Structuring Lifetime Transfers of Farm Ownership Interests

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I. Why would you want to make a lifetime transfer?

- Ease transition of farm management to next generation / successors
    - Get the successors involved by making transfers of partial ownership interests during lifetime
        - Slowly transitioning more responsibility to successors re: every day management of the farm
        - Take advantage of annual exclusion gifting and valuation discounts
        - Transferor can still retain some control while providing guidance to successors (ex. retain role as LLC manager even if no/reduced ownership in LLC; consulting agreement)
    - Structure the deal in a way that provides transferor will retirement income they will need
    - Reward children/key employee (successors) for efforts already provided
- Can be more complicated to implement transfer upon death
    - Probate administration for individually owned farm assets
    - Assets owned at death will be includable in gross estate and may trigger requirement for decedent's estate to pay estate taxes
    - Potential for family dysfunction if transfer handled by others (fiduciaries) in probate or trust setting
- Avoid / minimize concerns re: potential erosion of assets due to need for long term health care
    - Improve transferor's ability to qualify for Medicaid

II. What is being transferred?

- Transfer of Real Estate vs. Business Entity
    - Real Estate – Issues that arise upon a fractional gift
        - Rights of Partition
            - Fractional owners of an interest in real estate cannot be forced to continue to own that interest if they do not wish to do so
            - Any owner can petition the court to partition the real estate
                - Partition in Kind = court physically divides the real estate amongst the owners

        - Partition by Sale = court forces property to be sold and divides net proceeds amongst the owners
    - No centralized management
    - No protection from creditors of owners of the real estate
    - No restrictions on owner's ability to transfer their interest during lifetime or upon death
        - Exception: Right of First Refusal
    - Cost of additional deeds and recording fees for series of gifts becomes excessive.
    - Possible confusion or defect in title on land records arising from series of fractional interests. In successive years need to be careful to clarify when gifting an additional fractional interest whether such fraction applies to the whole, or whether it is a percentage of the remaining share held by the grantor.
  - Business Entity – Issues that arise upon gift of a partial interest
    - Rights granted under governing documents (LLC Operating Agreement, Corporate Bylaws, Buy-Sell Agreement)
        - Provides rules for management of the entity
        - Ex. Who is in charge, who is responsible for debts and expenses, when and how any distributions are to be made, restrictions on transferability during lifetime and/or upon death or incapacity, etc.
    - LLC Managers vs. LLC Members
        - Donor can still be manager even if not owner of membership interest
        - Retain right to control / be involved in running of the farm
        - Consulting agreement; provide source of income to donor even if no longer directly own the farm
    - Voting Rights
    - Creditor protection
        - Need to abide by business entity formalities to avoid "piercing of the veil"
        - Ex. Holding annual meetings, establishing a separate bank account for the entity, etc.
- Acquiring Assets vs. Business Ownership Interests
  - Buyers typically prefer asset purchase
    - Tax regulations permit buyer to "step-up" tax basis of purchased assets to reflect the purchase price, resulting in bigger depreciation and amortization deductions.
    - Limits buyer's exposure to undisclosed or unknown liabilities of the business (if entity purchase, liabilities generally transfer to buyer)
    - Seller taxed at higher ordinary income tax rates
  - Sellers typically prefer entity purchase
    - Seller's proceeds are taxed at a lower capital gains rate
    - Buyer loses ability to gain stepped-up basis

    - Allocation of purchase price among assets, including intangibles, and other contractual obligations

III. Valuation Discounts

- Lack of marketability
    - Takes into account the fact that an owner of an interest in a nonpublicly traded entity will have more difficulty finding a willing buyer.
    - Ex. An interest in a family held LLC or LLP. Very little market for these types of interest, and usually only willing buyers of the interest are other family members.
- Lack of control (a.k.a. minority interest)
    - Appropriate when the holder of the interest does not have the right to decide:
        - When distributions of earnings will be made,
        - When the entity will be liquidated, OR
        - Other issues that affect the financial benefits of ownership.
    - Ex. Individual only owns a 5% ownership in an LLC, and/or the ownership interest is "economic only"(no right to participate in management of the LLC).
- Fractional interest
    - Takes into account that it may be difficult to find a willing buyer for only a fractional interest in an asset.
    - Often seen in the context of real estate.
    - Ex. Four siblings inherited a piece of real estate from their parents such that they each own ¼ of the property. If a sibling wants to sell their ¼ interest, it would be difficult (if not impossible) to find a third party who wants to purchase their interest in the property.

