



**Estate Planning Opportunities
and Strategies for
Private Forest Landowners**

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The Pennsylvania State University
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Michael G. Jacobson and John Becker, Penn State

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Chapter I

Course Description

A. How to Use This Book

The purpose of this book is to educate readers about the tax and property law issues involved in planning the transfer of property after death. It is not intended to be and should not be considered as legal advice to those who read it. Information provided here will help people who want or need legal advice to understand the questions they must answer, the problems with which they must deal, and some of the choices and options that are available to them as they plan their own estates.

As described in more detail below, the book is divided into chapters to make the discussion more focused. Chapters II through VI are the “basic” chapters: They include information about transfer methods and tax implications that nearly everyone will face. Chapters VII through X are focused on particular issues that might not be involved in estate plans. We suggest the reader decide which of the specific chapters to read based on personal interest in the topics or desire to use the strategies. Chapter XI describes a series of estate planning strategies specifically directed to forest land owners. Chapter XII presents a series of estate planning problems and notes several ways to approach each of them. This chapter is useful after the reader has gained an understanding of the material. Review of earlier chapters is encouraged. Chapter XIII is a series of short forms that will allow readers to begin the process of planning their own estate by preparing an inventory of their assets. This inventory will assist in identifying crucial issues and thereby help focus the plan that is ultimately prepared.

B. Course Objective and Purpose

Estate Planning Opportunities and Strategies for Private Forest Landowners is an outreach education course designed to acquaint readers with fundamental issues involving transfer of property following the death of the property owner. Although awareness of these issues through personal experience prompts many people to consider lifetime planning for this transfer of property, estate planning also involves other important lifetime decisions. This course will examine each of these issues in some detail.

In addition to this basic approach to understanding estate planning opportunities and issues, this course is designed to include a planning strategy component that focuses specifically on the needs and circumstances of private forest landowners. The audience we hope to reach includes private forest landowners in the northeast region of the United States. Our materials contain information on the planning issues relevant under federal estate and gift tax law as well as state inheritance and estate tax laws in each of the northeastern states. Planning strategies will incorporate consideration of these laws in analysis of various options. While this publication was being written a major change in the tax law took place in June 2001. We have incorporated these changes into the text to make it more useful and up to date. There is a possibility that

further changes will occur in the near future. Always check the accuracy of information on tax law-related issues.

The focus of the course is on the estate planning situation of private individuals who own forest land and other assets. These individuals are concerned about the future use and ownership of their asset and they fear that without proper planning, the investment potential of the assets and the prospect of long-awaited returns may be lost. Two of the least understood aspects of forest management by landowners are the role of forests in their estate, and the need for coordinated planning to avoid conflicts and compromises that threaten achieving desired goals and objectives. In many respects, their situation is identical to that of other individuals and their families. In some respects, planning choices and opportunities available to forest land owners and their heirs are unique. The course attempts to address both aspects of the subject, pointing out, where applicable, those provisions that have limited application. Although the title might suggest a narrow discussion, it is intended to be much broader. Both non-forest landowners and forest landowners will find interesting and useful information in the course

The course is written for an average lay person who is not experienced with property transfer or death tax issues, but who has an interest in knowing more about them. Bank trust officers, insurance agents, financial counselors, accountants, and others whose interests or employment involve them in these issues will recognize that this course is not as exhaustive a treatment of the topic of estate planning as it would be if it were written for a professional financial or estate planning advisor audience. This decision was intentionally made to limit the scope of the material and the level of discussion so it would help property owners understand what estate planning is about.

The objective of the course is to help you understand how issues arise in these estate planning situations. The issues may involve ownership of property, particularly forest land, organization and operation of businesses and interests in various types of business organizations, or the several income or inheritance tax issues that apply to the transfer of property during lifetime and after death. Increased understanding will aid in evaluating the application of these issues to individual situations and improve your decision-making capability in relation to property.

Although the course is intended to increase your knowledge and understanding about this subject, it is not intended to be and should not be interpreted as legal advice or opinion concerning these issues or their application. As will be seen in the discussion of income and estate tax issues, this is a detailed and complex matter. Professional advice and counsel are needed to apply these ideas to actual situations. This advice and counsel can only be given after a thorough review has been made by someone competent to evaluate the situation and offer advice. The course does not provide this advice and is not intended to replace the need for it.

C. Overview of Content

In Chapter II, the term *estate planning* is defined to assist you in understanding the scope of the topic. In this discussion, *the tools of estate planning* and the important role that families play in designing effective plans is described. The concept of an *estate planning team* and the

composition of that team is discussed. This focus is intended to introduce you to the basic framework within which lifetime planning takes place to influence lifetime and after death matters.

In Chapter III, the topic of managing forest lands in the northeastern states will be discussed, including such key topics as the importance of establishing forest management objectives, identifying your role as a forest land manager, developing your forest management plan, the role of forestry professionals, forming forest management contracts and finding forestry assistance of various kinds.

Chapter IV discusses four ways by which property is transferred after the property owner's death. ***Transfer by operation of law, through a will, under an intestate distribution statute, and under the terms of a living trust*** are described and compared to each other. General information needed to prepare wills and living trusts are identified. Ownership of property by a single individual or jointly with two or more people is discussed in terms of identifying when ***joint interests*** exist and the characteristics of each form. In comparing the forms, consideration is given to the method by which the transfer takes place and costs associated with it.

Chapter V introduces the topic of ***the tax impacts of property transfer***. The chapter discusses various ***state and federal death, inheritance and gift taxes***. In the discussion, consideration is directed to identifying when the tax applies, how it is calculated, when it is due, and who is obligated to pay it. Within the last few years, tax laws were frequently amended and the discussion focuses on the interrelationship among taxes that must be identified in the planning process.

Chapter VI addresses how taxes that apply to various types of estate are calculated. Included in this discussion are topics that include how property of various types is valued under a series of both general and special rules that apply to various kinds of property. In much of this discussion, the focus is on solving practical problems that face estates in these situations.

Chapter VII discusses the concept of ***lifetime gifts of property*** as a means to shift property from one owner to another to achieve a particular planning objective. The emphasis of this chapter is to explain what constitutes a gift for property transfer purposes and the tax issues and matters that arise when a gift is made. These tax issues involve income, inheritance, and gift tax considerations.

Chapter XI addresses the estate planning opportunities provided by using trusts created either during lifetime or after death. This chapter will explain the essential elements in the creation of a trust discuss typical situations in which a trust can be used. This discussion will help to explain the various forms that trusts take and the essential requirements they must meet.

Chapter X examines the role that ***life insurance*** plays in estate planning. Life insurance products have many different forms; the chapter describes the most common ones. Life insurance is also subject to particular treatment under state inheritance and federal estate tax law and the chapter describes the treatment and issues associated with it.

Chapter XI brings together the various issues and concepts of estate planning and applies them to an estate plan involving a variety of assets, including various quantities of private forest land. Pre-planning information and key decisions are discussed along with strategies for employing the various techniques and opportunities described in other chapters.

Chapter XII addresses a series of additional problems and issues that arise in planning estates that include forest land assets of one type or another. This chapter will give you additional opportunity to evaluate the application of planning strategy.

Chapter XIII outlines the steps needed to gather the information needed to develop the plan. This is information you will need to begin the evaluation of your own situation.

Performance Objectives - Study Hints

At the end of all chapters except Chapters I, III and X through XIII, you will find a series of multiple-choice questions that ask you to evaluate the facts in the situation and address a specific question about it. Each question is intended to evaluate how well you understand the concepts in the chapter and how you will apply these concepts to new situations. You may be asked to compare several concepts on one point or test your understanding of the concept and the situations where applicable. In addition to the multiple choice questions you will also find several short essay questions for you to consider. These questions involve greater analysis of the situation and help you to understand how the various strategies will work in a given situation.

One of the most common errors in answering multiple-choice questions has to do with not carefully reading and understanding the question. As a result, students respond to what they think the question is asking rather than what the question actually is asking. In some cases these differences are very significant. To avoid this problem, please take your time and carefully read the question before responding. Taking this additional time will prevent wasted effort.

Good luck!

