Estate Planning Seminar

Thursday, December 8, 2016

Courtyard Marriott ~ Mankato

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GISLASON & HUNTER LLP

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Year End Tax Planning and Tax Tips

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Year End Tax Planning and Tax Tips

Topics

- Reacting to a Possible Revised Tax System in 2017
- Do's and Don'ts of Dealing with the IRS
- Lessons on Tax Planning
- The Big Picture: Ag and our Tax System
  - The cash method of accounting
  - Systemic IRS attacks

New Tax Legislation in 2017??

- Generally: Lower rates, but also fewer deductions
- Business tax rate of 20-25% (all entities)
- Repeal AMT (Alternative Minimum Tax – 1969)
- Top individual rate 33% (from today's 39.6%)
  - Three brackets: 12% - 25% - 33%
- Repeal of 3.8% net inv. income tax (NIIT) from ACA

New Tax Legislation in 2017??

- Probable change in cap. gain rates
  - Possible revised system (exclusion of ½ of gain)
  - Repeal of 3.8% NIIT benefits most capital gain sales
- Special repatriation rate for U.S. corps. of 10%
- Big Picture: Systemic change to tax system

Strategies for 2016 (pending ‘17 Legislation)

- Consider prepaid state income tax, until reach AMT
- Defer income: Possible lower brackets in ‘17
- Defer on initiating land sales/cap. gain transactions
  - Some past cap. gain rate changes have been mid-year
- Consider extending ‘16 return to apply hindsight
  - 2/3rd tax est. 1-17-17; balance due 4-17; file by 10-16-17

Update: Pending ACA Reform in 2016

- **ACA "mkt. reforms" outlawed small employer medical reimbursement plans (Sec. 105 & 106)**
  - Penalty of $100/day/employee!
- **Pending H.R. 34: Restore Sec. 105 reimb. plans**
  - Up to $4,950 for employee; $10,000 for family
  - Nondiscriminatory
  - Employer under 50 FTEs
  - Effective in 2017

Dealing with the IRS

Tax follies: "I can handle that IRS notice on my own."

Lessons

- Never assume IRS notices are correct (use a professional)
- Obsess about 1099s & charitable receipts each Jan.
- Identity theft risks: Contacts from IRS only by letter (until after exam in process)

Dealing with the IRS

- **IRS audits (SBSE):**
  - **Always with an experienced tax professional (Never alone: The verbal slip-up)**
  - **Examiners often wrong (poor training; bias toward ag)**
  - **Appeals level: A wild card**

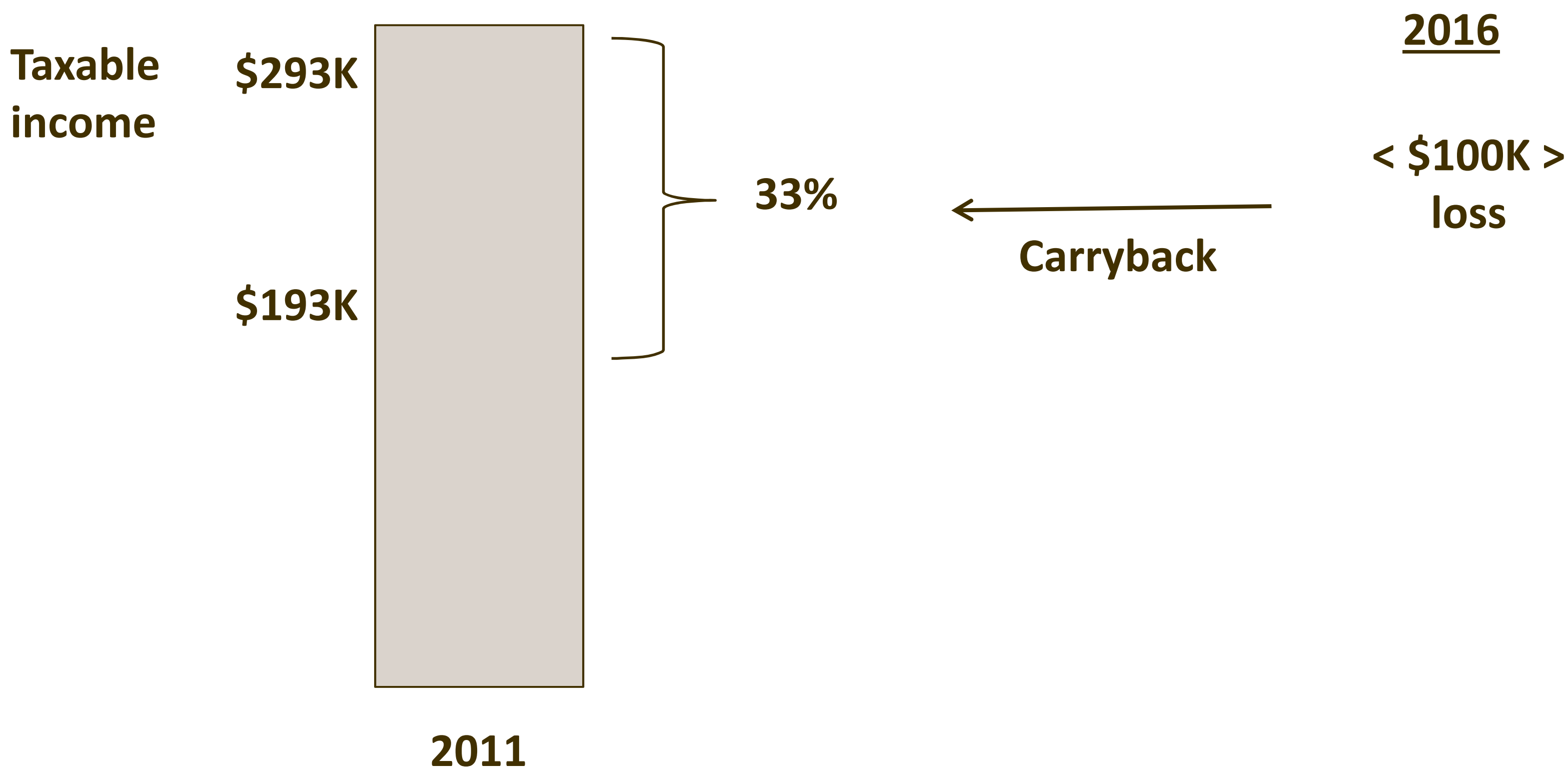
Lessons on Tax Planning

Tax follies: “I don’t need to plan…lost money in ‘16.”

<u>Lessons</u>

- **Loss years are opportunities for carrybacks against prior high bracket tax years**
  - **Farm rule: Back 5 yrs. & then forward**
  - **1^{st} election: Back 2 yrs. & then forward**
  - **2^{nd} election: Forward only**

5 Yr. Farm Loss Carryback



- Additional advantage: Lower income in 2011 may save income averaging tax in 2013 and 2014 (2012 is likely a closed year under statute of limitations)

Lessons on Tax Planning

Tax follies: "Paying zero tax is my goal."

<u>Lessons</u>

- **Use brackets effectively (10%-15%-25% lower tier rates)**
- **Building equity: <u>Only</u> through net income or asset appreciation**
- **Importance of Nov.-Dec. vs. Feb. tax advisor sessions**

Lessons on Tax Planning

Tax follies: "But the document says it is a lease …"

Lessons

- **The label does not govern; facts & economic reality**
  - **No bright line test or safe harbor (a messy tax issue)**
- **Beware of trade-in if replace via operating lease**
- **See your tax advisor before executing the deal**

Ag Leadership Issues

- Preserving the cash method of accounting for tax purposes
  - Unique to ag; no taxation of yr.-end inventory or receivables (vs. service business with receivables only)
  - Does Congress understand volatile prices/production?
  - Over 35% non-farm investor brings accrual method

Ag Leadership Issues

- IRS broad attacks on ag tax
  - SE tax on CRP (*Morehouse* CA-8 victory)
  - SE tax on self-rental (*McNamara* CA-8 victory)
  - Sec. 119 corp. meals and lodging

Wrap-Up

- **Questions??**

THANK YOU!

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Farming Entity Options and Related Tax Considerations

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Why Use Business Entities or Trusts?

- Quantify the value of the farming operation
- Transfer ownership over time
- Control and management
- Liability protection
- Taxation
- Financing

Minnesota's Corporate Farm Law – Minnesota Statute Section 500.24

- The corporate Farm Law restricts the circumstances under which corporations and other limited liability entities can either (1) take an interest in agricultural land; or (2) engage in farming.
- The law creates exemptions permitting certain types of entities to own land or engage in farming, such as Family Farm Corporations, Family Farm Partnerships, Authorized Farm Corporations, and Authorized Farm Partnerships.
- The Corporate Farm Law has been controversial since its enactment in 1973.
- The law underwent significant revisions in 1994, 1997, and in 2000.

