was transferred into the new residence.

The other provision, which was substantially modified, enabled the owner of a principal residence to exclude, on sale after age 55, up to \$125,000 of gain on the residence (\$62,500 on a separate return). That provision was replaced with one allowing the owner of a principal residence to exclude up to \$500,000 on each sale after May 6, 1997, if married filing a joint return (\$250,000 for a separate return). Gain is recognized to the extent of depreciation claimed for business use or rental of the principal residence for periods after May 6, 1997. The exclusion can be used no more frequently than once every two years. To be eligible, the residence must have been owned and occupied as the principal residence for at least two of the last five years before sale.

# Installment Sales, Private Annuities, and Self-Canceling Installment Notes **8**

If the decision were made to sell assets during life, there are several options open. One would be a sale for cash. A second possibility is the installment sale. Third, one could make use of the private annuity. Fourth, the assets could be sold using a self-canceling installment note at death. And fifth, it might be desired to use a part gift, part sale transaction, especially if family members are involved.

The major income tax considerations for cash transactions were discussed in the preceding chapter, examining the income tax basis, the amount of gain or loss involved, the reinvestment problems, and the effects of inflation.

## Installment Sale

The installment sale has a number of advantages and disadvantages. The first advantage is that the seller's gain can be spread over the life of the contract. This can ease the income tax burden that the seller may have if there is substantial gain in the property sold. For the buyer, the down payment is typically fairly low.

A third point to consider and one that favors the seller is that if the buyer is unable to make payments, the seller can recover the property after giving notice—often as little as 30 days. The seller can recover the property much faster than would be the case with a mortgage foreclosure.

The installment sale produces income for the seller. That income changes over the life of the contract if the payment is a fixed amount of principal with a decreasing amount of interest. With that arrangement, the total payment declines over the life of the contract. Or the payment may be fixed, but with a decreasing amount of interest and increasing amount of principal each year of the contract. In this instance, the amount of income does not change, but the nature of the income changes.

But with either system, the seller knows how much each year's payment will be. The only real risk to

the seller is the risk that the buyer might be unable to make the payments.

The income received under a contract is partly in the form of return of basis, which is not taxable; partly in the form of gain; and partly in the form of interest. These three components do not reduce social security benefits in retirement, regardless of amount received.

One drawback is that if land is sold under installment sale, the contract is an asset in the seller's estate and is not eligible for special use valuation of land for federal estate tax purposes and usually will not be eligible for the family-owned business exclusion. If the land were held until death, it might be eligible for special use valuation. Land or other business assets held until death perhaps would qualify for the family-owned business exclusion.

Also, inflation can be a problem with the installment sale since it's a fixed principal obligation. If inflation continues, the fixed principal amount can reduce the real value or purchasing power of the income stream to the seller.

## Income Tax Aspects of Installment Sale

One of the desirable features of the installment sale is the possibility for spreading the income amount over the life of the contract. But there are some constraints.

First, a minimum interest rate is specified. You cannot set whatever interest rate you might wish on the contract. From a seller's point of view, it may be desirable to reduce the interest rate and increase the selling price. The increased selling price produces capital gain, which receives preferred income tax treatment, while the interest is always taxable as ordinary income. For sales or exchanges after May 6, 1997, the maximum income tax rate on net long-term capital gains for an individual was reduced from 28 percent to 20

percent. For those in the 15 percent income tax bracket, the long-term capital gains rate has been reduced to 10 percent. On the sale of depreciable real property, such as buildings, gain to the extent of depreciation claimed is taxed at a maximum of 25 percent.

Beginning in 2001, an 18 percent rate will be imposed on long-term capital gains on assets held more than five years, 8 percent for those in the 15 percent tax bracket. That provision, however, is effective for those above the 15 percent tax bracket only for assets for which the holding period begins after December 31, 2000.

For long-term capital gain treatment, the general rule has been that eligible assets had to be held more than one year. That requirement was increased to more than 18 months for sales after July 28, 1997. The holding period for livestock (24 months or more for cattle and horses, 12 months or more for other livestock) was left unchanged.

The maximum tax rate on "collectibles" remains at 28 percent.

For a number of years, the Internal Revenue Service has specified a minimum interest rate for installment sales. At present, the minimum rate is the lesser of 9 percent or the "Applicable Federal Rate" (which is published monthly) for transactions up to \$3,723,800 (for 1997) of seller financing. Where the amount of seller financing is more than \$3,723,800 (for 1997), the minimum rate is the applicable federal rate. The Applicable Federal Rate varies by length of contract. The AFR is separately quoted for short-term contracts (three years or less), midterm contracts (more than three but not more than nine years), and long-term contracts (more than nine years).

For sales of land up to \$500,000 in a calendar year between family members (brothers, sisters, spouse, ancestors and lineal descendants), the interest rate is 6 percent.

For large transactions (more than \$2,659,900 in 1997) the minimum interest rate rules are more complex.

Here's an example of how the seller calculates the income tax liability when the gain is spread over the life of the contract. Let's assume that we have a

tract of land with a fair market value of \$100,000. Let's further assume that there's a mortgage on that land of \$40,000 and that the land has an income tax basis of \$60,000.

First, we must determine the amount of *gross profit*. Gross profit is the selling price less the income tax basis in the property, or \$100,000 minus the \$60,000 basis. The gross profit is \$40,000.

The second calculation is total contract price. That is the total amount of principal to be paid by the buyer to the seller. In addition, the buyer will eventually pay off any mortgage assumed. In our example, the total contract price is calculated by taking the selling price of \$100,000, minus the \$40,000 mortgage taken over by the buyer. So the total contract price is \$60,000. The gain on sale is reported as the payments on the total contract price are received by the seller.

Next we calculate the *gross profit percentage* by dividing gross profit by the total contract price, or \$40,000 divided by \$60,000, or two-thirds. So two-thirds of every principal payment would be capital gain. One-third of every principal payment is return of basis. The return of basis is not subject to income tax. The capital gains amount is usually taxable as long term capital gain, which is relatively more attractive than reporting it as ordinary income.

The seller, of course, receives interest payments that are taxable each year as ordinary income. In addition, there may be recapture of depreciation on an installment sale of property.

There are other problems with the installment sale. One is if the mortgage on the property to be taken over by the buyer exceeds the income tax basis, that excess is gain. Such excess would generally be gain in the year of the takeover of the mortgage — a point to watch. Also, if the seller disposes of the contract other than at death, there is a taxable event — a taxable disposition. So sale or gift of the contract can trigger tax liability.

If property is sold to a related party with gain reported on the installment method, disposition of the property by the purchaser within two years

may cause taxable gain to the original seller. There are exceptions if the second sale was because of the death of the seller or buyer, it was not motivated by tax avoidance motives, or it involved sale of stock of the issuing corporation. For sales of depreciable property to an entity as a related party, installment reporting is not available. For installment obligations held until death of the seller, to the extent the obligation passes to the obligor under the contract, the gain on the contract is taxed to the seller's estate.

Cancellation or forgiveness of installment payments by the seller as the payments come due is usually treated as a taxable disposition to the seller.

### **The Private Annuity**

Another option for the disposition of assets during life is the private annuity. It is similar to its first cousin, the commercial annuity. A commercial annuity involves a payment of cash to an insurance company in exchange for a promise to pay an amount to that annuitant for the rest of the annuitant's life or to the annuitant and the surviving spouse. The private annuity differs in several respects from the commercial annuity.

First, the private annuity usually does not involve cash—it typically involves an asset like land or some other family asset. Second, it doesn't involve an insurance company—it involves someone else, often a member of the family, as obligor.

In the usual situation the parent is the annuitant and a family member is the obligor. The family member makes payments to the parent as long as the parent lives. The annuitant is taking a risk that

something may happen financially to the obligor so the obligor can't make payments. The annuitant is not permitted to retain a security interest in the property involved. If that is done, the transaction is likely to be treated as a sale.

Also, there may be a windfall involved. If the annuitant—the parent in our example—dies prematurely, that's a windfall gain to the obligor. If the parent lives a longer than normal life, that's a different matter. The obligor then may pay more than the property is worth. Also, there's no interest deduction for the obligor with the private annuity. The private annuity can be a useful technique, but it has problems.

### **The Self-Canceling Installment Note**

The Self-Canceling Installment Note (or SCIN) is a relatively recent development. It resembles an installment sale with the seller able to retain a security interest in the asset involved. However, payments cease at the death of the seller. That feature resembles a private annuity. Because the buyer may not be required to make all of the payments, a premium must be built into the selling price or interest rate.

The major tax disadvantage of a SCIN is that income tax on payments remaining at death must be paid by the decedent's estate even though the payments are not received. In general, no part of the value of the property is included in the seller's estate for federal estate tax purposes.

The part gift, part sale is discussed along with the gift tax aspects in the next chapter.

The estate planning process often involves the question: "Should gifts be made during life?" There are both advantages and disadvantages in making gifts. It's an option, however, that many may want to consider.

The federal gift tax rules are important in estate planning because they establish how much property can be given during life without paying the gift tax. The federal gift tax is levied on outright gifts made during life and is imposed on the donor—the one who makes the gift. Some states, but not Iowa, have a state gift tax, also.

You can give away a considerable amount of property without incurring any liability under the federal gift tax.

The federal gift tax is integrated with the federal estate tax in that both use the same tax schedule and the single unified credit applies to both taxes. Use of part or all of the unified credit during life is taken into account by including taxable gifts during life in the taxable estate at death and allowing the full unified credit at death.

For federal gift tax purposes, property is valued at its fair market value. That applies even to land, which if held until death might be valued for federal estate tax purposes at special use value. Special use value is often considerably less than fair market value. Thus, there may be a heavier tax burden on gifts during life than if the property were held until death.

Three key deductions and a credit influence the calculation of the federal gift tax: the annual exclusion, the gift tax marital deduction, the charitable deduction, and the unified credit.

## Annual Exclusion

Each person (donor) can give up to \$10,000 of property each year to each of as many people as he or she would like with no federal gift tax liability. The persons to whom the property is given need not be related to the donor for the annual exclusion to be available. A husband and wife could give

\$20,000 to each person each year even though the property is owned by only one of them. The \$10,000 and \$20,000 amounts are indexed for inflation after 1998.

To be eligible for the annual exclusion, the gift must be of a present interest. It must not be a gift of something like a remainder interest, which would be a future interest. If the person receiving the gift would have the right to the income from the gift and possession of it now, it would generally be a present interest and would be eligible for the annual exclusion. If the person receiving the gift is to receive the property and income later, such as after expiration of a life estate, then the gift would not be eligible for the annual exclusion.

## Gifts to Charity

In addition to the annual exclusion, an unlimited deduction is available for gifts to a qualified charity. Other than for gifts to a subdivision of government or a church, a charity should have an exemption letter from the Internal Revenue Service indicating that gifts are eligible for the gift tax charitable deduction if it is planned for the gift to be deductible.

## Marital Deduction

Under the federal gift tax marital deduction, 100 percent of the value of gifts from one spouse to another is deductible. That permits a couple to arrange property ownership in any desired pattern with no federal gift tax concern.

The federal gift tax marital deduction can also be claimed for a life estate left to the surviving spouse. The executor of the first spouse to die can elect to treat a life estate left to the surviving spouse as "qualified terminable interest property." In that event, the entire value of the property—and not merely the value of the surviving spouse's life estate—qualifies for the marital deduction.

Later, if the surviving spouse disposes of his or her interest by gift, the entire value of the property is

subject to federal gift tax. Similarly, if retained until death, the entire value of the property is subject to federal estate tax at the surviving spouse's death. Any gift tax or estate tax attributable to the remainder interest may be recoverable from those holding the remainder interest.

Gifts to the spouse can be used to help balance the estates of husband and wife, which may be an advantage in some estate plans. With balanced estates, use of the federal estate tax marital deduction may not be as crucial.

As an example of how these deductions and exclusions may be used, a husband and wife with five children in any year through 1998 could give away \$100,000 each year—\$20,000 to each of the five children. That annual exclusion could be continued each year for as long as desired and, as noted, is indexed for inflation after 1998.

There is no limit to the number of years the annual exclusion can be used nor is there a limit on the amount of property in the aggregate that can pass under the annual exclusion. In addition, one spouse could give the other an unlimited amount under the gift tax marital deduction without encountering federal gift tax problems.

For gifts beyond those amounts, the single unified credit is available. The unified credit is discussed in detail in Chapter 12.

Under the unified gift and estate tax rules the same tax schedule applies to gifts during life and to property transfers at death.

### Gift Tax Return

If a gift of more than \$10,000 is made to any person (other than spouse) in any year, a federal gift tax return must be filed, even if no gift tax would be due. Any size gift of a future interest requires that a federal gift tax return be filed. The gift tax return is to be filed on an annual basis; however a gift tax return is not required unless gifts exceed the annual exclusion for that year. If gifts exceed \$10,000 for at least one person, a return should be filed.

Federal gift tax returns are filed on an annual, calendar year basis. The gift tax return is to be filed on or before April 15, except for the year of death, and that year the gift tax return is due with the federal estate tax return.

Gifts are reported to the Internal Revenue Service on Federal Form 709. Again, gifts of more than \$10,000 to any one person (other than to a spouse) in any year are to be reported if they are gifts of a present interest. A gift of a future interest, such as a remainder, should be reported on a gift tax return regardless of the size of the gift. Form 709A may be used to report gifts by husband and wife wishing to split the gift to take advantage of the combined federal gift tax annual exclusion.

Gifts that exceed the annual exclusion, the marital deduction, and the charitable deduction are taxable gifts. Taxable gifts are brought back into the taxable estate at death for federal estate tax purposes if they were given after 1976. IRS after death can challenge the date of gift valuation of property given away as a taxable gift.

### Inadvertent Gifts

Gifts may occur on transfer of insurance policies or other property—land, stocks, bonds, inventory items, for example—and are valued for gift tax purposes at fair market values as of the date of the gift.

The IRS position is that a gift may also occur if property is sold with payment over a period of years at an interest rate different from a market rate of interest. This may occur, for example, on sales of land to family members where a special interest rate of 6 percent is allowed up to \$500,000 of sales of land each year.

**Example:** Parents sell farmland to their two daughters for \$400,000 with payment over 20 years at 6 percent interest. IRS determines that a market rate of interest at the time would be 11 percent. At that interest rate, the contract is valued at \$250,000. The difference, \$150,000, is a gift from parents to the daughters.

The IRS position has been upheld by the Tax Court and by the Eighth and Tenth Circuit Courts of Appeal but not by the Seventh Circuit Court of Appeals. The Seventh Circuit decision generally prevails in Illinois, Indiana and Wisconsin.

Taxable gifts may also occur in transfers to or from co-ownership. As a general rule, a transfer of cash or other property from one person to that person and another as co-owner would constitute a gift of

an appropriate fraction of the value involved. Hence, purchase of \$100,000 of corporate stock by A from A's funds would involve a gift of \$50,000 to B if title to the stock were taken by A and B as tenants in common or joint tenants. The gift occurs at the time the property is acquired.

But there are two current exceptions to the general rule. (1) Deposits of funds in a joint bank or brokerage account by one owner alone do not constitute a gift—until the co-owner not providing the funds withdraws from the account without any responsibility to account to the one who deposited the funds. (2) Purchase of U.S. Government savings bonds by an individual with title taken in joint tenancy with another is not a gift—until the one not providing the funds redeems the bonds while both are living without any responsibility to account to the one who provided funds for the bonds.