Chapter II

Estate Planning and You

Consider This Situation

Harry, Betty, and their four children, ages 17 through 29, live together. Harry and Betty have worked in a farm business for over 35 years. They started by farming the 200-acre main farm and implemented a forest management plan for the 85-acre woodlot, all of which Harry inherited from his parents when they both died in 1969. A few years later, Harry and his brother, Joe inherited a parcel of land as the sole heirs of their older brother, Dick. Dick's property included an additional tract of 150 acres, 75 acres of which was wooded and located adjacent to a real estate development. All of these wooded acres included mixed hardwood species of an average age of 50 years. The average value of the wood on the wooded acres is \$1,500 per acre.

After Dick's death, Harry took over farming operations on Dick's land and began to examine the potential opportunities in the additional wooded acreage. Having managed forest acreage to achieve its maximum potential, Harry began to include the added acreage in his current plan.

Joe had no interest in the operations on Dick's property as he was a successful businessman involved with his own business.

Residential development now completely encircles the main 200-acre farm and the additional 150-acre parcel. As a result, land values have soared upward. Harry has been approached by several people about selling the farm, but he graciously expresses no interest in selling. Developers are particularly interested in the wooded portion of the tract, as it provides an ideal setting for a wooded residential development. Three years ago the combined value of the main farm and woodlot and Harry's interest in the additional parcel was \$3,165,000. The 150-acre parcel alone was worth \$1,600,000.

Harry and Betty own the main farm and additional properties jointly, although the deeds to the properties list Harry's name alone as owner. The 150-acre parcel was distributed to Harry and Joe after Dick's death and ownership of the land passed to them through Dick's estate. In addition to the farmland, Harry and Betty accumulated over \$900,000 of machinery, livestock, and equipment in their farming operation.

Harry prepared a will thirty years ago that transfers all of his property to Betty after his death. Harry also assumed one or more of his children would return to farm and keep the family tradition alive. Family tradition was something that made Harry very proud. He wanted the land to stay in the family and he didn't view himself as the person who should make decisions about its future.

Harry and Betty's oldest child works on the farm having earned a degree in dairy science with a minor in forestry. This child has big plans for the future of the farming operation. The second oldest child travels throughout the country as a public accountant for a national firm. This child

is not interested in the production side of agriculture, but is very aware of the value of Harry and Betty's holdings. The third oldest child graduated from college this year and is deciding what the next step should be toward some type of a professional career. The youngest child is a high school senior who wants to go to college to earn a degree in wildlife science.

Harry and Betty do not spend much time wondering what will happen to their property if either or both of them die. Why should they fill out information about their property and pay outrageous fees to lawyers or others who are only interested in finding out what they own? It's none of their business! At one time Harry considered a partnership with the child who is on the farm, but nothing was done about it. Harry didn't think the child was ready to enter a partnership, and she knew she wasn't really interested either.

Harry and Betty carefully guard their property because they are concerned about their financial future. Medical care costs are rising and it is difficult to set aside a specific amount of property to feel secure about their future. Giving their property away is not a subject that either want to discuss. Harry and Betty work hard for what they have. Why give property away to someone who could waste it, or squander its value?

Neither Harry nor Betty have an accurate idea of the financial value of what they own. They consider only their bank accounts and certificates of deposit as available funds. In these accounts they have a total of \$65,000, in both their names.

Harry never thought much about insurance or retirement planning and has less than \$20,000 of life insurance protection. His income from farming and timber sales is modest, but Betty and the kids are taken care of to his satisfaction.

Harry and Betty are concerned about the future of the farm and timber business and the value that the growing trees will bring in the next few years. The children are concerned about these issues as well. There has been only one family discussion about the businesses and what Harry and Betty would like to see happen to them when they are gone.

A. Overview and Purpose

The issues presented in the above situation provide important questions that will help you understand what is involved in estate planning. For example, what happens to the property owned by Harry if he dies suddenly? What are the tax impacts of Harry's death? Which taxes apply? Who pays the tax? When is the payment due? How will Betty and the kids get along after Harry's death? What will happen to the kids if Betty dies suddenly? In this chapter we will explore the concept of estate planning and the issues it creates.

B. Lesson Objectives

When you have successfully completed this chapter, you will be able to accomplish these objectives.

1. Define the meaning of the term “estate planning.”
2. Describe the importance of setting family goals and objectives as part of the estate plan.
3. Describe the tools of estate planning.
4. Identify the members of the estate planning team and the role they play as team members.

C. What is Estate Planning?

Estate planning is defined in several ways. In one sense, it means maintaining a continuous inventory of what you own and owe and your plans for disposing of your accumulated property if you die. In another sense, it means the process that you apply in planning for the transfer of property after your death. In a third sense, estate planning also involves important decisions you can make that have lifetime impact or significance. Some of the other important lifetime decisions that don't involve the transfer of property, but that are made in the estate planning process include giving someone authority to deal with your property if you become disabled or incapacitated.

In recent years much interest has been shown in the right of an individual to personally decide whether medical care and services should be provided in the case of a terminal illness, disease, or injury. What if the person is incapable of communicating their personal desires concerning care when the condition is diagnosed? In many states laws in place allow individuals to write their own wishes and instructions concerning medical care in cases of irreversible medical problems. These written instructions are known by several terms, including *advanced directive concerning medical care* or in some states the term *living will*. In states where this issue is addressed by legislation, specific procedures and choices may apply to individuals who want to exercise their personal right to decide.

A second issue that is related to an individual's disability in matters involving their property is their right to designate someone to have authority over their property. This transfer of authority is known as *a power of attorney*. In this process an individual who is fully competent to manage property and make decisions designates another person, in writing, to act in their behalf in performing specific duties regarding their property. The authority must be specifically described and can include *the power to authorize a person's admission to a medical or nursing facility or authorization of specific medical procedures and treatment*.

To avoid any future disagreement or confusion about the impact of disability or incapacity on this transfer of authority, the person who designates the other person can specify that any later occurring disability or death has no effect on the grant of authority created by the power of attorney. Documents that make this statement are known as *durable powers of attorney*.

These are just a few examples of lifetime decisions that do not involve the transfer of property. Each example identifies an opportunity to use the planning process to make an important decision. Other lifetime decisions, such as the choice of job or profession, where to live, or how to invest your money, are concerned with accumulating assets or establishing a steady stream of income. In comparison, estate planning decisions look beyond the accumulation of property to the question of what happens to the property you accumulate after you die.

Among the three definitions of estate planning are several key points. Estate planning is a process rather than an act that ends in a single, final event. Estate planning involves many issues that change over time. The individuals to whom the property will be distributed change as families pass through their cycles of lifetime development. Laws that influence choices regarding ownership of property, inheritance and estate tax, business organizations, marital property rights and the status of family members often change. Law changes may present new opportunities for the estate plan. Therefore, it is wise to review the plan from time to time and ask if it still provides for the efficient and effective transfer of property.

D. How Does an Individual or Family Plan an Estate?

Since an estate plan involves many important decisions, the best way to start the plan process is to set individual or family goals or objectives you would like the plan to achieve. These goals or objectives are the guiding light you will follow throughout the process. As choices or alternatives are presented, ask yourself, "How do these choices or alternatives contribute to or detract from accomplishing the goals or objectives I've set?" The goals become the measure against which new choices are evaluated.

Goals and objectives can be individual, family, or a mix of both. Involving family members in a plan in which they play an important part serves to increase the likelihood that the plan will be a success and the family members will perform their roles effectively. Being in the dark about such matters creates a significant risk of misunderstanding or overlooking important issues the plan is to address.

What kinds of goals and objectives do families choose in their estate plans? The answer to this question is really quite broad for each estate plan is a personal decision about individual situations. Although the decisions are personal, a number of general points can be made about them. These include the determination of personal goals; handling of a family business; and property transfer and reduction of attendant state and federal taxes.

First, most estate plans involve a series of personal goals, such as providing financial and personal security for a financially or personally dependent family member. Within families, some individuals have greater needs than others and a plan goal should address those needs. Other individuals may need to have a dependable, regular source of income, either before or after retirement. A plan can address several ways to create an income-producing fund and management of the fund to improve its income performance.

