



ESTATE PLANNING CONSIDERATIONS



- THE PROCESS
- AVAILABLE TOOLS
- GENERAL PROBLEMS
- SUGGESTED SOLUTIONS

RON ANDERSON
Resource Economist
Cooperative Extension Service

DAVID SAXOWSKY
Attorney and Assistant Professor
Agricultural Economics Department

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**COOPERATIVE
EXTENSION
SERVICE** 

North Dakota State University Fargo, North Dakota 58105

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The material in this publication is not intended to serve as a substitute for sound estate planning advice. Its purpose is to serve as a nontechnical summary of the estate planning process and some of the more pertinent Federal and North Dakota Estate Tax Laws. It is strongly recommended that you see your attorney for additional interpretation and sound legal advice.

I. BASIC ESTATE PLANNING CONSIDERATIONS

A. INTRODUCTION

Between the ages of 25 and 65 we spend approximately 80,000 hours building an estate through hard work and sound management. We want to enjoy and use our property both before and after our retirement, and, at our death, to have our estate transferred to the next generation. Yet, we often neglect to spend a sufficient amount of time planning for the enjoyment, use and orderly transfer of our estate.

This publication will acquaint the reader with some of the problems, opportunities and tools associated with estate planning. It is meant to serve as a non-technical reference, not to advise, but rather to inform and help individual families make better use of professional advice. Since resolution of specific problems depends on the circumstances of each individual situation, ALL families are strongly urged to seek advice from competent professionals throughout the estate planning process.

B. WHAT IS ESTATE PLANNING?

Estate planning is a broad and complex subject. It is not something we do once and then forget. Also, estate planning should not be postponed with the idea of doing it when we are older. It is a lifetime process of accumulating property, enjoying that property, and then taking steps to eventually distribute that property to our heirs, either before or after our death.

Estate planning should be included as part of our on-going financial management program because many of the decisions we make now will some day affect the eventual transfer of our estate. For example, if we buy a quarter of land tomorrow, the decision we make tomorrow on how we are going to own that quarter (sole owner, tenants-in-common, etc.) could eventually affect the cost and ease of passing that property to our heirs. Also, some of the gift options available for substantially reducing the size of our estate and the related estate tax consequences are lost if we don't use them during a specific period of time.



C. WHO SHOULD PLAN?

Every property owner can benefit from estate planning regardless of age or size of estate. Without planning, estates both large and small can be quickly eroded and not meet the needs of the families involved. Planning for small estates is important because fewer resources are available to provide for retirement income and to meet other family objectives.

D. WHY IS PLANNING IMPORTANT?

Many individuals tend to avoid thinking about death and find it easy to postpone planning. Yet, the returns from developing an adequate estate plan can come back to us manifold in the form of dollar savings. This is especially true at present because of two factors—the progressive nature of the estate tax and inflation.

The progressive nature of the estate tax dictates that as the value of our estate increases, a larger proportion of the estate may be needed to pay the tax. During a period of inflation the value of our estate can increase tremendously even though the estate has not materially increased in size. For example, at a modest inflation rate of around 7 percent, the value of our property doubles every 10 years. Consequently, many families have moved from a position with relatively few tax problems to one where they now have severe estate tax problems.

Returns from developing an adequate estate plan also include a sense of accomplishment and peace of mind. Survivors' concerns over taxes, settlement costs, and property transfer procedures can be significantly reduced by planning to reduce uncertainty and ease read-

justment. Careful planning will also ensure that all monetary and non-monetary objectives are realized.

To obtain the maximum benefit, planning must be done before either spouse passes away. Once the first spouse is gone, much of the flexibility available in estate planning is gone.

Finally, recent changes in Federal Estate Tax Legislation do not eliminate the need for estate planning. If inflation continues at its present rate it will soon erode the increased estate and gift deductions. Also, estate planning is concerned with addressing a number of other problems which, in some cases, are more important than having to pay unnecessary estate or gift taxes.

II. THE ESTATE PLANNING PROCESS

Estate planning normally involves a series of steps. First, we must determine what planning objectives are important to meet the unique needs of our family. Next, we must inventory our estate and determine the settlement costs and liquidity needs under our present plan. Knowing how we own property and the consequences of various ownership methods is part of this process.

Once we know our present situation we need to examine available estate planning tools and methods to determine if our present plan or a new plan will allow us to more effectively meet our planning objectives. Finally, our completed plan must be reviewed periodically and updated to account for changes in legislation and changes in our family situation.

A. OBJECTIVES OF AN ESTATE PLAN

The first step in the estate planning process is determining the objectives to be accomplished. Objectives must be clearly defined so that possible conflicts can be resolved and a set of priorities established.

Determining relevant objectives should be a family affair. This is not an easy task to accomplish. It's difficult for a son in business or farming with Dad to initiate such a discussion. Yet his parent's estate plan can significantly affect his future.

It's equally difficult for Mom and Dad to invite the children home to discuss how best to distribute the parents' estate after they're gone. However, if this task can be accomplished, the family has come a long way in establishing a plan that will eventually meet most of their individual needs.

Following is a list of objectives many families find important. The order does not reflect degree of importance. This must be established for each family situation.

Possible Estate Planning Objectives

- 1) Provide for an adequate retirement income for the parents or surviving spouse. This is often considered one of the most important objectives. Those who have worked hard to accumulate property and other wealth should have first claim to benefits received from the property. Keep in mind that continued inflation will increase your retirement needs. What you think is adequate by today's standards may not be 10 years from now.
- 2) Provide financial protection for younger children who are not yet established, or who may not yet have finished their education.
- 3) Maintain an efficient farm or business unit and keep that business in the family. One way to insure that this happens is to gradually transfer the assets to the operating heir over a period of years. This can be done through partnership agreements, forming a corporation, or utilizing a combination of gifts and sales. Experience has shown that the sooner the operating heir gets control of the property the better chance it has of staying efficient and in the family. Also, the estate tax consequences can be substantially reduced thereby solving part of the liquidity problem.
- 4) Minimize state and federal estate and gift taxes along with the estate's income taxes. While it may not be possible to eliminate all taxes, it is generally possible to significantly reduce them by careful planning.
- 5) Reduce legal fees, probate and other costs.

6) Treat children equitably though not necessarily equally. In some cases, the operating heir has actually helped increase the size of the parent's estate. It may not be fair for that person to receive a share equal to other heirs not directly involved with the business. In other cases, the operating heir may have been able to build a substantial estate of his own due largely to special help and guidance from the parents.



- 7) Reduce property management responsibilities. A surviving wife with young children may not want to manage the family business in addition to raising a family. Business management responsibilities could be transferred to a trust, the widow could receive the income from the business and concentrate fully on family responsibilities. Reducing managerial responsibility may also be an objective for retired persons.
- 8) Limit the power of successor spouse on remarriage. Remarriage and subsequent estate plans could actually disinherit children from property acquired during the original marriage. This can be prevented by adequate planning.
- 9) Reduce ill feeling among heirs. Bitterness from family disagreements can remain throughout a lifetime. A well reasoned plan, made known to and even agreed upon by family members, can do much to eliminate this possibility.
- 10) Avoid forced sales. Planning can reduce estate erosion caused by part of the business having to be sold to meet settlement costs. Also, having no plan could result in heirs not involved with the family business insisting it be liquidated so they can receive their inheritance.

This list contains only some of the more common estate planning objectives. It should be emphasized that each family situation is unique, and planning priorities will differ considerably among different families.

B. PROPERTY INVENTORY

The second step in estate planning is to determine what property will be included in the estate. In general, if property of any kind has value and is owned or controlled by you at death, that property will be included in your estate for tax calculation purposes.

All property must be valued at its fair market value in the inventory process. However, where real property devoted to farming or other closely held businesses is concerned, we can also use the "current use value" method of valuation.

Current Use Valuation

The "current use value" is determined by dividing a five-year average of cash rent for comparable land minus property taxes by the effective Federal Land Bank interest rate. If cash rent information for comparable land is not available, net share rent for comparable land may be used. Net share rent is the value of the produce received by the landlord in a share crop rental minus operating costs of raising the produce which the landowner paid according to the lease arrangement.

The advantage of using this method is that if the current use value is less than the fair market value, the real property will be included in the decedent's gross estate at the lower current use value. There is a limit to the amount which an estate can be reduced by using current use valuation. For decedents dying in 1981, the limit is \$600,000. This increases to \$700,000 for persons dying in 1982 and to \$750,000 for 1983 and thereafter.

To qualify for current use valuation, numerous pre-death and post-death requirements must be met. The general requirements listed below are explained in more detail in Appendix A.

1. At least 25 percent of the gross estate (net of mortgages) must be “qualified” real property.
2. The property must pass to a qualified heir.
3. The real property must have been used for a qualified use by the owner or a member of the owner’s family five of the last eight years before the death of the owner.
4. The owner or a member of the owner’s family must have materially participated in the operation of the farm or business five of the eight years before the death of the owner.
5. For 10 years after the death of the owner, the tax benefits will be recaptured if the “qualified” property is sold to a nonfamily member or ceases to be used for farming or other closely-held purposes. A special lien is placed on the property to back up the recapture role.

The new law also stipulates that for purposes of determining eligibility for current use valuation, all property transfers within three years of death will be included in the gross estate at their date-of-death value. Because of these and other requirements for current use valuation, all persons intending to use this method are urged to seek the advice of someone competent in this area.

Inventory Sheet

The last page of this publication contains an estate inventory form. By completing the form, you will get a approximation of the total value of your estate, the state and federal estate tax due, and additional liquidity that may be needed to pay estate settlement costs and avoid a forced sale of fixed assets.

C. PROPERTY OWNERSHIP

Knowing how property is owned is essential, because the type of ownership often dictates how property can be transferred and how it will

be taxed upon the death of the owner. The more common forms of ownership are sole ownership, a life estate, tenancy-in-common and joint tenancy with the right of survivorship (JTWS).

Sole Ownership

Under sole ownership, one individual has full title to the property. The sole owner can sell, mortgage, or otherwise dispose of the property during or after his lifetime. The sole owner can convey parts of the property during or after his lifetime. The sole owner can convey parts of his interest in the property completely or with conditions attached.¹ An example of this is a life tenancy or life estate.

Life Estate

A life estate can be created by will or deed. The property owner draws up a will in which a “life tenant” and “remainderman” are named. Upon the death of the property owner, the life tenant receives the right to use the property for the remainder of his or her life. Upon the death of the life tenant, complete ownership of the property passes to the remaindermen. A life estate can also be put into effect before the death of the property owner with the owner named as one of the life tenants.

The creation of a life estate can have a number of different tax consequences.

1. If the owner of the property wills a life estate to someone and the remainder interest to a third party, the full value of the property is included in owner’s estate for estate tax purposes. However, when the life tenant subsequently dies, none of the property is included in the life tenant’s estate for estate tax purposes.
2. If the owner of the property creates a life estate during his lifetime for someone other than himself and grants the remainder interest to a third party, the entire transfer is subject to a gift tax. However, none is included in the owner’s estate for tax purposes nor in the life tenant’s estate when the life tenant passes away.

¹Exceptions to this control may vary depending upon state regulations regarding a possible homestead exemption, exempt personal property, the spouse’s elective share, and mandatory support for survivors during the settlement period.