Acquisition of land, by a husband and wife, in joint tenancy between December 31, 1954, and January 1, 1982, even though only one of them provided the money, was not a gift at the time of acquisition unless expressly declared to be a gift on a timely filed federal gift tax return.

For acquisitions of land by a husband and wife in joint tenancy after 1981, if initial contributions are not equal, a gift is involved (and would be covered by the federal gift tax marital deduction). Thus, such a joint tenancy could be later severed into tenancy in common without a gift.

### Gifts from Value Freezes

As noted in Chapter 7, some individuals cap or "freeze" their estates or specific items of property by converting the assets into a form that does not change in value over time. An installment sale of land is a type of freeze for the seller. The value of the contract in the seller's hands does not change as land values change. All fluctuations in value of the land are felt by the purchaser, not by the seller.

In 1990, federal legislation repealed an attack on such freezes enacted in 1986 that involved federal estate tax rules. The 1990 law imposed detailed rules governing the valuation of interests retained and transferred as a result of a freeze for federal gift tax purposes.

### Gifts to Minors

Another tool for estate planning is gifts to minors. Because minors are not competent to manage property from a legal standpoint, there is a problem of making transfers of property to those under the age of majority. Until recently it was often necessary to set up a trust if property was to be transferred to minors in Iowa. But the trust may be somewhat cumbersome, particularly for small gifts. The Iowa General Assembly has authorized the use of a simpler device than the trust for making gifts to minor children—the "Transfers to Minors Act" custodianship.

Under this act, property can be given to a custodian who acts for the minor. The custodian manages the property until the time control over the property is relinquished to the individual. Unlike a trust, property cannot be held beyond that age. The custodian could be one of the parents, another adult, or a bank or trust company.

The Transfers to Minors Act provides a relatively simple and convenient device for making gifts of property to minors without a great deal of complexity. It can be used for gifts of cash, stocks, life insurance policies, or securities, as well as for gifts of tangible property.

Tax reasons suggest the same person should not be the donor of the property and also the custodian under a Transfers to Minors Act arrangement. For example, if a father makes the gift and is also custodian and the father dies before the child reaches the age for distribution, the property managed could be included in the father's estate for tax purposes. The matter of control of property is again the influencing factor.

Also, it may be preferable that a parent legally obligated to support the child not act as custodian. Another adult or a bank or trust company might be used as custodian.

The custodianship can be activated simply by putting title on the stock, security, or bank account in the name of "Mrs. John Doe as custodian for John Doe, Jr., under the Iowa Uniform Transfers to Minors Act."

Though more complex, the trust also is an option for making gifts to an adult or minor. Trusts are discussed in Chapter 16.



Tax aspects of estate planning typically concern as many as five different taxes. There's the federal gift tax, the state and federal income tax, the state inheritance tax, and the federal estate tax. Here, our focus is on the federal estate tax with particular emphasis on when property is valued and how it is valued for that tax.

## When Property Is Valued

In general, property is valued as of the date of death. However, there is an alternate valuation date. If the requirements are met, the property can be valued up to six months after death if that would be more advantageous. A later valuation might be advantageous if property values had gone down after the date of death. If property in existence at death is disposed of during the six-month period, you would use the date of disposition for valuation. Property not in existence at death—such as crops planted after death—is usually not subject to the alternate valuation rule.

To be eligible to use the alternate valuation date, the value of all property in the estate and the federal estate tax liability of the estate must be reduced by making the election.

## Valuing the Property:

### General Rule

The general rule is that property included in the estate is valued at its fair market value. That's the value at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell.

### Special Use Valuation

However, the executor may elect to value real property devoted to farming or other businesses at its special use value, rather than fair market value.

If the real property eligible for special use valuation is used for farming, its value can be determined in two ways. One involves capitalization of the cash rent for comparable farm land in the locality. Specifically, the formula involves dividing the average annual gross cash rental for comparable

farm land in the locality less property taxes for comparable land by the average annual effective interest rate for all new Federal Land Bank loans. The calculations are to use the five most recent calendar years ending before the deceased's death. For the Federal Land Bank interest rate, a district rate is to be used. The rate in the Omaha district, which includes Iowa, is shown in Table 1. The rate varies by Federal Land Bank District. The interest rate used is the rate for the Federal Land Bank District where the land is located.

**Table 1. Interest rate for special use valuation calculations in Omaha Farm Credit District.**

Death in	Rate (percent)
1977	8.70
1978	8.92
1979	9.05
1980	9.25
1981	9.59
1982	10.17
1983	11.52
1984	11.86
1985	12.45
1986	12.99
1987	12.50
1988	12.56
1989	12.07
1990	11.59
1991	10.87
1992	10.10
1993	9.54
1994	9.15
1995	8.63
1996	8.38
1997	8.09

As an example of this method of valuation, assume average annual gross cash rental of \$90 per acre with property taxes at \$9.10 per acre leaving an amount of \$80.90 to be capitalized. If the average annual Federal Land Bank loan rate is 8.09 percent, dividing \$80.90 by 8.09 percent would produce a value of \$1,000 per acre.

If there are no cash rented tracts of comparable land in the locality, use can be made of "average net share rentals" from crop share leases. The term "net share rentals" means the landowner's portion of the crop share return from the land minus the "cash operating expenses which, under the lease, are paid by the lessor." The rent capitalization approach is not to be used if there is no comparable land for determining average rentals or if the executor elects to value the real property using the following factors (this is the procedure also for non-farm land): (1) capitalization of income the property could be expected to yield over a reasonable period under prudent management; (2) capitalization of the fair rental value; (3) assessed value for property tax purposes based on current use; (4) comparable sales in the same geographical area but without significant influence from metropolitan or resort areas; and (5) any other factor that would fairly value the real property.

To qualify for special use valuation, several conditions must be met: (1) the value of the farm or other business real or personal property must be at least 50 percent of the deceased's gross estate less indebtedness attributable to the property and that amount or more must pass to a qualified heir or heirs (by inheritance or by purchase); (2) at least 25 percent of the deceased's gross estate less indebtedness attributable to the property must be qualified farm or other business real property; (3) during five or more years in the eight-year period ending with the deceased's death, the real property must have been owned by the deceased or a member of the deceased's family and held for use as a farm or other business; and (4) the deceased or a member of the deceased's family must have "materially participated" in the operation of the farm or other business for five or more of the last eight years before the earlier of the date of disability, retirement, or death. For this purpose, "disability" is defined as the inability to engage in material participation; "retirement" means receiving social security benefits. For a surviving spouse who inherits qualified real property from a deceased spouse, "active management" substitutes for material participation.

In addition, the "qualified use" test must be met. The decedent or a member of the family must have had an "equity interest" in the farm operation at

the time of death and for five or more of the last eight years before death. Each qualified heir must meet the same test during the recapture period after death. In general, that means no cash renting of land after death except for the two-year grace period immediately following death and except that surviving spouses can cash rent to a member of the surviving spouse's family and lineal descendants of the decedent may cash rent to a member of the lineal descendant's family so long as the lessees or tenants are "at risk."

Crop share leases give the decedent (or qualified heir) the necessary equity interest. Cash rent leases between family members are acceptable in the pre-death period. In general, cash rent leases to non-family members do not meet the test before death other than for the exceptions.

In the period after death, a cash rent lease triggers recapture of special use valuation benefits even if the lease is to a family member, except for a two-year grace period immediately after death when the qualified use test need not be met and except for a cash rent lease by a surviving spouse to a member of the surviving spouse's family and by a lineal descendant of the decedent to a member of the lineal descendant's family. To the extent that use is made of the two-year grace period, however, the recapture period after death is extended for a like time.

As noted, at least 50 percent of the deceased's gross estate must pass to qualified heirs. Qualified heirs include the decedent's ascendants and descendants (children, grandchildren, and great grandchildren). It also includes the descendants of the parents of the decedent, which would include brothers, sisters, nieces and nephews, and spouses of all those persons, the spouse of the decedent and the descendants of the spouse of the decedent.

If special use value property is purchased from the estate by a qualified heir, the purchaser does not receive an income tax basis for the property equal to the purchase price, as is usually the case. Rather, the purchaser's income tax basis is generally the special use valuation for the property in the hands of the estate. The estate does not have income tax liability on the sale except to the extent the fair market value of the property on sale exceeds the fair market value on the date of death.

**Example:** Farmland with a fair market value of \$2,000 per acre is valued under the special use valuation rules at \$850 per acre. If the on-farm heir purchases the land for \$2,000 per acre at a time when fair market value is \$2,000 per acre, the estate would recognize no gain. The purchaser's basis would be \$850 per acre. In the event of later sale of the property by the purchasing heir at \$2,000 per acre, the seller would have \$2,000 minus \$850 or \$1,150 per acre of gain subject to income tax.

If farmland is distributed to all of the heirs with the interests of off-farm heirs then sold to the on-farm heirs, the gain on sale above special use valuation (up to the selling price) would be taxable to the sellers. Thus, there is a substantial difference in income tax treatment between purchase of land *from the estate* and purchase of land *from the other qualified heirs*.

If the property is disposed of within the recapture period after the death of the deceased to non-family members or ceases to be used for farming or other closely-held business purposes, the tax benefits must be repaid. For deaths after 1981, the recapture period is 10 years. For deaths before 1982, the recapture period was 15 years.

Absence of material participation by the qualified heir or a family member for more than three years during any eight-year period ending after the deceased's death also causes repayment of the tax benefits. However, for a qualified heir who is a surviving spouse, person under age 21, full time student or disabled person, "active management" by the qualified heir substitutes for material participation. For those under age 21 and disabled persons, a fiduciary (such as a conservator) can provide the involvement for meeting the active management test.

Each qualified heir must meet the "qualified use" test for the recapture period after death. That means, in general, no cash rent leases during the period, except during the two-year grace period immediately after death and except for a cash rent lease by a surviving spouse to a member of the surviving spouse's family and a cash rent lease by a lineal descendant of the decedent to a member of the lineal descendant's family (so long as the lessees or tenants are "at risk").

If land is taken by eminent domain or condemnation after special use valuation, there is no recapture if the proceeds are reinvested in property with the same use. That is considered to be an involuntary conversion and does not affect the special use valuation status. Similarly, if land is exchanged in a tax-free trade, there is no recapture if the replacement property is in the same use—farmland for farmland. It is believed that bankruptcy filing does not cause recapture of special use valuation benefits but transfers in bankruptcy other than to a member of the qualified heir's family could cause recapture to occur.

Death of the qualified heir does not trigger repayment or "recapture" as to the property interest of that qualified heir.

To be eligible for special use valuation, *all interests* in the land must be held by qualified heirs. A special problem arises if interests in land could pass to someone other than a member of the decedent's family.

**Example:** At the mother's death in 1997, land was left to the husband for life, then to the children living at the father's death. Because of the contingency, it is not known who will hold interests in the property until the father's death. Therefore, the property may not be eligible for special use valuation. Court cases have allowed special use valuation if the probabilities were slight that the property might pass to non-family members.

Remainder or other "future" interests in land cannot be valued under special use valuation unless a present interest in the land is also being valued.

**Example:** At father's death in 1970, land was left to mother for life, then to children. If one child were to die before the mother, the child's remainder interest would not be eligible for special use valuation.

The special use valuation procedure is applicable to real property interests held in a partnership, corporation, or trust.

For a trust, care should be exercised that a qualified heir has a "present interest" in the property. That means all of the income should go to family members. Any discretion in the trustee to pay

income or principal should be limited to family members.

For land held in a partnership or corporation to be eligible for use valuation, the entity must be a closely held business. At least 20 percent of the corporate voting stock or partnership interest, as the case may be, must be included in the deceased's gross estate or the entity must have 15 or fewer owners. The entity itself is then apparently disregarded with an examination of the amount of farmland and farm personal property held by the entity. Remember, at least 50 percent of the decedent's estate, directly or indirectly through ownership of an entity, must be farmland or farm personal property. Non-farm investments or cash beyond the reasonable needs of the business don't appear to count toward the 50 percent test. Similarly, at least 25 percent of the decedent's estate, directly or indirectly through ownership of an entity, must be farmland.

The special use valuation procedure cannot be used to reduce the deceased's gross estate by more than \$750,000. That figure is indexed for inflation after 1998.

## Leases

Leases take on special importance in planning if one expects to take advantage of special use valuation. Since a typical retirement step is to lease out farmland, the type of lease becomes rather important at this stage in order to meet the material participation and qualified use tests for special use valuation.

A cash rent lease to a tenant who farms the land and who is a member of the family should meet both the qualified use and the material participation tests. Both tests would be met by a family member as tenant.

If the decedent rents the land to a tenant who is not a member of the family, a cash lease would violate the qualified use test. If the landowner were retired or disabled and had accrued five or more years of material participation before retirement or disability, the material participation requirement would be met until death, so long as the landowner remained retired or disabled, as the case may be. Thus, the minimum lease for a retired or disabled landowner renting to an unrelated tenant is generally a nonmaterial participation crop share lease.

If the decedent rents to an unrelated farm tenant before retirement or disability, a material participation crop share lease would be the minimum required to meet the tests.

If the decedent operates the land until death, there should be no problem of eligibility in the pre-death period. If the decedent had formed a family partnership or corporation totally owned, controlled, and managed by family members and leases the land to the partnership or corporation as the tenant, a cash rent lease should ordinarily meet the requirements.

Leases should be checked carefully with a tax adviser if one plans to take advantage of special use valuation.

Taxes are an expense at death and thus play a role in planning for the distribution of property. Knowledge of the federal and state taxes that apply may be helpful in minimizing taxes and in assuring that objectives will be met in an estate plan.

There are two types of taxes on property transferred at death, the federal estate tax and the Iowa inheritance tax. Closely related is a third tax, the federal gift tax, imposed on gifts during life.

The federal estate tax is levied on the value of property owned by the decedent at death, on other property transferred during life over which the person retained some interest or control, and, under certain circumstances, on property given away within three years of death. The total value of such property is the gross estate.

## What Is Included in the Gross Estate?

The gross estate includes land, inventory items, machinery, bank accounts—all the real and personal property of the decedent.

The gross estate also includes the decedent's proportional ownership of property held in tenancy in common. That's usually half. However, it could be any fractional share if it is clearly spelled out on the title that the decedent owned other than half. Otherwise it is presumed that half the value would be included in the gross estate for two person tenancies in common.

## Joint Tenancy Property

When a person dies owning property in joint tenancy, one of two rules is applied to determine the portion of value subject to federal estate tax. Under the "consideration furnished" rule, applicable to all joint tenancies except those involving only husbands and wives, the full value of the property is included in the estate of the first person to die for federal estate tax purposes (and the full value receives a new income tax basis), except to the extent the survivor can prove he or she pro-

vided the money when the property was acquired or the mortgage was paid off.

The survivor bears the burden of proving he or she provided part of the money. This burden might be met by showing that an inheritance, gift or income from employment had been used to acquire the property. The basic question is the source of money when the property was acquired.

The "fractional interest" rule makes one-half the value of joint tenancy property held by a husband and wife subject to federal estate tax at the first death. Each is considered to own half the property for federal estate tax purposes. Proof of contribution is not important. The rule operates arbitrarily: one-half is taxed if the husband dies first; one-half is taxed if the wife dies first. Moreover, only one-half the total property value receives a new income tax basis at the first death.