Other individuals select the goal of benefiting people or organizations that are outside of the family. Organizations such as charities, hospitals, churches, and private schools depend to a large extent on the generosity of other people to support their activities, programs, and physical facilities. The tax laws provide an incentive to those who are interested in pursuing this approach and specific benefits to those who make such contributions.

Another example of a personal goal is the issue of promoting family harmony and avoiding those things that tend to disrupt harmony. An issue that many people find particularly distressing has

to do with how to treat children. Should all children be treated equally in the distribution of a parent's property or should parents provide for a distribution that recognizes the special contribution of one or two children and treats them differently from other children? If a parent views this pattern of property distribution that recognizes a special contribution as a fair method of providing for the children, the other children who do not receive the special treatment may question the situation. Earlier, the suggestion was made to involve the family in estate planning decisions. This is for the purpose of explaining why decisions are made rather than permitting family members to influence decisions for personal reasons.

A second set of common goals involves a family business and how the plan treats it. For example, a family business that has existed for generations has quite a bit of incentive to find ways to continue the business. Decisions directed at continuing the business must find family members capable of and interested in continuing the business. If maintaining the family business can be accomplished by distributing the property to only one or two children, other children may feel angry about their sibling's good fortune. Explaining why this decision is made can avoid negative reaction and dissent.

After finding the family member who will continue the business, the next question is, how does one provide for the transfer and meet the expenses of completing it? A great deal of that expense involves inheritance and estate taxes that arise from the transfer. Finding ways to avoid the threat of having to sell the business to pay the required inheritance and estate taxes is the central objective of the plan.

A third set of common goals involve the financial issue of reducing state and federal taxes and the expenses associated with the property transfer. As will be seen in later chapters, property is potentially subject to several different taxes as it is transferred after the owner's death. Since most of us do not want to pay more tax than necessary, opportunities to save taxes are attractive goals for people to set. Within the tax laws and regulations are several important opportunities to accomplish the goal of reducing taxes if the property being transferred is of a particular type or kind and requirements to use the tax saving maneuver can be met. Estate planning goals focus on evaluating the tax-saving maneuver if applied to the owner's situation and ensuring that requirements for application are met. Not all estates are able to take advantage of tax savings maneuvers. The eligible groups are often small and the requirements can be complex. Therefore, the process should involve careful analysis and decision making.

In reviewing these common estate planning goals, keep in mind that they only illustrate common goals. Some estates will have aspects of all three, but effective plans can also be developed that have different objectives. Each estate plan should reflect the personal situation of the property owner and the personal goals and objectives he or she chooses for the plan. Plans vary from individual to individual and family to family.

Size of a family affects the question of whether a parent treats all children equally or fairly. Providing for the transfer of land among five children, only one of whom wants to continue managing the timber, is substantially more difficult than distributing it to two children, both of whom share the same goal. If the plan is developed before the children are at the level to decide,

the parents' desire to see the business continue may have to be accomplished another way or delayed until a future date.

The value of assets directly involves the various tax statutes that apply to the transfer. Having substantial property to pass to others increases the risk that taxes will take a portion of the property before it gets to the intended beneficiary. Planning that recognizes the tax threat and employs planning strategies to reduce the threat has very specific goals and objectives that reflect individual situations.

The type of assets involved in an estate affects the estate's ability to liquidate its assets to pay bills and expenses and make distribution to the beneficiaries. If one of the assets is a family business, a decision to maintain the business faces the practical and tax problems described above. If the decision is to sell the business, important questions about its value to a potential buyer must be answered. Also, the practical problem of continuing operation of the business until a buyer is found is driven by the fact that the value of an active, on-going business is generally higher than one that is out of business. Closing the business while a successor is being sought may result in a rapid decline in business value. In keeping a business going after an owner's death, another problem is the authority of the person running the business. To maintain an active business, the business owner should direct his or her personal representative to do so, or the representative should seek court approval to do so when the owner has not made clear instructions to the representative.

E. Estate Planning Advisors and the Tools They Use

In the previous discussion we touched on a number of problems relating to estate planning issues. To whom would a person go to get all of the information needed to deal with these issues? The answer is found in the concept of the *estate planning team* and the tools used by the team members.

For matters that involve legal issues such as preparation of a valid will or trust agreement to transfer property after death, lifetime gift transfers or advice on property ownership forms that transfer property and save taxes, a person consults an attorney whose practice and experience is in the area of estate planning. The practice of law is complex and many professionals limit their practice to specific kinds of cases. As a result, their knowledge and experience centers on limited subjects. Selecting the right advisor who is experienced in the area you need is an important decision.

Information about *income, estate, or gift tax* questions may come from an accountant or attorney who has the proper background. Since many decisions have lifetime as well as post-death impact, the advisor must be able to coordinate matters in order to avoid an unexpected and detrimental result. Tax advisors use the tools of tax planning strategies and opportunities to minimize taxes or lessen their impact

The *trust*, as a tool in estate planning, involves a transfer of property to a trustee along with a detailed description of the trustee's duties and obligations to the beneficiary of the trust.

Important decisions in the formation of the trust include selection of the trustee and defining the trustee's role in the trust agreement.

In law, a trustee is described as a person who acts as a *fiduciary*. Exercising this authority is a serious matter for which the trustee bears substantial responsibility for decisions made. Operation of a trust with a professional trustee raises important issues concerning the trust agreement and cost of the trustee's services that should be explored by property owners before decisions are made.

Information about trusts as a life-time or post-death device to accomplish planning goals and the role of a professional trustee is available from banks and trust companies whose charter gives them the authority to act as a trustee for another person. Their experience makes them particularly valuable in providing information on the creation and operation of trusts, as well as their cost.

Other members of the estate planning team include advisors whose expertise and skill is in particular areas, such as insurance, investments, or business organization management and operation. The tools used by insurance and investment advisors are insurance and investment products applied to estate planning situations. Product choices have grown dramatically over recent years, and the deluge of new products creates the need to seek out advisors who are aware of and knowledgeable about the range of new products and the functions they serve. Business organization consultants offer advice and recommendations on the organization and operation of alternative business forms such as partnerships, limited partnerships, corporations, tax-option corporations and joint ventures. As alternatives to evaluate in a particular setting, these structures provide opportunities to plan for business changes.

One part of the estate planning team that doesn't bring knowledge or expertise to bear on planning choices, but does play an important role nonetheless, is the family. As the primary group to benefit from property transfers, family members help to define the goals and objectives of the plan. Certain family members will also play important roles in implementing the plan. Their strengths and weaknesses may well influence the plan in significant ways. Understanding the reasons for plan decisions is another role for family members to play in implementing it. Although not the final decision maker, the family should be involved in shaping goals and objectives and supporting the plan that is put in motion. If family harmony is an important plan objective, it may be difficult to gain the harmony without family involvement.

F. Student Exercises

1. The concept of estate planning has several different aspects to it. Which one of the following statements does not describe an aspect of estate planning?
 - a. Planning for the transfer of property after you die.
 - b. Maintaining an inventory of what you own and owe.
 - c. Designating someone to act on your behalf if you become disabled.
 - d. Selecting the investment that offers the highest rate of return on your funds.

NOTE: The following four questions may have more than one correct answer.