IV. Impact on Medicaid Eligibility

- 5 year lookback
    - When evaluating applicant eligibility for Medicaid, State reviews financial statements or other documents reflecting ownership of assets for 5 years prior to date of application
    - Imposition of penalty period for transfers (for less than fair market value) of assets within 5 year lookback
- Penalty period
    - Ineligible for Medicaid benefits during term of penalty period
    - Best to await expiration of lookback period before applying for Medicaid
    - Begins on the day applicant is otherwise eligible; not from date of transfer.
    - Calculation of penalty period:
        - Property transferred ÷ average monthly cost of private pay nursing home ($13,512 in CT) = Months ineligible for benefits
- Exceptions:
    - Transfers to:
        - Spouse
        - Blind/disabled child or trust for the benefit of blind/disabled child
    - Transfer of Primary Residence:

        - Children under age 21
        - Sibling with equity interest in home and residing there for at least 1 year before application
        - Child caregiver = child residing in home at least 2 years immediately prior to institutionalization and who provided care for the applicant that permitted applicant to remain at home during that period
- Annual Gift Exclusion – still a problem for Medicaid
    - Gifts of less than $15,000 per year per done = no gift tax
    - BUT…still incurs penalty period for Medicaid eligibility purposes

V. <u>Gifting to Irrevocable Trusts</u>

- Remove assets likely to appreciate from gross estate
- Primary advantage of gifting to an Irrevocable Trust is the resulting control by the trustee over the gifted asset. Useful if there is potential for dysfunction of donees.
- Gift of asset (ex. Life insurance policy, real estate) plus lump sum of cash to pay for premiums, carrying costs, etc.
- Intentionally defective trusts; allows grantor to continue to shoulder income tax burden
- Comparison to LLC
    - Less flexibility to modify terms of governing document.
        - Hard to predict and provide for the future needs of the family.
        - Not all states have "decanting" statutes that allow trustees to modify the terms of the trust.
    - Possibly subject to highest marginal income tax bracket
        - Can control by making distributions
    - Democracy versus Dictatorship
    - Trusts provide beneficiaries with less current vested property rights; need to evaluate whether such is desirable or not.

VI. <u>Importance of Abiding by Administrative Requirements</u>

- When gifting business interests, make sure to issue new stock certificates or LLC membership certificates to evidence transfer
- Filing Form 709 for gifts over $15,000 ($30,000 for married couples)

VII. <u>Timing of Gifting</u>

- Year end gifts; simplifies ownership changes for accounting purposes

VIII. <u>Annual Gifting Schedule</u>

- Maximize use of annual gift exclusion
- Gifts of less than $15,000 per year per done = no gift tax; no requirement to file gift tax return
- Couple with valuation discounts when gifting interests in real estate or business entity to decrease valuation of gift given and maximize annual exclusion amount

IX. <u>Equality vs. Equity</u>

- If all farm passing to one child, compensate by directing other assets pass to non-farm children?
- If insufficient assets to achieve equity, consider purchasing life insurance policy to provide additional liquidity.

X. Role of Trustee / Agent under Power of Attorney

- Ability to continue gifting programs even after settlor's/principal's incapacity
- Document should specifically recite power of fiduciary to make gifts.

XI. Conflict of Interest

- Potential conflict of interest if same attorney representing both donor and donee
- Tax impacts for donor different for donee
  - Can you zealously advocate for one position that is detrimental to other other side while representing both sides?
- Options:
  - Have both sides execute a Waiver acknowledging the conflict but still agreeing to the joint representation
  - Serve as scrivener to memorialize terms of the deal but then have parties have documents reviewed by their own counsel

XII. Impact of Lifetime Gifting/Transfers on Estate Planning Documents

- Advancements language in Will / Trust
  - Take into account lifetime gifts prior to dividing assets owned at death amongst beneficiaries.
  - Ex. If Will provides all assets pass to the three children in equal shares, and gifted real estate to Child 1 during lifetime, Child 1's share of the estate passing under the Will is reduced by the amount of the lifetime gifts and instead passes to other children.
- Remove specific bequests/devises in Will or Trust if those assets were already grifted or transferred during lifetime
- Transfer of complicated assets (ex. business interests, farm real estate) during lifetime may allow for overall estate plan to be simplified

XIII. If gifting assets, be wary of the Gift Tax.

- Gift tax only arises if value of gift exceeds exemption amount
- Value of the gift will depend on how gift is structured
  - Full gift
  - Part gift / Part sale
- Federal and State gift tax
  - Federal exemption for 2021 = $11.7M
  - Currently only state with state gift tax is Connecticut
- **Gift Tax Returns (Form 709)**
  - When you need to file
    - Gifts in amounts above the annual exclusion