Three cases have allowed the "consideration furnished" rule to be applied in a husband-wife situation. Because the husband provided all of the funds for the purchase initially in those cases, the result was a new basis for all of the property at the husband's death at no federal estate tax cost because of the 100 percent marital deduction for the amount passing to the surviving spouse.

A major problem with joint tenancy is that it can create a heavy tax burden at the survivor's death. Since property is transferred outright to the survivor, the entire value of the property frequently is included in the estate of the survivor. Joint tenancy property ownership is, therefore, inconsistent with the major tax saving techniques designed to reduce federal estate tax liability at the death of the surviving spouse.

For those concerned with federal estate taxes, the best strategy, therefore, might be to get out of joint tenancy.

## Certain Transfers During Life

Property transferred by gift within three years of death is not included in the estate at death for

federal estate tax purposes. There are, however, two categories of exceptions to that general rule: (1) transfers of property are included in the decedent's gross estate if the decedent retained a life estate in the property, the transfer was to take effect at death, the transfer involved a revocable transfer, or the transfer involved a life insurance policy; and (2) for purposes of determining eligibility for special use valuation of land, installment payment of federal estate tax and redemptions of corporate stock to pay death taxes and estate settlement costs, property transfers by gift within three years of death are included in the gross estate for the limited purpose of determining whether the eligibility requirements have been met.

Any increase in value of the property after the date of the gift is excluded from estate and gift taxation. The value of the gift is already taken into account in reducing the unified credit or incurring a gift tax (or both). In addition, property transferred by gift does not receive a new income tax basis at death and, if land, is not eligible for special use valuation.

Because life insurance policies come within the exception, a transfer of insurance policies by gift within three years of death makes the proceeds (or the value of the policy if on another's life) includible in the insured's gross estate.

Under a different rule, retaining control over property that is transferred may also make the property subject to tax. The general rule is that to give away property to save taxes at death, all connections must be severed with the property. For example, a couple cannot save taxes by deeding a farm to the children while retaining the right to collect the income. Retention of income or other interests subjects the full value of the property to the federal estate tax at the death of the person retaining powers or control over the property.

Thus, the gross estate contains all property owned outright by the individual, property transferred with retained powers, and some property given within three years prior to death.

### **Insurance Proceeds**

Proceeds of life insurance policies may be subject to the federal estate tax, depending on the circumstances. Two factors determine whether proceeds are taxable: policy ownership and beneficiary

designation. If the person who dies and whose life was insured is also the owner of the policy, the proceeds are subject to the federal estate tax.

If the beneficiary is the estate of the insured, the insurance proceeds are subject to tax. Thus, two conditions must be met for insurance proceeds not to be taxed. First, the owner of the policy must be someone other than the insured, and second, the beneficiary must be someone other than the insured's estate.

The owner of a life insurance policy is the one who has the right to change the beneficiary, borrow on the policy, take paid up insurance, or collect the cash value.

Typically, when a husband takes out a policy on his life, he makes his wife the beneficiary and he is the owner. Under these circumstances, the proceeds are subject to tax but are covered by the marital deduction.

If the wife is the owner of the policy on the husband's life, the proceeds are not subject to federal estate tax. Thus, the husband is the insured, but the wife is the owner and beneficiary. The husband should recognize that the policy may be a valuable piece of property and that the policy would then belong to his wife. Also, if the wife dies before the husband, the cash value (not the face value) of the policy would be included in her estate. If the wife has a large estate, ownership of the policy by her might be undesirable. Again, it depends on the circumstances. If the wife does become the owner of insurance policies on the husband's life and then she dies first, it is important how she disposes of the policies. If she gives them to the surviving husband by will, for example, at his death later the proceeds would be subject to federal estate tax. Hence, it is common for policy ownership to be specified for a step beyond the wife's life, perhaps to a trust or an adult child.

Ownership of a policy can be changed by assignment. For a whole life or ordinary life policy, this may create a gift, and, depending on the value of the gift, may be subject to the federal gift tax. Remember, gifts to a spouse are eligible for the federal gift tax marital deduction.

Your insurance company can give you the precise amount of the gift, but for a rough estimate in your planning, the cash value of the policy will be reasonably close.

## Retirement Benefits

In general, the value of a retirement plan is included in an estate. If you are involved in a qualified employee plan or retirement plan, your plan administrator can indicate the amount that would be included in the gross estate.

In computing the federal estate tax, the first step after determining the amount of the gross estate is to identify deductions. Deductible items include debts of the decedent, the attorney's fee, the executor's fee, court costs, and costs of last illness, death, and burial. The costs involved in selling property, if claimed as a federal estate tax deduction, cannot also be used to offset gain for income tax purposes. (An estimate of estate settlement costs appears in Chapter 13.)

## Family-Owned Business Exclusion

One of the most dramatic features of the Taxpayer Relief Act of 1997 is the creation of the "family-owned business exclusion" or FOBE. That exclusion is available to cover part or all of the value of a qualified family-owned business interest. Many farm and ranch operations with asset values exceeding what can be covered by the unified estate and gift tax credit should be able to qualify for the exclusion.

In several respects, the pre-death and post-death requirements parallel those for special use valuation. Unfortunately, the two provisions, both of which are likely to be important in farm and ranch estate and business planning, do not have identical requirements even though the rules are similar. This will likely lead to some confusion over use of the two provisions. It is important to approach special use valuation and the family-owned business exclusion as separate and distinct concepts, each with unique pre-death requirements for eligibility and post-death requirements to avoid repayment or recapture of the benefits involved.

One major difference between special use valuation and the family-owned business exclusion is that special use valuation applies only to land and

contains detailed rules on how eligible land is to be valued for federal estate tax purposes. The family-owned business exclusion, by contrast, is applicable to all assets used in the farm or other closely held business. Thus, machinery, equipment, livestock, stored grain and cash needed in the business are eligible for the exclusion. The assets involved are valued at fair market value in the traditional manner. Up to the available amount for the year of death, the assets are excluded from the federal estate tax gross estate.

### Amount of the family-owned business exclusion.

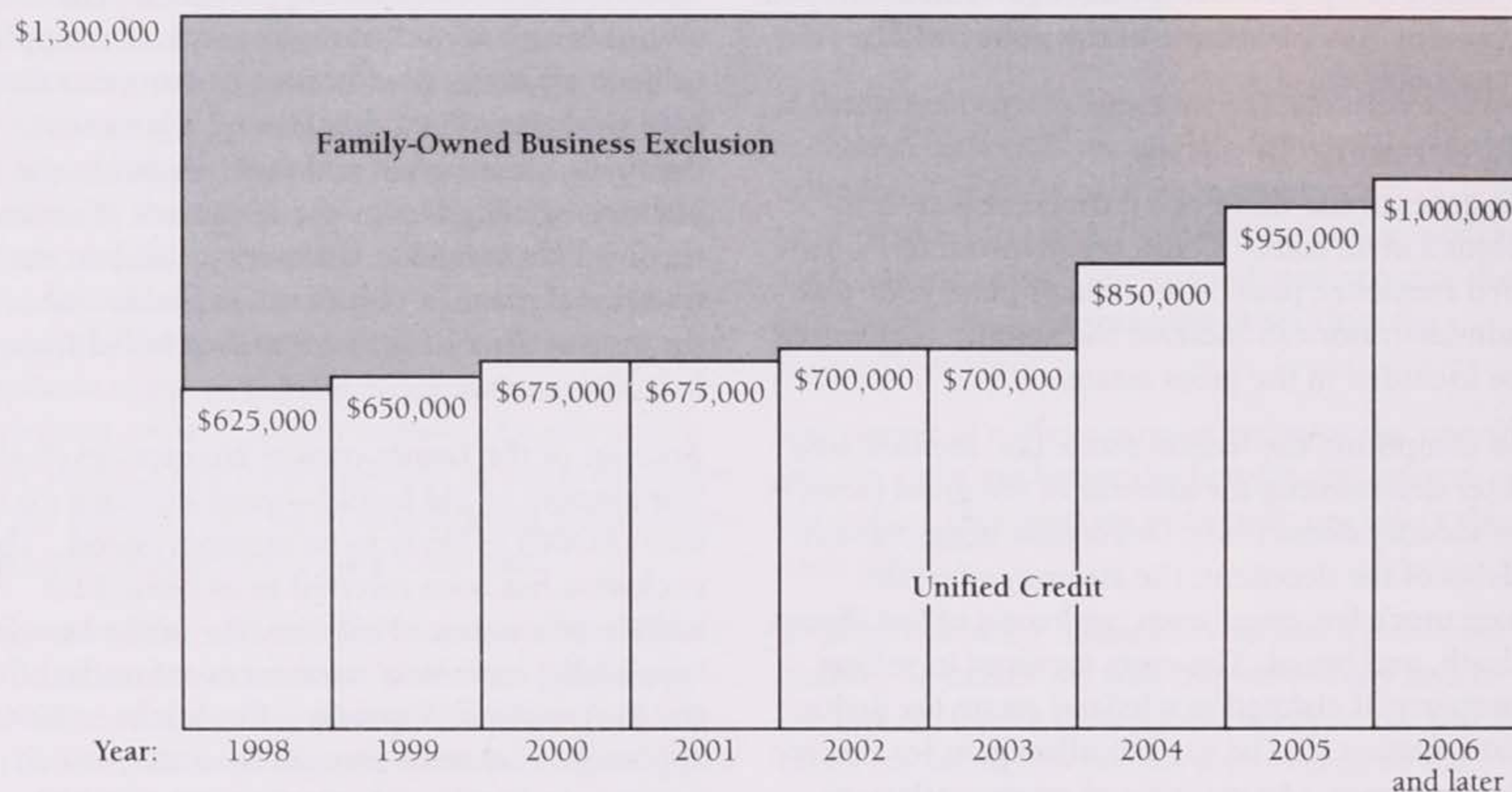
The amount of the family-owned business exclusion (FOBE) is likely to be misunderstood. The exclusion has been referred to as being \$1.3 million in amount. However, the unified credit "applicable exclusion" amount is subtracted from the \$1.3 million. Therefore, for deaths in 1998, the applicable exclusion amount from the unified credit is \$625,000. The FOBE is \$1,300,000 - \$625,000 or \$675,000. As the applicable exclusion amount increases (through 2006) to the \$1,000,000 level, the FOBE drops from \$675,000 to \$300,000. Unless amended further, the \$300,000 amount will continue to be available after 2006.

Figure 1 (next page) shows the relationship of the applicable exclusion amount and the family-owned business exclusion (FOBE) from 1998 through 2006.

**Requirements for eligibility.** Several requirements must be met for estates to be eligible for the FOBE. These requirements are expected to be scrutinized as carefully as have the requirements for special use valuation over the past 20 years.

- First, the decedent must have been a U.S. citizen or resident at the time of death and the principal place of business must be in the United States.
- Second, the executor or personal representative must elect to use the FOBE and file an agreement of personal liability for possible "recapture" or repayment of the tax benefits.
- Third, the aggregate value of the decedent's qualified family-owned business interests must exceed 50 percent of the adjusted gross estate (gross estate less allowable deductions).

Figure 1. Unified credit and family-owned business exclusion



To ascertain whether the decedent's "qualified family-owned business interests" make up more than 50 percent of the decedent's adjusted gross estate, a calculation is used involving a numerator and a denominator.

- The numerator is the aggregate of all qualified family-owned business interests that are includible in the decedent's gross estate and are passed from the decedent to a qualified heir, plus any lifetime transfers of such interests by the decedent to members of the decedent's family (other than the decedent's spouse), if those interests have been held continuously by members of the family and were not otherwise includible in the gross estate. For this purpose, transferred interests are valued as of the date of the transfer. That amount is reduced by all indebtedness of the estate except for that on a qualified residence, indebtedness incurred to pay educational or medical expenses of the decedent, spouse or dependents and any other indebtedness up to \$10,000.
- The denominator is the gross estate of the decedent reduced by estate indebtedness and increased by lifetime transfers of qualified business interests made by the decedent to members of the decedent's family (other than

the spouse) if the interests were held continuously by members of the family, plus transfers (other than de minimis transfers) from the decedent to the spouse within 10 years of death plus any other transfers made by the decedent within three years of death except for non taxable transfers made to members of the decedent's family.

- The qualified family-owned business interests, which must make up more than 50 percent of the decedent's adjusted gross estate as noted above, must pass to or be acquired by qualified heirs to the extent of that 50 percent figure or more. This is a critical requirement and means that any post-death sale of business assets should be considered carefully with an eye to whether a sale would jeopardize eligibility for the family-owned business exclusion.
- There is no "qualified use" test as such as under special use valuation. That test requires, in the pre-death period, that the decedent or member of the decedent's family be "at risk." It is pointed out that the qualified use test emerged in IRS regulations four years after enactment of special use valuation based upon language in the statute requiring the property to be devoted to "use as a farm for farming purposes or use in a trade or



business of farming.” The inclusion in the statute of the term “...trade or business of farming” gave rise to the qualified use test.

It is noted that the family-owned business exclusion also requires the existence of a “trade or business.” Under the statute, it appears that several categories of assets are considered passive assets and are not included in the value of a qualified business — (1) assets producing interest, dividends, rents, royalties, annuities and personal holding company income; (2) assets that are interests in a trust, partnership or real estate mortgage investment conduit (REMIC); (3) assets producing no income; (4) assets giving use to income from commodities transactions or foreign currency gains; (5) assets producing income equivalent to interest; and (6) assets producing income from notional principal contracts or payments in lieu of dividends. Thus, a cash rent lease of assets by the decedent (or by the qualified heirs) is unlikely to be considered a “trade or business.” This has clearly been the biggest single hurdle for eligibility purposes under special use valuation and for purposes of recapture after death. It promises to be a significant problem with FOBE.

- The decedent or a member of the decedent’s family must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent’s retirement, disability or death.

The “material participation” requirement is specifically made similar to the special use valuation material participation test. It is important to note that material participation cannot be achieved through an agent under the special use valuation rules. The same limitation applies to the family-owned business exclusion. For purposes of FOBE, material participation is required by the decedent or member of the decedent’s family for five or more of the last eight years preceding the decedent’s retirement, disability or death. The meaning given the term for purposes of FOBE is the same as for special use valuation. The Senate Finance Committee report states that “...an individual generally is considered to be materially participating in the business if he or she personally manages the business fully, regardless of the number of hours worked, as long as any necessary functions are

performed.” It is noted that this committee report language is substantially less demanding than is required for material participation under special use valuation as the FOBE statute states is to be used as the guide on what constitutes material participation. A question is raised as to whether the committee report language can be relied upon.

The Senate Finance Committee report states that “if a qualified heir rents qualifying property to a member of the qualified heir’s family on a net cash basis, and that family member materially participates in the business, the material participation requirement will be considered to have been met with respect to the qualified heir for purposes of this provision.” That language seems to support the position that the presence of a cash rent lease does not preclude a finding of pre-death material participation. However, as noted above, cash rent leasing may be inconsistent with the “trade or business” requirement, both pre-death and post-death. Indeed, it is puzzling why the committee report speaks so favorably of a cash rent lease.

Remember, the FOBE rules do not contain a “qualified use” test or “at risk” requirement as such. However, the provision does specify that the two-year “grace period” rules under special use valuation are to apply to the FOBE. In the context of special use valuation, the two-year grace period only applies to the qualified use test. This puzzling feature of FOBE is discussed below.