2. The estate planning team refers to those individuals who can provide information and assistance to people who are interested in planning their estates. Of the following individuals, who would be part of the estate planning team? Please circle the letter(s) that references those people who would be part of the team.
 - a. Physicians
 - b. Bank Trust Officers
 - c. Bank Loan Officers
 - d. Tax Accountants

3. The tools of estate planning are the devices and techniques that planners use to create plans to achieve the goals of property owners. Which of the following statements describe the tools that could be used in an estate plan? Please circle the letter(s) that correspond(s) to those items that you consider to be tools.
 - a. Wills
 - b. Trust Agreements
 - c. Insurance Plans
 - d. Partnerships and Corporations

4. Estate planning involves making decisions that help to achieve individual or family goals. Which of the following statements would not be considered an individual's personal goal in an estate plan? Please circle the letter(s) that correspond(s) to the goal(s) that you feel are not individual personal goals for your estate plan.
 - a. Improving physical fitness
 - b. Improving nutrition and weight
 - c. Helping someone who is in financial need
 - d. Assuring that children will have funds available to further their education

5. Which of the following events should prompt a person to review their estate plan? Please circle the letter(s) that refer(s) to such an event.
 - a. Birth of a child
 - b. Winning a multi-million dollar lottery
 - c. Changing jobs
 - d. Selling property

Chapter III

Managing Forestlands with a Focus on the Northeast

A. Overview and Purpose

Knowing your forest, its assets, and how it functions are important for making financial and estate planning decisions. Before going into detail about specific estate planning concepts, this chapter provides some very general information on some key topics in forest management. Although not extensive, this chapter should provide a starting point for seeking more information. Forest management is both an art and a science. There are specific scientific tools and methods available for making decisions about tending, harvesting, and regenerating forests. However, because every forest is unique, the decisions must incorporate site-specific considerations. First and foremost, every forest landowner should have a well-written management plan that describes the forest conditions and directs future activities. In addition, and especially for estate planning purposes, a landowner should know the value of their forest assets. This chapter highlights some of the approaches used to value forests. Another central part of forest management is dealing with taxes, other than estate or gift taxes. Property taxes are usually paid on an annual basis, and each state has different rules for forestland assessment and valuation. Income taxes are paid when revenue is received from timber sales or other forest activities. In addition forest landowners may be able to deduct certain management expenses from their income taxes. This chapter provides an overview of taxes and the importance of record keeping. Finally, the chapter provides information about where landowners can find additional forest management assistance.

B. Lesson Objectives

When you have successfully completed this chapter you will be able to accomplish the following objectives:

1. Understand some basic concepts in forestry.
2. Understand the importance of a forest management plan.
3. Describe the key steps involved in writing a management plan.
4. Understand some basic elements of forest valuation.
5. Learn the importance of record keeping, especially for income tax purposes.
6. Know where to obtain assistance in forest management.

C. Introduction

In the twenty northeast states,¹ approximately 4 million private forest landowners own almost 130 million acres. Over 50% of the ownerships are in tracts of 10 acres or less, and 25% are in ownerships of 500 acres or more. Forest types in the region are diverse and vary from spruce-fir along Canadian border states to northern hardwoods and oak hickory in the Mid Atlantic states.

¹ Connecticut, Delaware, Illinois, Indiana, Iowa, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, Vermont, West Virginia, Wisconsin.

Many of these owners want to be good stewards of the land they own—that is, they want to protect and enhance their forest resources for themselves and future generations.

Forestland is owned for a variety of reasons. Some think of their land primarily in terms of timber production or investment potential. Others value the land primarily for its recreational or aesthetic value. Frequently, landowners seek a combination of benefits, using the land for wildlife habitat and recreation as well as a source of income from timber production. Each landowner should have their own set of management objectives to guide them in planning their activities.

Managing your forest estate is a long-term process. It requires planning beyond normal horizons because forests and trees may take hundreds of years to mature and provide the desired benefits. An important part of the estate forest planning process is knowing the value of your forest and managing it for those values it provides. A wisely managed forest can provide many resources and benefits. Not everyone who acquires forestland realizes the need for management. However, careful planning for most forest-based activities, such as timber sales and building roads, will ensure that the forest benefits are not lost. Lack of planning can result in erosion, poor water quality, destruction of natural beauty, lowered timber value, and loss of wildlife habitat, all of which can reduce the future value of the forestland.

D. Important Forestry Concepts

For a basic understanding of tree growth one needs to know a few key concepts. This is by no means exhaustive but provides some initial understanding. The first concept is **site**. A forest grows differently depending on its location or site conditions. If your forest runs along a stream the soil may feel cool, moist and spongy. However, if your forest runs along a ridgetop the forest floor may feel firm, and the soil thinner and dryer. Site is the physical environment in which trees grow. The factors that make up the site conditions include soils, air temperature, humidity, and water availability. In addition, the living vegetation itself affects the site conditions. As trees grow they may shade out sunlight, thereby affecting soils and temperature. Also, wildlife that live in the forest influence site conditions. Trees adapt to the site conditions. One finds different tree species and different growth rates of trees because of site conditions.

The next key concept is **growing space**. This is the space that allows the tree to grow, including the area around a tree and the light, water and nutrients available to that tree. This concept is important in understanding the growth rate of trees. Trees that are clumped together compete for the same resources and may not grow to their maximum potential unless one out competes others for the resources. The trees that are crowded out grow less well, and may not be as healthy. As trees grow bigger they need more space.

The third concept is **shade tolerance**. This has to do with how well a tree does in the shade of other trees. Typically, species are either defined as shade tolerant or shade intolerant. Tolerant species can survive, prosper and reproduce in the shade of trees. Intolerant species are those that can only survive in the open or as overtopping trees. Seedlings of intolerant species can only survive in the shade for a few years, whereas tolerant species may survive in undergrowth for

decades. If there is complete sunlight the intolerant species usually out-compete tolerant species. Species such as hemlock and sugar maple are tolerant species, while pines, some oaks, black cherry and yellow-poplar are examples of intolerant species. Knowledge about species' tolerance helps explain why some species are present and others absent. It is also useful in planning a harvest and thinking about the residual trees and what will regenerate.

The fourth concept is **succession**. This is the process of plant communities succeeding each other over time. This provides the landowner with knowledge about the type of vegetation that will grow in an area at a given time. Typically an area devoid of vegetation will first return to grasses and weeds. Then in a simple scenario, seeds of trees may blow or be carried in by animals. The intolerant and tolerant species will compete with the intolerant usually emerging in the canopy. As the forest ages the tolerant species in the understory emerge when the overlying intolerant species begin to die.

All these concepts relate the process of management planning, and determining how long a forest should grow before a harvest. The length of time a forest is allowed to grow is known as the **rotation age**. This is important from a financial perspective as trees grow more valuable as they age. Trees start off with low value but value increases rapidly as the tree matures. Later in the rotation the growth rate slows. In financial terms you want to harvest a tree when it reaches financial maturity, i.e., when the expected value of the increased tree growth no longer equals or exceeds the net return possible from cutting the tree. Another way to put it is if the landowner's acceptable rate of return for the timber is 4%, the landowner will let the tree grow as long as the annual value increase exceeds 4%. When the tree begins to slow in growth and the annual value drops to 4% or below it is time, from a financial perspective, to harvest. However, there are other values a landowner may be concerned about such as wildlife habitat that require rotations that may be longer than when the trees reach financial maturity.

E. Developing a Management Plan

The first step in being a good forest steward is developing a management plan. The plan is a tool to guide the landowner toward meeting their goals and objectives. Some landowners may not realize that most forestry activities are compatible with maintaining the aesthetic quality and recreational value of their land. In fact, properly planned forestry activities can enhance visual appearance, provide improved recreational opportunities, and sustain and often increase wildlife populations.

An important approach in forest planning is to realize that forests do not stop at legal property boundaries and that your forest may be part of a larger forested area involving a number of landowners. Foresters generally think about a forest as a collection of individual stands. This is suitable for prescribing timber harvests and regeneration plans. However, many attributes of a forest such as wildlife and water quality are components of the larger landscape, not just one forest stand. Managing at the forest or landscape level allows one to consider the complexities and linkages among the various attributes, ecological communities, and stands. This does not imply that you should manage the land together but adapt your planning to limit potential negative impacts of your actions on adjacent owner's properties.

Also, in managing forests you should have a long-term perspective. Creating desired landscapes may take many years. Rotation ages for certain species or stands may be lengthened to address wildlife or ecological issues. The approach to thinking about the larger landscape and over longer time periods is often referred to as **ecosystem management**. Ecosystem management is not intended to impose management restrictions on private forest landowners. Private landowners have the right to manage their land as they wish, within the range of applicable laws and guidelines.