3. If the owner of the property, during his lifetime, reserves a life estate for himself for the rest of his life and grants the remainder interest to someone else, the remainder interest is a gift for tax purposes. Also, upon the owner's death, the full value of the property is included in his estate for tax purposes.

ADVANTAGES

- 1) A life estate can be used as a means of providing support for the surviving spouse and to assure other heirs of the eventual transfer of the business to them.
- 2) There is no probate when the life tenant passes away.

DISADVANTAGES:

- 1) If the income from the life tenancy property is insufficient, the life tenant cannot sell a portion of the property or borrow against it. These types of decisions can only be made jointly by the life tenant and the remaindermen. If the remaindermen are minors, additional problems are created.
- 2) The life tenant can sell the "right to use" the property, but the buyer has that right only as long as the life tenant is alive. Upon the life tenant's death, the ownership passes to the remaindermen.
- 3) Because the surviving spouse or life tenant never gets complete ownership of the property, it does not qualify for the marital deduction. This important deduction will be explained later. However, there are ways in which we can take full advantage of the marital deduction and still use the life estate as a method of transferring part of the property.
- 4) A life estate could delay the transfer of property for a considerable length of time. If the life tenant lives to be 70 or 80 years old, the remainderman won't get complete control of the property until he or she is 50 to 60 years of age. This may conflict with reaching the objective outlined earlier of getting the property to the operating heir as soon as possible.
- 5) A life estate does not insure quality management of the estate property. If this might be a problem, a trust arrangement should be considered to insure quality management along with adequate income to the surviving spouse. The trust could be authorized to use part of the principal each year if the income is not suffi-

cient to maintain a certain level of living. It is possible for the surviving spouse to serve as co-trustee. The amount of power given the surviving spouse as co-trustee would depend on the purpose of the trust. More on this later.

Tenancy-In-Common

If two or more individuals own property as tenants-in-common they have an undivided interest in the property. This type of ownership can be created by deed, will or inheritance laws. All co-owners have equal property rights and together can sell, mortgage, lease, manage and divide the income from the property.

An individual co-owner has these same rights pertaining to his undivided share. If one of the owners wants to terminate the arrangement, they can sell the property and divide the proceeds. They can also simply divide the property, exchange deeds, and remove the property from co-ownership. One co-owner can force division or sale if he wants out and the others do not. Upon the death of one co-owner, his or her share becomes part of his or her estate and goes to the designated heirs, not to the other co-owners.

ADVANTAGES:

- 1) Tenancy-in-common is a more flexible form of ownership than JTWS or a life estate. With this form of ownership it is possible to take greater advantage of trusts and other tools to reduce estate taxes.

DISADVANTAGES:

- 1) Without a will, tenancy-in-common property will be distributed as dictated by state succession laws.
- 2) Management, sale or mortgaging can sometimes be a problem, depending upon the compatibility of co-owners.
- 3) When a tenancy-in-common is created, a gift may result unless each owner contributes a portion of the acquisition cost equal to the portion of property received by the co-owner. Such gifts between spouses qualify for the unlimited marital gift deduction (see Page 20).
- 4) It may be difficult to prove a tenancy-in-common relationship if income from the property goes entirely to one person.

Joint Tenancy With Right of Survivorship (JTWS)

If two or more people own property as JTWS, they also have an undivided interest in the property. However, two or more individuals wishing to enter into a joint tenancy agreement must take the necessary legal steps to do so—it can't happen automatically like tenancy-in-common. JTWS requires specific wording to be valid. The suggested form is "to John Doe and Mary Doe, husband and wife, as joint tenants, and not as tenants-in-common, with the right of survivorship."

Upon the death of one of the joint tenants, his or her share becomes the property of the remaining joint tenants named in the original agreement. The property does not go to the designated heirs as is the case with tenancy-in-common property.

ADVANTAGES:

- 1) The primary advantage of JTWS ownership is that there are no delays in transferring property when an estate is being settled. Ownership of the property is transferred immediately to the other co-owner(s) by operation of law.
- 2) JTWS property is not subject to probate proceedings and probate costs. Costs of transferring JTWS property (aside from estate taxes) range from one-fourth to one-third the cost of transferring property through probate.
- 3) Joint tenancy between spouses can be a good way to own property if the estate is small and not subject to federal estate taxation.

DISADVANTAGES:

- 1) Once the JTWS agreement is in effect, that portion of a will drawn up by one of the joint tenants pertaining to the distribution of his or her share of the JTWS property would have no effect on the distribution.
- 2) Generally speaking, the JTWS agreement cannot be broken unless all joint tenants agree to dissolve the agreement. If an agreement cannot be reached the property can be partitioned through the courts.
- 3) JTWS ownership does not allow for maximum advantage to be taken of the estate planning tools to reduce estate taxes. Lack of flexibility is especially a problem for estates subject to federal estate taxation.

- 4) Owning property as a JTWS does not eliminate the need for a will. A will is needed to direct the distribution of property not owned as a JTWS if the owner is not satisfied with the distribution dictated by the State's intestate succession laws. Likewise, the last surviving joint tenant is the sole owner of the JTWS property. Upon the owner's death, the property will pass according to the State's succession laws or the owner's will if one is available.
- 5) Estate taxes under JTWS may be higher than under tenancy-in-common. Taxing procedures for co-ownership property are outlined in the next section.



TAXING PROCEDURES — CO-OWNERSHIP

Estate and gift taxes are normally associated with the creation, dissolution, and transfer at death of co-owned property. However, the tax implications of these factors differ between tenancy-in-common and joint tenancy with the right of survivorship (JTWS).

In outlining these differences, two estate planning tools require explanation. These are (1) the annual gift exclusion which allows any individual to gift \$10,000 per person each year free of gift tax; and (2) the unlimited marital deduction which allows all lifetime and death-time transfers of property between husband and wife to pass without any gift or estate tax liability. Both of these tools will be explained in greater detail in a following section.

Tenancy-In-Common

Any tax liability in **creating** a tenancy-in common arrangement depends on (1) which co-owner furnishes the capital needed to buy the

property, and (2) the share of interest each co-owner acquires. The proportion contributed must equal the proportion owned to escape gift tax liability. If not, the person contributing a larger proportion of the capital than the proportion of property eventually owned is considered to have made a gift to the other co-owners. If this gift exceeds the \$10,000 annual exclusion, a gift tax will have to be paid. However, if the tenancy-in-common is created between only husband and wife, the unlimited marital deduction eliminates any gift tax liability regardless of the spouses' original contribution or ownership interest.

Dissolving a tenancy-in-common arrangement will not result in a gift tax as long as each co-owner's share of the property or proceeds after dissolution equals the share owned as a co-owner. If one co-owner receives less than his or her proportionate share, that person will be considered to have made a gift to the other co-owners. For unmarried tenants-in-common, the annual exclusion can be used to reduce any gift tax liability. When the tenants-in-common are husband and wife, the unlimited marital deduction eliminates any possibility of paying a gift tax.

At death, the share of property owned by the tenant-in-common will be included in his or her estate and will pass to the heirs by will or the state succession laws. If the heir is the surviving spouse, the unlimited marital deduction could be used to eliminate any estate tax liability.

Joint Tenancy With the Right of Survivorship (JTWS)

Creating joint tenancy ownership of property will result in a gift unless all co-owners contribute equal amounts of capital or property. If not equal, the co-owner contributing the greater amount will be considered as making a gift to the other co-owners. As before, the annual gift exclusion is available to reduce any tax liability between unmarried joint tenants. The unlimited marital deduction protects a married couple from any tax liability.

The one exception is the creation of a joint bank account or joint ownership of Federal government savings bonds. No gift is considered to have been made in creating these joint tenancy situations regardless of which joint tenant contributed the funds.

Dissolving a JTWS agreement results in a gift only if the co-owners receive unequal interests when the property or funds are divided. Any joint tenant receiving less than an equal share will be considered as making a gift to the others involved. If a gift is made, the annual exclusion and the unlimited marital deduction are available to reduce or eliminate any gift tax liability.

An exception again applies to bank accounts and Federal savings bonds. Dissolving these joint interests will result in a gift if the noncontributing co-owner withdraws the funds without an obligation to repay the account.

At death, the taxation of joint tenancy property is much more complicated than for tenancy-in-common property. The general rule is that the **entire** value of the joint tenancy property is automatically included in the estate of each joint tenant to pass away unless one of three exceptions apply.

1. **Surviving joint tenants can keep a portion of the JTWS property out of the decedent's estate by proving a valid contribution to acquiring the property. The proportion that will be excluded is the same proportion that the surviving joint tenants can prove they contributed. If contribution cannot be substantiated, the entire amount of JTWS property will be taxed according to the general rule. In the case of unmarried joint tenants, the payment of gift tax by the decedent at the creation of the JTWS does not allow the gift to be considered as a contribution by the surviving joint tenant.**
2. **If the co-owners received the joint tenancy property as a gift or inheritance, then each will be considered as owning only their share. When a joint tenant passes away, only that person's share will be included in that person's estate.**
3. **If joint tenancy property is purchased and owned by a married couple, the new law assumes the husband owns half and the wife owns half regardless of the spouse's contribution. When the first spouse passes away, only half of the property will be included in that person's estate. Also, with the new unlimited marital deduction, the half included in the estate of the first spouse to die will pass tax-free to the estate of the surviving spouse.**

Even with these exceptions, the overall tax consequences of JTWRs ownership can be severe. Regardless of how successful the surviving spouse is in excluding JTWRs property from the estate of the first joint tenant to die, the TOTAL amount of property ends up in the estate of the surviving joint tenant. Even though there could be little or no tax at the death of the first joint tenant, the entire amount of JTWRs property is going to be taxed when the last joint tenant passes away. In the case of a married couple, this estate has the least exemptions because the marital deduction no longer applies.

As pointed out earlier, JTWRs between spouses may be fine when there is limited wealth. However, when the size of the potential estate becomes large enough to be taxed on a federal basis, JTWRs often results in paying unnecessary estate taxes. If a married couple's net worth is in the \$600,000 range and up, future property purchases probably shouldn't be put in joint names.

D. YOUR ESTATE FOR TAX PURPOSES

Once the estate planning objectives have been established and the inventory completed, steps can be taken to estimate the estate tax implications of alternative plans.