**Meaning of “qualified family-owned business interest.”** This is an important term in FOBE and one of the “gates” to keep mere investors from trying to gain eligibility.

A “qualified family-owned business interest” includes an interest as a proprietor in a business carried on as a proprietorship or an interest in an entity carrying on a business if at least 50 percent of the entity is owned, directly or indirectly, by the decedent or a member of the decedent’s family. Also, an interest in a business qualifies if 70 percent of the entity is owned by members of two families (and at least 30 percent is owned by the decedent or members of the decedent’s family). Similarly, an interest in a business qualifies if 90 percent of the entity is owned by members of three families (and at least 30 percent is owned by the decedent or members of the decedent’s family).

In applying the ownership test in a corporation, the decedent and members of the decedent's family must own the required percentage of the total combined voting power of all classes of stock entitled to vote and the required percentage of the total value of all shares of stock of the corporation. For a partnership, the decedent and members of the decedent's family must own the required percentage of the capital interest in the partnership (the Senate Finance Committee report indicates that the required percentage of ownership interest applies also to the profits interest).

In the case of entities in which a trade or business owns an interest in another trade or business, a "look-through" test is employed with each trade or business owned by the decedent and members of the decedent's family separately tested to determine whether that trade or business meets the requirements of a qualified family-owned business interest. Any interest that a trade or business owns in another trade or business is disregarded in determining whether the first trade or business is a qualified family-owned business interest. The value of any qualified family-owned business interest held by an entity is treated as owned proportionately by or for the entity's partners, shareholders or beneficiaries.

A trade or business does not qualify for FOBE if the stock or securities of the business were publicly traded at any time within three years of the decedent's death. Other than for banks and domestic building and loan associations, an interest in a trade or business does not qualify if more than 35 percent of the adjusted gross income of the business for the year of the decedent's death was personal holding company income—rents, interest and dividends, for example.

**Excess cash.** The value of a trade or business for purposes of FOBE is reduced to the extent the business holds passive assets or excess cash or marketable securities. The value of a qualified family-owned business interest does not include any cash or marketable securities in excess of the reasonably expected day-to-day working capital needs of the trade or business.

**Member of family.** The term "member of family" is used throughout the FOBE statute and has the same meaning as for purposes of special use

valuation. That definition includes the individual's spouse; lineal ancestors; lineal descendants of the individual, the individual's spouse and the individual's parents; and the spouse of lineal descendants.

**Qualified heir.** The term "qualified heir" defines the group of eligible individuals to receive interests in a qualified family-owned business. The term is defined as under special use valuation and includes members of the decedent's family who acquired the property (or to whom the property passed) from the decedent. In addition, for purposes of FOBE, the term "qualified heir" includes an "active employee of the trade or business to which the qualified family-owned business interest relates if such employee has been employed by such trade or business" for at least 10 years before the decedent's death.

**Recapture rules.** Establishing eligibility for the family-owned business exclusion is only half of the battle. There's also a set of requirements in the after-death period to avoid repayment or "recapture" of the benefits from the provision.

The family-owned business exclusion rules levy a recapture tax if, within 10 years of heir's death and before the qualified heir's death, a recapture event occurs. Recapture is triggered by any one of several events:

- Absence of material participation by the qualified heir or a member of the qualified heir's family for more than three years in any eight-year period ending after death causes recapture.

The rules specify that the provisions applicable to special use valuation which allow active management to substitute for material participation for some qualified heirs apply also to FOBE. That includes surviving spouses, full-time students, those under age 21 and those who are disabled. Members of that group can get by with "active management" which requires less involvement than material participation.

The meaning given the term "material participation" for purposes of the family-owned business exclusion is the same as for special use valuation. As noted above, the Senate Finance Committee report states:

“...an individual generally is considered to be materially participating in the business if he or she personally manages the business fully, regardless of the number of hours worked, as long as any necessary functions are performed.”

That language is hardly consistent with the statutory mandate to use the special use valuation definition of the term. Where committee report language and the statute are in conflict, the committee report language usually is disregarded.

As noted above, the legislation incorporates the two-year “grace period” from special use valuation. For special use valuation purposes, the two-year grace period immediately following death applies only to excuse the estate or qualified heirs from meeting the “qualified use” or “at risk” test. It has no application to material participation. The family-owned business exclusion rules do not explicitly include a qualified use or at risk test. But the widespread use of the term “business” throughout the statute and the reference to passive assets being ineligible for the exclusion clearly indicate that Congress contemplated that a business be carried on. That is one possible interpretation of the incorporation of the two-year grace period into FOBE. With that interpretation, the requirement of a “business” is waived during the two-year period after death and the 10-year recapture period is extended for a like time. This interpretation harmonizes with the statute and is believed to be the correct interpretation. However, it would mean that the decedent could not cash rent assets in the predeath period and in the recapture period starting two years after death but could cash rent during the two-year grace period. It is not clear whether the “passive income” provision would be waived during the two-year grace period.

The other possible interpretation is that the two-year grace period is intended to allow a two year lapse in material participation immediately following death. The problems with that interpretation are (1) the post-death material participation rule already allows a three year lapse; and (2) this interpretation would be inconsistent with material participation for special use valuation purposes which would be contrary to the FOBE statute.

Although the family-owned business exclusion statute does not define “trade or business” or refer to a code provision where the term is defined, the term generally requires continuity and regularity of activity and that the owner or owners be bearing the risks of production and the risks of price change. If, indeed, the term has that meaning in the FOBE statute, and the exclusion from eligibility of passive assets supports that interpretation, a rental of assets for cash would almost certainly not meet the test and has not met the test in a similar setting under special use valuation. In the event a cash rent lease would be considered to create a trade or business relationship, as is intimated by the Senate Finance Committee report, mere investors could take advantage of the family-owned business exclusion.

If it is determined that there must be continuity and regularity of activity and a sharing of risks of production and the risks of price change, the requirement would be substantially more demanding than for special use valuation. For special use valuation purposes, in the pre-death period, the qualified use or “at risk” test can be met by the decedent or member of the decedent’s family; in the post-death period, amendments in 1988 and 1997 permit limited cash rent leasing. Without comparable statutory language, and in the presence of the language on passive assets not being eligible, it would appear that the decedent would have to meet the test personally in the pre-death period and each qualified heir personally in the post-death recapture period. This constitutes a dangerous trap for the unwary.

The recapture rules for the family-owned business exclusion phase down the recapture tax based on the number of years of material participation.

<u>Recapture event occurring in following year of material participation</u>	<u>Percentage of Recapture Tax Due</u>
1 through 6	100
7	80
8	60
9	40
10	20

It is pointed out that the provision is ambiguous in that it uses "year of material participation" to calculate the recapture tax. Lapses in material participation in the post-death period are allowed without recapture for up to three years (absence of material participation for more than three years in any eight year period ending after death triggers recapture). Moreover, if the second possible interpretation of the presence of the two-year "grace period" (as discussed above) prevails, that would add two more years of possible non material participation. This ambiguity should be resolved.

- Recapture is triggered if the qualified heir disposes of a portion of a qualified family-owned business interest other than to a member of the qualified heir's family (not the decedent's family) or through a qualified conservation contribution.

Under the family-owned business exclusion rules, recapture is apparently calculated on a proportionate basis in the event of a partial disposition. As drafted, the family-owned business exclusion rules do not contain an exception to post-death recapture for sales or exchanges of crops or livestock held for sale or for property used in the business (such as machinery, equipment, dairy animals or breeding stock). Thus, as the statute is now worded, a sale of a corn crop or of cull cows would trigger recapture consequences. Similarly, a sale or trade of machinery or equipment would cause recapture. The same outcome would be expected from the sale of inventory of a nonfarm sole proprietorship. It is unclear how a sale of all or a substantial part of the assets of a business held by an entity would be handled.

Language in the conference committee report (which was added at the last minute when this problem was called to the attention of committee staff members) supports the view that sales or exchanges of grain or livestock in inventory and sales or exchanges of assets used in the business (other than land) in the course of business should not lead to recapture:

"The conferees clarify that a sale or disposition, in the ordinary course of business, of assets such as inventory or a piece of equipment used in the business (e.g., the sale of crops or a tractor) would not result in

recapture of the benefits of the qualified family-owned business exclusion."

With no statutory provision providing support for that statement, however, a question is raised whether language in the conference committee report will be sufficient. An amendment to the statute will likely be necessary to resolve the matter.

The FOBE statute contains rules drawn from special use valuation allowing tax-free exchanges (without triggering recapture) and allowing reinvestment of proceeds received in an involuntary conversion without recapture.

- Recapture is also caused if the qualified heir loses U.S. citizenship or the principal place of business of the family-owned business interest ceases to be located in the United States.

**Election.** The FOBE statute contains rules drawn from special use valuation for purposes of making the election and filing an agreement of personal liability.

Several other provisions including authority for a special lien for the additional estate tax are also included.

**Other considerations.** The enactment of the family-owned business exclusion raises several questions in a planning context. A few are discussed below; others will almost certainly arise.

For those with assets exceeding \$1,300,000, can part or all of the land be "removed" from the business and valued under special use valuation with the remaining assets passing under the family-owned business exclusion? Or will it be necessary to keep the land (for which special use valuation is desired) outside of the business and rent the land to the business?

Can part of the overall business (say a fractional amount or specific assets) be subjected to the family-owned business exclusion election?

One effect of the family-owned business exclusion is to discourage farmers and others in small business from building up savings. Savings beyond the reasonable needs of the business aren't eligible for the tax break involved. That provision, especially

for older farmers, will encourage individuals to remain fully invested in land and other assets. Sale of land before death will be discouraged. Land sales on contract will be discouraged inasmuch as a land contract is unlikely to be considered a business asset, at least in a sole proprietorship.

The family-owned business exclusion will be viewed widely as an attractive way to shelter assets. Because of the ready availability of tenants to operate farms under crop share leases in almost all areas of the country, investments in farmland are likely to be viewed with particular favor. If the material participation test can be met by a member of the family, as is permitted, or if the Senate Finance Committee language is accepted by IRS, the barriers to eligibility will be modest, provided the "trade or business" makes up more than 50 percent of the decedent's adjusted gross estate. This could mean increased investment in farmland by older taxpayers and higher farmland prices.

As with many parts of the Taxpayer Relief Act of 1997, the family-owned business exclusion is almost unbelievably complex. At the moment, the statute needs to be repaired.

The provision is effective for deaths after December 31, 1997.

### **Permanent Conservation Easement Exclusion**

The legislation allows the exclusion from the taxable estate of up to 40 percent of the value of land subject to a qualified conservation easement meeting the following requirements: (1) the land must be located within 25 miles of a metropolitan area or a national park or wilderness area or is within 10 miles of an Urban National Forest; (2) the land has been owned by the decedent or a member of the decedent's family during the three year period ending on the date of the decedent's death; and (3) a "qualified conservation easement" of a qualified real property interest was granted by the decedent or member of the decedent's family. To the extent the value of land is excluded from the estate, the basis is not adjusted at death.

The exclusion (of up to 40 percent) may be taken only to the extent that the total exclusion for the qualified conservation easement plus the exclusion

for the family-owned business does not exceed the following limits:

1998	\$100,000
1999	\$200,000
2000	\$300,000
2001	\$400,000
2002	\$500,000

and thereafter

In the event the value of the conservation easement is less than 30 percent of the value of the land without the easement, reduced by the value of any retained development rights, the exclusion percentage is reduced. The reduction in percentage is equal to two percentage points for each point that the ratio falls below 30 percent. Thus, the exclusion percentage is zero if the value of the easement is 10 percent or less of the value of the land before the easement less the value of retained development rights.

The granting of a qualified conservation easement is not treated as a disposition for purposes of special use valuation recapture and the existence of a qualified conservation easement does not prevent the property from subsequently qualifying for special use valuation.

The provision further allows a charitable deduction for a permanent conservation easement on property where a mineral interest has been retained and surface mining is possible but its probability is "so remote as to be negligible."

The provision is effective for deaths after December 31, 1997 and easements granted after December 31, 1997.

### **Marital Deduction**

A marital deduction may be claimed for property passing to a surviving spouse. Since the marital deduction is 100 percent of the qualifying property passing to a surviving spouse, the marital deduction is a major factor in planning for estate tax saving.

The marital deduction can never exceed the value of the property passing to the surviving spouse and qualifying for the marital deduction. Historically, property passing outright has qualified, whether

passing to the surviving spouse under the will, under state law of distribution, to the surviving joint tenant, or as life insurance proceeds subject to federal estate tax.

The least interest that could qualify for the marital deduction has been a life estate to the surviving spouse plus a general power of appointment—the power to designate who ultimately receives the property. Those rules were retained in the major changes in the federal estate tax marital deduction effective in 1982. In addition, “qualified terminable interest property” was made eligible for the marital deduction.

Under that concept, a mere life estate passing to a surviving spouse may permit a marital deduction to be claimed for the property involved if the executor of the estate so elects. If that is done, any transfer of the life estate by the surviving spouse subjects the entire value of the property to federal gift tax. In the event of such a transfer, any additional federal gift tax paid on the remainder interest may be recovered from the holders of the remainder interest. Moreover, the entire value of the property is included in the surviving spouse’s estate if the property is retained until death.

Again, the additional federal estate tax may be recovered from the person receiving the property unless provided otherwise by will.

The major advantage of qualified terminable interest property (QTIP) is that the property owner can control the ultimate disposition of the property. Thus, a husband could leave property to a second spouse for life with the property to pass at her death to children of the first marriage, for example.

### **Charitable Deduction**

Earlier, the federal gift tax charitable deduction for gifts during life was discussed. There is also a federal estate tax charitable deduction. To qualify for that deduction, again, the gift must be made to a qualified charity. A qualified charity is a church, a division of government, or an organization that has been approved by the IRS as authorized to give a charitable deduction.

To qualify for the federal estate tax charitable deduction, property may be passed directly to the

charity. There are limited possibilities for leaving the charity less than complete ownership of property.

Thus, a farm or personal residence could be left to a surviving spouse or someone else for life, with the remainder interest passing to charity. The value of the remainder interest would be eligible for the federal estate tax charitable deduction.

For assets other than a farm or personal residence, for tax deductibility, it is necessary to set up a trust in order for the property to pass to someone for a period of years or for their life and then to the charity. Corporate stock, for instance, could be placed in a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. Income could go to a designated person, say a surviving spouse, with the remainder interest passing to a charity. Again, the value of the remainder interest would be deductible.

There are important differences in the types of trusts for passing property to charities. With the charitable remainder annuity trust, property is valued at the time it goes into the trust with at least five percent of the value paid as income to whomever is designated.

With the unitrust, the property is revalued every year, so the amount of income changes as the property value changes.

Another possibility for benefiting a charity with a limited interest is the charitable lead trust. With this type of trust, corporate stock or other property could be left for the benefit of a charity for a period of years, with the property then passing ultimately to family members.

The charitable lead trust can reduce federal estate taxes because the income interest to the charity reduces the taxable value of the remainder interest the family holds. This arrangement benefits the charity, reduces the estate tax and still places ultimate control of the property with the family.