As discussed already, you should talk about goals and objectives with family members and those who will assist you in carrying out forest management activities. Often the assistance of forestry professionals is needed to achieve the best results. You should think about short- and long-term goals and objectives. Begin by asking yourself questions about why you own the land. Answers may include the following:

1. The forest has been in the family for years and I want to continue the tradition.
2. I am looking for a future income source.
3. I like the beauty of the woods.
4. I like watching or hunting animals in my woods.

Then ask, how would you like your land to look? Answers may require you to make some investments. Are you willing to conduct a timber sale? Will you allow public recreation on your land? Will hunting be allowed? Once this is done you can start thinking about the tradeoffs you are willing to make. For many landowners this gives them the opportunity to focus their thoughts. Goals may include maintaining a forested appearance around your home or along access roads or manage timber stands for scenic beauty, recreational trails, and responsible profits.

Based on your goals you should work with a resource professional such as a forester when writing the management plan. A forester can even help frame your goals and objectives. The professional will then need some information about your land to develop a complete resource inventory of your property. Maps provide information on vegetation types, unique features, bodies of water, timber stands, fields, clearings, and boundaries. Topographic maps delineate major features and show property lines. Aerial photographs provide birds-eye views of the land uses and vegetative cover within you boundaries and on adjacent land. After reviewing the maps, walk the property to note the type and condition of the resource. Examples of resources noted in the field include vegetation, landscape features, wildlife, and water bodies. Once the evaluation is done, the plan is written and a schedule of activities for the short and long-term is developed. For more information on writing management plans see:

 The Elements of a Successful Forest Management Plan: The Key to Forest Stewardship
<http://www.agnr.umd.edu/ces/pubs/pdf/FS625.pdf>

 Forestry Management Workshop Manual
<http://www.webcom.com/duane/wood/woodindx.html>

F. Valuing Your Forest

Typically appraisers value forestland based on its land and timber values. However, there are other benefits such as wildlife or recreation which have value but are not calculated for tax or estate planning purposes. The land value is typically derived from sale prices of recently cutover forestland in your area, but there are other methods if sales of cutover land are difficult to find. It is important to use a certified appraiser to derive land value for estate tax purposes.

Property appraisers generally use one of three approaches to determine market value of forestland:

1. Market or comparable sales approach. This method compares properties to others that have recently sold.
2. Cost approach. This method is based on how much it would cost to replace a property with a similar one.
3. Income approach. This method values the property based on the potential income from the property.

The appraiser may use more than one approach to check for accuracy. Factors involved in determining timber value include species type, age, size, timber quality, and quantity per acre. An inventory (or timber cruise) is carried out to determine the volume of timber products on a tract of land.

It is important that timber value is appraised separately from land value. This will ensure an identifiable timber basis (discussed in next section) for tax purposes when the timber is eventually sold. Timber values depend on many factors, including land accessibility, markets, interest rates, mortgage rates, and overall economic climate. For bare timberland, the market sales approach is usually most reliable. Generally, for land with mature timber, the income approach is the most practical method for a number of reasons. For timber that is not yet mature, some hybrid of the cost and income approach may be most effective. For more information on forest valuation see:

When to Harvest Your Trees

<http://www.ag.iastate.edu/departments/forestry/ext/pubs/F-325.pdf>

G. Income Tax Aspects of Forest Management and Recordkeeping

The Federal government provides tax incentives to encourage timber production, and many local and state governments provide preferential property tax for forested properties. One of the keys to taking advantage of tax incentives is to keep good records. Not only is recording keeping beneficial for tax filing or saving money, but it should provide information needed to make wise forest management decisions. Forest management for timber is a long-term investment that requires knowledge about the land that is built up over many years. Records are one of the keys to having a successful and sustainable forest to enjoy for many generations. Well-organized

records are also important for reporting forest management expenses and revenues for income tax purposes.

Good records help you determine production costs, establish basis, and estimate taxable income or expenses due to timber sales, involuntary conversions, casualty losses, timber theft, and estate transfers. Many of these topics are complex and details are found in reports such as. “Timber Taxation: A General Guide for Forestland Owners” (Penn State Extension) which provides a simplified overview of forest taxation while “Forest Landowners Guide to the Federal Income Tax” (USDA Forest Service) provides more detailed information. Also, landowners should consult with accountants, estate planners, lawyers or foresters familiar with the tax code.

Landowners who manage their forestlands as an investment or trade or business should consider a formal system of accounts, since these owners can deduct expenses. Generally, those active in a trade or business are allowed the most deductions. The IRS has strict rules for reporting revenues and expenses, and provides the Federal tax form T (Timber), “The Forest Activities Schedule” to show and separate capital assets (land, timber, buildings, equipment), and report timber sales, land improvements, and reforestation expenses. The Form T has schedules showing where to record each activity. Information recorded on Form T transfers to your Income Tax Schedules depending on your income classification (personal, corporate, or farmer). Copies of Form T and other tax forms and schedules are downloadable and available at www.irs.com.

There are three key situations when a forest landowner needs to keep accurate records for tax purposes:

1. To establish accounts and allocate costs for land and timber purchases.
2. To record expenses associated with forest management activities.
3. To record income from timber sales and adjust timber accounts.

The first step, establishing accounts is done on Form T. This provides the framework for recording all other income and expenses associated with forest management activities. The following sections describe the process for setting up initial accounts, and recording expenses and income. Remember, many of the specific tax related details for filing taxes are dealt with in other publications.

1. Establishing Capital Accounts: Recording Land and Timber Purchases

When you purchase, inherit or are gifted forestland you are acquiring a capital asset. Record these capital assets on Schedule B of Form T. Differentiated from assets with a life of less than a year, capital assets are not be deductible from income taxes in the year acquired. The costs associated with acquiring (or improving) capital assets are only deductible when disposed of through sale, depletion, or depreciation. There are three main types of capital accounts for forest landowners: land, timber, and durable equipment and buildings.

When establishing an account for each asset, determine each assets **original cost basis**. This is important as you can report less taxable income when filing because the basis is deductible from

the sale proceeds. The basis requires an estimate of the fair market value (FMV) on the date of purchase or acquisition. It is best to establish the basis when the property is acquired; however, it is possible to establish the basis later. To establish original basis you allocate the acquisition costs proportionally to each account relative to the FMV of each account. If the property is acquired by purchase or inheritance, the original basis is based on the FMV of the date of acquisition. If the acquisition is a gift, then the original basis is the donors adjusted basis. The original basis is adjusted with acquisition or depletions of the capital assets. For more details on allocating and depleting basis see the tax publications referred to at the end.

A discussion of each of the three primary capital accounts follows:

Land account: The FMV is the bare land value. To derive the FMV you can use the sale price of recently cutover forestland in your area. Cost or income appraisal methods are used if sales of cutover land are difficult to find. In the land account keep track of land costs and improvements such as permanent roads and firebreaks. These types of improvements and the land itself cannot be depreciated or depleted. Some improvements such as culverts, bridges, fences, or temporary roads are depreciable and you may want to establish a separate sub-account for such assets. The basis in the land account is recovered when the land is sold or disposed of.

Timber account: You can divide your timber account into two sub-accounts: merchantable timber, and young growth (pre-merchantable timber). The merchantable (marketable) timber is recorded in standard units – usually board feet, cords, or tons, depending on the intended product. Pre-merchantable timber is usually recorded in acres. As the timber matures, adjust the accounts accordingly. The IRS allows landowners to separate accounts for each timber stand (a individual management unit). The criteria for a stand include, similar species type and age, a separate plan and identifiable on a map.

Equipment and Buildings account. This account includes all non-land and timber assets, such as tractors, chainsaws, skidders, and farm buildings, or residential rental properties. You can establish separate accounts for each type of equipment and the buildings based on the FMV at time of acquisition or purchase price. These items, as capital assets, should be depreciated. Major repairs that extend the life of the equipment or buildings can be considered as capital improvements, and also should be depreciated. Normal operating expenses on equipment and buildings such as repair and maintenance (discussed below) are deductible in the year they occur.

2. Recording Management and Operating Expenses

Landowners should distinguish between capital expenses and normal operating expenses. Capital expenses include those that improve a capital asset that has a life generally of a year or more. Capital expenses were discussed above and depreciable over the life of the asset. However some expenses such as permanent roads are usually only recovered when the property is sold.