The gross estate generally consists of the following items:

- 1) **All property owned as the sole owner.**
- 2) **All property owned with someone else, including that share owned as a tenant-in-common, 50 percent of the JTWRs property when the first spouse passes away, and in the case where the joint tenants are not married, all of the jointly owned property less the value of any portion that can be proven to have originated with another co-owner.**
- 3) **All proceeds from life insurance policies over which the deceased had any incidents of ownership or which are payable to the estate. The incidents of ownership include the powers to change the beneficiary, borrow against the policy, select the settlement method, and the power to surrender the cash value.**

- 4) **The value of any property transferred at any time prior to death where the owner retained the use, enjoyment or income from the property at the time of death.**
- 5) **Property over which the person passing away has a power of appointment (see page 28).**
- 6) **For estates of persons dying after 1981, all taxable gifts are included back into the estate at their date-of-gift value. However, gifts involving retained interest made within three years of death come back into the estate at their date-of-death value. These include transfers where the giver gave up the FINAL interest in property which had previously been transferred with some interests retained. Examples include revocable transfers, transfers with a retained life estate, property containing a retained general power of appointment, etc.**

These gifts include all transfers not covered by the \$10,000 annual gift exclusion except for the following exceptions:

- a) **If the \$10,000 was used to gift a portion of the "cash" value of a life insurance policy, the \$10,000 gift is automatically returned to the estate unless the giver lives more than three years after making the gift.**
- b) **Any gift for which a gift tax return is required. In terms of the annual \$10,000 exclusion, this might hold true where the husband owns all of the property, but elects to use his wife's \$10,000 exclusion to make a total "tax-free" gift of \$20,000. To keep the entire amount out of this estate, he may have to live three years after making the gift.**
- 7) **All gift taxes paid within three years before the giver's death.**
- 8) **All annuities and supplemental contracts.**

Deductions

Allowable deductions, exemptions and credits subtracted from the gross estate to determine the net taxable estate include the following:

- 1) **Debts, funeral expenses, costs of the last illness, costs of administering the estate, and theft and casualty losses during the estate settlement period.**

- 2) **Money or property left to charitable, religious and educational organizations.**
- 3) **A marital deduction for a portion of or all money or property passing without reservation to the surviving spouse. The Economic Recovery Act of 1981 expanded the options for using this valuable planning tool. These changes are outlined in the following section.**

Unlimited Estate Marital Deduction

After 1976 and through 1981, a surviving spouse could receive the greater of \$250,000 or one-half of the decedent's adjusted gross estate tax free, if received in such a manner that the property would be included in the surviving spouse's estate. The adjusted gross estate is the total estate minus the costs listed in Item 1 of the previous list of deductions.

The 1981 act repeals these limits. For example, if the husband wishes to transfer all of his property to his wife at death, the entire estate can be transferred under the new unlimited marital deduction without paying any estate tax.

However, the new unlimited marital deduction which went into effect in January of 1982 does not eliminate the need to plan. First, care must be taken not to overfund the marital deduction. The estate plan of the first spouse to die should not use the marital deduction to such an extent that none of the decedent's equivalent exemption is used, especially if such a plan leaves the surviving spouse's taxable estate greater than the equivalent exemption. For 1982, each individual has an equivalent exemption of \$225,000. By 1986, this will increase to \$600,000 (see page 14 for further explanation).

Care should be taken to not place rapidly appreciating property in the surviving spouse's estate through the unlimited marital deduction. This could increase future tax liability in the surviving spouse's estate beyond what was saved by eliminating the estate tax when the first spouse passed away.

Before the 1981 Act, it was common to include language in a will instructing the estate to transfer the maximum amount qualifying for the marital deduction to the surviving spouse. With the elimination of the marital deduction limit, such a clause would pass 100 percent of the decedent's estate to the surviving spouse. This might result in something other than the decedent has originally intended.

To remedy this situation, and without requiring all existing wills drawn up before the 1981 Act to be changed, the act states that for all wills and trusts containing the "old" language drawn up before 30 days after the act became law (September 13, 1981), the new unlimited marital deduction would not apply. As a result, the following steps may have to be taken:

1. **Those estate plans drawn up BEFORE the above date which desire ALL property to be transferred to the surviving spouse under the unlimited marital deduction must amend the plan to allow the total transfer to take place.**
2. **Those estate plans drawn up AFTER the above date which desire LESS THAN all of the property to be transferred to the surviving spouse must specify how much property is to be transferred.**

As outlined earlier, the property must go to the surviving spouse without reservation in order to qualify for the marital deduction. Therefore, life estates (page 8), limited powers of appointment (page 28), and trusts with the right of income held by the surviving spouse (page 21) do NOT qualify.

However, the new act allows one type of transfer which, in the past, did not qualify. In order to qualify, the executor of the decedent's estate must irrevocably elect a transfer method that entitles the surviving spouse to ALL income from the property for life and no one has the power to appoint (transfer or gift) any part of the property to anyone but the surviving spouse during his or her lifetime. Once this election is made, the property will have to be included in the surviving spouse's estate and the surviving spouse cannot gift this specific property away in an effort to reduce the size of his or her taxable estate. Competent legal advice should be sought before using this option.

Tentative Tax

The amount remaining after the deductions are subtracted and pertinent gifts and gift taxes are included is the Federal taxable estate. Using this figure as the "value of assets subject to tax," the **tentative** federal estate taxes due can be computed from Tax Rate Table 1.

Tax Rate Table 1

| NEW UNIFIED RATE SCHEDULE FOR FEDERAL ESTATE AND GIFT TAXES | | |
|--|---|----------------------|
| Value of assets subject to tax | Tentative Tax (before deducting credit) | Rate on next bracket |
| Under \$10,000 | 18% | -- |
| \$ 10,000 | \$ 1,800 | 20% |
| 20,000 | 3,800 | 22 |
| 40,000 | 8,200 | 24 |
| 60,000 | 13,000 | 26 |
| 80,000 | 18,200 | 28 |
| 100,000 | 23,800 | 30 |
| 150,000 | 38,800 | 32 |
| 250,000 | 70,800 | 34 |
| 500,000 | 155,800 | 37 |
| 750,000 | 248,300 | 39 |
| 1,000,000 | 345,800 | 41 |
| 1,250,000 | 448,300 | 43 |
| 1,500,000 | 555,800 | 45 |
| 2,000,000 | 780,800 | 49 |
| 2,500,000 | 1,025,800 | 53 |
| 3,000,000 | 1,290,800 | 57 |
| 3,500,000 | 1,575,800 | 61 |
| 4,000,000 | 1,880,800 | 65 |
| 4,500,000 | 2,205,800 | 69 |
| 5,000,000 | 2,550,800 | 70 |

Tax Rate Table 1 is the rate schedule effective for 1981. After 1981, the new Economic Recovery Act reduces the maximum estate tax rate from 70 percent to 50 percent over a four-year period according to the following schedule:

| Year | Maximum Tax Rate | On This Amount And Over |
|------|------------------|-------------------------|
| 1982 | 65% | \$4,000,000 |
| 1983 | 60 | 3,500,000 |
| 1984 | 55 | 3,000,000 |
| 1985 | 50 | 2,500,000 |

During 1981, the maximum estate tax rate is 70 percent for taxable estates worth \$5 million and over. By 1985, the maximum rate will be 50 percent for taxable estates worth \$2.5 million and over. The rates and tax brackets under \$2.5 million will remain the same.

Credits

After the tentative federal tax has been determined, we are allowed to subtract a number of credits directly from the federal tax due. These credits include:

- 1) The unified tax credit which replaces the \$60,000 personal exemption available before 1977. During 1977 the credit was \$30,000, which had the same effect as an equivalent personal exemption of \$120,677. In other words, the estate tax on \$120,667 is exactly \$30,000, which meant a single person didn't have to worry about Federal estate tax if the estate was less than this amount.

Under the old law, the unified tax credit increased to \$47,000 by 1981 or an equivalent exemption of \$175,625. The 1981 Act again increased this credit and the related equivalent exemption in future years as shown:

| Year | Unified Credit | Equivalent Exemption |
|------|----------------|----------------------|
| 1982 | \$ 62,800 | \$225,000 |
| 1983 | 79,300 | 275,000 |
| 1984 | 96,000 | 325,000 |
| 1985 | 121,800 | 400,000 |
| 1986 | 155,800 | 500,000 |
| 1987 | 192,800 | 600,000 |

& after

Keep in mind that increases in the unified credit are being phased in and the \$600,000 taxable estate will not be able to pass free of estate tax until 1987.

The increase in the equivalent exemption does not lessen the need for planning by persons with taxable estates of less than \$600,000. Inflation, coupled with increased earnings, is capable of substantially increasing the future value of an estate. In order to make maximum use of the equivalent exemption, married couples may find it advantageous to develop and maintain separate estates, nearly equal in value. This estate planning objective is more easily reached if a plan is developed early and adhered to over the years even though there are presently no estate tax concerns.

- 2) Federal Estate Tax paid if the property has passed through an estate during the prior 10 years. The credit is:
 - a) 100%, if the second death occurred within two years.
 - b) 80%, if within the third or fourth year.

- c) 60%, if within the fifth or sixth year.
 - d) 40%, if within the seventh or eighth year.
 - e) 20%, if within the ninth or tenth year.
 - f) no deduction beyond the tenth year.
- 3) State estate taxes paid. Since estate taxes vary among states, the Federal government allows a maximum credit which applies to every state. This credit can be computed from Tax Rate Table 2.²
- 4) Gift taxes paid on all gifts made after 1976. At present, each individual is on one tax rate schedule for all property transfers. If an initial transfer in the form of a gift was made, any amount over \$10,000 would be taxed at the lowest rate. Subsequent transfers, whether additional gifts or remaining property transferred at death, are added to previous transfers made after 1976. The tax is then calculated on the TOTAL of all transfers. Gift taxes paid on all gifts after 1976 plus those gift taxes outlined below in Item 5 are subtracted as a credit.

- 5) Gift taxes paid before December 31, 1976 on prior gifts that were subsequently included in the gross estate. This includes, for example, gift taxes on:
- a) Gifts made in contemplation of death under pre-1977 regulations.
 - b) Gifts of other property eventually included in the estate such as property with a retained life estate.
- 6) Death taxes paid to foreign countries.

Maximum Non-Taxable Estate Levels

In 1981, a married couple need not worry about federal estate taxes when the first spouse passes away unless that person's estate is over \$425,625. This assumes that the maximum use is made of the 1981 marital deduction (the greater of \$250,000 or one-half of the adjusted gross estate) along with the 1981 equivalent exemption of \$175,625 available to each estate.

After 1981, the unlimited marital deduction goes into effect along with the increased equivalent exemption. How large a married couple's estate can become and still escape taxation depends on how the unlimited marital deduction is used. Examples of estate settlements shown in the last section of this publication indicate the tax consequences of using the marital deduction in different ways.

A single person need not be concerned about federal estate taxes unless his or her estate is larger than the equivalent exemption. This exemption will increase from \$175,625 in 1981 to \$600,000 in 1987 and will remain at that level if not changed by future legislation.

The last page of this publication contains an inventory form and additional steps outlined to aid you in determining the tax consequences of your present or proposed estate plan. Liquidity requirements can also be determined. The form is general in nature and should be used only in preliminary planning.

Planning for Liquidity

Planning for the eventual payment of estate settlement costs and estate taxes is a must. If it's planned that the business continue to operate after the death of the owners, loss of assets used to pay necessary costs and taxes could

Tax Rate Table 2

| MAXIMUM CREDIT FOR STATE DEATH TAXES (BASED ON FEDERAL TAXABLE ESTATE) | | |
|---|---------------------------------|------------------------------------|
| Value of Assets Subject to Tax | Tax on Amount in Column 1 | Tax Rate on the Next Bracket |
| Under \$100,000 | \$ 0 | None |
| \$ 100,000 | 0 | 0.8 |
| 150,000 | 400 | 1.6 |
| 200,000 | 1,200 | 2.4 |
| 300,000 | 3,600 | 3.2 |
| 500,000 | 10,000 | 4.0 |
| 700,000 | 18,000 | 4.8 |
| 900,000 | 27,600 | 5.6 |
| 1,100,000 | 38,800 | 6.4 |
| 1,600,000 | 70,800 | 7.2 |
| 2,100,000 | 106,800 | 8.0 |
| 2,600,000 | 146,800 | 8.8 |
| 3,100,000 | 190,800 | 9.6 |
| 3,600,000 | 238,800 | 10.4 |
| 4,100,000 | 290,800 | 11.2 |
| 5,100,000 | 402,800 | 12.0 |

²North Dakota State Estate Taxes have been reduced to the amount of the credit shown in the table.

create a debt problem or lead to a reduction in the size of the estate as part is sold to create needed liquidity.