### **Calculating the Estate Tax**

Once the gross value of the estate is established, the deductions just covered are subtracted—the estate settlement costs and the marital and charitable deductions. The remaining amount of property is then subject to tax. Also any taxable gifts

made during life after 1976 are added back into the taxable estate. IRS cannot reexamine after death the value of gifts made earlier to see if the value placed on the property was reasonable at that time once the period for assessing federal gift tax has passed. If a gift is required to be reported on a federal gift tax return, and it isn't, the gift tax can be assessed at any time.

Next, the federal estate tax rates are applied. The federal estate tax rates begin at 18 percent of the first \$10,000 of taxable estate. The maximum tax rate is 55 percent. The tax table is on page 55. The same rate structure applies to taxable gifts made during life. Once the amount of tax has been calculated, there are credits available to reduce the amount actually paid.

### Unified Credit

The unified credit is called that because it is available for gifts during life, or for property passing at death. It reduces the calculated tax dollar for dollar. The unified credit can be used only once, either during life to offset gifts or at death to offset the calculated federal estate tax.

The unified estate and gift tax credit of \$192,800 for 1997 is equivalent to a deduction or exemption of \$600,000—for someone with that size estate.

The unified credit, expressed as the "applicable exclusion amount," is scheduled to increase as follows:

Year of Gift or Death	Applicable Exclusion Amount
1998	625,000
1999	650,000
2000	675,000
2001	675,000
2002	700,000
2003	700,000
2004	850,000
2005	950,000
2006 and thereafter	1,000,000

As a rule of thumb, no federal estate tax would be due on an estate of that size or smaller if the unified credit had not been used during life, since the credit would cover the estate. The estate could be as much larger than that as the amount of the estate settlement costs and other deductions and still not be subject to federal estate tax. The largest tax burden nearly always falls on the estate of the survivor. Ways to minimize tax at the two deaths are discussed below and in Chapter 13.

### Other Credits

Three other credits may be subtracted from the calculated tax. There is a credit for state inheritance tax based on the taxable estate for federal estate tax purposes. The amount of the credit is based on a formula that involves subtracting \$60,000 from the taxable estate to produce the "adjusted taxable estate." The amount of the credit is determined from a table on a graduated basis. (See table, page 55.)

The other credits allowed to reduce the calculated federal estate tax include death taxes paid to a foreign government and part or all of the federal estate tax paid on the same property included in an estate within the previous 10 years.

Planning can be done to ease the estate tax liability, particularly at the second death of a husband and wife. Careful use of the unified credit is one way not only to reduce estate tax liability, but to "inflation-proof" the second estate. "Inflation-proofing" can be used in certain instances to allow the second estate to grow in later years without encountering increased estate taxes.

Here's an example of how planning can reduce federal estate taxes. Take a gross estate of \$1,000,000, as shown in table 2, all in the husband's name. Assume that the deductions are \$50,000, leaving an adjusted gross estate of \$950,000. Assume that the maximum marital deduction is used and the property is left to the surviving spouse outright. The taxable estate would be zero and the computed tax would be zero.

Assume that the husband dies and his wife dies 10 years later with an assumed 8 percent per year increase in property value. The wife's estate would total \$2,050,978. Deductions (at an assumed rate of five percent of the gross estate) would total \$102,549 with no marital deduction available. The taxable estate would total \$1,948,429 and the tentative tax would be \$757,593. After subtracting a unified credit of \$345,800 and a state death tax credit of \$95,887, the federal estate tax due would total \$315,906.

Using the same facts except that the first spouse to die leaves the property to the surviving spouse for life rather than outright, except as to the marital deduction portion which would be left outright, as shown in table 3, there would be no federal estate tax due at either death. The savings would total \$315,906 compared to leaving the property to the surviving spouse outright as shown in table 2.

### Basic Planning Strategies

Given a specific size of estate, two basic systems (and one variation) can be used to reduce sharply the federal estate tax that would otherwise be due at the death of the surviving spouse if the property

had been left to the surviving spouse outright at the death of the first to die. For the larger estates, the savings are the most dramatic, of course.

**Table 2. Death of property-owning spouse in 1997 with all property left to surviving spouse outright with death of surviving spouse 10 years later.**

	Estate of Property- Owning Spouse	Estate of Surviving Spouse
Gross estate	\$1,000,000	\$2,050,978
Deductions	<u>- 50,000</u>	<u>- 102,549</u>
	950,000	1,948,429
Marital deduction	950,000	0
Taxable estate	0	1,948,429
Tentative tax	0	757,593
Unified credit	192,800	345,800
Federal estate tax	0	411,793
Credit for state death tax	0	<u>95,887</u>
Federal estate tax due	0	\$315,906

**Table 3. Death of property-owning spouse in 1997 with use of life estate and with death of surviving spouse 10 years later.**

	Estate of Property- Owning Spouse	Estate of Surviving Spouse
Gross estate	\$1,000,000	\$647,678
Deductions	<u>- 50,000</u>	<u>- 32,383</u>
	950,000	615,295
Marital deduction	350,000	0
Taxable estate	600,000	615,295
Tentative tax	192,800	198,459
Unified credit	192,800	345,800
Federal estate tax	0	0
Credit for state death tax	0	0
Federal estate tax due	0	0



Depending upon the way the property is owned, as well as a number of other variables, the optimal estate planning strategy may or may not involve claiming a full marital deduction. Estate planning strategies vary, depending upon whether it is desired to minimize the tax for the two deaths—that of the husband and that of the wife—or whether the desired strategy is to minimize the tax at the death of the first spouse to die with little attention given to the tax burden at the death of the survivor.

The strategies outlined in this section—referred to as Model I, Model II, and Modified Model II—are based on the premise that it is desired to minimize tax at both deaths. More precisely the assumption is made that an objective is to maximize wealth passing from the second estate.

### Zones for Planning

If it were known (1) when death would occur and (2) the amount of property that would be owned at death, the best planning strategy for saving tax could be readily determined. The answers to those questions are not, of course, known with certainty in most situations. The following “zones” of property value may provide helpful guidelines for planning.

**Zone I**—If the combined wealth of husband and wife is expected to be no greater than the equivalent deduction amount from the available unified credit at the death of the surviving spouse (\$625,000 in 1998), the optimal strategy may be to

leave the property outright to the survivor at the death of the first to die. Leaving the property in trust would be helpful if management assistance were needed. For individuals in this category, state death tax and income tax considerations may be more important than federal estate tax concerns.

**Zone II**—If the combined wealth of husband and wife is expected to be no greater than twice the equivalent deduction from the available unified credit at the death of the surviving spouse (\$1,250,000 in 1998), the optimal strategy may be to (1) divide the property between the spouses equally during life and (2) each leave the other a life estate in the property owned with no marital deduction claimed at the first death. The plan outlined below as Model II is designed to accomplish that result.

In making transfers to equalize property ownership between the spouses, the 100 percent federal gift tax marital deduction would normally cover any gift involved.

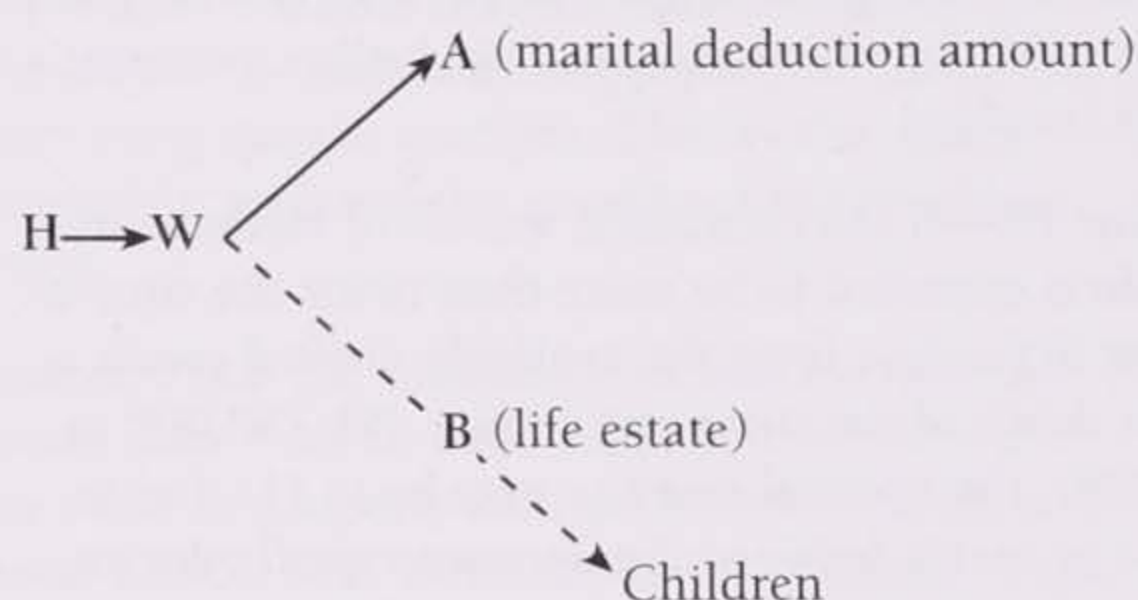
**Zone III**—If the combined wealth of husband and wife is expected to be more than twice the equivalent deduction from the available unified credit at the death of the surviving spouse (\$1,250,000 in 1998), the optimal strategy may be to (1) divide the property between the spouses equally during life, (2) create a partial marital deduction at the death of the first spouse to die and (3) leave the remaining property of the first spouse to die in a life estate for the other spouse.

## Planning Strategies

### Model I

The first method of saving estate taxes we'll call Model I. This approach to federal estate tax saving has been in use for years and was popular in past years. Many wills in existence are based upon this approach to leaving property for the survivor's use. This model involves two assumptions for it to work properly: The husband must die first, and the husband must own the property in his name alone.

Figure 2. Model I



Through his will, the husband leaves his property to his wife in two packages, as shown in Figure 2. The first package (A) is generally designed to qualify for the marital deduction. A marital deduction is available for up to 100 percent of the amount of property included in package A. The package A amount is given to the wife outright or in a manner that would qualify for the marital deduction. As noted earlier, the least interest that would qualify for the marital deduction would be a life estate plus a general power of appointment to dispose of the property, except for the special arrangement (referred to as QTIP) involving a life estate only as discussed in Chapter 12. In most instances, the remainder of the estate (package B) goes to the children or a favorite charitable organization but with a life estate to the wife, so that she has the use and income from it for as long as she lives.

For practical purposes, the wife has the income from the entire estate. But there are some limitations on her use of the principal. Acting alone, she cannot sell or dispose of the life estate property. She cannot live on the principal, only the income, of the property in package B. An independent trustee over package B could, if necessary, dip into the principal of the property in package B for the wife's care, support and maintenance.

She may be able to sell or reduce the principal of the property in package A, however, with fewer restrictions. In fact, it would be desirable to use the principal of package A first, since it is this property that will be taxable at the death of the wife.

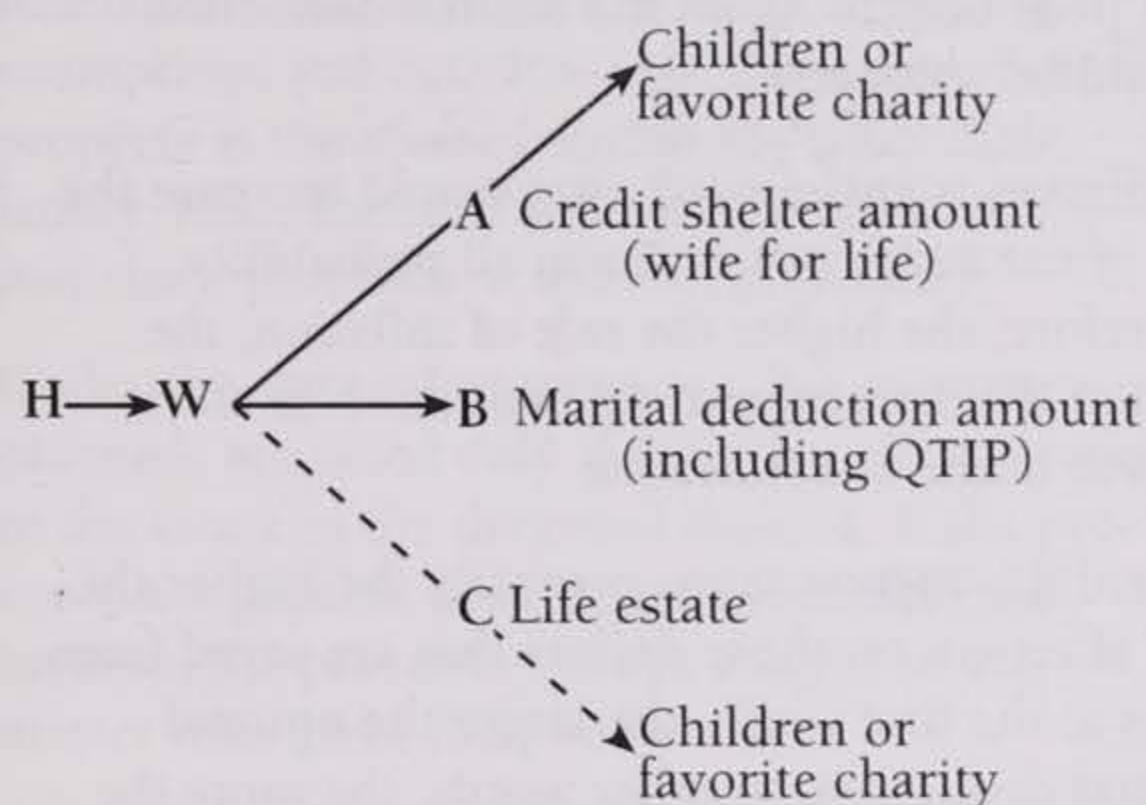
Upon the death of the wife, package B property goes to the children immediately with no further federal estate tax. Estate taxes were covered in the estate of the husband when the package B property was given to the children with the life estate to the wife. The wife's estate then contains the remaining amount in package A, plus what other property she may have at the time.

Model I is designed to take advantage of the marital deduction and allows the rest of the husband's estate to go directly to the children, or a favorite charity, subject to the wife's life estate. Model I usually reserves the income from the entire estate for the surviving wife, but does not require that all the property be taxed in both the husband's estate and the wife's estate. If the property is owned largely in the husband's name, approximately half the family wealth is taxed in the husband's estate and the other half in the wife's estate. Thus the tax liabilities in the husband's estate should about equal the tax liabilities later in the wife's estate.

Model I doesn't save tax if the wife dies first. Actually if the wife dies first, the tax burden would be much greater, for the husband is left with all the property in his own name and without a marital deduction.

A variation of the traditional Model I is shown in figure 3.

Figure 3. Model IA



An amount representing the maximum amount that can be covered by the unified credit is set aside in package A. Usually, that amount would be left to the surviving spouse for life, then to the children or a favorite charity. All or part of the remaining property is left in package B, which is set to qualify for the marital deduction. The package C amount could be qualified for the marital deduction under the rules for qualified terminable interest property (QTIP).

Thus, in some instances, it may be desirable to leave some property in a life estate with a remainder interest to the children or a favorite charity. This provides flexibility in acting after death to create a marital deduction under the special arrangement discussed earlier for life estates and qualify additional property for the marital deduction.

### Model II

The second model is based upon equal property ownership, as shown in figures 4 and 5. Here the amounts of property owned by the husband and wife are balanced to keep them as equal as possible. This can be done through separate ownership of different items, or through tenancy in common. With Model II, it makes no difference, tax-wise, who dies first.