There is a special exception for reforestation expenses, which are considered capital expenses and should be included in the pre-merchantable account. However, the IRS allows up to \$10,000

of those expenses deducted in the year they are incurred through a special reforestation tax credit and amortization option. See references for details. Expenses incurred during the life of the rotation such as timber stand improvement costs (thinnings, herbicide or fertilizer applications) can be deducted as operating expenses or carried as a capital expense, depending on whether the owner is a trade or business or investor.

Operating expenses are considered ordinary and necessary to managing, maintaining and improving the profitability of your forestland. Types of expenses include consulting fees, property taxes, insurance premiums, equipment repairs, travel and meeting costs for forest-related events. Expenses incurred for using your land for tours, demonstrations and other forestry related events may also be tax deductible. Landowners may wish to lump expenses or divide them into separate categories such as fixed expenses and variable expenses. Expenses for personal use such as recreation are not tax deductible. Reporting expenses for tax purposes, the type and how much of an expense the IRS allows you to deduct depends on how you own your forest: as a business, for investment or only for personal enjoyment. For details on IRS criteria for which category you may fit refer to other publications.

3. Recording Income From Timber Sales

There are a number of legal and tax implications for timber sales, including the type of sale, length of ownership, and ownership classification. Income is received when timber, land or equipment is sold. Landowners can deduct expenses associated with the sale of the asset from the sale proceeds. These may include lawyers or consulting fees, surveys, maps, advertising, and state and local taxes. In addition to these expenses one may also deduct the basis of the timber you sold. Details on adjusting basis from timber sale are shown in tax references. Depending on the method of timber sale, (lump-sum vs. pay as cut), the length of ownership, and ownership classification (investor or trade and business) you can receive capital gains treatment. All other income such as cost-share payments, hunting leases, maple syrup, and firewood permits are considered ordinary income. Some cost-share payments may be excluded from income taxes. Schedule C on Form T is where you record profit or loss for timber sales. Schedule C is also where the adjustment to your timber accounts is made. It allows you adjust your basis as timber is depleted.

A timber sale often involves a substantial sum of money, not to mention that such a sale is something the typical landowner does infrequently. Anyone considering a timber sale should not rely on personal judgment, but should confer instead with a recognized professional forester. First, when selling timber, be certain your interests are protected. Professional assistance is well worth the cost. Usually, matters that deal with deeds, contracts, and other legal formalities are generally complex and confuse laymen. Ideally, the sale agreement should be prepared with the advice of a forester who is knowledgeable of provisions that an attorney could express in legal terms. Second, a good timber sale agreement is clearly understandable, workable, and enforceable for both buyer and seller.

A contract establishes both the conditions to which buyer and seller agree and also their rights and duties under these conditions. No two timber-cutting contracts are exactly alike, but all contracts should include basic provisions such as:

1. Guarantee of title and description of the land and boundary lines.
2. Specific description of timber being conveyed, method of designating trees to cut, and when, where, and how to determine volume.
3. Terms of payment.
4. Duration and starting date of agreement.
5. Clauses to cover damages to non-designated trees, fences, ditches, streams, roads, bridges, fields, and buildings.
6. Clauses to cover fire damage where harvesting crew acts in a negligent, willful, reckless, or malicious manner to protect the seller from liability that may arise in the course of harvesting. Also, a clause about indemnification from liability should be inserted.
7. A standard to completely utilize the merchantable portion of trees.
8. Clauses for arbitration in case of disagreement.

4. Key Terms

Adjusted Basis: The original basis of a capital asset minus any reductions from sales, depletion, depreciation, amortization or losses claimed.

Basis: The money invested in a capital asset.

Capital account: An account used to keep track of the basis and quantity of capital assets

Capital Asset: An income-producing property used for investment or in a trade or business that is acquired through purchase, inheritance or gift of an asset with a useful life of more than one year. Examples include land, timber, buildings, machinery, equipment, bridges, roads, and tree planting.

Capital gain (or loss): The net income realized from the sale or disposal of a capital asset. Capital gains (or losses) are treated differently for tax purposes from ordinary income.

Depreciation: The wearing out of an asset for which the IRS allows the cost recovered over a certain number of years, depending on the type of asset.

Depletion: The removal or using up of trees or other natural resources from property. The depletion allows recovery of the owner's basis. The depletion allowance is the portion of the adjusted basis and is based on the volume removed. Unexpected losses of timber from events such as tornado or fire also result in depletion of basis. This is not to be confused with "depletion allowances" from mineral exploration.

Fair Market Value: The current price at which an asset would exchange hands in a transaction between both a willing and informed buyer and seller.

Operating Expense: An ordinary and necessary expense associated with carrying on a trade or business. Operating expenses may be deducted annually as they occur.

Ordinary Income: Reportable income other than a capital gain. Ordinary income is liable for self-employment taxes.

Original Cost Basis. The amount entered in a capital asset account (land, timber, or equipment) when it was acquired. If the asset is purchased the original basis is the total cost of acquisition. If the asset is inherited the original basis is the FMV on the date of the decedent's death (or alternate valuation date). If the asset is gifted the original basis is the donor's adjusted basis.

5. For more detailed income tax information:

Jones, S. and M. Jacobson 2000 Timber Taxation: A General Guide for Forestland Owners. Penn State Extension. <http://pubs.cas.psu.edu/FreePubs/uh131.html>

Haney, H. et al. 2001. Forest Landowners Guide to the Federal Income Tax. USDA Forest Service Agriculture Handbook No, 718. www.fs.fed.us/spf/coop/

National Timber Tax Web Site: <http://www.timbertax.org/>

H. Obtaining assistance

Forest landowners often seek advice and information about improving their forests for production and conservation purposes. Managing forests is a complex process that involves information from a number of disciplines, including biological sciences, social sciences, economics, policy, and law. A landowner's questions may range from how to acquire and sell forest land, to the variety of approaches for growing and marketing forest products. Some questions may require a lawyer or tax accountant, others a professional forester or wildlife expert. A variety of public and private services are available to forest landowners. Many owners indicate that much of the success and satisfaction they derive from their land comes from services provided by forestry or natural resource professionals

Professional foresters can provide landowners with management assistance that will increase the value and productivity of their forested acreage. There are foresters who work with state agencies, often at the county level, and administer government cost-share and incentive programs. The county extension service may also have forestry experts on staff. They are useful sources of information and technical assistance. Contact your county extension office for more information.

Private consulting foresters are another source of assistance for landowners. A consulting forester represents, for a fee, the best interests of clients in all matters concerning the forest. A consulting forester usually provides more services than the government forester. They can help improve the quality of the forest environment and increase the production of marketable products. When the trees become merchantable, he or she can secure buyers and supervise the

timber sale. The fees charged by a consultant may be based on an hourly or daily rate, forest acreage, or a contract price based on a percentage of gross revenues from the sale of forest products. The cost of services can be repaid by faster tree growth and the higher prices received for timber that is marketed correctly.

Industrial foresters and timber dealers procure wood from private owners who are ready to harvest. There are also forestry companies that have landowner assistance programs that provide technical advice and planning services. Generally the assistance is geared to timber production. County foresters or extension agents can identify participating forest industries in your county. Other sources of assistance for specific situations include timber harvesters, accountants and lawyers who are experienced in these matters. Not all professionals have the experience in the areas in which you are concerned. Be sure to find reputable and knowledgeable assistance. Talking to other forest landowners, specifically your neighbors, may also be a useful source of information. For more information, see:

 Sources of Information and Guidance for Forest Stewards

<http://pubs.cas.psu.edu/FreePubs/uh076.html>

 USDA Landowner Assistance Programs

<http://www.fs.fed.us/na/morgantown/frm/perkey/ctpub/ctpub.html>

I. Student Exercises

1. List the key factors that affect how a tree grows on your land.
2. What does the concept of ecosystem management imply for managing lands?
3. Describe how your objectives may be translated into a management plan.
4. What is basis and why it is important?
5. Why is a written contract important prior to conducting a timber sale?