Liquidity to meet estate settlement costs can be achieved in a number of ways. Pre-death funding possibilities include life insurance, "flower bonds," accumulating savings, and development of investment programs such as Keogh (HR 10) or IRA Plans. The option also exists of plowing all available capital into the business knowing that liquidity would have to be squeezed from the business after death.

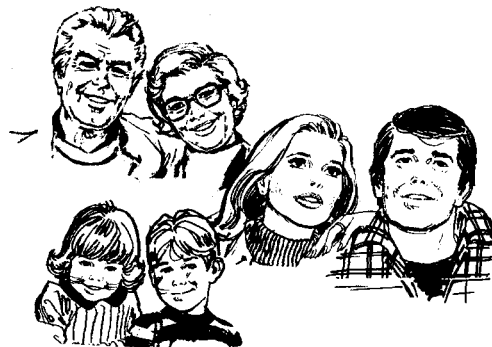
Also keep in mind that pre-death gifting, sale of farm property, and structuring of property ownership before death could reduce the need for liquidity. These same factors could influence the selection of alternatives used to provide any needed liquidity.

After-death possibilities include the 15-year option for installment payment of all or part of the federal estate tax obligation. If this option looks promising, make sure certain pre-death requirements are met and that heirs are fully aware of after-death requirements such as shifts in lease arrangements or sale of the property that could affect eligibility.

A certain proportion of the estate must be real or personal property devoted to the farm or closely-held business in order to qualify for the 15-year deferred payment plan. To keep individuals from gifting certain kinds of property away shortly before death in order to qualify, all taxable gifts within three years of death will be added back into the estate before determining the proportion of property devoted to each use.

In some cases, the installment payment period may be further extended for reasonable cause or undue hardship. Another possible source of funds for paying estate taxes is the redemption of stock after death if the business is organized as a corporation.

If liquidity is needed, carefully evaluate each possibility and select the alternative that best meets your future needs under your present financial situation.



E. ESTATE PLANNING TOOLS

After developing an understanding of how we own property and the mechanics of how estate property is taxed, we can now turn to the tools available for meeting family estate planning objectives.

A number of tools are available, including the life estate and the two methods of co-ownership briefly discussed earlier. These tools and others such as wills, sales, gifts, trusts, and life insurance may be used separately or in combination. The succession laws of each individual state can also be thought of as an estate transfer method in the absence of a will. A brief review of some of the strengths and weaknesses of these methods follows:

Succession Laws

A will is a legally acceptable document stating how a person's property is to be distributed among the heirs. When an individual dies without a will (intestate) the state succession laws must be used to make this determination.

Some kinds of property can pass to heirs without a will and are not subject to the succession laws. Life insurance, where a beneficiary is named when the policy was purchased, and JTWS property, where the surviving joint tenant(s) automatically become the new owners, fall into this category.

However, if you are the sole owner of some property, or own property as a tenant-in-common, and you pass away without a will stating how that property is to be transferred, the distribution pattern of the succession laws must be followed.

ADVANTAGES:

- 1) The major advantage of succession laws is that they do provide a means of distributing property to heirs if the property owner neglects to plan.

DISADVANTAGES:

- 1) The method of distribution is rigid and inflexible and may not be according to the wishes of the deceased. Choice and individual preference are not considered. For example, succession laws do not provide for a portion of our estate to be gifted to religious, public or charitable institutions. These bequests can only take place if stated in a will or trust agreement.
- 2) Minor children left without parents usually necessitates a court appointed guardian which involves both red tape and expense.
- 3) A business may be in jeopardy if both husband and wife die without an estate plan. The property distributed among heirs is owned as tenants-in-common and any of the owners can force a division of the property.
- 4) Succession laws may provide equal treatment for heirs but not necessarily equitable treatment. In the case of an heir operating a farm business, succession laws dictate equal treatment for all heirs even though the operating heir may have contributed substantially to the accumulation and development of the estate.
- 5) More than likely the estate will be assessed maximum state and federal estate taxes.
- 6) A court appointed administrator may be required to post a bond, an expense that might be saved if a suitable provision is included in a will.

Wills

A will provides for the distribution of a person's estate after death. It is also used for purposes other than transferring property such as naming a guardian for minor children.

Every person of legal age who owns property should have a will and it should be kept up-to-date. If minor changes are desired, a codicil, which is a legal addition to the original will, can be used. A codicil can revoke some of the provisions in the will or add new provisions. If major changes are desired, a new will should be drafted and the old will revoked and destroyed.

ADVANTAGES:

- 1) A will enables the owner to distribute his or her property to best fit individual situations and desires.
- 2) A will might be used to reduce estate taxes by making effective use of the unlimited marital deduction (after 1981) or by providing for a testamentary trust (explained later).
- 3) A will can be used to select who will administer your estate and also waive the surety bond required for that person to serve.
- 4) Guardians for minor children in the event they are left orphaned can be nominated in a will.
- 5) Management of assets after death can also be established in a will by use of trust arrangements.

DISADVANTAGES:

Most disadvantages result from improper use or preparation of wills.

- 1) Improper drafting or executing may fail to carry out the wishes of the maker.
- 2) Conditions change, and, if not kept up to date, a will can become outdated. Even so, the provisions of the outdated will must be followed if it is the only estate plan available.
- 3) Uncertainty can be prolonged for farming heirs if the farm isn't transferred by will until after the death of the parents. If one of the estate planning objectives is to maintain an efficient farming unit in the family, then one of the methods of transfer before death, such as sale or gift, might well be considered.
- 4) A will cannot (without agreement with the spouse) take precedence over succession laws preventing disinheritance of spouses. Succession laws in a number of states prescribe that the surviving spouse can claim approximately one-third of the estate unless waived after fair disclosure.
- 5) A will does not take precedence over property transfers prescribed in joint tenancy ownership with rights of survivorship.
- 6) A will does not take precedence over a written agreement made between spouses before their marriage. This situation is most common in a second marriage where children and property were brought into it from the first marriage.

SALES

Selling property to a family member or eventual heir can be an effective estate planning tool. However, when capital assets (land plus anything on your depreciation schedule) are sold, added income taxes in the form of a capitals gains tax and recapture of depreciation become important considerations.

A capital gains tax is a tax on the profit made by selling a capital asset. The profit is the difference between the sale price and the original cost or value of the property, usually called the basis. The profit is decreased by any costs associated with the sale.

Three types of property can be sold and the basis is determined differently in each case. The basis of **purchased** property is the price you paid for it. The basis of property received as a **gift** is the "givers" original basis which carried over into the hands of the "receiver." The basis of **inherited** property is the value of the property as determined for federal estate tax purposes when the past owner's estate was settled.

For all three types of property, the basis is increased by the cost of improvements made on the property and decreased by the amount of depreciation claimed as an income tax deduction. Also, any gift tax paid on gifted property can be added to the original basis.

Generally, 40 percent of the profit (sale price minus the cost-basis) is taxed as ordinary income. Thus, the income tax consequences of selling property with a low cost or basis can be severe. A general rule of thumb for selling property that was purchased or inherited is to "sell first what was acquired last." Property recently acquired would have the highest basis leaving a smaller profit to be taxed as a capital gain. It may be more advantageous to let gifted property go through an estate settlement thereby increasing its basis, especially if the property is going to be sold in the near future.

Two options are available to sell property—a direct sale or an installment sale.



Direct Sale

In a direct sale the seller deeds title to the property to the buyer. The buyer either pays in full or makes a down payment and usually gives the seller a mortgage on the property to insure payment of the balance of the purchase price. This method is desirable in family transfers when the purchaser can make a sufficient down payment.

A direct sale will not reduce the size of the estate. It will simply change the form. What was formerly held in real estate value is converted to cash after the sale.

ADVANTAGES:

- 1) A sale is a business-like way of making the transfer.
- 2) Equitable treatment of all children can be separated from the problem of transferring the farm because the size of the estate is not changed if the property is sold at the current market value.
- 3) It makes it possible for the purchaser to operate the farm during his most productive years and make necessary improvements to keep the business an efficient unit.
- 4) Through a sale to a family member, overall income tax liability can be reduced. The combined tax of two smaller incomes being taxed in lower income tax brackets will be less than one large income being taxed in a much higher bracket.

DISADVANTAGES:

- 1) Sellers lose control over the property.
- 2) Parents may be tempted to sell to a son or daughter for less than the market price and use gift exemptions to cover the difference. If wealth is limited, hardship could result in later years due to an unexpected illness, etc.

- 3) The direct sale may trigger a capital gains tax which could be substantially greater than estate taxes.

- 2) The seller takes a credit risk during early years of the contract assuming buyer equity is low.

Contract for Deed-Installment Sale

Contract for deed or an installment sale is an agreement whereby the seller agrees to convey property to the buyer for a certain price. The title of the property will pass to the buyer and the deed will be delivered at a date outlined in the contract. Equitable title passes to the buyer while legal title is retained by the seller.

Sales after June 30, 1981 must specify at least a 9 percent rate of interest. However, for the sale of land between family members, the required minimum interest rate is 6 percent. This exception applies to only the first \$500,000 of the sale price. For the excess over \$500,000 on sales made after June 30, 1981, the contract must state an interest rate of at least 9 percent. If not, IRS may reapportion the interest and capital gain as if the interest rate were 10 percent.

ADVANTAGES:

- 1) **Helps a young man with limited funds purchase a farm because the down payment is usually lower than for a direct sale.**
- 2) **Seller retains some control over the property. Ownership reverts back to the seller if the buyer defaults.**
- 3) **The repayment schedule can be arranged to encourage building equity during the buyer's most productive years.**
- 4) **Capital gains taxes are reduced by spreading the payment of the total capital gains tax over the period of the contract, allowing lower percentage tax rates to be used.**
- 5) **Periodic payments help insure retirement income.**
- 6) **The value of the property is frozen on the date the contract is signed. Should the seller pass away before the contract is completed, remaining payments in the seller's estate stay at the value established when the original contract was signed.**
- 7) **Future payments remaining in the seller's estate may qualify for a discount.**

DISADVANTAGES:

- 1) **The buyer has a less secure hold on the property.**

New Rules For Installment Sales

A new law, effective October 20, 1980, rewrote the rules on installment sales. It will take some time before the new law is fully interpreted. Highlights include:

1. **The limit that no more than 30 percent of the payments could be received in the year of sale no longer exists.**
2. **The requirement of at least two payments in two separate tax years has been abandoned. Now all that is required is that at least one payment is to be received after the close of the tax year in which the sale occurs.**
3. **The minimum \$1,000 selling price has been dropped.**
4. **Installment reporting is now automatic unless the taxpayer elects not to have the provision apply to a deferred payment sale.**

Three additional provisions are aimed at correcting a number of abuses under the old law. These include:

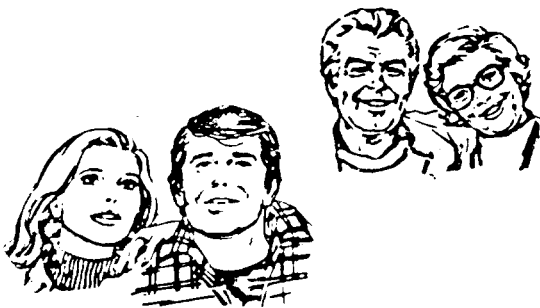
1. **Property sold to relatives cannot be resold for two years without triggering the payment of ALL capital gain taxes due from the original seller. These rules generally do not apply when the sale occurs after the death of the first seller or purchaser, or when the sale is an involuntary conversion.**
2. **If property is sold on an installment basis, and the installment obligations are cancelled as they come due, the seller is required to pay income tax as if the installment was actually paid.**
3. **If the contract is not paid off at the death of the seller, and the seller wills the obligation to make payments to the buyer, the seller's estate must report all the gain that would have been realized from future payments and pay the appropriate income tax. Thus, the estate must pay both income and estate taxes on the obligation.**

Most provisions of the new law apply to sales after October 19, 1980. However, the provisions eliminating the 30 percent rule and the two-payment rule apply for all of 1980 if you pay taxes on a calendar basis. The 'related-party' rules apply to installment sales made after May 14, 1980.