Who can farm or own farmland in MN is limited to:

- Sole Proprietorship
- General Partnership
- Family Farm
- Family Farm Corporation
- Family Farm Trust
- Authorized Farm Corporation
- Authorized Livestock Farm Corporation
- Family Farm Partnership
- Authorized Farm Partnership
- Family Farm Limited Liability Company
- Authorized Farm Limited Liability Company
- Research or Experimental Farm
- Breeding Stock Farm
- Aquatic Farm
- Religious Farm
- Utility Corporation
- Development Organization
- Exempt Land (agricultural land owned or leased by a corporation prior to May 21, 1973)
- Gifted Land
- Repossessed Land
- Nonprofit Corporation
- De Minimis (an interest in 40 acres or less of agricultural land with les than $150 per acre in gross revenue)
- Commissioner's Exemption (does not meet the other exemptions, does not contradict purpose of corporate farm law, and does not have a significant impact on the agriculture industry)

Sole Proprietorship

- **Advantages:**
  - Ease of formation
  - Simplified ownership and management
  - Cost savings – no organizational or legal expense
  - Taxation simplified – individual
  - No regulation by the Minnesota Corporate Farm Statute – no reporting requirements or restrictions on the number of partners, acres, etc.
- **Disadvantages:**
  - No liability shield – non-business assets at risk
  - Cumbersome transfer of ownership – piecemeal per asset v. shares or units
  - Unstructured succession – ownership and management coupled, but potentially unbalanced or without structure
  - Unintended partners – divorce, death – no buy/sell agreement
  - Potential multiple proprietorships without contractual agreements or succession plan

Sole Proprietor

- Reported on personal return (Schedule F)
- All income subject to SE tax
  - 2017: 15.3% on first $127,200; 2.9% to $200K/$250K; 3.8% on excess
- Payments to spouse
  - Wages for services (to allow deductible fringe benefits)
  - Rent for land ownership (not subject to SE tax)
- Farm income averaging available
- Sale of equipment: Ordinary income via depr. recapture
- Single-member LLC reports as proprietorship (with liability shield)

2016 Income Tax Rates

- **Federal tax rates**

	Single	Joint
10%	$0 - $9K	$0 - $18K
15%	$9K - $38K	$18K - $75K
25%	$38K - $91K	$75K - $152K
28%	$91K - $190K	$152K - $231K
33%	$190K - $413K	$231K - $413K
35%	$413K - $415K	$413K - $467K
39.6%	> $415K	> $467K

- **Minnesota tax rates**
  - Four brackets: 5.35% - 7.05% - 7.85% - 9.85%
  - Low bracket under $25K single/$37K joint
  - Top bracket over $156K single/$259K joint

General Partnership

- **Advantages:**
  - Choice of level of formality (i.e., no written v documented agreement)
  - Ease of formation and low expense (if informal)
  - Simplified taxation – like individual proprietorship
  - Gradual transfer of the partnership interests to existing partners
  - No regulation by the Minnesota Corporate Farm Statute – no reporting requirements or restrictions on the number of partners, acres, etc.
  - Creditors of individuals cannot attack other partners' interests
  - Can be structured as a Limited Liability Partnership
  - Can provide liability protection if formalized

General Partnership

- **Disadvantages:**
  - No liability shield if not formalized
  - Distributions and assets exposed to creditors of partnership
  - If informal, dispersed and unregulated management and control
  - Partnership interests not easily divisible or transferable
    - ◊ May require unanimity if informal – no rules to regulate
  - Unintended partners if informal – divorce, death – no buy/sell agreement

General Partnership

- Separate return filed (Form 1065), but tax paid by partners
- All income subject to SE tax
- Entity may employ spouses but not partners
- Entity may pay rent to partners for land ownership (no SE)
- Similar to proprietorship tax rules
- Entity structure allows transfer of ownership units
  - Via sale or gift
  - Guaranteed payments to partners for services (subject to SE tax)

Limited Partnership

- **Advantages:**
  - Limited Partners have liability protection
  - Good succession transfer tool for farm and non-farm members
    - ◊ Legacy – keep the farm in the family
  - Structured transfers of interests
  - Management control – formalized – can maintain segregation of ownership of assets and distributions from management
  - Good tool for ownership of farm real estate
  - Avoid unintended partners with buy-sell agreements

Limited Partnership

- **Disadvantages:**
  - Regulation under the Minnesota Corporate Farm Law (see next slide)
  - General Partners do not have liability protection unless Limited Liability Limited Partnership
  - Expense: filing requirements, initial and maintenance expenses for organization
    - ◊ Must maintain certain formalities to keep liability shield
  - Not suited well for farming business operations

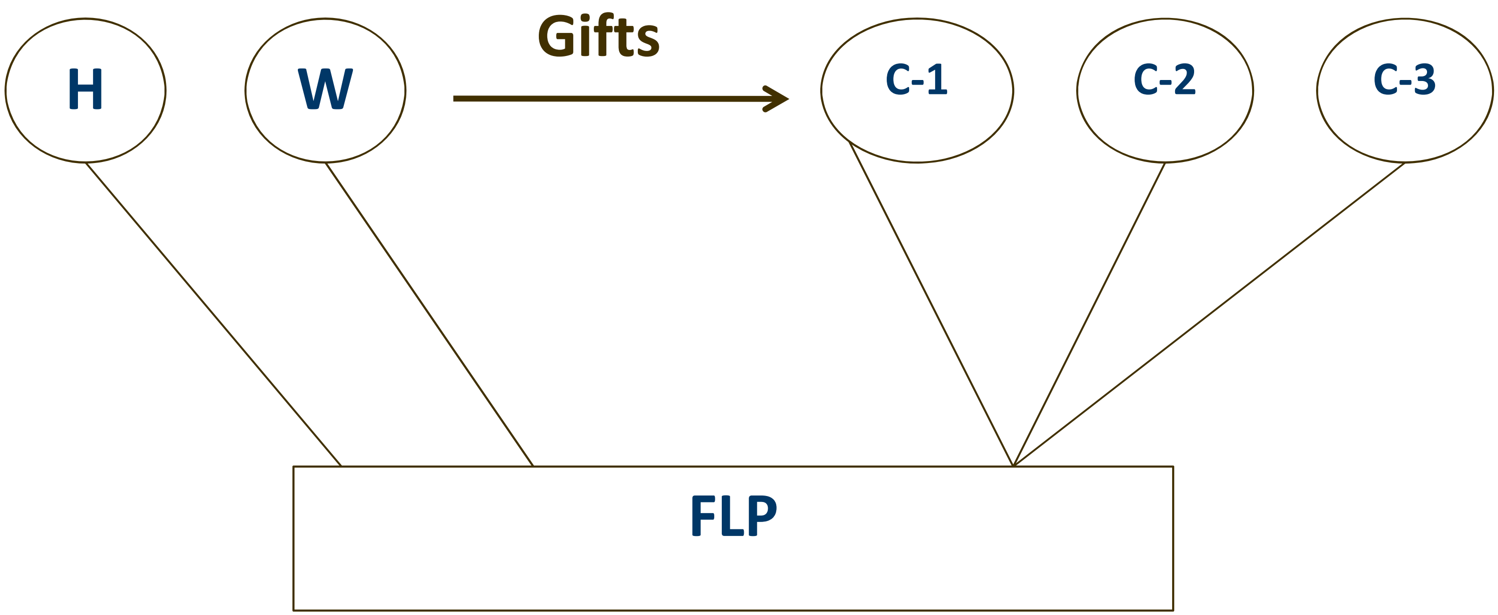
Limited Partnership: Corporate Farm Law Regulation

- The majority of the interests in the partnership must be held by, and the majority of the partners must be:
  - Natural persons or current beneficiaries of one or more family farm trusts in which the trustee holds an interest in a family farm partnership, and
  - Related to each other within the third degree of kindred according to the rules of civil law.
- At least one of the related persons must reside on the farm, or else the agricultural land must have been owned by one or more of the related persons for a period of five years before its transfer to the limited partnership.
- None of the partners may be a corporation.
- The entity must apply with the Commissioner of Agriculture and file an annual report.