        - The IRS permits individuals to make a gift of $15,000 per year, per recipient ("annual exclusion") without being subject to a gift tax.
            - Married couples can combine their annual exclusion and gift $30,000 per year, per recipient (see discussion below on gift splitting).
            - If you give a gift(s) to a recipient valued at over $15,000 over the course of one year, then the gift(s) needs to be reported to the IRS on a Form 709.
        - Exceptions
            - Gifts to spouse
                - Marital deduction also applies to gifts.
                - You can give an unlimited amount of gifts to your spouse without the need to report the gifts.
            - Transfers to political organizations
            - Transfers to charities (so long as all requirements for charitable gifts are met)
            - Payments that qualify for educational exclusion.
                - Payments <u>made directly</u> to a qualifying educational institution as tuition for an individual.
                - Payments made to the individual for the purpose of paying for tuition, books, room and board, etc. do not qualify.
            - Payments that qualify for medical exclusion
                - Payments <u>made directly</u> to an institution that provides medical care to an individual or to a company that provides medical insurance to an individual.
                - Payments made to the individual for the purpose of paying medical costs do not qualify.
    - Gifts of future interests not subject to annual exclusion
        - The annual exclusion is only available for gifts of a <u>present</u> interest in property, which is defined as "[a]n unrestricted right to immediate use, possession, or enjoyment of the property or the income from the property."
        - If the recipient does not have complete use and enjoyment of the gift until some future point in time, it's a future interest gift.
        - Ex. Deeding a piece of real estate to your child while reserving a life use (a.k.a. life estate) for yourself.
        - If the gift is of a future interest, the full value of the gift is to be reported as taxable.
    - Gift-splitting between spouses
        - Gift splitting is a rule that permits a married couple to split a gift's total value as if each spouse contributed half the amount.

            - Ex. Husband makes gift to child of $30,000. Husband and Wife each file a Form 709 splitting the gift so that each spouse is treated as having made a $15,000 gift to child. The entire amount of the gift is excluded from taxation as it falls within Husband and Wife's annual exclusions.
            - Gift splitting treatment is not automatic. Each spouse needs to file a Form 709 to get the benefit of gift splitting. This is true even if the total amount of the gift is not taxable.
            - In order for gift splitting to apply:
                - Gift needs to be to a third person (not a gift to spouse)
                - Both spouses must be US citizens or residents at the time of the gift
                - Spouses must be married at the time of the gift, and must not divorce and remarry before the end of the year
                - Both spouses must consent to the gift split on the Form 709
    - <u>Who should file a gift tax return (Form 709)</u>
        - Individuals
            - Spouses cannot file joint return; each spouse files own return
            - Trusts/estates/partnerships/corporations do not file
            - Individual beneficiaries/partners/shareholders would be liable for any gift taxes
        - If you die before the return is filed – executor/administrator of your estate must file
    - <u>Effect on remaining Estate tax exemption</u>
        - If taxable gift made in amount less than available exemption, then no tax is due to the IRS.
        - The value of the gift simply reduces the amount of your applicable estate tax exemption by the amount of the gift in excess of the annual exclusion.
        - Every individual can gift up to $11,700,000 during their lives without having to pay any gift tax.
        - If you use your full exemption during your life (i.e. make $11,700,000) of lifetime gifts, your entire estate will be taxable upon your death as you will have no remaining estate tax exemption.
- Pros and Cons of lifetime gifting above annual exclusion
    - PRO – Removes property from your estate that is likely to appreciate
        - Ex. You own real estate that is currently valued at $500,000. Over the next 10 years, the value is expected to appreciate to $1,000,000.
        - If you gift the property now, you have reduced your available exemption by $500,000 (minus the $15,000 annual exclusion). But if you then pass away 10 years from now when the property is worth $1,000,000, you have effectively removed $500,000 from your estate tax free.

    - CON – If the estate tax exemption continues to increase with inflation, you may regret gifting now. You could have retained control and access to those assets and your estate may still not have to pay an estate tax.
        - The income tax basis of the gifted asset in the hands of the donee is the same basis as the donor had at the time of the gift (‘carryover basis”). Lifetime gifting misses the opportunity for a change in income tax basis at death.
- Valuation
    - IRC § 6501 – Statute of Limitations (SOL)
        - This may sound obvious, but when you make a gift, you have assigned a value to it.
        - The IRS has the right to question whether the value you assigned to the gift was accurate.
        - If you have not filed a Form 709, the IRS can audit you at any time and potentially assess taxes and penalties. If you fail to file a return, then there is no limit on how long the IRS has to do so.
        - If you file a Form 709 to report the gift, the IRS only has a 3 year window in which they can review the accuracy of the gift (i.e. 3 year Statute of Limitation - SOL).
            - If no audit is commenced within 3 years, the IRS is foreclosed from ever reviewing the accuracy of the gift.
            - However, “adequate disclosure” is required to start 3 year SOL.
        - Adequate disclosure
            - Form 709 must include:
                - A description of the gifted asset.
                - The relationship between the donor and the donee.
                - A statement describing any position taken on the Form 709 that is contrary to any Treasury regulations or IRS revenue rulings.
                - A <u>qualified appraisal</u> (as performed by a <u>qualified appraiser</u>) OR a detailed description of the method used to determine the value of the gift.
                - It must also disclose whether the value of the gift reflects a valuation discount, and, if so, to attach an explanation (see discussion below on Valuation Discounts).
            - Qualified appraisal – An appraisal that:
                - Is treated as a qualified appraisal under Treasury regulations, and
                - Is conducted by a qualified appraiser in accordance with generally accepted appraisal standards.
            - Qualified appraiser – An appraiser that:
                - Has earned an appraisal designation from a recognized professional appraiser organization, or has met

otherwise met minimum education and experience requirements as set forth in the Treasury regulations,

- Regularly performs appraisals for which he receives compensation, AND
- Meets any other prescribed requirements.