Because of the complexity of these changes, it is strongly recommended you consult your attorney or tax advisor before entering into any type of sales contract. Many of the previous advantages of using installment sales as an effective estate planning tool have been diminished by this recent law.

Gifts

Gifts provide a means of decreasing the size of your estate and the related estate tax. To qualify, you must give up **all** control of the property and not receive any benefit from it.



A number of tax-free options exist for property transfer through gifts.

- 1) Each individual has an annual exclusion of \$10,000 per year per person. This is a "tax-free" transfer — no gift tax has to be paid nor does the receiver have to pay any income tax when the gift is received. These gifts can be made to as many different people as desired each year with no limit placed on the number of years. Also, regardless of when given, these gifts never come back into the estate except under the conditions outlined under Item 6 Page 12.

Only "present" interests in property qualify for the annual exclusion. A "present" interest is defined as the unrestricted right to immediate use, possession, or enjoyment of property or the income from property.

- 2) A husband and wife can give \$20,000 to each of any number of individuals each year. Even if the wife owns no property, the husband is allowed to use his wife's \$10,000 annual exclusion. Tax-free gifts given under the husband and wife annual exclusion must also be gifts of "present" interest in order to qualify.
- 3) The unified credit and its related equivalent exemption can also be used to cover the gift tax on lifetime gifts over and above the annual exclusion. This exemption will increase from \$175,625 in

1981 to \$600,000 in 1987 and thereafter. However, if any part of the unified credit is used to reduce the gift tax on lifetime transfers, the same amount cannot be used to reduce the estate tax on death-time transfers.

- 4) Similar to the unlimited estate marital deduction when the first spouse passes away, the 1981 Act also allows an unlimited marital deduction for gifts. This means that all exchanges between husbands and wives — inheritance at death and gifts during life — will be tax free after December 31, 1981.

These tax free exchanges will provide greater flexibility in family estate planning because it allows spouses to more easily achieve equal ownership of property. Sole ownership property can be divided without any gift tax consequences. JTWSR property agreements can be dissolved without any gift tax consequences regardless of who provided the consideration or when the agreement went into effect (page 11). Equal ownership will, in turn, allow more effective use of gifts, trusts, estate tax credits, and other estate planning tools.

- 5) Gifts made to religious, charitable and public institutions are exempt from any gift tax.
- 6) The 1981 Act stipulates that, if certain conditions are met, tuition to an educational organization and paying the cost of medical care not reimbursed by insurance will not be considered as transfers by gift. These exclusions would be in addition to the \$10,000 annual gift tax exclusion and would be permitted without regard to the relationship between the giver and the receiver.

One intent of Federal legislation passed in 1976 and 1978 was to eliminate misuse, and some of the advantages, of gifting to reduce estate taxes. At present, gifts not covered by the above exclusions will be taxed at the same rate as transfers at death. The gift and estate tax rates are the same. Also, all gifts made after 1976 and not covered by the annual exclusion are automatically added back into the estate and taxed as though they were never given away. These gifts come back into the estate at their value on the date of the original gift.

All gift taxes paid within three years before death must also be added back into the estate at death. The tentative estate tax is then computed on all lifetime taxable transfers made after 1976, all gift taxes paid within three years of death, plus all other taxable property remaining in the estate at death. All gift taxes paid as outlined in Items 4 and 5 under the Estate Tax Credits section on page 15 are then subtracted

to calculate the actual tax due. There is one exception to this that applies to estates where taxable gifts in excess of \$2.5 million might be given between 1982 and 1985. See your attorney if this applies in your situation.

Even with the above changes which were meant to greatly reduce the advantage of gifting large amounts of property, there is still an advantage in making lifetime gifts over the \$10,000 annual exclusion. Suppose a father owned land that would eventually go to a son. It may be advantageous for the father to use all or part of his unified tax credit along with his annual \$10,000 exemption to make a tax free gift of the property to the son. Any further appreciation in the property would then take place in the son's estate and not in the father's estate. If the land remained in the father's estate, the appreciation would be taxed at the very highest estate tax rates. Transferring the property by gift at the present time could mean considerable estate tax savings along with "split income" income tax savings mentioned earlier.

ADVANTAGES:

- 1) Gifts covered by the annual exclusion can remove property from the individual's estate and reduce estate taxes.
- 2) Except for the two exceptions listed earlier, gifts of \$10,000 or less per individual per year never come back into the estate even if given a few days before death.
- 3) Rapidly appreciating property can be transferred to limit estate size or to reduce future income tax liability.
- 4) Substantial gifts to a spouse to balance estate ownership are possible without gift tax liability.
- 5) Any gift tax paid further reduces the estate of the giver if he or she lives three years or more after making the gift. This is not the case with estate taxes; that is, the taxable estate at death is not reduced by the amount of the federal estate tax that is going to be due.

DISADVANTAGES:

- 1) Large gifts may create a hardship on parents in later life if the estate is small. Gifts should only be used if property owners can afford to give property away and if gifts help meet specific estate planning objectives.

- 2) The amount of gift tax due on any one gift depends partially on the amount of previous lifetime gifts. The tax is figured by computing a tentative gift tax on the amount of ALL previous taxable gifts plus the amount of the present gift. The gift tax due is the difference between the tax figured on all gifts and the amount of gift taxes paid previously.

Trusts

The trust is a useful and flexible estate planning tool. A trust is created by a written agreement and 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 upon the termination of the trust. The trustee, the person or firm managing the trust, receives the property, invests the capital if necessary, collects income, handles accounting, pays taxes, and reinvests or distributes income and principal according to the rules of the trust established by the original property owner.

A trustee can be an adult person, including family members, or a bank with trust powers. A combination of the two is often used.



Fees charged by a bank with trust powers vary according to the services provided. A typical annual fee for managing a trust of corporate stock or money would be about .75 percent of the property in trust. This means a fee of \$750 would be charged for managing \$100,000. For bonds, the fee might be less. If the trust contains a business, the bank trustee usually charges from 2 to 10 percent of the landlord's share of the gross income depending on the complexity of the business operation.

There are basically two types of trusts: The **living or lifetime trust** and the **testamentary trust**. **Lifetime trusts** are generally of two types—

revocable and irrevocable. Under a revocable trust, the power is retained by the property owner to alter, amend or revoke the trust and therefore, is included in the estate of the person who established the trust.

The irrevocable trust cannot be altered, amended or revoked by the person who established it once it is in force. The property is transferred as completely as if by gift. Gift taxes will be due if the value of property put in trust is large enough to exceed the \$10,000 annual exclusion. However, the property of an irrevocable trust is not included in the estate of the person who established the trust if that person lives three years after the trust goes into effect.

A variation of the living trust is the short term or Clifford type trust. It is used primarily to save income taxes. Property is transferred to a trust and income is paid to the beneficiaries (for example, to pay college expenses). If the trust is at least 10 years in duration, the income is taxed to the beneficiaries and not to those who transferred property to the trust.

The second type of trust, a **testamentary trust**, is set up to become effective at death and is usually established in a will. This type of trust is frequently used as a vehicle for property management if both parents should die leaving dependent children. The testamentary trust for minors is a useful device for managing the property for the children's benefit until each attains a stated age. Another use of the testamentary trust is to manage property for the benefit of the surviving spouse and still keep that property out of her estate.

Trusts have considerable potential for attaining certain desired estate planning goals because of their great flexibility. However, trusts are complex and assistance should be sought from bank trust officers and/or a lawyer.

ADVANTAGES:

- 1) They may be used to reduce total estate taxes since property can be managed for the benefit of the surviving spouse and, upon the death of the surviving spouse, pass directly to the children without additional estate tax.
- 2) Estate administration expenses may be reduced.
- 3) Professional management services can be provided for your property.

- 4) The creator's instructions concerning the property will be observed so he may dictate how property will be used long after his death.

DISADVANTAGES:

- 1) To save income and estate taxes by using a living trust, control of property must be given up.
- 2) Property in a testamentary trust is included in the taxable estate of the person making the trust. A testamentary trust is included in a will. Since a will can be changed at any time, the maker controls all of the property until death.

Life Insurance

Life insurance is an important part of many estate plans and is a useful estate planning tool. Life insurance can be used to build up an estate, preserve the family business by providing liquidity to cover estate settlement costs, and provide retirement income to parents. For example, life insurance can be used for an annuity to provide life-long income for parents. It can be used to finance the transfer of a family business or farm to certain heirs. Or it is possible to transfer the business in a will to one heir and use life insurance proceeds to distribute like or equitable value to other heirs.

ADVANTAGES:

- 1) The proceeds go directly to the beneficiary with minimum delay.
- 2) It adds immediately to the owner's estate and hence provides financial security.
- 3) Will escape estate taxes if all incidents of ownership are held by someone other than the insured. The incidents of ownership include the right to change policy beneficiaries, cancel or surrender the policy, assign or revoke an assignment of the policy, pledge the policy for a loan, borrow against the policy, and convert the policy to another form of insurance.
- 4) Proceeds received are not subject to income tax.
- 5) When used with a buy and sell agreement, an estate can be converted to cash immediately.

DISADVANTAGES:

- 1) The insured often fails to rename beneficiaries even though substantial changes have occurred since a given policy was first written.

- 2) If the deceased owned the policy (the usual situation) then the full proceeds will be included in the estate for estate tax purposes.
- 3) There may be gift tax consequences when incidents of ownership are transferred.

F. ESTATE PLANNING TIPS

The Right Sized Marital Deduction³

With the federal estate tax marital deduction increasing to 100% in 1981, a major planning decision will have to be made concerning the optimum size of the marital deduction. Also, after 1981, the federal gift tax marital deduction increases to 100% for gifts between husband and wife which means couples will be free to rearrange property ownership any way they like. For many, this will mean moving toward equal property ownership — the best ownership pattern for death tax savings.