Limited Partnership

- Separate return filed (Form 1065), but tax paid by partners
- Income to general/mgmt. authority partner subject to SE tax, but may not be SE income to limited partner without management authority
- Other tax rules same as general partnership
- Often used to hold land and control transfers to heirs

Family Limited Partnership (FLP) Illustration



- Land

Farm Corporation (Family / Authorized / Livestock)

- **Advantages:**
  - Liability protection – shareholders, officers, directors
  - Formal management – shareholders, officers, directors
  - Separation of management (employees) from ownership (shareholders)
  - Well suited for farm operations
  - Avoid unintended partners with buy-sell agreements
  - Allows for non-farm owners
  - Succession and transfer simplified – shares v. assets
  - Keep control with majority ownership, voting agreements or distinctions in type of stock

Farm Corporation (Family / Authorized / Livestock)

- **Disadvantages:**
  - Regulation under the Minnesota Corporate Farm Law (see next slide)
  - Not well suited for ownership of farmland
  - Expense: Filing requirements, initial and maintenance expenses for organization
    - ◊ Must maintain certain formalities to keep liability shield
  - Complexities imposed by formalities in management, ownership, succession, documentation

Farm Corporation (Family / Authorized / Livestock): Corporate Farm Law Regulation

- **Family Farm Corporation**
  - Majority of stockholders must be related to each other within third degree of kindred
  - Must have purpose of farming and the ownership of agricultural land
  - The majority of the stockholders must be persons, the spouses of persons, or current beneficiaries of one or more family farm trusts in which the trustee holds stock in a family farm corporation, related to each other within the third degree of kindred according to the rules of the civil law
  - At least one of the related persons must reside on or actively operate the farm
  - None of the stockholders may be corporations
  - The entity must apply with the Commissioner of Agriculture and file an annual report

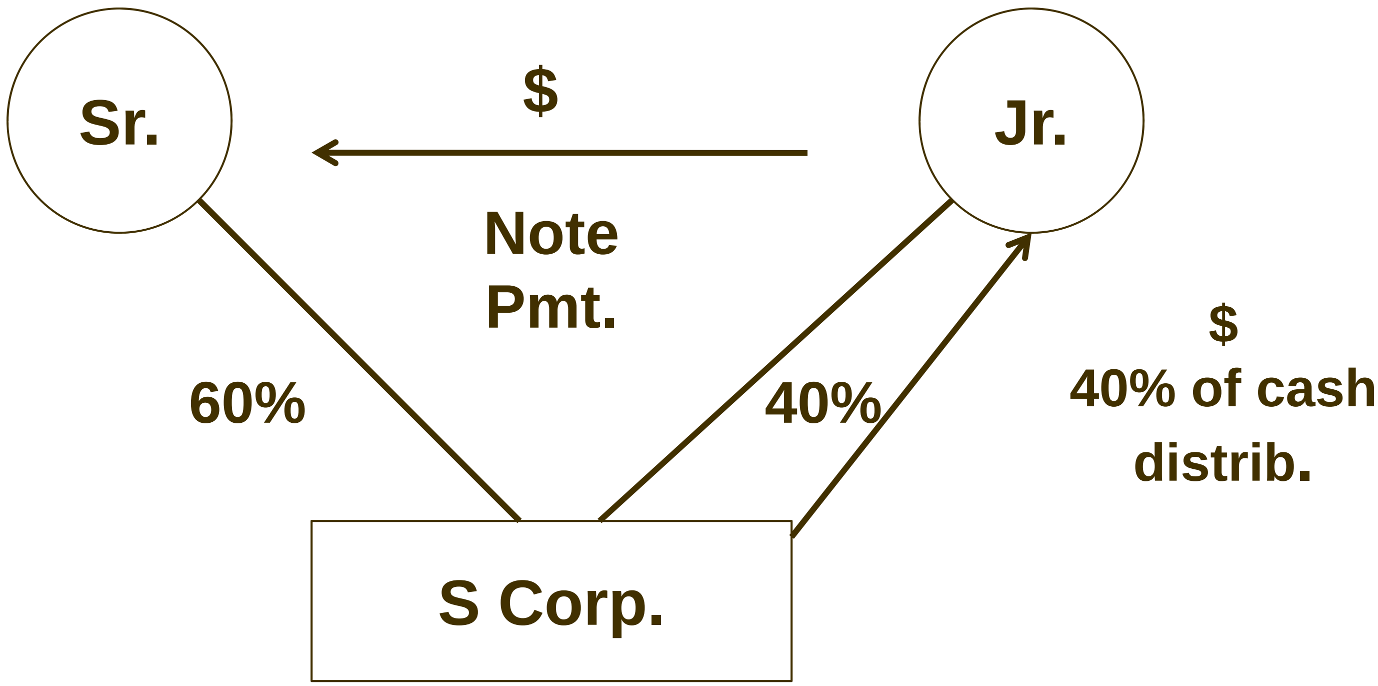
Farm Corporation (Family / Authorized / Livestock): Corporate Farm Law Regulation

- **Authorized Farm Corporation**
  - Maximum of five shareholders
  - Corporation must meet the following standards:
    - ◊ (1) it has no more than five shareholders, provided that for the purposes of this section, a husband and wife are considered one shareholder;
    - ◊ (2) all its shareholders, other than any estate, are natural persons or a family farm trust;
    - ◊ (3) it does not have more than one class of shares;
    - ◊ (4) its revenue from rent, royalties, dividends, interest, and annuities does not exceed 20 percent of its gross receipts;
    - ◊ (5) shareholders holding 51 percent or more of the interest in the corporation reside on the farm or are actively engaging in farming;
    - ◊ (6) it does not, directly or indirectly, own or otherwise have an interest in any title to more than 1,500 acres of agricultural land; and
    - ◊ (7) none of its shareholders are shareholders in other authorized farm corporations that directly or indirectly, in combination with the corporation, own more than 1,500 acres of agricultural land.
  - The entity must apply with the Commissioner of Agriculture and file an annual report.

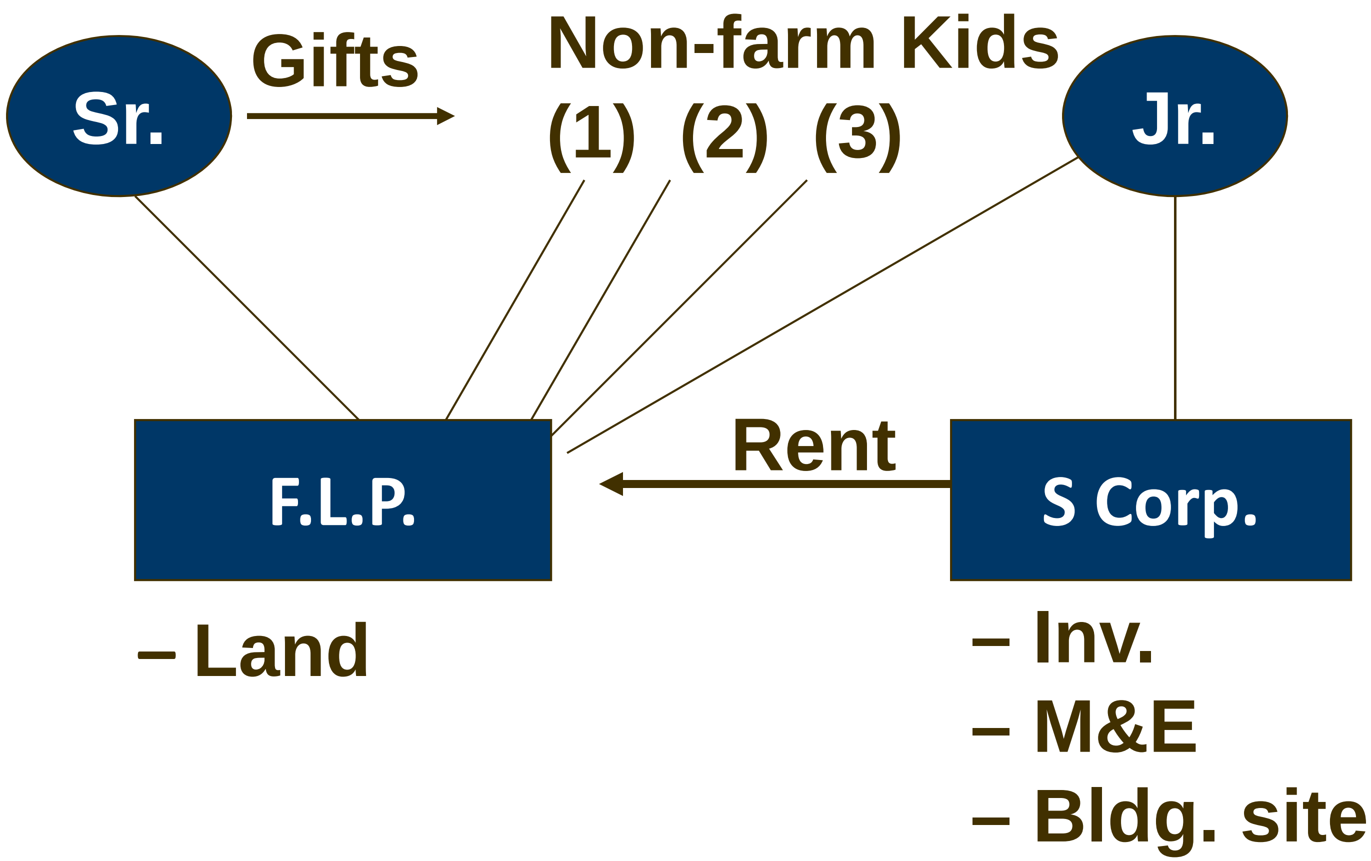
S Corporation

- Separate return filed (Form 1120-S); tax pd. by shareholders
- Wages to shareholders for services subject to FICA
- But remaining net income/distributions not subject to SE tax
- Entity pays rent to shareholders for land ownership
  - Never land inside corp., as triggers taxable gain if remove
- Entity structure allows transfer of ownership (stock certif.)
  - Via sale or gift

Example: Sale of Stock to Successor



FLP Illustration: Leasing Land to Jr.'s S Corp.