Chapter IV

Property Transfers After Death

A. Overview and Purpose

Land is a valuable asset. When land ownership includes forest areas and wood lots, the value attributed to such assets can be misunderstood or overlooked. When the owner of such assets dies, however, the assets transfer to the deceased owner's estate where they await distribution to a new owner or set of owners.

The significance associated with the death of a property owner is illustrated by this basic point all items of property have an owner at any point in time. When an owner dies, transfer of the owner's property to someone else is a central issue resulting from the owner's death.

In this chapter, we will explore *four ways in which property is transferred after an owner's death, i.e., by operation of law, by the intestate law, by a last will and testament, and by a trust created during the owner's lifetime that provides for this transfer after the owner's death.* As will be shown here, a person's death sets in motion specific legal rules that make our basic point, that all items of property have an owner at any point in time, a workable legal proposition.

The chapter starts with a discussion of joint ownership of property in the form of joint tenancy with the right of survivorship, tenancy by the entirety, and tenancy in common. In some states, these various types of ownership are known by other names such as joint accounts or multiple-party accounts. Some states also recognize the concept whereby an account is owned by one person during his or her lifetime and the balance that remains at the owner's death is payable on request to someone else after the owner's death. Such an account is known as a P.O.D. account or one that is "payable on death" to another. Following this discussion we turn our attention to the issue of sole ownership of property and its transfer under a last will and testament or the intestate law that applies in cases where a person dies owning property in his or her own name, but without having prepared a will that provides for the transfer of the property. The fourth way in which property can be transferred is under the terms of a trust created by a property owner during his lifetime and to which the owner's property is transferred under instructions that provide for the transfer to other owners under described conditions. Under the terms of the trust, the owner designates those who are to benefit from the property. During the owner's lifetime, the owner may retain some benefit from the trust property which ends at the owner's death. Having created the trust relationship, the owner, through the trust agreement, can designate someone to receive it after his death.

B. Lesson Objectives

When you have successfully completed this chapter, you will be able to accomplish these objectives:

1. Compare the various forms of joint ownership of property and explain how they are created.
2. Compare property distribution under the terms of a last will and testament to property distribution without a will.
3. Discuss the general characteristics and concepts of distributing property under the intestate law.
4. Discuss the various kinds of trusts that are used in the estate planning situation and discuss the role they play in distributing property after an owner's death.
5. Evaluate the various ways you own your own property and consider the advantages and disadvantages.

C. Property Transfers After the Death By Operation of Law

Transfers of real estate or personal property that occur by operation of law take place when one joint owner of a property dies and the owner's interest passes to other owners who survive the deceased owner. Typically this form of ownership form is referred to as joint ownership with the right of survivorship. In some states this concept is simply referred to as joint ownership. This form of ownership is created when the joint owners make a lifetime decision to share ownership of property, and provide that at the end of any joint owner's life, the surviving owner(s) automatically become the owner(s) of the property. During their lifetime joint owners share the right to use all of the property as their own and they share in the income, rents, or profits that the land produces. If the property is sold each joint owner receives a share of the proceeds from the sale. Joint ownership can generally be created in a variety of ways, such as joint sharing of the purchase price, a gift of a one-half interest to the new owner, or purchase of a one-half interest in property that is fully owned by a current owner.

Not all forms of ownership involving more than one owner are considered to have this survivorship feature. One way that a joint tenant with the right of survivorship is recognized is by identifying a transaction in which the interests of the owners satisfy the requirement of *the unities of time, title, interest and possession*. These unities recognize that all owners acquired their interest at the same time, the nature of their ownership interest is identical, their interests are equal in relation to each other, and they share an equal right to possession of the property.

Creating a joint ownership interest with the survivorship feature is a matter of state law. Joint ownership with the right of survivorship may require the owners to clearly express their intent to create the survivorship feature as a part of their decision to share ownership with each other. If the owners fail to make this clear expression of their intention a different form of joint ownership, known as tenants in common (described below), is created. In some states, tenancy in common form of ownership is referred to a multiple-party ownership.

Unless there is clear evidence of intent to include the survivorship feature when it is created, state law, such as The Uniform Probate Code, may give each joint owner access to the account only to the extent of their net contribution to it. This result is based on the assumption that a person who deposits money in a multiple owner account normally does not intend to make an irrevocable gift of all or any part of the funds represented by the deposit. Rather, such a person

is presumed to intend no change to the present form of beneficial ownership. The funds in the account should be accessible by those who deposited them there. Any amount remaining on deposit at the death of the original owner belongs to the surviving owner.

Example: If a single owner decides to add another owner to an account, thereby creating a joint ownership interest, the question is whether the original owner intends to give the new owner a present gift of a one-half interest in the account, or intends for the new owner to receive the property at the original owner's death. In the absence of clear and convincing evidence of the intent to share access to the account during the original owner's life, it will be presumed that the owner intended to delay the transfer until after death.

However, if clear and convincing evidence of an intent to create a present gift is established, each owner has access to an equal share of the account, as though each had contributed an equal amount to it. The person who received the property gift has complete authority and control over the property he or she is given. If such evidence cannot be established, however, then each owner has access to the account in whatever amount equals the proportion of their net contributions to the total account. If the original owner contributes all of the funds and the new owner fails to contribute any funds, then the original owner has lifetime access to the full account and the added owner has no lifetime access to it. Upon the death of one of the owners, the survivorship feature transfers the deceased owner's share to the surviving owners, who acquire a equal share of the portion previously owned by the deceased.

For example: If three people are joint owners with the right of survivorship, at the death of one person, that person's share is divided equally between the surviving owners. Their ownership share increases by one-sixth; their new ownership share would be one-half ($1/3$ or $2/6 + 1/6 = 3/6$ or $1/2$). At the death of one of the two owners, the surviving owner becomes the sole owner of the property by receiving the deceased's one-half share and adding it to his or her one-half share. Transfer takes place automatically upon the death of the person who owns property as a joint owner with the right of survivorship. Documents which show ownership must specifically state that it is owned as joint tenants with the right of survivorship.

Who can be a joint owner of property? Anyone can share ownership of property with another person under this ownership form. No restrictions or requirements limit its availability to family members or other limited groups.

Property acquired by either spouse during the time of the spouse's marriage also creates a question about the rights of a spouse to property that is owned by the other spouse. Married persons can generally acquire property and own it as an individual person, or they can share ownership of the property with their spouses. In some states, state law grants spouses certain specific interests in each other's separately owned property. That discussion is beyond the scope of this book.

In a number of states, property owned by spouses is considered to be owned as community property. Under this concept spouses are considered to share ownership of property that is acquired during their marriage. Property acquired before marriage, as well as property acquired after marriage under a transfer from another's will, by gift, or by inheritance is considered separate property to which the other spouse has no claim. At each spouse's death, essentially one-half of the community property is considered to be owned by the deceased spouse and the other one-half is owned by the surviving spouse. In some states property owned jointly by a husband and wife is classified under a special form of joint ownership called tenants by the entirety. At the death of the first spouse, the surviving spouse automatically becomes the owner of this property. Documents which show ownership of property must specify joint ownership and that the joint owners are lawfully married to each other.

One situation in which joint ownership creates a problem is the simultaneous death of both owners under circumstances that cannot determine which owner died first. Since surviving the death of the other owner is the key requirement to transfer of ownership, time of death of the first party to die is required to make that determination.

To resolve the problem created by the simultaneous death of both joint owners, state law, such as the Uniform Simultaneous Death Act, provides that unless a will, living trust, deed, or insurance contract provides otherwise, property held in these ownership forms is to be distributed in the following way: one-half is to be distributed as if one owner had survived and one-half as if the other owner survived. If there are more than two joint owners and all owners die simultaneously, the fractional share would be proportional to the number of joint owners. A person can change this result by specifying in a will, trust, deed, or insurance contract their own rule for determining the order of death in such situations. In other words, the person can create their own presumption of who dies first in the case of a common disaster or accident. This decision is frequently made when planning an estate in order to direct that the property owned by the spouses be transferred in the way that best minimizes federal estate taxes.