To complicate the planning process, the unified tax credit increases every year through 1987 allowing increasing amounts of property to escape Federal estate tax. Having these factors to consider, Neal Harl, attorney and agricultural economist at Iowa State University, offers the following guidelines:

1. If the combined wealth of husband and wife is expected to be no greater than the equivalent deduction available at the death of the surviving spouse, the best strategy may be to leave the property outright to the survivor at the death of the first spouse.

For couples, in this category, state estate taxes could influence how the property is left at the death of the first spouse. The Federal estate tax equivalent exemption and corresponding North Dakota estate tax for 1982 through 1987 and thereafter is shown below.

| Year | Equivalent Individual Exemption | Corresponding North Dakota Estate Taxes |
|------|---------------------------------|---|
| 1982 | \$225,000 | \$ 1,800 |
| 1983 | 275,000 | 3,000 |
| 1984 | 325,000 | 4,400 |
| 1985 | 400,000 | 6,400 |
| 1986 | 500,000 | 10,000 |
| 1987 | 600,000 | 14,000 |

or later

³Adapted from an article by Neal Harl entitled "A New Era Begins — The Economic Recovery Tax Act of 1981." The article appeared in the October 1981 edition of the AGRI FINANCE magazine.

Keep in mind that the North Dakota taxable estate is the same as the Federal taxable estate. Therefore, if the unlimited marital deduction is used to transfer all property to the surviving spouse, there will be no Federal and no State estate tax due when the first spouse passes away.

2. If the combined wealth of husband and wife is expected to be no greater than TWICE the equivalent exemption at the death of the first spouse, the best strategy may be to: a) divide the property equally between the spouses during life, b) each leave the other a life estate in the property owned with no marital deduction claimed at the first death, and c) make full use of the unified credit at EACH death to eliminate the federal estate tax.
3. If the combined wealth of husband and wife is expected to be MORE THAN TWICE the equivalent exemption at the death of the first spouse, the best strategy may be to: a) divide the property between the spouses equally during life, b) create a PARTIAL marital deduction at the death of the first spouse with the amount increasing from zero as the property owned by each spouse rises above \$600,000, and c) leave the remaining property of the first spouse to die in a life estate for the other spouse.

Other Considerations

The preceding portion of this publication provides an outline for establishing an estate plan, a mechanism for calculating the settlement costs of various plans, and a brief explanation of estate planning tools available to help us meet our planning objectives. Several additional factors to be considered in the planning process are listed below:

- 1) The best estate planning always involves a family discussion. This can eliminate much of the ill feeling among heirs when an estate is settled.
- 2) It could be that a plan that saves maximum taxes does not accomplish the estate planning goals the property owner feels are the most important. Therefore, tax savings alone should not be the sole basis for a plan.
- 3) There are ways in which estate taxes and income taxes can be reduced. With proper planning there are ways to accomplish your goals AND save taxes.
- 4) The best estate plan utilizes a combination of estate planning tools. A will completed after a family discussion can prevent ill feeling among heirs. Co-ownership and direct sales can help

maintain an efficient business unit and keep it in the family. Installment sales can provide retirement income, trusts can reduce management responsibility for survivors, gifts can reduce estate taxes, and life insurance may provide one form of liquidity.

- 5) An estate plan is never complete. Once a plan is worked out it should be periodically re-evaluated perhaps every three years or more often if there are significant changes in the law or family situation.
- 6) With recent changes in the law, estate planning has become an extremely complex field. It is no longer a "do-it-yourself" project. Seek help from professionals in formulating the best possible plan for you and your family. A lawyer with knowledge in the planning field should always be used to make sure your plan incorporates all pertinent tools available and is legally correct. A trust officer can help set up mechanisms to safeguard your property and insure competent management. Life insurance underwriters can help initiate the planning process and provide information concerning the kinds and costs of different insurance programs which may be considered. Accountants can help evaluate the estate and income tax consequences of various types of business organization and various estate planning mechanisms.

III. NORTH DAKOTA ESTATE LAWS AND REGULATIONS

The previous portion of this circular deals primarily with estate planning under current Federal regulations. This portion contains a brief explanation of estate planning considerations specifically for North Dakota residents. The explanations are not intended to serve as a substitute for sound estate planning advice. It is strongly recommended that you see a competent attorney for additional interpretation and legal advice.

A. PROBATE PROCEEDINGS

When a person dies, his property is subject to settlement or probate in the state in which the person's property is located.

Probate in North Dakota is a legal procedure used by the county courts of jurisdiction to:

- 1) Legally verify the death of the property owner.

- 2) Inventory all property of the deceased.

- 3) Pay all valid debts including taxes.

- 4) Distribute legal title to those entitled to receive property.

The probate procedure applies to property owned solely by the individual or his share of property owned as a tenant-in-common. It does not apply to property held in joint tenancy with the right of survivorship or any property passing to others through contractual agreements. However, regardless of how the assets are owned, the estate will be subject to tax clearance procedures.

Settlement Procedures

In North Dakota, four basic types of settlement procedures are available; formal, supervised, informal and "no-action" proceedings. As one moves from the formal to the "no-action" alternatives, the amount of court involvement decreases. However, the amount of protection from liability provided the heirs and the personal representative also decreases.

The various probate alternatives can be used in combination or one of the procedures may be used throughout the administration of the estate. Ask your attorney for help in selecting the best procedure to protect all interests and to eliminate unnecessary procedural steps.

Personal Representative

Under the current Uniform Probate Code (UPC), the key person in settling an estate is the personal representative of the decedent. The personal representative is either designated in a will and appointed by the courts or appointed according to law. Current law grants the personal representative a maximum of flexibility and that person has nearly complete authority in distributing the assets of the deceased according to whatever plan must be used.

B. LAWS OF SUCCESSION

What happens to a person's property when that person dies intestate (without a will)? In the absence of a will, the North Dakota Succession Laws dictate property distribution. Examples are shown in Table 3.

In general, the North Dakota succession laws start inheritance with the spouse, then to the children and grandchildren, then up the ancestral ladder from parents to grandparents. In rare cases where no relatives closer than the descendants of the decedent's grandparents survive, the current UPC states the estate goes to the state school foundation fund.

TABLE 3. NORTH DAKOTA SUCCESSION LAW

| SURVIVORS | DIVISION OF PROPERTY |
|--|--|
| 1. Spouse and children | First \$50,000 and half the remainder to spouse, the other half of remainder to children. ^{a/} |
| 2. Spouse, no children, estate \$50,000 or less | All to spouse |
| 3. Spouse, no children, parents of deceased are living, estate over \$50,000 | First \$50,000 and half the remainder to spouse, and other half of the remainder to parents of the deceased. |
| 4. Spouse, no children, father and mother of deceased aren't living | All to spouse |
| 5. Brothers and sisters are surviving, no spouse, no children or no parents | All to brothers and sisters by right of representation |
| 6. No spouse or next of kin | To the state of North Dakota for support of common education |

^{a/}If there are children of another marriage, the spouse may be entitled to **only** one-half the estate and not the first \$50,000.

The succession laws do not apply to joint tenancy with right of survivorship transfers or insurance policies with a designated beneficiary other than the person's estate.



C. PROTECTION FOR SURVIVORS

The North Dakota UPC protects the surviving spouse and minor children with a number of safeguards. The basic family protections are the elective share, the homestead right, exempt property, family allowance and the survival clause. Except for the survival clause, all of these safeguards may be waived before or after marriage by a written agreement signed by the person waiving those rights. Such waivers are common, especially in second or later marriages. In fact, persons contemplating second marriages should always discuss the subject of a premarital agreement with their attorneys.

Spouse's Elective Share

It is no longer possible to disinherit your spouse in North Dakota. A provision in the present UPC called the "spouse's elective share" applies both in cases of intestacy (no will) or when a valid will exists. It allows the surviving spouse the choice of taking approximately one-third of the estate, rather than (1) what "intestate succession" provides, or (2) the amount of property the person passing away provided for the spouse in a will.

The "elective share" feature encourages estate planning by a husband and a wife, because it generally restricts a person from transferring property to others without the consent or joint action of the spouse. For example, an elderly farmer wills his entire farm to his son. If the elderly farmer passes away, the surviving wife can freely claim one-third of the worth of the farm as her share. Her claim will hold despite provisions of the will unless it can be proven that she consented to the total farm transfer to the son.

The elective share must be claimed by the surviving spouse within six months of published notice to creditors.

Homestead Exemption

The homestead exemption is the surviving family's right to possession and use of the homestead. The homestead includes the home residence plus surrounding property up to a total combined value of \$80,000.

The homestead right cannot be sold or encumbered during the marriage unless it is done

by both husband and wife. Also, the exemption is generally exempt from lien and forced sale, and to claim the homestead the survivors must live on the designated property. The homestead exemption is usually over and above any benefits passing to the surviving spouse or children by the will, by intestate succession or by the "spouse's elective share."

Family Allowances

In North Dakota, the UPC provides that the surviving spouse and dependents have a right to a reasonable allowance for living expenses while the estate is being settled. The family allowance has a priority second only to the homestead right. The allowance can be up to \$6,000 unless a larger sum is approved by the court.

Exempt Personal Property

The surviving spouse is allowed to claim certain personal property of up to \$5,000 in value and that property is exempt from claims such as funeral expenses or expenses of the last illness. If the person passing away has no surviving spouse, the children can claim the exemption.

Unless otherwise stated in the will, the claim for exempt property is in addition to property distributed by the will.

Survival Clause

Before the Uniform Probate Code (UPC), if both husband and wife were killed in the same accident, the estate of one spouse might be subject to two probates—first passing to the spouse who may have lived a few hours longer, and then on to the surviving children. To remedy this situation, the UPC now states that any person who fails to survive the decedent by more than 120 hours is considered to have died before the decedent for purposes of inheritance, homestead allowance, exempt property, and intestate succession.



The 120-hour survival clause applies both to persons who die without a will or who have a will without a specific survival clause.

D. NORTH DAKOTA ESTATE TAX

The North Dakota Legislature has virtually eliminated state estate taxes for small to medium sized estates. The amount of state tax imposed is equal to the maximum credit allowed for state taxes on the Federal estate tax return. The tax can be computed using Table 2 on page 15.

Interest of one percent per month is charged for state estate taxes not paid within 15 months after death.

IV. ADDITIONAL PLANNING TOOLS

Along with the estate planning tools examined previously, the following tools may also have application in more specific situations.

A. HOLOGRAPHIC WILL

The North Dakota UPC permits a handwritten (holographic) will. This will must be written and signed by the property owner, but need not be witnessed. The will must be dated and provisions which grant inheritance must be in the person's own handwriting.

While the holographic will may be useful in emergency situations, it does have some major faults. The person drafting the will may have clear intentions, but his wording may not mean the same to those interpreting the will after his death. Legal accuracy is necessary and it is strongly recommended that a competent attorney draft your will.

B. FARM AND RANCH CORPORATIONS

Action taken by the 1981 State Legislature now allows farm and ranch corporations in North Dakota. The measure limits shareholders in the corporation to a maximum of 15 members who must be directly related. No more than 20 percent of the corporation's income may be derived from passive sources (rents, interest, etc.), and at least 65 percent of the corporation's income must be derived directly from agriculture.

Forming a farm or ranch corporation has a number of advantages and disadvantages.