C Corporation

- Separate return filed (Form 1120); corp. pays tax on income
- Fiscal year ends are available (e.g. Jan. 31, Feb. 28, etc.)
- Income not subject to SE tax
- Reasonable salaries to owners for services (subject to FICA)
- Meals and lodging fringe benefit may be available to key employee
- Entity pays rent to shareholders for land ownership
  - Never land inside corp., as triggers taxable gain if remove
- Double tax if sell and liquidate (corp. tax + shareholder gain)

C Corporation Tax Rates

- Federal tax rates
  - $ 0 - $50K 15%
  - $50K - $75K 25%
  - $75K - $100K 34%
  - $100K - $335K 39%
  - $335K - $10M 34%
  - >$10M 35%
- Minnesota 9.8%

Limited Liability Company (Family / Authorized)

- **Advantages:**
  - Liability protection – members, governors, managers
  - Formal management - members, governors, managers
  - Election for taxation as partnership (pass through) or corporation
  - Suited for ownership of farmland – if taxed as partnership
  - Restrictions on transfers to unintended partners with buy-sell agreements
  - Suited for farm operations in some instances

Limited Liability Company (Family / Authorized)

- **Disadvantages:**
  - Regulation under the Minnesota Corporate Farm Law (see next slide)
  - Not well suited for ownership of farm land if taxed as corporation
  - Expense: Filing requirements, initial and maintenance expenses for organization
    - ◊ Must maintain certain formalities to keep liability shield
  - Complexities imposed by formalities in management, ownership, succession, documentation

Limited Liability Company (Family / Authorized): Corporate Farm Law Regulation

- **Family Farm LLC**
  - Majority of members must be related to each other within third degree of kindred
  - Must be founded for the purpose of farming and the ownership of agricultural land
  - The majority of the membership interests must be held by, and the majority of the members must be, natural persons or current beneficiaries of one or more family farm trusts in which the trustee holds an interest in a family farm limited liability company related to each other within the third degree of kindred according to the rules of the civil law
  - At least one of the related persons must reside on the farm or actively operate the farm, or the agricultural land must have been owned by one or more of the related persons for a period of five years before its transfer to the limited liability company
  - None of the members can be corporations or limited liability companies
  - The entity must apply with the Commissioner of Agriculture and file an annual report

Limited Liability Company (Family / Authorized): Corporate Farm Law Regulation

- **Authorized Farm LLC**
  - Maximum of five members
  - LLC must meet the following standards:
    - ◊ (1) it has no more than five members;
    - ◊ (2) all its members, other than any estate, are natural persons or family farm trusts;
    - ◊ (3) it does not have more than one class of membership interests;
    - ◊ (4) its revenue from rent, royalties, dividends, interest, and annuities does not exceed 20 percent of its gross receipts;
    - ◊ (5) members holding 51 percent or more of both the governance rights and financial rights in the limited liability company reside on the farm or are actively engaged in farming;
    - ◊ (6) it does not, directly or indirectly, own or otherwise have an interest in any title to more than 1,500 acres of agricultural land; and
    - ◊ (7) none of its members are members in other authorized farm limited liability companies that directly or indirectly in combination with the authorized farm limited liability company own more than 1,500 acres of agricultural land.
  - The entity must apply with the Commissioner of Agriculture and file an annual report.

A Few Notes on Minnesota's New LLC Statute: Minn. Stat. § 322C

- Minnesota enacted a new LLC statute in 2015
  - LLCs formed on August 1, 2015, or later are subject to the new statute
  - All LLCs that have not converted to the new LLC Act will be automatically converted on January 1, 2018
- The new LLC statute offers 3 management structures: member-managed (default), manager-managed, and board-managed
- Almost every concept in the new LLC statute can be modified by an individual LLC's operating agreement
- Fiduciary duties can be modified within an operating agreement under the new LLC statute, so long as such changes are not "manifestly unreasonable."

A Few Notes on Minnesota's New LLC Statute: Minn. Stat. § 322C

- **Dissenters' rights** are limited in the new LLC statute.
  - LLC must be formed under the old LLC statute (Minn. Stat. § 322B), and the LLC must not have disclaimed dissenters' rights in its operating agreement.
  - Rights only arise if an amendment to the articles of organization seeks to materially and adversely affect the rights of preferences of a member's interest.
- The new LLC statute grants courts broad authority to grant equitable remedies to members that apply to the court for dissolution of the LLC, if managers, governors, or members act illegally, fraudulently, or oppressively.

Limited Liability Company (LLC)

- Generally taxed as a partnership (income passes through and taxed to partners)
- SE tax if operating a farming business and member has management authority
- If landholding only, rental income is non-SE
- May elect to be taxed as a corporation (S or C corp.)

Family Farm Trust

- **Advantages:**
  - Liability protection – settlor/trustee/beneficiaries
  - Separation of management and ownership from beneficial attributes
  - Protection of assets from creditors of beneficiaries
  - May afford favorable gift tax and estate planning opportunities
  - Allows for structured generational transition
  - Avoids probate

Family Farm Trust

- **Disadvantages:**
  - Expenses: preparation of trust and conveyance documents, recording/governmental fees, separate tax return, ongoing operational expenses
  - Potential adverse income tax treatment
  - Dealing with third parties may be cumbersome
  - Settlor may lose control/management of assets

Trusts

- Drafted under two alternative tax regimes:
  - Simple trust: Passes through all taxable income to beneficiaries
  - Complex trust: May retain taxable income (taxed at trust rates) or make cash distributions to move income to beneficiaries
- Complex trusts: High rates on undistributed income
  - Top 39.6% rate above $12,400 of taxable income
  - Income not subject to SE tax
- Sec. 179 deduction not available to trusts

Changing Entity Status

- Sole proprietorship → anything
- Partnership → LLC
- LLC → partnership
- Partnership or LLC → corporation
- Corporation → LLC or partnership
- C Corp. → S Corp.
- S Corp. → C Corp.

Changing Entity Status (Tax Treatment)

- **Tax-free: Assets into entity in exchange for ownership units**
- **Tax-free: Converting proprietorship or partnership into a corporation (whether S or C corp.)**
- **Taxable: Converting a corp. into proprietorship/partnership**
  - **Considered a taxable distribution of assets out of corp. to owners**
- **Taxable: Converting a C corp. to S status (to extent of built-in gains recognized in first five S corp. years)**

There is no "One Size Fits All"

- **Questions?**

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Minnesota Estate Tax Issues for Farmers

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Introduction

- Minnesota Estate Tax Basics
- MN Estate Tax Quirks
  - Limits on 2032 and 2032A elections
  - 3-Year Claw-Back Rule
  - "Look-Through" Rule
- MN Estate Tax Deductions
  - Qualified Small Business Deduction
  - Qualified Farm Property Deduction
    - ◊ A Note on Property Taxes
- Intersection of MN Estate Tax & Federal Income Tax Considerations
  - Is avoiding MN Estate Tax Always Worthwhile?

