Land Access Project: Farm Service Provider Training
A Seminar on Generational Farm Transfer for Lawyers and other Farm Service Providers

9:30 AM – 11:30 AM - Session 4, Track 1:

Donald Sienkiewicz

I. Avoiding Probate – To Trust or Not to Trust

Trust Basics : living (inter vivos) vs. testamentary; revocable vs. irrevocable

There are two primary options for leaving instructions about how to handle one's estate: a trust and a will. Assets controlled by a will must be "probated," that is, managed and disposed of under the oversight of a State probate court; whereas assets held in trust need not be probated – their management and disposition are controlled by a Trustee according to instructions left by the person who created the trust (variously called a grantor, settlor, trustor or fundor) in a document called a trust agreement or a trust declaration (with any missing pieces filled in by the default rules governing trusts and trustees in that particular State). For a five-minute overview, see video: https://www.youtube.com/watch?v=FPXUBxtOtug

Testamentary trusts require ongoing judicial supervision in New Hampshire, which adds cost. They are, I hear, still popular or even the norm in New York, and possibly Connecticut… and can't imagine why (from a client's standpoint)

The purpose of probate: protection of creditors; protection of heirs unable to advocate for themselves; and oversight of the executor/administrator where he/she might go astray or be tempted to deviate from the wishes of the decedent (it's not just a uniform full-employment bill for attorneys!)

Where there are no creditors or vulnerable heirs, probate adds little to no societal value compared to private administration of a trust or nonprobate will substitutes (TOD registration, beneficiary designations), and only adds delay or cost to settlement of an estate (which is why it has a bad rap)

Where there is dissension among the heirs/beneficiaries, probate arguably makes it easier to escalate the dissension because the estate is already "in court," whereas in trust settlement a disgruntled heir would have to take the added step of hiring a lawyer and filing suit to initiate judicial oversight

However, where there is significant dissension among heirs, the fiduciary and her lawyer can protect themselves by seeking a probate judge's blessing on their actions.

Where there are creditors, there may be significant added value in the probate process vs. private trust administration, in that a judicial forum for settlement of claims is built into the settlement process, which can create a *res judicata* defense against later claims – as opposed to a Trustee settling a claim with a creditor directly, where the creditor can later be overcome by some version of buyer's remorse and sue the Trustee for a better deal.

Also, there may be value in intentionally leaving some assets to probate given shorter creditor claims period under state probate statutes than trust administration statutes (e.g., NH RSA 556:5 bars claims begun one year after grant of probate administration, and NH RSA 556:29 bars suits begun two years after death from attaching real estate of the decedent even when the estate was never probated; whereas NH RSA 564-B:5-508 (a portion of New Hampshire's enacted version of the Uniform Trust Code) bars claims against the decedent (settlor) one year after a Trustee gives *notice* of the settlor's death and the limitation period, a clock which may start later than the probate one, depending on the Trustee's knowledge and diligence. Also, NH RSA 564-B:5-509 bars claims against the Trustee of an irrevocable trust one year after the Trustee gives notice that the trust has terminated – which may be many years after the death of the grantor.

II. Insurance Trusts / Insurance Planning

The most common use of insurance trusts used to be Irrevocable Life Insurance Trusts designed to increase the estate, often for the limited purpose of giving the heirs cash to pay the estate tax, without increasing the estate tax itself. If a decedent buys a life insurance policy in her own name, the proceeds are included in her taxable estate upon her death [CITE]. If, however, she creates an irrevocable trust with the right language and cedes sufficient control over that trust, and the Trustee of that trust then purchases a policy of insurance on the grantor's life, when she dies, the proceeds of that policy will NOT be included in her taxable estate, but WILL be available to her beneficiaries [CITE].

It may be that ILITs have become less common as the Federal individual exemption has climbed, excluding many estates from the need for such planning.

Non-Farming Heirs

Life insurance, whether held in a trust or not, is a useful tool for balancing estates where there are non-farming heirs. Where the farmland cannot be liquidated because it is the basis for the ongoing farm operation, and the farm operating entity is owned and controlled mostly or entirely by the farming heir in order to give him or her sufficient autonomy to maximize the chance of business success, and there is not (as with most farm families) a pile of cash equivalent to the value of the land and the farm business to compensate the non-farming heir, the planning generation can purchase life insurance benefitting the non-farming heir for a much smaller amount of money than if they had to pay an equivalent amount of cash as the value received by the farming heir.

Another strategy, where the farmer has sole or majority management control of the farm operating entity, the latter can lease the farmland and the non-farming heirs can receive most or all of the cash rents.