In Model II, the husband provides by will for the wife to receive a life estate in the property owned

Figure 4. Model II: Husband dies first

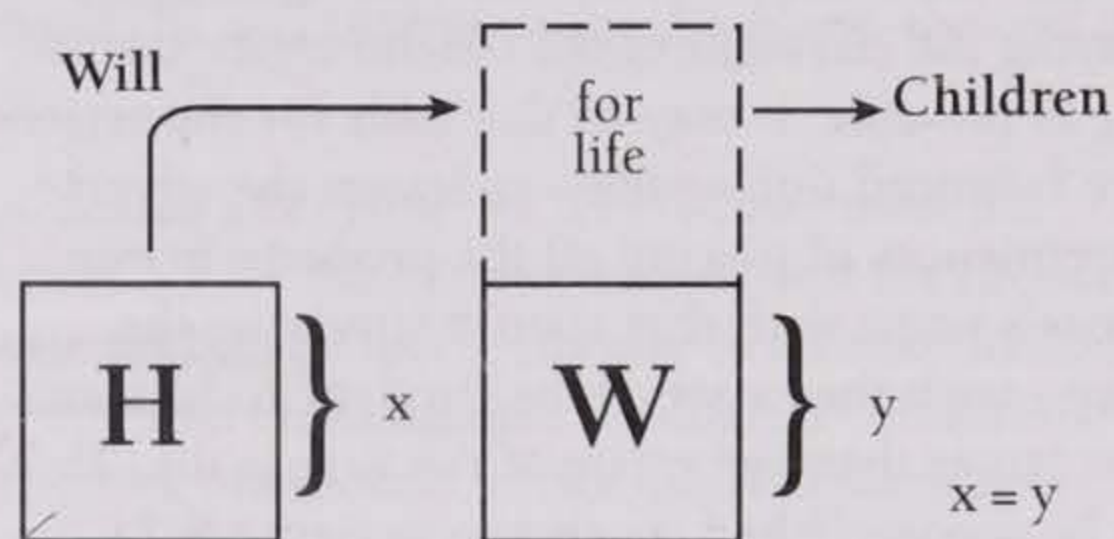
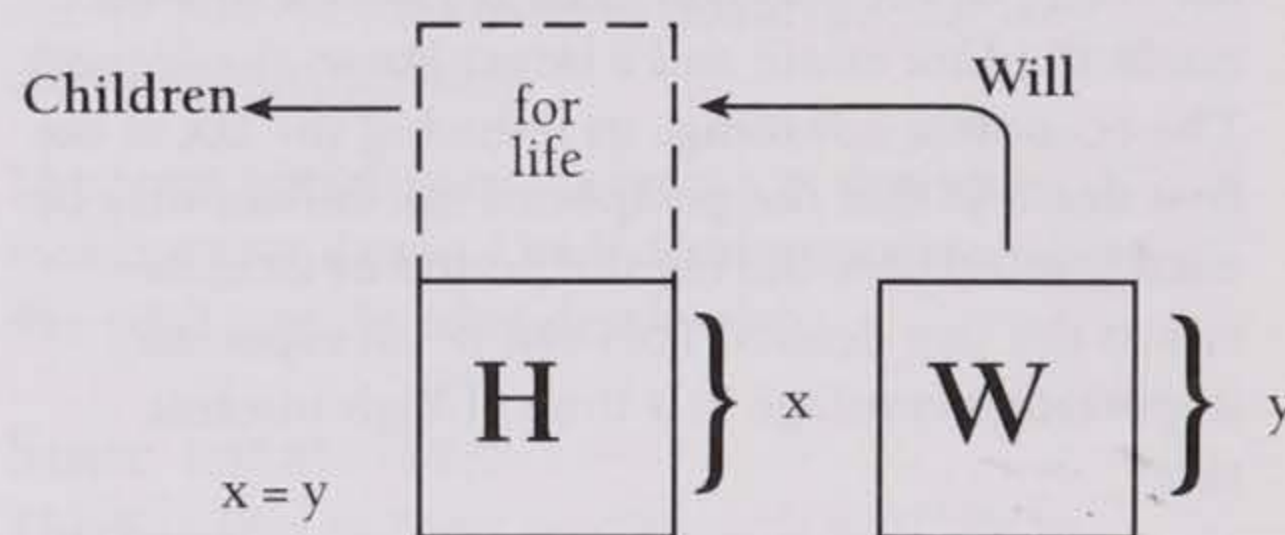


Figure 5: Model II: wife dies first



in the husband's name. Thus, if the husband dies first, property in his name goes to the children but with a life estate to his wife. She has income from all the property, but as to the life estate portion previously owned by her husband she is limited to only the income.

Conversely, the wife, by will, leaves her property to the children but with a life estate for the husband. If she dies first, her husband may receive the income from the property previously owned by the wife, but is limited in using the principal of that portion.

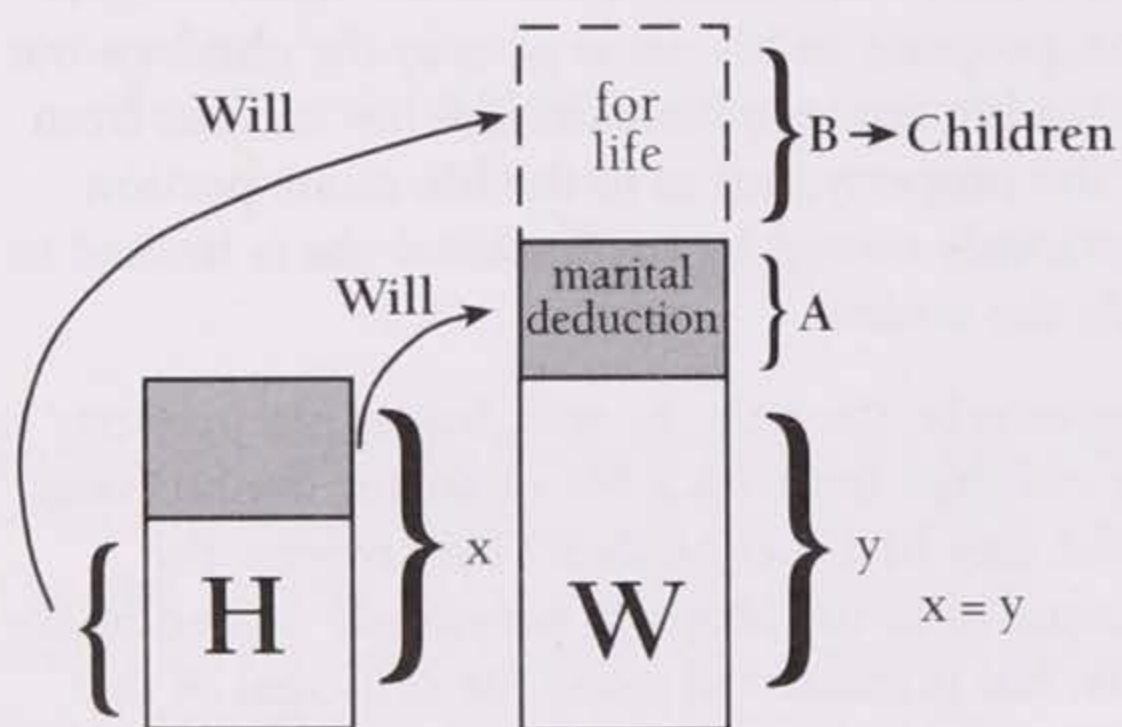
In a sense, this system creates a marital deduction result *during life* by the way in which property is held. Though the usual marital deduction is not used, tax savings occur because half the total property goes through one estate, the other half through the other estate, rather than all property going through both estates.

Model II does not put the property all in the name of one spouse as is done with Model I. Some like the Model II approach because it recognizes the contribution of each spouse in property acquisition or otherwise in the marital relationship.

## Modified Model II

Because there is economic merit in legitimately delaying the payment of the federal estate tax as long as possible, it may be desirable for the estates to be balanced during life—to lessen the adverse consequences of placing all the property in one spouse's name with that spouse surviving the other—with the estate of the survivor to be somewhat larger than the estate of the first to die. This can be accomplished, as shown in figure 6, by providing for a partial marital deduction at the death of the first to die. The marital deduction reduces the estate of the first to die and increases the estate of the survivor. The result is a smaller tax in the first estate and a larger tax in the second. The economic advantage in reducing the tax at the first death is that the postponed tax dollars may be used interest-free during the period of time between the two deaths. This can be an especially important advantage in a time of high interest rates.

Figure 6. Modified Model II: husband dies first



The size of the marital deduction, for optimal tax saving in both estates, depends upon five factors: (1) life expectancy of the surviving spouse; (2) the state of health of the surviving spouse (disregarded if normal for age, but it would overrule life expectancy if it appeared that health was poorer than expected for age); (3) the return expected on deferred tax dollars; (4) expectations about rates of inflation (or deflation); and (5) expected changes in tax rates, exemptions, and credits.

The older the surviving spouse, the smaller the optimal marital deduction because there's less time

to gain interest on tax savings. The Modified Model II plan is based on gaining interest earnings to offset larger taxes later.

The same principle applies if the surviving spouse is in poor health. Again the marital deduction should be reduced.

If inflation is anticipated, that would increase the size of the survivor's estate in all probability. Therefore, the higher the rate of inflation, the smaller the optimal marital deduction to allow growth in the second estate.

Regarding interest rates, generally the higher the rate of return on those dollars that are saved from taxes at the first death, the larger the optimal marital deduction. In other words, the more the savings earn, the more we want to invest.

If tax rates are expected to rise, the marital deduction might be smaller with more of the estate taxed now rather than later at higher rates. Or, if a decrease in death taxes is expected, the marital deduction might be increased at the death of the first spouse with a larger estate later under the lower rates.

## Making the Choice

For most couples personal preference as to property ownership is a major factor in determining which of the three tax saving techniques should be used. With the 100 percent federal gift tax marital deduction, changes in property ownership between spouses may be made without concern about federal gift tax consequences.

Desired changes in property ownership patterns should not be delayed. An unexpected death could preclude use of the tax saving features of any of the plans designed to reduce federal estate tax liability at the second death.

## Iowa Inheritance Tax

The Iowa inheritance tax is the second death tax and differs from the federal estate tax in a number of important respects.

Philosophically, the inheritance tax differs from the federal estate tax. The estate tax is imposed on the estate—the property held by the decedent at death. The estate tax is actually paid by the estate.

The inheritance tax is imposed on those who

inherit the property. Thus, the amount of property each individual inherits and the degree of relationship to the decedent influence the rate of tax.

There is no marital deduction under the state inheritance tax. However, a series of varying exemptions and tax rates ease the tax burden when property is transferred within the immediate family. Also, the state inheritance tax handles insurance proceeds in a different manner.

Under the state inheritance tax, life insurance proceeds are taxed only if the proceeds are payable to the estate of the deceased insured. If the proceeds are payable to someone other than the insured, the proceeds are not subject to tax, no matter who owns the policy.

For joint tenancy property owned by a husband and wife, no more than one-half of the value is subject to state inheritance tax at the death of the first to die. And, to the extent the survivor can prove contribution to acquisition of the joint tenancy assets in money or other property to an extent greater than one-half, even more of the value may escape tax at the death of the first to die.

Property subject to the Iowa inheritance tax is the basis used to determine such costs as the executor's fee and the attorney's fee. Therefore, it is doubly important to know what property is subject to the tax.

The Iowa inheritance tax reaches most of the property held by the decedent. It includes property held in the decedent's name, that in tenancy in common to the extent of his or her portion of it, and joint tenancy and life insurance proceeds as indicated. The special use valuation concept has been extended to Iowa farmland for inheritance tax purposes. The special use valuation method for valuing farmland is similar to the federal rules on special use valuation discussed in Chapter 10.

To determine the Iowa inheritance tax, the estate settlement costs, attorney's fee, executor's fee, debts due at death, funeral expenses, and a temporary allowance for the surviving spouse and children during estate settlement may be subtracted from the gross estate.

At this point, it is necessary to determine who is going to receive the property. The relationship

between the recipient of the property and the decedent determines the tax rate. The more closely related the recipient is to the decedent, the less the tax.

For deaths after June 30, 1997, Iowa does not impose a state inheritance tax (except for the state estate tax) on property passing to a child (including adopted children and "biological" children), stepchild, grandchild, other lineal descendants, parent, grandparent or other lineal ascendant. Property passing to a spouse has not been subject to Iowa inheritance tax in recent years. State inheritance tax is imposed on property passing to others (except for charities qualifying for the charitable deduction).

The Iowa inheritance tax return is due nine months after death. The federal estate tax return is due nine months after death, also.

### State Estate Tax

There is also an Iowa estate tax. It is rarely imposed except for amounts passing to individuals who are exempt from paying Iowa inheritance tax. It is only levied where it is necessary to impose an additional tax to fully utilize the amount of credit available against the federal estate tax for state inheritance tax paid. Thus, if the credit for state inheritance tax allowed on the federal return is \$2,000, for example, and the actual tax levied is only \$1,200, the Iowa estate tax is imposed to collect an additional \$800. This results in no more tax being paid by the estate. But it keeps the additional \$800 in tax in Iowa instead of going to the federal government.

### Estate Settlement Costs

As for specific estate settlement costs, court costs usually claim a relatively small share of the estate—usually less than \$500. Fees for the administrator or executor can be substantial. These fees are set by Iowa law for ordinary services at six percent of the first \$1,000 of probate inventory (property subject to Iowa inheritance tax), four percent on the next \$4,000, and two percent on all over \$5,000. On a \$100,000 estate the administrator's or executor's fee would be \$2,120. If the estate representative supplies extraordinary services, the court might be asked to approve an additional fee. In many situations, especially where a member of

Table 4. State Inheritance Tax\*

1. Taxable amount equaling	2. Taxable amount not exceeding	3. Tax on amount in column 1	4. Rate of tax on excess over amount in column 1
0	12,500	0	5 percent
12,500	25,000	625	6 percent
25,000	75,000	1,375	7 percent
75,000	100,000	4,875	8 percent
100,000	150,000	6,875	9 percent
150,000	—	11,375	10 percent

\* For property passing to the deceased's brother or sister, son-in-law or daughter-in-law.

the family serves as administrator or executor, these fees may be partially or totally waived.

For those who serve as administrators or executors and waive fees, there is a caution. In some instances, the Internal Revenue Service requires payment of income taxes on waived fees. The rule is that a fee, once earned, is taxable income even though never actually paid. Generally, however, if the fee is waived within the first six months after service begins as an estate representative, there is no income tax due. If the fee is waived later, income tax might be levied, unless the facts indicate a continuing intention to serve gratuitously.

### What about Attorney's Fees?

The attorney's fee is based on the same percentage as the administrator's and executor's fees. Again, these are ordinary fees for ordinary services. If there are extraordinary services, the attorney would be entitled to additional fees as allowed by the court. Such extra service might include extra

work involving disagreements among heirs, contested debts, land title problems, or unusual tax matters.

### Bond Costs

Another expense may be the bond required for the administrator, or an executor serving under bond. As noted in Chapter 5, the testator can request in the will that the named executor serve without bond. This eliminates the expense of a bond. However, unless the executor is nominated in a will or those to receive the property all agree, a bond is required to cover the value of personal property of the estate plus the estimated annual income from the estate. Bond costs usually run \$5 or so per \$1,000 worth of coverage up to \$100,000.