MINNESOTA ESTATE TAX BASICS

Current Minnesota Estate Tax

- Each estate gets an *exclusion* from estate tax—meaning that only the amount over the “limit” is taxed
- Estate exclusion amount starts at $1.2 million for decedents dying in 2012, and ratchets up $200,000 annually until 2018, when the exclusion tops out at **$2,000,000**
- **Plus, Qualified Farm Property and/or Small Business** Deductions
  - Maximum value of Qualified Deductions started at $3.8 million in 2012 and ratchets down as basic exclusion ratchets up
- “Basic” Exclusion + Maximum Qualified Farm Property/Small Business Deduction = **Maximum of $5 million can pass free of Estate** Tax (married couple can pass $10 million with a little planning)
- **Tax Rate: 9-16%, based on the size of the estate**

Estate Tax "Basic Exclusion" and the Qualified Small Business and Farm Property Deductions

Year	MN Basic Exclusion	Maximum Qualified Farm/Small Business Deduction
2014	$1,200,000	$3,800,000
2015	$1,400,000	$3,600,000
2016	$1,600,000	$3,400,000
2017	$1,800,000	$3,200,000
2018	$2,000,000	$3,000,000

Calculating Minnesota Estate Tax

- As the basic exclusion amount changes, the “brackets” for each estate tax rate shift, until final scheme goes into effect in 2018:

Amount of Minnesota Taxable Estate	Tax Rate
< or = $2,000,000	0
>$2,000,000 but < or = $2,600,000	10% of excess over $2,000,000
>$2,600,000 but < or = $7,100,000	$60,000 + 13% of excess over $2,600,000
>$7,100,000 but < or = $8,100,000	$645,000 + 13.6% of excess over $7,100,000
>$8,100,000 but < or = $9,100,000	$786,000 + 14.4% of excess over $8,100,000
>$9,100,000 but < or = $10,100,000	$925,000 + 15.2% of excess over $9,100,000
$10,100,000 or more	$1,077,000 + 16% of excess over $10,100,000

MINNESOTA ESTATE TAX QUIRKS

IRC 2032 and 2032A Valuation Availability

- Federal Section 2032 Alternate Valuation Date = Estate can elect to be valued as of 6 months after decedent's death, rather than on decedent's date of death
- Federal Section 2032A Special Use Valuation = Permits use of different valuation approach to reduce estate tax value of farmland in certain estates
- **Section 2032 and 2032A valuations not available to Minnesota Estates unless Estate also has to file a Federal Estate Tax Return**
  - **Outcome: "Mid-sized" estates (over MN limit but under $5.49 million Federal limit) not able to take advantage of Section 2032 or 2032A**

Three-Year "Claw-Back"

- Minnesota does not have a gift tax.

- **However, all gifts made within 3 years of the decedent's death *and* after June 30, 2013, are taxed as part of the decedent's estate**
  - Doesn't matter whether gift was made in contemplation of death/for purposes of avoiding estate tax
  - Annual exclusion gifts ($14,000/person/year) don't count

- Example: Jane gave Bill $200,000 on March 1, 2018. After making this gift, Jane dies with $2,000,000 in assets.
  - If Jane died **after** March 1, 2021, no MN Estate Tax is owed (Jane's MN taxable estate = $2,000,000)
  - If Jane died **on or before** March 1, 2021, her Estate owes $20,000 tax

  (Jane's MN taxable estate = $2,000,000 + $200,000 gift made within 3 years of death)

The "Look Through" Rules

- Minnesota taxes property of non-resident decedents that isn't "located" in Minnesota under most legal definitions
- Basic Rule: MN Estate Tax Applies to:
  - MN real property, regardless of whether owner is an MN resident
  - Tangible personal property located in MN, regardless of whether owner is an MN resident
  - Intangibles owned by MN residents <u>only</u>

The "Look Through" Rules

- **The Twist: Pass through-entities** (LLC, S-Corp, Partnership, Trust), which are normally treated as intangibles, are **disregarded** when determining where property is located for estate tax purposes
  - This means that a non-MN resident will be subject to MN estate tax if he owns an interest in property located in MN, **even if he only owns the property indirectly via ownership interest in an LLC, Trust, or other entity.**
  - Law has been changed to exempt publicly-traded entities from the look-through rule

The “Look Through” Rules

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

MINNESOTA ESTATE TAX DEDUCTIONS

Qualified Farm Property (and Small Business) Deductions

- In addition to basic exclusion
- A single estate can claim both the qualified small business *and* qualified farm property deduction, but combined deduction is limited to $3 million (in 2018)
- First enacted in 2011, with substantial drafting issues that limited its applicability
- 2013 amendments fixing many of these issues are retroactive to all decedents dying after June 30, 2011
- Still lots of problems

Qualified Small Business & Farm Property Deductions (cont'd)

- For either deduction, person who acquires the property must be a **"qualified heir"**
- "Qualified Heir" = "Family Member" of decedent (as defined in IRC Sec. 2032A(e)(2)) OR a <u>trust</u> whose current beneficiaries are all "family members"
  - "Family Member" means Decedent's:
    - ◊ Ancestor
    - ◊ Spouse
    - ◊ Lineal descendant (or his/her spouse)
    - ◊ Decedent's spouse's lineal descendant (or his/her spouse) [step-children, step-grandchildren]
    - ◊ Decedent's parent's lineal descendant (or his/her spouse) [siblings, nieces/nephews]

Qualified Small Business Property Deduction

- Not going to discuss in detail, as it's not particularly useful for planning—more like a consolation prize for dying young
- Know that it is out there, but it is not as easy as it looks to use because of material participation requirements
  - Particularly: the trade or business must not be a "passive activity" under IRC 496(c) during year preceding decedent's death or the three years after death; the decedent or spouse must have materially participated in the t/b in the year prior to the decedent's death; and a family member must materially participate in the three years after death
  - NOTE: "Material participation" does NOT include substitute forms of material participation (i.e., retired person or surviving spouse) allowed under IRC § 469(h)(3)
- **Takeaway—to get Qualified Small Business Property Deduction, you have to "die with your boots on"**

Qualified Small Business Property Deduction Requirements

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

Qualified Farm Property Deduction

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

Qualified Farm Property Deduction (cont’d)

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

A Few Notes on Property Tax Classifications

- Property has to be "Class 2a" and "Ag Homestead"
  - What does that mean?
- You can't necessarily tell from your Property Tax Statement
  - Very roughly speaking, "class 2a" means tillable acres, livestock buildings (but NOT pasture), grain bins/machine sheds
  - Common non-qualifying property: pasture, woods and lawn/yard in excess of 1 acre
  - Most County Assessors do not use "Class 2a" or numerical classifications that match the statute on property tax statements
  - Plan ahead to save headaches later on: if a property tax statement says anything other than "AG HMSTD," ask Assessor what the notation means and whether the additional classification is really necessary

A Few Notes on Property Tax Classifications (Cont'd)

- You may be able to keep Ag Homestead classification if you move off the farm…but it's complicated
  - 1. You must remain a MN Resident, no matter what
  - 2a. OK if you move directly from the farm into assisted living or a nursing home, no matter where it's located in MN
  - 2b. OK if you move to town and a qualifying relative moves into your house, if that relative doesn't claim a separate Ag Homestead
  - 2c. OK if you live within 4 cities and townships of the land; a relative who lives within 4 cities and townships actively farms the land; and that relative doesn't claim a separate Ag Homestead

A Few Notes on Property Tax Classifications (Cont'd)

- You may be able to keep Ag Homestead classification if you put your farmland in an entity (LLC, Partnership, LP/LLP/LLLP, Corporation), but:
  - 1. At least one of the owners must always be farming,
  - 2. Whoever is farming can't claim his own, separate Ag Homestead, and
  - 3. It's complicated.
- Also, with a few narrow exceptions, you can't "link" properties together into one homestead unless the ownership on the title is <u>identical</u>
  - Example: Mom owns 200 acres in her own name and 100 more in "Mom Farms, LLC," 100% owned by Mom. It is <u>impossible</u> for all 300 acres to be homesteaded, even if all the land meets the Ag Homestead requirements. Mom can only have 1 Ag Homestead and the LLC and personally-owned land cannot be "linked."

INTERSECTION OF MN ESTATE TAX & FEDERAL INCOME TAX CONSIDERATIONS

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

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

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

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

Basis: Lifetime Gifts vs. Transfers on Death

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

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

Long-Term Capital Gains Rates 2016

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

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

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

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

Minnesota Estate Tax vs. Capital Gains Tax

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

Minnesota Estate Tax Liability	Son's Capital Gains Tax on Sale
$0	$1,010,000 - $200,000 basis = $810,000 First $391,450 x 15% Plus Remaining 418,550 x 20% = **$142,427 Federal Cap. Gains Tax** $810,000 x 9.85% = **$79,785 Minnesota Income Tax** = $178,605 total Fed/MN Income Tax
=$222,212 Overall Tax	

Minnesota Estate Tax vs. Capital Gains Tax (cont'd)

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

Minnesota Estate Tax Liability	Son's Capital Gains Tax on Sale
$60,000 + (13% x $400,000)= **$112,000 Minnesota Estate Tax**	$1,010,000 - $1,000,000 basis = $10,000 $10,000 x 15% = **$1,500 Federal Cap. Gains Tax** $10,000 x 7.05% = **$705 Minnesota Income Tax** = $2,205 total Fed/MN Income Tax
=$114,205 Overall Tax	

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

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

Questions???