Yet another strategy is to design the operating or trust agreement of the land-owning entity so that non-farming heirs have an equity interest in the land and perhaps the "hard" assets of the farming entity, but give the farming heir majority management control. In most cases it will be desirable to restrict the transfer of equity interests in the entity to close family members so the farm isn't threatened by a minority ex-spouse owner. On the other hand, giving the non-farming heirs an equity interest in the farm protects them in the event the farming heir decides to cash out and look for an easier way to make a living.

III. Qualified and Non-Qualified Savings Accounts

In the old days (say, the first few decades after World War Two), large employers offered "defined benefit" retirement plans, known as pensions. The benefits were "defined" because they were known in advance, as in a formula like this: "work for our company for thirty years, and when you retire, we'll pay you 65% of your salary every year as long as you live."

In 1978 Congress added Section 401(k) to [26 U.S. Code s. 401] in 1978. In 1981, the IRS approved an innovative plan by a Pennsylvania financial advisor that allowed employees of his client's businesses to contribute to the company's retirement trust fund out of their salaries, thus reducing their current income tax; and allowed the employer company to match the employee's contribution, thus reducing its own taxable corporate income.[1] Plans under Section 401 became known as "defined contribution" plan, because the law limited the amount employees and employers could put in each year, but the result – how much money a given employee would have in retirement – was unknown.

By 1997, the amount of money managed in defined contribution plans exceeded that managed by pension plans.[2] The most common plans today are employer 401(k)s and Individual Retirement Accounts (IRAs), although there are many other flavors of defined contribution plans, such as 403(b)s established by public and non-profit employers.

Another distinction often bandied about is that between "qualified" and "non-qualified" retirement vehicles – or more precisely, the money saved in these vehicles, since some of them can contain both types of money. "Qualified" plans are those defined as such in Section 401. "Qualified" money is – in almost every case - money on which the future retiree has not yet paid income taxes, as in the payroll deductions invested in a 401(k). Nonqualified money is that invested in a retirement vehicle AFTER the employee has declared it as income and paid taxes on it.[3]

"Qualified" plans have withdrawal rules, chiefly that one cannot (in most cases) withdraw money before age 59.5 without paying a ten percent penalty, and that one MUST begin withdrawals at age 70.5 or face a fifty percent penalty. In return, their chief advantage is that income and capital gains taxes are deferred until the money is actually taken out. Nonqualified accounts "are usually

---

[1] http://www.inc.com/encyclopedia/401k-plans.html
[2] Id.
[3] http://www.theproadvisor.com/FinancialAdvice/qualified-non-qualified-roth-difference

annuity or life insurance strategies that insurers offer as an alternative or supplement to qualified plans."[4]

"Roth" IRAs and are defined in Section 408A and the Treasury Regulations interpreting them. They are funded with post-tax contributions, and have annual limits on those contributions (defined contribution, remember?) but also allow growth and income to be deferred until withdrawal, and also have no withdrawal age limitations. There are also "Roth" 401(k)s.

Finally, there are "self-directed" IRAs and 401(k)s which can be used to hold businesses and investment assets.

Retirement benefits, and estate planning with them, is a very complicated topic. Perhaps fortunately, they are very common among middle-class Americans who have been employees all their lives, but do not often represent a large portion of the estates of self-employed farmers. Lawyers and other service providers wishing to become proficient with retirement asset planning should begin with Life and Death Planning for Retirement Benefits by Boston lawyer Natalie Choate.

IV. Homestead Exemption and Capital Gain / State level issues involved in transferring an interest in real estate to an LLC

- One needs to be very careful before deciding to transfer real estate that constitutes the residence or homestead to an LLC. By doing so, the client exchanges real property for intangible personal property (LLC membership units). This may cause them to lose the personal exemption for income tax on capital gain contained in 26 U.S.C. s. 121.
- By turning real estate into intangible personal property, they may also subject out-of-state real estate to estate taxes in the State where they die, because intangibles are deemed located in the situs where you reside [CITE].
- Finally, some states (such as New Hampshire) extend the exemption from Medicaid estate recovery to the land on which the homestead of a community (non-nursing home) spouse lives, even if that land is a 400-acre farm worth several million dollars, as long as the residence and the farm are owned by the spouse and the applicant in their own names. If they have converted them to intangible personal property by transferring title to an LLC, there is NO exemption and the State can force the farm and farmhouse to be sold to reimburse the state for the cost of the nursing home spouse's care.

[4] http://www.investopedia.com/ask/answers/206.asp