### Other Costs

Medical expenses of the last illness and funeral costs also are paid by the estate. These costs, of course, can vary greatly.

One of the important elements in estate planning is planning for liquidity. By that we mean planning to have the cash available or a way assured to pay the federal estate tax, the state inheritance tax, and the estate settlement costs. Those amounts can add up to a fairly large sum, especially for those with sizable estates. The amount of indebtedness for which the decedent is responsible at death may pose a serious liquidity problem, particularly if the assets are not readily salable.

Liquidity may be even more important for those who have a family business. If the family business is to continue beyond the generation of its founding into the next generation, it may be desirable to provide cash for those heirs who are not affiliated with the family business. If the business is to continue, it may be a handicap to have to sell essential business property, or to mortgage it heavily to compensate other heirs or to pay settlement costs.

### The Liquidity Plan

Though liquidity needed may vary with circumstances, the problem is serious enough to justify creating a liquidity plan as part of the estate plan. The liquidity plan should have four components.

**Assess Need**—The first step in planning is a realistic assessment of liquidity needs. That involves taking a look at the amount of property at today's values and also on a projected basis looking five to ten years into the future.

The liquidity need is influenced heavily by the goals for the family business operation. If there is no family business to continue, inventory property can be sold, or land can be sold or mortgaged.

However, if the family business is to continue, sale of such items may be painful economically. It could reduce the scale of operation to the point that it may be difficult to continue.

**Review the Alternatives**—Once the liquidity need is thoroughly assessed, you should examine the choices to solve the problem. There are two basic

classes of alternatives—pre-death and post-death. Life insurance is in the pre-death category. Extra investment in the family business may be planned, so the business could be reduced in scale to create funds to pay taxes and settlement costs at death. Or funds to cover these needs could simply be accumulated in a savings account.

There also are post-death options that can be arranged after death either to pay off death taxes and settlement costs, or to ease those payments. The latter include the 15-year installment payment provision on federal estate tax, or corporate stock redemption, if there is a corporation. Each of these is discussed in detail in this chapter. And survivors may simply obtain a loan to cover after-death costs and repay it later.

**Select the Best Choices**—After all the liquidity choices are examined, the one or ones that appear to be the most advantageous are selected. These are generally the ones that will produce the largest amount of wealth after all taxes and costs are paid.

**Meeting Requirements**—The fourth element of the liquidity plan is to list all the requirements that must be met in order to have liquidity alternatives we want available for use. Certain pre-death actions can influence which choices are available after death. For example, the kind of lease used to rent land to a tenant before death can affect use of certain alternatives. Whether gifts of property were made to the children during life, and how much, can have an influence, as can the sale of property to children during life.

### Deferring Payment of Federal Estate Tax

There are two ways payment may be delayed on federal estate taxes, which may help liquidity problems where a family business is involved. Requirements for the two methods vary, so individual circumstances may dictate which may be used.

For reasonable cause, the payment of federal estate tax on the due date may be extended for one-year

periods with interest on the unpaid balance. Up to 10 one-year extensions may be granted.

### 15-Year Installment Payment

Under the "15-year" installment payment provision, the portion of federal estate tax attributable to a closely held business may be totally deferred until 69 months after death with the tax payable in up to 10 equal annual installments thereafter. The last payment is due 177 months after death (which is three months short of 15 years).

Interest on the deferred tax commences nine months after death with interest payments due during the first five years. Interest is due on the unpaid balance until the deferred tax is fully paid. A special 2 percent interest rate (compounded daily) is allowed on the unpaid tax attributable to the first \$1,000,000 of taxable estate involving farm or other closely held business property for deaths after 1997. The rate was 4 percent for deaths before 1998. The first \$1,000,000 of taxable estate is in excess of the amount covered by the applicable exclusion amount and any exclusions.

The interest rate imposed on the amount of deferred federal estate tax attributable to the taxable value of a closely-held business in excess of \$1,000,000 is reduced to 45 percent of the rate applicable to underpayments of federal tax.

The regular interest rate on underpayments of tax is the federal short-term rate plus 3 percentage points. The federal short-term interest rate is based on the average market yield on outstanding marketable obligations of the United States with remaining periods to maturity of three years or less. Changes in the regular rate of interest are made quarterly.

For deaths after 1997, interest paid on deferred federal estate tax under the 15-year installment payment option is not deductible for either federal estate tax or federal income tax purposes.

Under a special transitional rule, estates involving deaths before 1998 that had elected the 4 percent interest rate may elect before 1999 to use the 2 percent rate on the amount originally eligible, not on the increased eligibility amount under the 1997 legislation, and to forego the interest deduction for installments due after the date of the election to use the 2 percent rate.

To be eligible for 15-year installment payment of federal estate tax, the decedent must have had an "interest in a closely held business."

- For a corporation, at least 20 percent of the voting stock must be in the deceased's estate or there must be 15 or fewer shareholders.
- For a partnership, 20 percent or more of the partnership capital must be included in the deceased's estate or there must be 15 or fewer partners.
- For a sole proprietorship, the interest of the sole proprietor counts as an interest in a closely held business.
- Some types of leases qualify the property as an interest in a closely held business. In a farm operation, a crop share or livestock share lease, where the landowner receives a portion of the crop (and a portion of the livestock produced, in the case of a livestock share lease) and pays part of the expenses, qualifies as an interest in a closely held business if the landowner or an agent or employee is involved in management under the lease.

A cash rent farm lease generally does not qualify the property involved for installment payment of federal estate tax. However, rental of residential rental units has, in some instances, qualified as a closely held business where the necessary level of management was present.

Eligibility for 15-year installment payment also requires that the interest in the closely held business must represent a significant part of the total estate. The interest in the closely held business must exceed 35 percent of the adjusted gross estate to be eligible. The adjusted gross estate is the gross estate less allowable costs and debts.

The 35 percent requirement may be difficult to meet if substantial amounts of business property have been sold during life. An installment contract held at death is considered an investment asset and not an interest in a closely held business. Gifts of business property during life may also jeopardize eligibility for installment payment of federal estate tax by reducing the amount of business property in the estate at death. Retaining non-business or investment assets until death and making gifts of business property could preclude eligibility for installment payment of federal estate tax.



The farm residence is considered an interest in the business if occupied by the owner, employee of the owner, tenant or employee of the tenant for purposes of operating or maintaining the farm. If the residence is rented to others, it is not an interest in the business.

Thus, it can be seen that actions during life in terms of lease used and in terms of decisions to sell or make gifts of property can affect eligibility for installment payment of federal estate tax.

Disposal of one-half or more of the decedent's interest in the business during the 15-year deferral program terminates the installment payment provision. Transfers at the death of an heir or transferee do not cause acceleration of payment if the transfers are to family members. In general, mere changes in organizational form do not result in termination of installment payment. Likewise, tax-free exchanges of property do not accelerate tax payments. However, some transfers do constitute dispositions or withdrawals (and accelerate the payment of federal estate tax if making up one-half or more of the decedent's interest in the business). These include sales or gifts, even to family members, and interruption of the business use of the property. The cash renting of farm land is treated as such a disposition. It is believed that bankruptcy filing does not cause acceleration of installment payment of federal estate tax but transfers in bankruptcy could trigger acceleration of payment.

There is relatively little authority as to whether property can be mortgaged during the 15-year period. One ruling allowed refinancing of an existing mortgage and another permitted the sale of property to pay off indebtedness existing at death.

Late payments made up to six months after the due date do not terminate installment reporting but do incur a payment penalty.

There is a lien to secure payment of the deferred taxes. The lien generally takes priority over other borrowing after death except for some borrowing in a special category of "super priorities."

### **Corporate Stock Redemption**

For those who have their business organized as a corporation, stock redemption may be a liquidity

alternative. In the period after death, the corporation may buy some of the stock held by the estate, with funds from the corporation paid to the estate. These funds can then be used to pay death taxes and settlement costs.

Generally, if you try to redeem part of a shareholder's corporate stock in a family or closely held corporation, the redemption is treated as ordinary dividend income. With estates, however, stock may be redeemed with only capital gain paid on any profits involved, if certain rules are followed.

This type of procedure is known as Section 303 stock redemption. Section 303 is the section of the Internal Revenue Code that prescribes the rules.

For Section 303 stock redemption, the corporate stock must represent more than 35 percent of the adjusted gross estate. Again, that's the gross estate, less estate settlement costs. And again, that qualification may be a difficult one to meet, particularly if a family corporation was formed and the decedent kept some of the major assets, such as land, outside the corporation.

Use of debt securities in formation of the corporation reduces the amount of corporate stock and may make meeting the 35 percent requirement difficult, also. These factors illustrate the importance of careful planning in forming corporations.

Stock from two corporations can be counted toward the 35 percent requirement in Section 303 redemptions if the decedent owned 20 percent or more of each corporation.

If all the requirements for a Section 303 redemption are met, stock can be redeemed for 48 months after death to pay death taxes and estate settlement costs. If the 15-year installment payment is used, you can continue to redeem stock over that period to generate cash to meet the payments.

### **"Flower Bonds"**

Flower Bonds are a special series of U.S. Government Bonds that may be used to produce liquidity for payment of the federal estate tax. The bonds are bought during life at their traded value, and are redeemed at death.

If a flower bond is purchased at \$94, it would be redeemed at \$100 (par value) to pay the federal estate tax. This would yield a profit from the bonds. When interest rates rise, bond values

generally fall, so that might be a good time to purchase bonds if you use this option.

The profit in flower bonds is not subject to income tax but it is subject to federal estate tax and some states levy a state inheritance tax against the full redemption value including the profits. Iowa does not tax flower bond profits in that manner, however, with only the traded value at death subject to inheritance tax.

Congress discontinued the flower bond program as of March 3, 1971, so no new bonds are being issued. However, bonds then issued were left in circulation. Be certain bonds you purchase were issued prior to this date and also recognize that there is a steadily shrinking supply with no new issues.

Generally, you should purchase only as many bonds as you need. Tax problems can arise if excess bonds were purchased and a tax deficiency develops later. Also, it is best to purchase bonds yourself. Some attempts to have the bonds purchased by someone else through a power of attorney have been challenged.

Special care is needed if flower bonds are purchased and held by a trust at death. For the bonds to be eligible for redemption, the trust must terminate in favor of the decedent's estate or the

trustee must be required to pay the decedent's federal estate tax. The only other instance in which flower bonds held by a trust could be redeemed to pay federal estate tax would be if the debts of the decedent's estate exceeded estate assets without regard to the assets in the trust.

## Life Insurance

Another estate planning device is life insurance. Briefly, life insurance can be used to build up an estate, cover estate settlement costs, provide income to parents, preserve a family business, or pay the decedent's debts.

For example, life insurance can be used to provide an annuity that would continue to provide income to the parents for as long as they live. Insurance can be used to fund passage of the family business or farm to certain children. Thus, if you want to pass the family farm or business to a son, you could do that in a will. Then life insurance could be used to provide an equal amount of cash to nonfarm heirs or to provide income for a surviving spouse.

With the many types of insurance policies and the lack of restrictions on the use of this option, life insurance is one of the more flexible methods of obtaining liquidity in an estate.

The trust is one of the most useful and flexible tools of estate planning. Yet it is probably the most underused estate management technique.

A trust is an artificial being, something like a corporation, created by a document or instrument. The trust instrument specifies the rules of operation of the trust, the powers of the trustee, and the beneficiaries to share in the income and principal from the trust.

A trust requires three basic elements—a trustee, property for the trustee to manage, and beneficiaries to receive income generated by the trust and the principal remaining at the time for ultimate distribution of the property.

The person or firm managing the trust, the trustee, receives the property, invests capital if necessary, collects the income, handles the accounting, pays taxes, and reinvests or distributes income according to the rules laid down by the trust. Finally, the trustee distributes the principal in accordance with the trust instrument.

A high degree of “fiduciary” care or responsibility is imposed upon the trustee. For example, a trustee cannot make high-risk speculative investments beyond the authority found in the trust or what a reasonable and prudent person would do under the circumstances. If the trustee does make imprudent investments, the trustee may have to repay the trust from the trustee’s own funds. This assures a degree of protection for the beneficiaries of a trust.

A trustee can be an adult person or a bank or trust company having trust powers. Fees vary according to the type of property being managed. A typical fee for managing a trust made up of corporate stock would be about one-half of one percent of the property in the trust annually. If a trust had \$300,000 worth of this type of property, the annual fee would generally run from \$1,500 to \$3,000 for management. If the trust owns bonds, the fee might be a bit less. If the trust owned a farm, the trustee usually claims a farm manager’s standard fee, often 10 percent of the landlord’s share of the

gross income. Again, family members serving as trustees may waive the fees, though most non-family members and banks and trust companies normally claim a fee.

## Two Types of Trusts

There are basically two types of trusts. One type is a living trust or *inter-vivos* trust. This type of trust is established by a living person and property is transferred into the trust at that time.

Living trusts are generally of two types—revocable and irrevocable. Under a revocable trust, the power is retained to alter, amend, or revoke the trust. This permits a person to change his or her mind after the trust is established. Frequently, under the revocable trust the person establishing it receives part or all of the income for that person’s remaining life. Part of the income might go to a wife, children, or grandchildren, or the income might be accumulated and added to the principal.

A *revocable* trust does not save death taxes. Retention of control over the trust subjects the property to the federal estate and state inheritance tax. Since the revocable trust is subject to state inheritance tax, the property becomes part of the estate for the purpose of figuring attorney’s and executor’s fees if probate of the estate is necessary. If all or most of the property is included in a revocable living trust at death, short-form probate (involving property valuation and payment of taxes only) may be feasible with some possible reduction of estate settlement costs.

In transferring property to a revocable trust, several points should be kept in mind.

- Transferring the residence does not make the residence ineligible for tax-free sale and reinvestment or tax-free sale after age 55 up to \$1,250,000 of gain. The tax-free sale and reinvestment possibility was repealed in 1997 and the tax-free sale after age 55 was amended substantially to allow tax-free sale of up to \$500,000 on a joint return (\$250,000 on a separate return). Apparently, a revocable trust could claim the exclusion enacted in 1997.

- Expense method depreciation does not apply to trusts (but that rule may not apply to “grantor” trusts).
- Flower bonds require special handling as explained in Chapter 14.
- Series E government savings bonds may be transferred without causing the accrued interest to become taxable. The election to report the accrued interest on the decedent’s final income tax return is still available.
- Installment sale obligations may be transferred without causing the gain to become immediately taxable unless the obligor under the obligation is a trust beneficiary.
- For encumbered property, check to see if the transfer would cause the mortgage or other indebtedness to become due and payable.
- A grantor trust can own S corporation stock up to the grantor’s death and for two years after death. “Subchapter S” trusts, “small business” trusts, and trusts with another than the grantor considered to be the owner may also own S corporation stock.
- The ordinary loss deduction on loss from corporate stock under the special provision for “Section 1244 stock” does not apply if the stock is disposed of by a trust. Again, that provision may not apply to “grantor” trusts.
- Transfer of closely held business assets could terminate installment payment of federal estate tax unless it is a mere change in organizational form.
- Recapture of special use valuation benefits could occur unless all beneficiaries are qualified heirs and consent to personal liability for any recapture.