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CliftonLarsonAllen

GISLASON & HUNTER LLP
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Estate Planning Seminar

Thursday, December 8, 2016

Courtyard Marriott ~ Mankato

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The Election is Over . . .
Now What?

Nick Houle & Wade Wacholz

CliftonLarsonAllen

GISLASON & HUNTER LLP
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Session Overview

- 2016 Election
  - Results
- Tax Update
  - Income tax
  - Estate tax

2016 Presidential Election Results

- Trump
  - 290 electoral votes
  - Trump won rural voters 2:1
- Clinton
  - Wins popular vote by 1.5% points (1.9 million votes)
    - ◊ 64.1 million v. 62.2 million
    - ◊ Only the fifth time in history the president-elect does not win popular vote
      - Bush/Gore: Gore won popular vote by 543,895 votes

*Source: http://www.cnn.com/election/results/president (results as of November 13, 2016 at 10 am EST)

2016 Congressional Election Results

- Republicans retain control of Senate and House
- 2016 Election . . . what was at stake
  - 34 Senate seats
    - ◊ 52 Republican to 48 Democrat
  - All 435 House seats
    - ◊ 235 Republican to 191 Democrat
- Democrats retain the ability to filibuster
  - Republicans have CR authority = 10 years

Trump's Proposed Tax Policy

- Reduce marginal tax rates
- Increase standard deduction
- Curtail tax expenditures
- Resembles Ryan's (House bill) proposal
- Reduce federal revenues by $4.4 to $6.2 trillion (over 10-years)

Trump's Proposed Tax Policy (Individuals)

- Collapse brackets into three (12%, 25% and 33%)
- Increase the standard deduction
- Limit tax value of itemized deductions
- Eliminate personal exemptions
- Maximum rate of 20% on dividends & capital gains
- Repeal the alternative minimum tax
- Tax carried interest as ordinary business income

Trump v. House (Individual)

	Trump	House
Tax Brackets	12%, 25%, and 33%	Same
Standard Deduction	$30,000 (joint) $15,000 (single)	$24,000 (joint) $18,000 (single w/ child) $12,000 (other)
Itemized Deduction	Cap total amount that could be claim at $100K (single) and $200K (joint)	Eliminate all itemized deductions except for mortgage interest & charitable contributions
Capital gains & dividends	20% max	16.5% max
AMT	Repeal	Repeal

Trump's Proposed Tax Policy (Estate & Gift)

- Immediate . . . pull back the proposed estate tax valuation discount rules
- Long-term . . . repeal estate and gift tax
  - House plan also repeals estate and generation-skipping transfer tax
- Reality - In 2015, 4,918 estates paid $17 B (1% Fed Revenue)
  - 266 Estates > $50 M paid $7.4 B estate tax

Trump's Proposed Policy continued

- Eliminate unlimited step up in basis at death
- Capital gains held at death over $10 Million will be subject to tax (mark to market Canadian system).
  - Exempt small business and farms
    - ◊ Not defined further anywhere
- Prevent abuses - gifts of appreciated property to private charities set up be descendent or descendant's family disallowed.

Trump's Policy's Planning Points

- Repeal of Gift Tax
  - Serves as a back stop to the estate tax system
  - Ensures the integrity of the income tax system also
    - ◊ With repeal income tax shifting will occur between family members to lower income tax costs on sales of assets
      - No restrictions in the movement of property or money between generations of family members
  - With the higher estate tax exemption ($5.45 M) less incentive to move assets in most situations

Trump’s Policy Planning Points (cont.)

- Repeal of Generation Skipping Tax (GST)
  - Trump’s proposal is silent
  - House proposal repeals GST tax
- GST designed to prevent significant wealth transfer outright or in Trust for multiple generations
  - Dynasty Trust concept usage might increase for ultra high net worth families
- GST Trusts proposal to tax values every so many years

Trump’s Proposed Tax Policy

- “Deemed sale” at death issues
  - Tax rate 20% (repeal of ACA 3.8% NIIT)
  - Exemption of $10 million per taxpayer
    - ◊ Technically a capital gains at death
    - ◊ Practically a reduction of estate rate from 40% to 20% (fully appreciated asset)
  - State income/estate tax issues?????
  - Larger estates still create a liquidity issue
  - Cost or Tax Basis of assets becomes critical here!
  - Will there be a deemed sale at date of lifetime gift?

Planning Considerations with "Mark to Market"

- Planning to shift future appreciation will still be viable
- Build up basis and reduce fair market value
  - Techniques to "freeze" value in senior generation's estate
    - ◊ Sales to Grantor Trusts & Grantor Retained Annuity Trusts (GRATs)
  - Push future appreciation to next generation
    - ◊ Dynasty Trusts
  - Focus on low cost basis assets versus high cost basis
  - Valuation discounts will still be applicable

Planning with "Mark to Market"

- Estate repeal with step of basis retained
  - Current planning is still viable
  - Pre mortem evaluation of assets to receive basis step for full mark to market exclusion of $10 million
- Estate repeal with no basis step up
  - Estates below $10 million: valuation discounts damaging
  - Which assets escape the mark to market requirement in estates over $10 million

Planning Considerations

- Planning in process now
  - Continue with process
    - ◊ Gifting of assets without paying gift tax
  - Annual exclusion gifts and 529 Funding
  - Use of Life Insurance Trusts and Crummey Funding
  - Death bed planning high estate tax states
  - Gift or transfer of lower basis assets now

Succession Planning –
Tools & Techniques for Preserving the Family Farm

Wade Wacholz & Nick Houle

CliftonLarsonAllen

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Succession Planning for Your Business

- What is Succession Planning?
  - Planning for the orderly transfer of the management and ownership of a business or farming operation to new managers and new owners in order to:
    - ◊ avoid liquidation or sale,
    - ◊ minimize taxes and other expenses, and
    - ◊ **carry out the family's non-tax objectives**.
  - Ownership & management may end up in different hands - some family, some not family, or some in certain family members some in other family members.

Succession Planning Process

- Four areas to assess/consider:
  - Financial
    - ◊ Understand assets, liabilities, cash flow, profitability
  - Business
    - ◊ Understand markets, competitive position, growth prospects
  - Family Dynamics
    - ◊ Understand physiological/emotional components, relative skills and interests of family members, commitment to shared goals
  - Taxes
    - ◊ Income (ordinary/capital gain distinction)
    - ◊ Gift/Estate (minimize and fund)

“Orderly Transfers”

- Lifetime transfer (via agreement or trust)
  - Gift
  - Sale
  - Combination
- Death transfer (via will or trust)
  - Bequest
  - Estate sale
  - Combination

“Orderly Transfers” (continued)

- Interplay of ***family*** goals (financial, business & personal) and implications of
  - Income tax
  - Gift/estate tax
- “Equal” versus “Fairness/Equity”
- Communication versus secrets

Planning Tools - Essential & Optional

- Structure Business Entity for Management & Control
  - Voting vs. Non-voting Interests
  - Entity Options
    - ◊ "Sub-S" Corporation
    - ◊ "C" Corporation
    - ◊ LLC
    - ◊ Partnership (LP, LLP, LLLP)
    - ◊ Trusts
  - Boards, Management Roles, Employment Agreements

Planning Tools - Essential & Optional (continued)

- “Buy/Sell” Agreements
  - “Triggers” for rights to buy/sell
    - ◊ Death
    - ◊ Disability
    - ◊ Divorce
    - ◊ Insolvency
    - ◊ Retirement
    - ◊ Employment Termination (with cause or without)
  - Pricing and valuation
  - Payment terms (interest, time, security)

Planning Tools - Essential & Optional (continued)

- Estate / Gift Tax Exemption
  - $5.43 MM – Federal
  - $1.6 MM – MN (going to $2.0 MM – unlimited gift)
  - Portability of Spouse's Unused Exemption (but not in MN)

- Annual Exclusion Gifts - Maximize the use
  - $14,000 per person per year
  - Leverage by using discounted assets
  - Fund premiums for life insurance in ILIT

Planning Tools - Essential & Optional (continued)

- GST Exemption
  - Transfers to 3rd Generation or beyond
  - $5.43 MM – Federal (no state)
  - Alongside Estate/Gift Exemption
  - Legacy assets / high potential for appreciation

Planning Tools - Essential & Optional (continued)

- Discounting opportunities
  - Farmland or other real estate – tenants in common
    - ◊ 10-15% discount for fractional interests.
  - Corporation Stock, LLC, Partnership
    - ◊ Potential discounts for lack of control and lack of marketability of 25% to 35%.
  - Sole Proprietorship.
    - ◊ Uncertain discounts (control versus marketability; "going concern" versus liquidation value)