1. A corporation may or may not provide income tax advantages depending upon the size of the business in earning capacity and the type of corporation formed.
2. While forming a corporation may allow more effective use of some estate transfer tools such as gifts, it may also inhibit the use of others. Forming a Sub-Chapter S Corporation may not allow the use of a testamentary trust for minors or the use of a marital deduction trust for a surviving spouse.
3. Corporate employees (including officers) are allowed to participate in several tax advantageous employee benefits, yet Social Security tax rates and other employment taxes for an employee or officer are higher than if self-employed.
4. The income tax (capital gains) consequences of forming a corporation is usually minimal, yet severe tax consequences can result when a corporation is dissolved.

Thus, forming a farm or ranch corporation should not be done without a great deal of study and competent legal advice. Also, check out the possibilities offered by other forms of ownership such as land trusts and limited agricultural partnerships (explanation follows). Both forms of ownership allow the gifting of "units of interest" while still retaining working control of the total operation.

North Dakota State University has researched various aspects of forming a farm or ranch corporation under the new law. Extension Bulletin 30 summarizes this research. The bulletin is available from the Extension Economics Department, NDSU, Fargo, ND 58105.



C. LAND TRUSTS

North Dakota is one of a half-dozen states which has legislation allowing the use of a land trust. A land trust is an arrangement where legal real estate title is held by a trustee, but all management rights, use and enjoyment of the

property are retained by the beneficiaries. A land trust is created by transferring real estate title to a trustee by a deed in trust. The parties enter a trust agreement stating who the beneficiaries are and who will have power to direct the trustee.

When title to real estate is transferred to a trustee the beneficiaries' interest is considered personal property rather than real estate. As a result, judgment claims against a beneficiary may not attach a lien to the real estate in trust. Duties the trustee can perform under the written direction of the beneficiaries include all things done by real estate owners such as selling, mortgaging, leasing or renting the property.

Land trusts offer an alternative to incorporation where the sole purpose is to enable a real estate owner to gift fractional real estate interests. "Units of beneficial interest" in the trust property can be transferred by gift. Also, probate is not necessary to pass title at an owner's death if the trust agreement provides for succession of ownership and management responsibility upon the death of a beneficiary.

Contact your attorney for a more detailed explanation of this relatively new estate planning tool.

D. AGRICULTURAL LIMITED PARTNERSHIPS

The farm or ranch limited partnership is finding increased use as an estate planning tool because it also serves as an alternative to farm incorporation. It can be an appropriate tool for the farm family seeking to divide the ownership of the farm assets in an equitable manner while allowing the family members most actively engaged in farming to retain control of the operation.

Typically, family members actively engaged in operating the farm will be the general partners in a limited partnership. The family members not actively engaged in farming can become limited partners through gifts of fractional "units of interest." This would allow them an ownership interest in the farm, without any interest in the farm operation.

Usually, the major farm assets are transferred into the limited partnership. However, the death of a general partner could force sale of these physical assets if liquidity is lacking to pay

estate taxes. Life insurance policies held by the partnership on the lives of the general partners can prevent this problem.

Contact your lawyer for a more detailed explanation of the advantages and disadvantages of limited partnerships. Competent legal advice is crucial if the benefits of this relatively new estate planning tool are to be realized.

E. COOPERATIVE/CORPORATION

A cooperative/corporation is an association of members who contribute either capital and/or labor and receive stock or membership in the organization. It distributes all profits back to its members as stockholders. Cooperative/corporations in North Dakota can be formed for farming or ranching purposes and can provide many of the advantages of farm corporations.

Under a cooperative/corporation, members have limited liability and a member may be able to transfer his or her shares without affecting the continuity of the farm business. Income tax consequences may also be an advantage.

On the negative side, the organization must follow formal operating rules, which can be both time consuming and expensive. Also, the father may lose absolute control of the family farm when other members control shares or capital invested. There may be complications in decision making because each member has one vote regardless of the amount of capital invested or stock owned.

For more details on how the Cooperative/Corporation form of business organization can be used, see *Agricultural Economics Miscellaneous Report No. 35*, available from the Agricultural Economics Department at North Dakota State University, Fargo, ND 58105.

F. POWERS OF APPOINTMENT

A power of appointment is a means by which the owner of property reserves to himself or grants to another person the power to designate the persons who shall receive his property as well as the share they will receive.

The power of appointment is another means of adding flexibility to the estate plan. It is a method of allowing adjustments in the distribution of the remainder interest of the estate many years in the future to meet possible future

circumstances such as a child being severely handicapped in an accident or the children having different financial successes or responsibilities.

For example, if the husband leaves one-half of his estate to a trust, with the income to his wife, he can also give her the power to appoint by will the person or persons she wants to receive the remainder of the trust when she passes away. Ownership of such special limited power of appointment is non-taxable in the wife's estate if it specifies that she cannot appoint to herself, her creditors, her estate or its creditors, the remainder interest of the trust over which she has the power of appointment.

The power of appointment can be a very useful and valuable estate planning tool. There are many potential uses for this power, but it requires considerable skill in analyzing when to use it and how it should be implemented. See your attorney for more information.

G. ANNUITIES

Annuities can be effective estate planning tools if proper guidance and advice is secured before they are put into effect. Two general types of annuities are available - commercial and private.

A **commercial annuity** is usually issued by an insurance company in exchange for cash. You pay a sum of money to the company which makes a legally binding contract to make periodic payments to you or someone else for the rest of that person's life or for a specific period of time. Some commercial annuities, because of certain terms in the policy, may be less effective than others as an estate planning tool.

A **private annuity** differs from a commercial one in two ways. First, property such as real estate is normally used to set up the annuity rather than cash. Secondly, an individual (often a relative) promises to make the payments rather than an insurance company.

Procedures for setting up a commercial annuity are relatively straight-forward. However, a complex array of factors should be considered when contemplating the use of a private annuity.

- 1. Problems could arise if the person promising the payments dies or becomes bankrupt.**

2. Care must be taken to make sure the property turned over to the person promising to make the payments will generate enough cash flow to meet the payments.
3. If the person receiving the payments lives longer than his or her life expectancy, the person promising the payments would pay more than Fair Market Value for the property.
4. If the person receiving the annuity has an unexpected and costly illness, difficulties may arise if the entire estate is "frozen" in an annuity.
5. Establishing an annuity may make it more difficult to assure equitable treatment of all heirs.
6. Tax problems associated with annuities run the full range—gift tax, income tax and estate tax—and pose advantages as well as possible pitfalls.

Even with these and other complex considerations, annuities may provide the most effective estate transfer alternative available in a specific situation. Generally, annuities are more effective in larger estates.

H. RENUNCIATION OF INHERITANCE

Not accepting one's inheritance is an estate planning tool available for use after the death of the property owner. We have the right to renounce or disclaim property received both through a will and through the succession laws.

Renunciation may be made for a number of reasons. We may wish to carry out the property owner's wishes that were not expressed in a properly executed will. Also, we may not need the property and wish to limit the size of our estate for future estate tax purposes.

There are specific state and federal regulations that must be followed in order to have a qualified renunciation or disclaimer. It must be done within a certain length of time after the death of the original property owner and it must be done in a specific manner. If not, state and federal estate tax regulations dictate it be treated as though the property was fully accepted and then gifted to subsequent heirs. Federal gift taxes may be assessed depending upon the size of the gift.

Because specific rules and regulations must be followed to make the best use of this valuable

after-death estate planning tool, it is strongly recommended that you seek the advice and counsel of an attorney.

V. LEGAL FEES

A foremost consideration in visiting a lawyer to prepare an estate plan or to probate an estate is the question of how much will it cost. Since no suggested fee schedule exists, the best way to determine what a particular legal service will cost is to simply ask your attorney. This should be discussed at the first meeting.

Estate planning costs will usually depend upon the size of your estate and the complexity of your situation. Most lawyers have an hourly rate for time spent in conferences, research and drafting of wills and other documents.

In regard to probate fees, as soon as the size of the estate is determined and questions having to do with possible sales or special use valuations are resolved, lawyers should be able to give you a very accurate estimate of total costs.

The UPC allows the personal representative "reasonable compensation" for his or her own services, and for attorney's services. The personal representative can waive compensation for himself but still draw from the estate to pay for legal services.

The probate court judge has the authority, under the UPC to review the fees and compensation paid to the administrator, attorney, or others involved in settling an estate. If excessive fees have been charged, the judge can order refunds to the estate.

VI. SETTLEMENT COST COMPARISONS

An important part of estate planning is comparing how the various tools can be used singularly or collectively to meet various objectives. The tax consequences of four selected estate transfer plans are outlined in Table 4. The tax rates used and the deductions allowed reflect state and federal regulations as of November 1, 1981.

A. SUMMARY OF DEDUCTIONS USED IN EXAMPLES

- 1) Administration Costs - These costs include funeral expenses, compensation for the

personal representative, reasonable attorney's fees, court costs, state and federal income taxes on the income of the decedent, miscellaneous debts, etc. While these costs will vary between individual estates, a recent study in North Dakota indicated the average of all settlement costs, not including taxes, to be 6 percent of the gross estate. This was the percentage used in the estate transfer examples.

- 2) Marital Deduction - For persons passing away after December 31, 1981, the marital deduction is unlimited. All property passing to the surviving spouse escapes taxation if the property is transferred in such a way that it will be included in the surviving spouse's estate.

B. EXPLANATION OF SELECTED PLANS

The examples point out the total cost of transferring property from the husband to the wife and then to their children, except in Plan 4 which pertains to a single individual transferring property to his or her heirs. It is assumed in all examples that the husband passed away in 1982, the first year in which the unified tax credit reached \$62,800. The unified credit will increase each year until 1987 when the credit will be \$192,800.

It is also assumed that the wife passes away at least 11 years after her husband. If she dies within 10 years of her husband's death, her estate gets credit for a portion of the taxes paid on the first death as outlined on page 14.

Future rates of inflation are unknown. Therefore, the wife's estate was not adjusted for increases in value due to inflation during the 11 year period following the husband's death. The effects of inflation must be kept in mind when putting together a total family estate plan. It magnifies the importance of adequately planning for the transfer of property that takes place when the surviving spouse passes away. Inflation could substantially increase the value of this estate which has the least amount of deductions - the marital deduction does not apply. At a 7.2 percent rate of inflation, the value of our property doubles every 10 years.

Plan 1

Under this plan, the husband owns all the property and wills it to his wife. It is assumed she

lives 11 years after her husband's death in 1982 and didn't change the size of her estate - the earnings from the estate were enough to provide an adequate level of living. Upon her death in 1993, her will stipulates her property be divided equitably among her children.

Plan 1 illustrates the worst possible tax consequences for two reasons. First, the \$800,000 estate was not equally divided between husband and wife as suggested by the guidelines on Page 23. Secondly, this plan illustrates the unfortunate result of overfunding the marital deduction; that is, passing too much property to the surviving spouse and not making use of the husband's equivalent exemption of \$225,000. This amount could have been set aside in a life estate or a trust for the wife's use during her lifetime and still be kept out of her estate. Use of the husband's equivalent exemption would have reduced the wife's estate by \$225,000 and eliminated all Federal estate taxes on her estate. Total cost of the two transfers would have been \$88,710 (State estate taxes and administrative costs) for a saving of \$43,955.