To have an effective living trust, the property actually must be transferred to the trust. That includes land, bank accounts, stocks, bonds, and other assets.

So long as the person setting up the living trust is also a trustee, no additional tax returns need be filed. The person establishing the trust reports all income on that person’s income tax return. However, once the person setting up the trust is not a trustee, the trust must begin filing state and federal income tax returns and obtain a taxpayer identification number.

Although there are reasons for establishing “joint” trusts for a husband and wife, in general it is believed that it is better for each spouse to have his or her own trust. Exercising the right to revoke the trust is more certain with separate trusts.

An *irrevocable* trust cannot be altered, amended, or revoked by the person who sets it up. The property is transferred as completely as if by gift to an individual. No powers are retained over the trust or its property. A completed transfer of property is made, subject to gift tax, and the value of the irrevocable trust is not subject to federal estate tax, attorney’s fees, or executor’s fees.

If property was transferred to an irrevocable trust within three years of death, the value would be subject to state inheritance tax. In general, property transferred by gift is not included in the gross estate for federal estate tax purposes even though the gift occurred within three years of death. That’s the outcome unless powers, rights or controls were retained over the property or the transfer involved life insurance policies.

However, the irrevocable trust is used only rarely. Few people are willing to give up complete control over their property during life. This accounts for the lack of popularity of the irrevocable trust.

### Testamentary Trust

A testamentary trust is the type of trust set up to become effective at death and is usually found in the will. This type of trust frequently is used as a vehicle for property management if both parents should die leaving minor children surviving. The testamentary trust for minors is a useful device for managing the property for the children’s benefit until each attains a stated age. The trustee could be the same person named as guardian for the children, or it could be a different person or a bank or trust company providing further control over expenditure of funds. Typically, a testamentary trust for minors distributes income as needed to the minors while growing up or in college, with the principal distributed to the children at the age specified in the trust.

One of the practical problems facing many trustees of such trusts is how money is to be used for education. Guidelines can be provided for the trustee to use in deciding the type of institution (in

terms of cost) for which the child would be eligible, level of support he or she could receive and the maximum time over which educational support could be paid. Otherwise, disagreements over these points could arise between a child and the trustee. Another important question is the age at which children should receive the principal from the trust.

A second use of the testamentary trust is to handle management of property passing to the surviving spouse, particularly property passing to the spouse for life. Life estate portions are more easily administered if in trust than if held in a "legal life estate." Arrangements for leaving property to a surviving spouse for life are discussed in Chapter 13.

### Generation Skipping

A trust may also be used for "generation skipping." Successive life estates may be created for family members in succeeding generations. Property held in a granted life estate is not taxable in the estate of the deceased life tenant for federal estate tax purposes.

In general, for generation-skipping transfers, a generation skipping transfer tax is imposed at the

highest federal estate and gift tax rate (55 percent). However, an exemption is provided for generation-skipping transfers of \$1 million per transferor.

Special use valuation for land is available in calculating the generation-skipping tax for direct skips.

### Family Estate Trusts

"Family estate" trusts, "pure" trusts or "constitutional" trusts that purport to be irrevocable and involve the assignment of lifetime services to the trust should be approached with caution. The Internal Revenue Service has indicated that such trusts will be challenged on several grounds. Court cases and rulings to date have bolstered the IRS position that (1) assignment of "lifetime services" to the trust is ineffective to shift the income tax liability to the trust, (2) the value of the property involved is taxed in the estate of the person who established the trust and who usually retains control over the trust, (3) the trust may be taxed as a corporation for income tax purposes, and (4) in general, creation of such a trust does not involve a taxable gift.

The use of "off-shore" trusts has been promoted in recent years with IRS challenging such trusts successfully.

Even the best of estate planning efforts means little unless we actually implement the plan in the form of a will, change in property ownership, or modification of the insurance plan. It's not easy to put an estate plan into place. Most of us prefer not to talk or think about death. But we owe it to those who are close to us and who are dependent upon us to take that step.

We suggest you begin by giving serious thought to objectives. What do you want to accomplish? What do you want to have happen to your property, or the family's property, over the next 10, 15, or 20 years? Try to review that scene without yourself being present. Who would be in charge? Who would make the decisions? Who would need the income? Who could authorize sale of property and distribution or reinvestment of proceeds?

After you have determined your objectives, you may want to consider objectives of yourself and spouse together. Some objectives may be obtained from family members. Especially if you want the family business to continue into the next generation, children should be consulted.

A family conference may be helpful to share concerns about the estate planning process, property disposition, estate settlement, and some idea of the governing objectives.

The next step is probably a visit with your attorney. Your attorney may advise you of other ways to accomplish your objectives. You may want to spend some time thinking and reflecting upon how you want to go about your plan. Another family conference may be helpful to discuss possible options.

After you and the family are certain of objectives, you'll want to work closely with your attorney and others on the estate planning team to implement the plan.

## Business Planning

For those involved with the family business or another business relationship, business planning

may be an important part of estate planning. This is because many business decisions made prior to death could influence and affect estate planning decisions.

For example, availability of installment payment for federal estate taxes can be affected by the way the business is structured. Similarly, eligibility for special use valuation of land can be affected. For those in a corporation, eligibility for stock redemption also can be influenced by how the business entities are structured.

## How Many Entities?

One of the more fundamental questions is the way to structure the business. Specifically, how many entities should you have in organizing the business? Should you have a single entity that holds all the business assets—inventory, machinery, livestock, and land? Or should you have two entities? One might carry on the production. Another entity might hold the land with the land leased to the production entity. The latter is a common practice. However, a 1995 case and a 1996 ruling have imposed self-employment tax on rents (which normally are treated as investment income, not subject to self-employment tax) if involvement in the business as lessor and as partner, employee or otherwise reaches the level of "material participation." Unless that result is changed by statute or future court cases, caution is suggested in setting up two-entity operations. Solutions to avoid paying the SE tax include transferring the rented land to a spouse who is not involved with the business or transferring the land to an entity (such as a limited partnership) where some or all of the owners would not be subject to self-employment tax.

The choice of organizational pattern can have much to do with the estate planning strategy. Let's look at a multiple-entity approach.

Consider a farm operation where one entity holds the land and leases it to the production entity. With this arrangement, parents who own the land

receive rent. Rent is usually certain, secure, and it won't reduce social security benefits.

The separate land entity also is a way to continue the ownership in land for the heirs who are not affiliated with the family business. Those heirs can continue to hold ownership interests in land as a major asset in the business without becoming involved in day-to-day management. Further, the heirs affiliated with the business do not need as much investment to control the production entity if land is left out of the production entity.

Usually those heirs affiliated with the business want to control the production entity no later than the time of death of the surviving parent. They tend to fear that a coalition of heirs not affiliated with the business might dissolve the operation to obtain their assets.

### **Disadvantages**

There are some negative estate planning aspects to multiple entities, however.

One concern is eligibility for installment payment of federal estate tax. As you recall, where there is an interest in a closely held business and it is more than 35 percent of the adjusted gross estate, payment of the portion of federal estate tax attributable to the business may be deferred.

Eligibility requirements for 15-year installment payment are discussed in Chapter 14. A key point is that assets cash rented to the production entity generally are not considered an interest in a closely held business for purposes of installment payment of federal estate tax.

In addition to structure of the organization, the type of lease used can influence eligibility for special use valuation of land. Special use valuation requirements are discussed in Chapter 10.

There are, in addition, questions regarding whether to use a general partnership, limited partnership, limited liability company, limited liability partnership, or corporation for part or all of the assets, or whether you should use a trust or individual ownership of land. The organizational problems of the farm business are discussed in a companion videotape series. The reference publication for that series is Pm-878, *Organizing the Farm Business*, available from Iowa State University Extension.

## **Steps in Implementing Your Plan**

Your plan may be implemented by a will to dispose of property, to designate an executor, and possibly to nominate a guardian for minor children. You may want to look at how property is owned. A change in property ownership patterns may be desirable. You may want to shift from joint tenancy on some assets, possibly to tenancy in common, or into individual ownership. A careful review of property ownership is part of the implementation process.

Also at this stage, you should examine your insurance plan for any needed changes. Beneficiary designations should be compatible with the estate plan and your desires. You may want to consider changes in the ownership of the policy, also. Ownership changes may reduce federal estate tax on life insurance proceeds.

Your estate plan may suggest a gift program, or the sale of some assets. All are properly part of the implementation process.

### **Charities**

You may want to consider benefiting a favorite charity. A gift to a charity either at or before death is a way of extending yourself. It may be a way to accomplish some of those things you had planned to do during life, but for various reasons could not.

A charity can provide a productive use of resources. For example, scholarship funds are often turned over year after year with the income used productively. Charities also often make efficient use of funds because they operate with a great deal of volunteer effort for low overhead costs.

Giving to a charitable cause at death conveys a special legacy to family members—the idea of support for humanitarian causes. That may be worth more to the family in terms of their development than leaving them all of the property.

Giving to a qualified charity may provide income tax advantages, estate tax deductions, and possibly a gift tax deduction as well.

### **Inventory**

In implementing your plan, an inventory of assets should be made. It can be helpful to family mem-

bers trying to settle an estate and continue management of your property after death. The task is simpler if they know what property is owned, where it is located, and the details associated with it.

Although you rely upon your attorney and other members of the estate planning team, don't turn your estate planning problems over to them and forget it. Be sure you understand your plan—what is in the will, and what it will do for you. If you know the provisions, you are in a better position to know when a will or trust needs to be changed.

Remember that if you have a great deal of property in joint tenancy and the value of your estate is growing, there may be tax concerns. If your estate is at the half million dollar level and still increasing, there are likely to be good reasons for considering a shift out of joint tenancy.

### **Employee Benefits**

For those of you who are employees, consider your employee benefits. Check with the employer—there may be death or retirement plan benefits. Be sure that beneficiary designations are compatible with your plan and wishes.

These benefits may be subject to death tax. There are typically a number of choices to be made in terms of how benefits should be paid, also. Often there are provisions for a surviving spouse or other dependents in retirement programs. Be sure you understand the death, retirement, and other benefits in the employee package.

### **A Team Approach**

Developing the total plan—including tax aspects and property disposition—suggests a need for a team approach. A key person, of course, is your attorney, who can help you in developing an integrated plan to accomplish your objectives. An accountant, who can help on tax and financial matters, also may be part of the team. A life insurance representative and a trust officer, if you are thinking of a trust, also could be useful members of the estate planning team. If your plan involves one or more charitable organizations, a full-time charitable giving officer may be a useful team member.

### **Changes**

In the process of developing an estate plan, one should study all possible arrangements, discuss the plan with the family, and obtain competent advice. Services of an attorney are essential.

Once the plan is developed, it is advisable to review the plan periodically to be sure it continues to accomplish current objectives. Your degree of wealth, marital status, or objectives might change, any one of which might call for a review of the plan. Or laws may change as they have in recent years.

A will can be changed or amended with a codicil—an amending document executed with the same formality as the will itself. It is not necessary to redraft the old will completely to make minor changes. The codicil must be in writing, signed by the testator and witnessed by at least two disinterested parties. You cannot amend the will simply by writing in the margin or by crossing out particular provisions.

A will may be revoked by making out a new will that expressly revokes the former one, or by destroying the original will completely.

Finally, this publication was designed to review some of the relevant points to consider, the problems involved and the tools available in estate planning. Emphasis has been placed on the need to examine alternatives and the consequences of failing to plan. The series was not intended to make participants “instant experts” in estate planning. Because of the breadth of the area and the complexities, it was necessary to omit some details and to summarize.

In brief, this series was designed to identify the major points to consider in planning an estate for the greatest benefit of the person and his or her loved ones. It has indicated the major tools available, some of the pitfalls, and some of the complexities. With this knowledge, you should be able to discuss estate management more competently with your legal adviser. The fundamental objective, of course, is the development of a plan designed to accomplish your goals now and for the foreseeable future.



## Unified Rate Schedules for Federal Estate and Gift Tax\*

Amount from which tentative tax is computed	Tentative tax
Not over \$10,000	18 percent of such amount
Over \$10,000 but not over \$20,000	\$1,800 plus 20 percent of the excess of such amount over \$10,000
Over \$20,000 but not over \$40,000	\$3,800 plus 22 percent of the excess of such amount over \$20,000
Over \$40,000 but not over \$60,000	\$8,200 plus 24 percent of the excess of such amount over \$40,000
Over \$60,000 but not over \$80,000	\$13,000 plus 26 percent of the excess of such amount over \$60,000
Over \$80,000 but not over \$100,000	\$18,200 plus 28 percent of the excess of such amount over \$80,000
Over \$100,000 but not over \$150,000	\$23,800 plus 30 percent of the excess of such amount over \$100,000
Over \$150,000 but not over \$250,000	\$38,800 plus 32 percent of the excess of such amount over \$150,000
Over \$250,000 but not over \$500,000	\$70,800 plus 34 percent of the excess of such amount over \$250,000
Over \$500,000 but not over \$750,000	\$155,800 plus 37 percent of the excess of such amount over \$500,000
Over \$750,000 but not over \$1,000,000	\$248,300 plus 39 percent of the excess of such amount over \$750,000
Over \$1,000,000 but not over \$1,250,000	\$345,800 plus 41 percent of the excess of such amount over \$1,000,000
Over \$1,250,000 but not over \$1,500,000	\$448,300 plus 43 percent of the excess of such amount over \$1,250,000
Over \$1,500,000 but not over \$2,000,000	\$555,800 plus 45 percent of the excess of such amount over \$1,500,000

(The rate continues upward on a graduated scale to 55 percent above \$3,000,000)

\*Before allowance of credits

## Credit for State Death Taxes Paid

Adjusted taxable estate*	Maximum tax credit
Not over \$90,000	8/10ths of 1 percent of the amount by which the taxable estate exceeds \$40,000
Over \$90,000 but not over \$140,000	\$400 plus 1.6 percent of the excess over \$90,000
Over \$140,000 but not over \$240,000	\$1,200 plus 2.4 percent of the excess over \$140,000
Over \$240,000 but not over \$440,000	\$3,600 plus 3.2 percent of the excess over \$240,000
Over \$440,000 but not over \$640,000	\$10,000 plus 4 percent of the excess over \$440,000
Over \$640,000 but not over \$840,000	\$18,000 plus 4.8 percent of the excess over \$640,000
Over \$840,000 but not over \$1,040,000	\$27,600 plus 5.6 percent of the excess over \$840,000

(The credit amount continues upward to \$10,040,000 on a graduated scale.)

\*Federal estate tax taxable estate minus \$60,000.



## Other Legal Affairs Programs

In addition to the series on estate planning, three other videotape programs are available through offices of Iowa State University Extension. These programs, featuring Neil E. Harl, include:

**Organizing the Farm Business**—A series of 12 programs designed to help you understand the legal aspects of organization of the farm business. A reference publication by the same title is available.

**Civil Liabilities**—Twelve programs looking at legal rights and responsibilities of both farmers and urban dwellers. Reference publication also available.

## Publications

The following ISU Extension publications on legal affairs are available through your county extension office.


*Pm-782 Civil Liabilities: Legal Considerations for Individuals, Families and Firms*

*NCR 11 The Farm Corporation*

*Pm-878 Organizing the Farm Business*

*CRD 112 Township Trustee and Clerk Orientation*

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