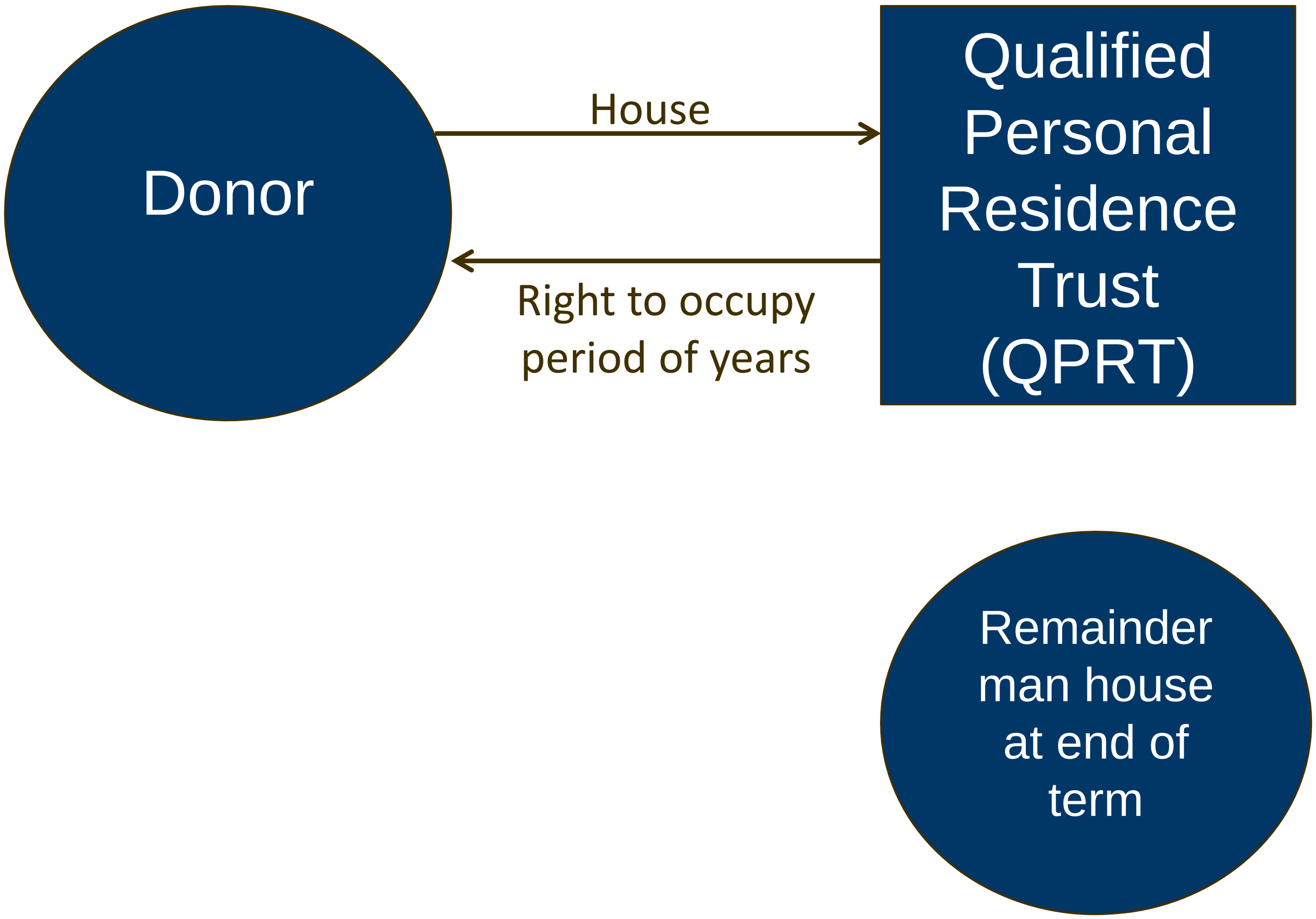
Planning Tools - Essential & Optional (continued)

- Irrevocable Life Insurance Trust
  - Take insurance proceeds out of taxable estate
- Advanced Tools: GRAT, IDGT Sale, QPRT
  - "Freeze Techniques"
  - Low interest rates, appreciating assets, cash flow analysis
  - Leverage transfer value by paying income taxes from transferred assets

Qualified Personal Residence (QPRT)

- Split interest trust
  - Donor retains the right to use residence for period of years
  - Remainder interest to beneficiaries of trust
  - Transfer delays the timing of the ultimate transfer to children
  - Reduces value of residence for gift tax purposes
- If donor survives QPRT term, residence excluded from estate (Section 2036)

QPRT Diagram



GRAT (Grantor Retained Annuity Trust)

Technique allowing a transfer of an appreciating asset to the next generation in exchange for a fixed stream of payments

Generally used to “freeze” value of transferred asset

Transferor retains value of asset plus a defined return based the federal interest rate called the 7520 rate currently 1.8%

GRAT Flowchart

Senior Family Member

- Transfers by gift company stock/equity to "GRAT"
- Receives annuity

Asset →

← Annuity

GRAT

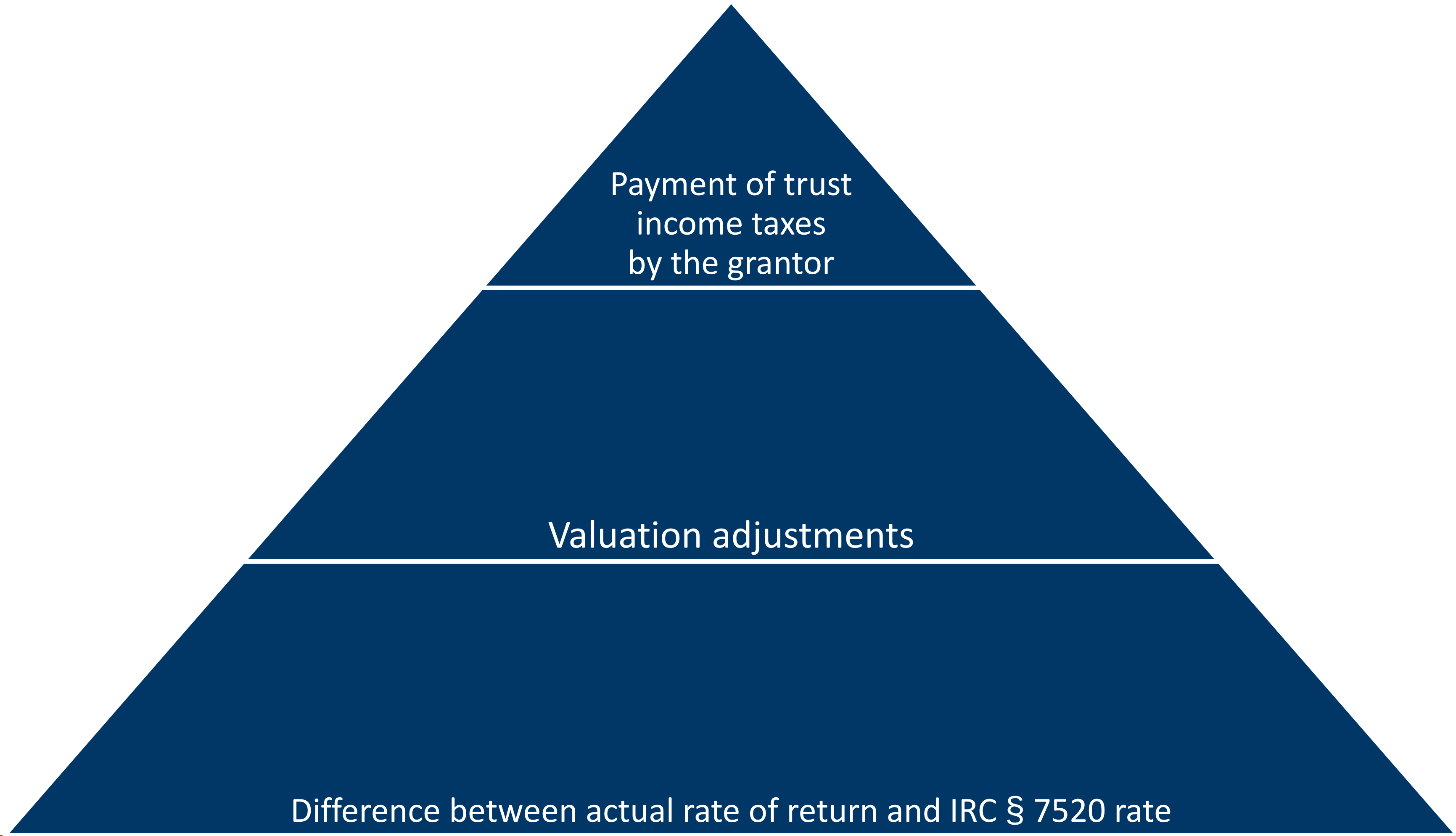
- Created by senior family member
- Pays annuity to senior family members for a term of years
- Receive stock/equity