Other problems also exist with Plan 1 as illustrated in Table 4. If the surviving spouse would die before the increase occurred in the unified credit, the total tax liability would have been even greater. However, this plan provides for full ownership of the couple's property by the surviving spouse and some families may be willing to pay extra tax to insure that the surviving spouse has sufficient resources during his or her lifetime.

Plan 2

Under this plan the husband and wife each own one-half of the property. Each has a will that stipulates that upon the death of one spouse, the surviving spouse inherits the property.

This plan follows the suggestion of split estates as outlined on page 23 but neglects to use a life estate or a trust to allow use of the property by the surviving spouse without the property being included in the surviving spouse's estate. This example also shows the problem of overfunding the marital deduction; that is, not effectively using the husband's equivalent exemption with a trust or life estate to keep the surviving spouse's estate from becoming too large. If planned correctly, total settlement costs could have been reduced to \$69,402 for a saving of \$49,050 (see Plan 3).

Plan 2 also indicates what happens when all of the property is owned in joint tenancy with the right of survivorship (JTWS). As outlined on page 11, only half of the JTWS property is included in the estate of the first joint tenant to pass away. However, the unlimited marital deduction allows that half to pass to the surviving spouse tax free. After the death of the first spouse, all property is then owned by the surviving spouse and all of it is taxed in that person's estate.

Plan 3

Under this plan the husband and wife each own one-half of the property. Each has a will that stipulates that upon the death of one spouse a partial marital deduction will be taken with the

remainder being placed in trust for the benefit of the surviving spouse. Upon the death of the surviving spouse, the trust property would be distributed equally or equitably among the children. Using a life estate would provide similar results.

Plan 3 also indicates the most advantageous use of the unlimited marital deduction and the husband's equivalent exemption when he passes away. While additional property is added outright to the wife's estate, her unified credit is still large enough to cover the additional tax. Should appreciation or future earnings push her estate over her equivalent exemption she may want to start a gift program to eliminate any Federal estate tax when she passes away. She

**TABLE 4. SUMMARY OF TOTAL COSTS INVOLVED IN
SELECTED ESTATE TRANSFERS**

| | Plan 1 Husband owns all, wills all to wife, she wills all to children | Plan 2 Husband and wife each own half, each wills their half to their spouse ^{2/} | Plan 3 Each owns half, each will allows partial marital deduction with remainder in trust or life estate for survivor | Plan 4 Single person wills property to heirs. |
|---|--|--|---|--|
| 1982 | | | | |
| Husband's Gross Estate | \$800,000 | \$400,000 | \$400,000 | \$800,000 |
| Administration (6%) | <u>48,000</u> | <u>24,000</u> | <u>-24,000</u> | <u>48,000</u> |
| Adjusted Gross Estate | \$752,000 | \$376,000 | \$376,000 | \$752,000 |
| Marital Deduction | <u>-752,000</u> | <u>-376,000</u> | <u>-151,000</u> | <u>0</u> |
| Taxable Estate | 0 | 0 | \$225,000 | \$752,000 |
| Tentative Federal Tax | | | \$ 62,800 | \$249,080 |
| State Tax Credit | | | -1,800 | -20,496 |
| Federal Unified Credit | | | <u>-62,800</u> | <u>-62,800</u> |
| Estate Tax-Federal | | | 0 | \$165,784 |
| Estate Tax-State | | | \$ 1,800 | \$ 20,496 |
| 1993 | | | | |
| Wife's Gross Estate ^{1/} | \$752,000 | \$776,000 | \$549,200 | |
| Administration (6%) | <u>-45,120</u> | <u>-46,560</u> | <u>-32,952</u> | |
| Adjusted Gross and Taxable Estate | \$706,880 | \$729,440 | \$516,248 | |
| Tentative Federal Tax | \$232,345 | \$240,692 | \$161,812 | |
| State Tax Credit | -18,330 | -19,413 | -10,650 | |
| Federal Unified Credit | <u>-192,800</u> | <u>-192,800</u> | <u>-192,800</u> | |
| Estate Tax-Federal | \$ 21,215 | \$ 28,479 | 0 | |
| Estate Tax-State | \$ 18,330 | \$ 19,413 | \$ 10,650 | |
| Total Estate Taxes plus Administrative Costs | \$132,665 | \$118,452 | \$ 69,402 | \$234,280 |
| Total Costs as a Percent of the Total Estate | 16.6% | 14.8% | 8.7% | 29.3% |

^{1/} The wife's gross estate is the husband's gross estate minus administration costs, any property placed in a life estate or trust for the wife's benefit, Federal and State estate taxes paid; plus any property owned outright by the wife.

^{2/} Plan 2 also indicates the settlement costs involved in owning property as joint tenants with the right of survivorship.

can make tax-free gifts of \$10,000 per year to as many different individuals as she desires.

Plan 4

This plan indicates the tax consequences when a single person passes away. The importance of not being able to take advantage of the marital deduction is evident.

C. OTHER PLANS AVAILABLE

The four plans are presented only to indicate the difference in taxes and settlement costs of selected methods of transferring property from one generation to another. Numerous other plans can be formulated making use of gifts, direct or installment sales, life insurance, annuities, etc. Each individual family, with the aid of competent advisors, must select the plan that best fits the family's individual situation. The next step is to make sure that plan is legally correct so that when it is put into effect it meets those objectives originally agreed upon by the family.

VII. REFERENCES

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VIII. ESTATE INVENTORY AND SETTLEMENT COSTS

A. Property Owned

1. Cash and savings \$ _____
2. Stocks and bonds _____
3. Life Insurance¹ _____
4. Grain Inventory _____
5. Livestock inventory _____
6. Land & buildings _____
7. Machinery & equip. _____
8. Non-farm property _____
9. Personal property _____
10. Other property _____

Gross Estate (Total of above items) \$ _____ (A)

B. Debts and Settlement Expenses

1. Debts \$ _____
2. Settlement Expenses (4% of Item A) \$ _____

Total \$ _____ (B)

C. Adjusted Gross Estate (Item A minus Item B)² \$ _____ (C)

D. Marital Deduction—Any portion of the estate going to the surviving spouse

in such a manner that it will eventually be included in the

surviving spouse's estate \$ _____ (D)

E. Taxable Estate (Item C minus Item D)² \$ _____ (E)

F. Tentative Fed. Estate Tax (Use Item E and Fed. Estate Tax Table

on Page 14) \$ _____ (F)

G. Credits Against Federal Tax

1. Unified Tax Credit² \$ _____

1981 \$ 47,000 1985 \$121,800

1982 62,800 1986 155,800

1983 79,300 1987 & 192,800

1984 96,300 after

2. Credit for State Taxes Paid (Use

Item E and State Estate Tax Credit

Table on Page 15.) _____

Total \$ _____ (G)

H. Federal Estate Taxes Due (Item F minus Item G) \$ _____ (H)

I. Liquidity Needs

1. Federal Estate Taxes Due (Item H) \$ _____
2. State Estate Taxes Due (Item G2) _____
3. Settlement Costs (Item B2)³ _____

Total Liquidity Needed (Total of above three items) \$ _____ (I)

J. Available Liquidity (Total of Items A1 through A4) \$ _____ (J)

K. Additional Liquidity Needed (Item I minus Item J) \$ _____ (K)

¹Include face value of policies on your life that you own. If you own a policy on someone else's life, include the cash value. See page 22.

²If lifetime gifts have been given, contact your attorney for information on how these gifts could possibly affect this particular item.

³Also include item B1 if you prefer the estate to be transferred free of debt.

APPENDIX A

Current Use Valuation

The following is a more detailed explanation of the various predeath and after-death requirements pertaining to the use of current use valuation.

1. At least 50 percent of the gross estate (net of mortgages) must be real or personal property devoted to the farm or business.
2. At least 25 percent of the gross estate (net of mortgages) must be "qualified" real property. Qualified real property is that real property which meets all requirements for current use valuation.
3. The property must pass to a qualified heir. Qualified heir must be a family member which means grandparent, parent, spouse, children, stepchildren, grandchildren, brother, sister, nephew, or niece.
4. The real property must have been used for a qualified use by the owner or a member of the owner's family five of the last eight years before the death of the owner. A person, to have used the real property for a qualified use, must have an equity interest in the farm operation. An equity interest means that the person's income from the land varies according to production and price. This means a person operating the farm will have an equity interest, and an owner leasing the land with a share rental arrangement will usually have an equity interest. However, a cash rent lease will seldom qualify the owner as having an equity interest in the operation.
5. The owner or a member of the owner's family must have materially participated in the operation of the farm or business five of the last eight years before the death of the owner.

If the owner or a member of the owner's family is operating the farm, the material participation requirement is met. If the owner is leasing the property to a nonfamily member, then the owner or a member of the owner's family will be materially participating if one of the following four tests is met:

a) Regularly and frequently make decisions which significantly affect the success of the enterprise,

b) Work at least 100 hours spread over five or more weeks (not necessarily consecutive) on activities connected with production of the crop,

c) Advance, pay, or stand good for a significant part of the cost of production; furnish a significant part of the tools, equipment, and livestock used in producing the commodities; make periodic inspections of the production activities; advise and consult with the tenant periodically, or

d) Do those things which, in total, show that the owner is materially and significantly involved in production.

If this material participation requirement is not met on the date of death, then the last eight years before the owner's continuous retirement or continuous disability will be the critical period. Retirement means receiving old-age Social Security benefits. Disability means a mental or physical impairment which renders the owner incapable of material participation in the operation of the farm.

6. For ten years after the death of the owner, the tax benefits will be recaptured if the qualified property is not used for the qualified use. Qualified use ceases when:
 - a) The property is sold to a nonfamily member,
 - b) The property is no longer used for farming, or
 - c) The qualified heir no longer has an equity interest in the operation of the property.

Likewise, recapture will be triggered if the qualified heir or a member of the qualified heir's family does not materially participate in the operation of the farm or business so that there is an eight-year period ending any time after the death of the owner (which means this eight-year period can extend back to include predeath time but does not include the period of retirement or disability if such period was not considered in determining whether predeath requirements were met) in which there are more than three years of no material participation. Should the qualified heir die before the 10-year period has ended, there will be no recapture and all post-death requirements will be considered met.

This 10-year recapture period does not begin until the qualified heir begins to use the property but that cannot be more than two years after the death of the owner. A special lien is placed on the property to back up the recapture rule.

For certain qualified heirs, the post-death material participation requirement is replaced with a less demanding active management requirement. Active management is defined as making the management decisions of a business other than the daily operating decisions. The qualified heirs eligible for the active management requirement are those which are less than 21, a student, disabled or the spouse of the owner/decedent.

If the property is leased to someone, the owner or qualified heir, whichever the case may be,

must be careful that the requirements are being met. For the owner, a cash rent lease to a family member will meet pre-death requirements. However, a share rent lease is necessary if the rentor is not a member of the family. If the owner is not retired, or is retired, but still has not met the material participation requirement of five of the eight years, then the share rent lease to a nonfamily member must also be a materially participating lease.

For the qualified heir, cash rent leases do not work in meeting post-death requirements. All post-death leases must be share rent and, if the rentor is not a member of the qualified heir's family, it must also be materially participating. Note that the family of the owner/decedent does not necessarily include all the same persons as are in the family of the qualified heir.