↓

GRAT Beneficiaries

At end of term, remaining stock/equity is transferred outright or to another trust for senior family member's children

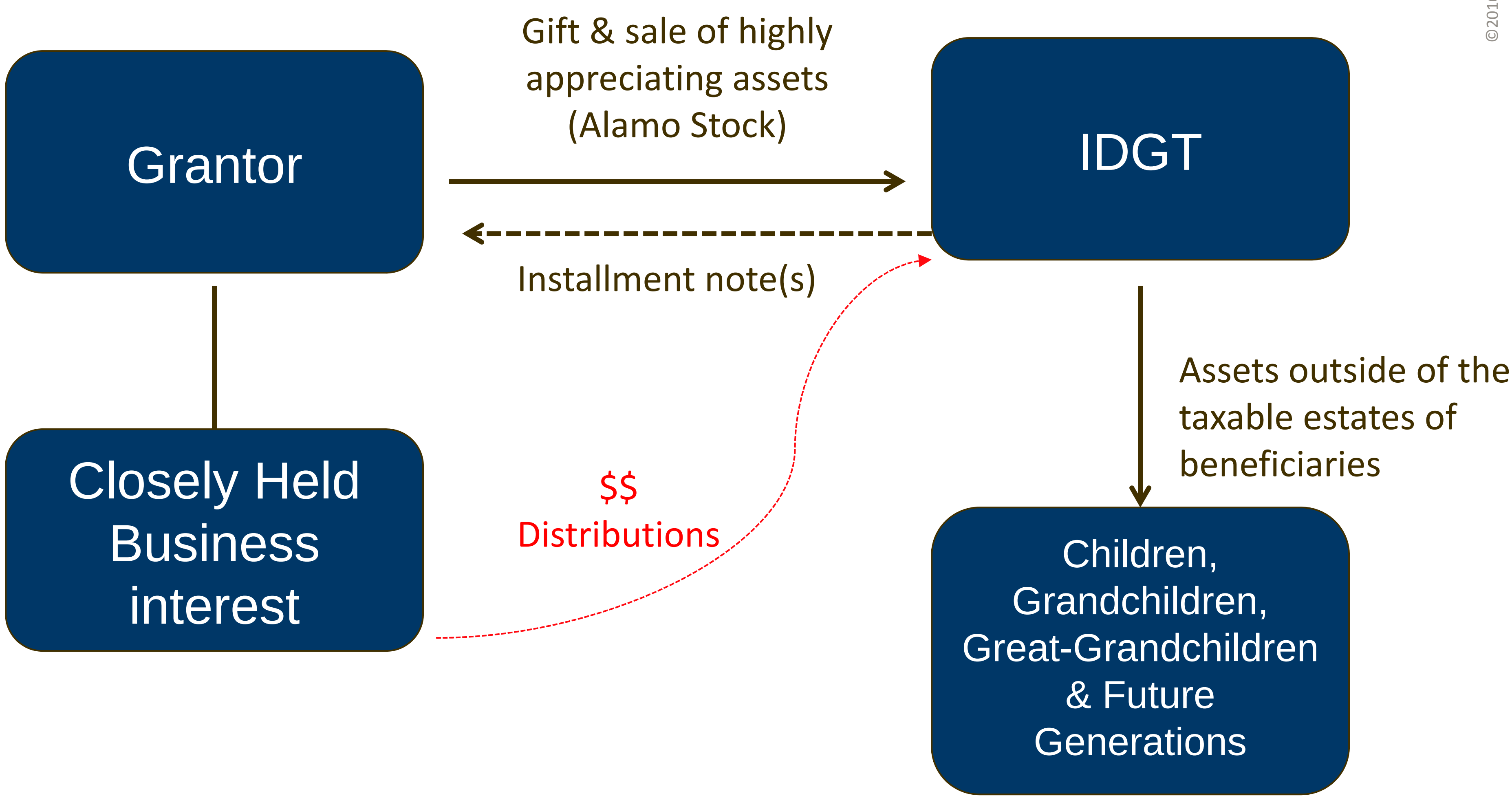
Why GRAT Gift/Sale Works



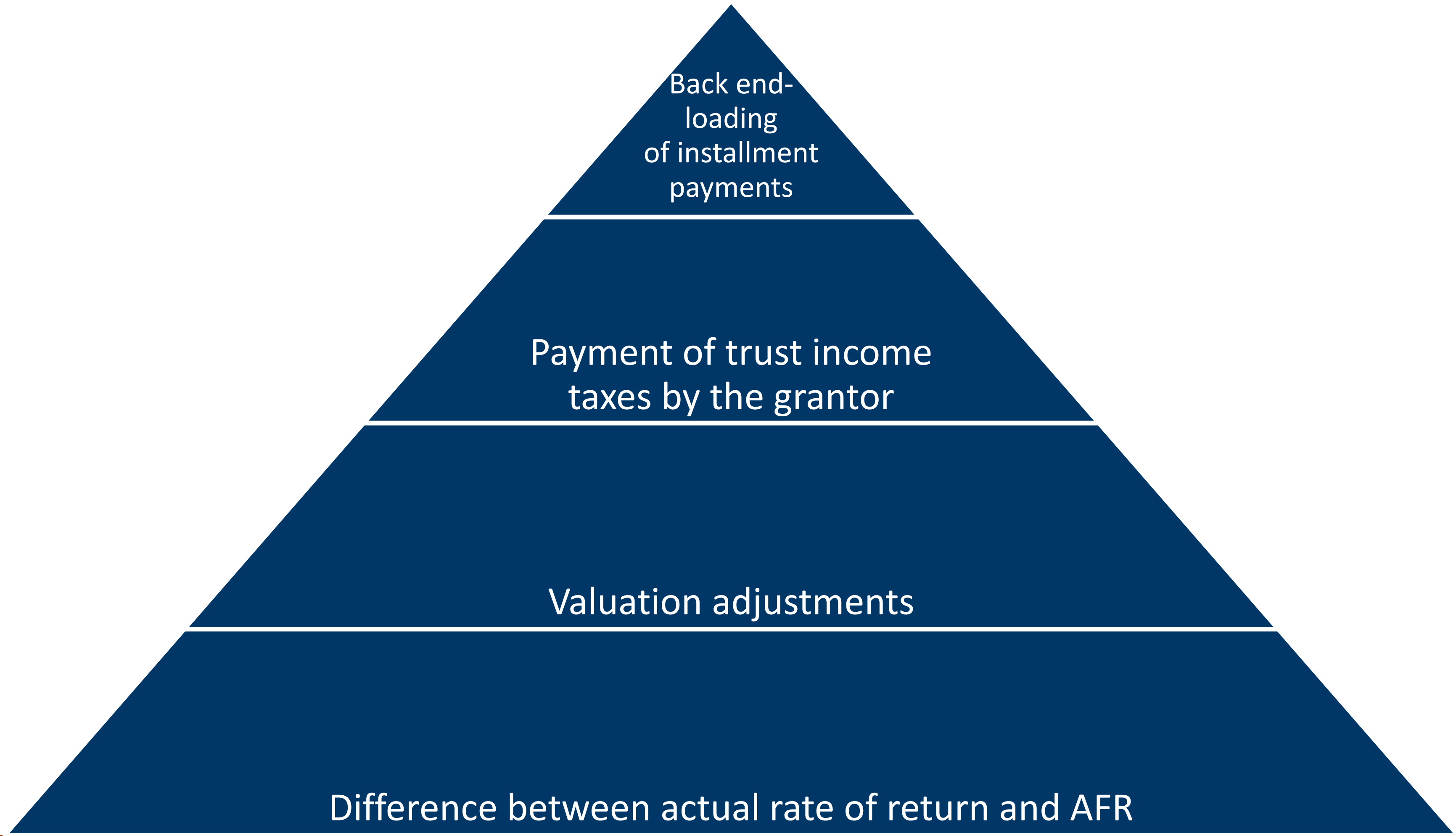
Sale to Intentionally Defective Grantor Trust

- Similar to the GRAT except
  - Portion of transaction a taxable gift
  - Note payments have more flexibility
  - Note interest rate maybe lower than 7520 rate
  - Generation Skipping works well with this strategy

Sale to an IDGT Strategy Diagram



Why IDGT's can be effective for transferring wealth



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