A third form of joint ownership of property is tenancy in common. Under this form, two or more people are the owners of undivided fractional shares of a larger piece of property. Unlike joint owners with the right of survivorship, tenants in common need not have equal ownership shares in the property. Under the four unities of time, title, interest, and possession discussed above, a tenant in common form of ownership is often recognized by the unequal ownership interests among the joint owners. One owner can own a large share while others own small shares. A second distinguishing factor involves the effect that death of one of the tenants in common has on the surviving owners. Tenants in common who survive the death of any other tenant do not have a claim to the deceased tenant's share simply because they are surviving joint owners. When a tenant in common dies, that tenant's share of the property becomes an asset of the deceased owner's estate and is transferred to the heirs designated in the deceased owner's will or under the intestate law. This method of transfer may completely disregard the surviving tenants on the property if the owner has decided to do so.

How are the various joint ownership interests created? To create a joint tenancy with the right of survivorship, the owners at the time the joint tenancy is created must specifically express the

intention to create the interest. Simply establishing ownership that is shared by two or more people may not be enough to create the survivorship feature. Words that describe the joint owners as "joint owners with the right of survivorship" are needed to create the ownership form. Under the law of some states, it is presumed that a tenancy in common is created if the document that creates the ownership interest does not contain words that express the intent to apply the survivorship feature.

Example: John and his brother, Charles purchase a tract of land in Happy Valley. Each contributes to the purchase of the property and both wish to create a joint tenancy with the right of survivorship. When the deed to the property is prepared, the deed should be to "John and Charles of Happy Valley as Joint Tenants with the Right of Survivorship" to create the necessary interest. Other language that conveys the same meaning, but uses different words, will also be effective in creating the desired result if they clearly express the intent to apply the survivorship feature.

In order to create a tenancy by the entirety, the joint owners must be legally married to each other and reference to the marriage relation is sufficient to create the interest.

Example: Mary and her husband, Bob, are purchasing a tract of land near Silver City. Mary and Bob want to create a tenancy by the entirety relationship for their ownership of the property. When the deed to the property is prepared, it should describe the buyers as "Mary and Bob, wife and husband of Silver City."

Another important issue concerning jointly owned property is the ability of each joint owner to sell his or her interest to other persons. In a tenancy by the entirety, both spouses must sell their share for a transfer of title to be effective. In a tenancy in common, each tenant is free to sell his or her own share without any involvement from the other tenants. In a joint tenancy with the right of survivorship, a sale of one joint tenant's share converts the ownership form from a joint tenancy with the right of survivorship to a tenancy in common.

What right do creditors of any joint owner have to reach the owner's share in the jointly owned property to collect on delinquent debts of the owner? In the case of a tenancy by the entirety, creditors of individual spouses cannot reach property owned jointly by the spouses. Individual creditors, however, are able to reach separately owned assets of their debtor spouse. Creditors of a tenant in common are able to reach the tenant's share since it is viewed as an individual asset. Creditors of a joint tenant with the right of survivorship are also able to reach the tenant's share of the jointly owned property. By attaching such property and executing on it to satisfy an obligation, the joint tenancy is converted to a tenancy in common.

D. Transfer By the Intestate Law

If a person owns property in his or her name alone, or the property is a tenant in common share of property that is owned jointly with others, the transfer of ownership is made either under a will prepared during the person's lifetime or under the provisions of the intestate law of the state

where the owner resides. If a person does not have a will, the intestate law of the state that the deceased considered his or her domicile creates a schedule for the distribution of separately owned property. Within the schedule, the statute decides who is to receive the property, how much they are to receive, and any special conditions that apply to this transfer. The following table describes how the intestate statute distributes property owned by a person who died and who considered this state to be her domicile, the place which the person considered to be her home at the time of her death. This information is based on the Uniform Probate Code (UPC), a sample law prepared at the national level and available to states to adopt as part of their own state probate law. The UPC offers a typical example of what these laws address:

- A. If a *spouse survives the decedent*, the share of the surviving spouse depends on the following circumstances.
 - 1. The surviving spouse is entitled to receive all of the decedent's estate if either:
 - a. No descendants of the deceased survive, or
 - b. All of the decedent's surviving descendants are also descendants of the surviving spouse. For these purposes the term descendants includes descendants of all generations.
 - 2. If one or more of the decedent's surviving descendants is not a descendant of the surviving spouse, then the surviving spouse receives the first \$100,000 of the estate plus one-half of the remaining estate balance.
- B. Whatever share is not distributed to the surviving spouse, i.e. one-half of the remaining estate balance, or the entire estate if there is no surviving spouse, is distributed to the descendants of the deceased by the process of representation. Under the process of representation, a decedent's estate is divided into as many equal shares as there are (i) surviving children of the decedent, if any, and (ii) children of the decedent who failed to survive the decedent but who left descendants who survive the decedent. In this process each surviving child is allocated one share and each deceased child who was survived by descendants also receives one share that is divided among the descendants of the deceased child.
- C. *If no descendants of the decedent survive*, then to the parent(s) of the deceased.
 - 1. If both survive, they take equally.
 - 2. If only one survives, to that person individually.
- D. *If no descendants and none of the deceased's parents survive*, then to the descendants of the deceased's parents (i.e., the deceased's brothers, sisters, nephews, nieces, grandnephews, or grandnieces) take by the process of representation described above.
- E. *If no brothers, sisters, nephews, nieces, grandnephews, or grandnieces of the deceased survive*, then to the deceased's grandparents or descendants of grandparents
 - 1. If one or both of the maternal and paternal grandparents of the deceased survive, one-half of the estate is distributed to the maternal and one-half to the paternal grandparent(s).

2. If one of either the maternal or paternal grandparents survive and neither of the other grandparents nor any of their descendants survive (aunts, uncles, and cousins of the deceased), the entire estate is distributed to the surviving grandparent.

F. *If neither the maternal nor paternal grandparents of the deceased survive, and none of their descendants survive, the estate is considered to have no taker. In the case where there is no taker, the entire estate passes to the state.*

In order to receive the share that the intestate law designates, each beneficiary, including a surviving spouse, must survive the decedent by at least 120 hours. This requirement will not be applied, however, if as a result the property passes to the state as described in paragraph F, above.

When property is distributed to more than one heir under the intestate law, the several owners take each of their shares as tenants in common to each other.

Example: There is a distribution of \$170,000 under the Uniform Probate Code. The sum was owned by a person who is survived by a spouse and two children who are children of the marriage. Following the payment of debts, administrative expenses, and a family exemption, the spouse receives all of the estate as the descendants of the deceased are also descendants of the surviving spouse.

If one of the children is not a child of the marriage between the deceased person and the surviving spouse, but was born in a prior marriage, the shares to the spouse and children will change. The spouse is entitled to the first \$100,000 of the estate plus one-half of the remaining amount or \$35,000 (1/2 of \$70,000). Each child's share is one-half of the remaining \$35,000.

If the deceased person and spouse did not have any children from their marriage or a prior marriage, but the deceased person is survived by parents, then the spouse receives the entire estate and the parents receive nothing.

E. Transfers By a Last Will and Testament

Property owners who want to direct distribution of their property after death can do so by preparing a will. Like the intestate law, a will only provides for the distribution of separately owned property. Unlike the intestate law, which primarily benefits family members, a will can bestow benefits and property on family members, strangers, corporations, charities, churches, and other beneficiaries.

For a transfer to be made according to the will, the document must identify the person to receive property at the owner's death. Therefore, most wills provide for several levels of distribution. The first level is considered to be the primary beneficiaries. If the primary beneficiaries die before the property owner, a will commonly provides for a second level of distribution. In some cases, a will may provide for distributions beyond the second level. If all of the named

beneficiaries in the will die before the owner, the owner's property is distributed according to the intestate law even though the owner took steps to avoid this possibility. Under the laws of some states, the children of certain beneficiaries named in a will who die before the person who prepared the will can take the share that their deceased parent would have taken. In such cases, the statutory method of transferring the property can step in to avoid a situation where the intestate law would otherwise apply. Distributing property under the terms of the will can be achieved by ensuring that the will always names a beneficiary who will survive the decedent.

Under the Uniform Probate Code, a valid and enforceable will is one prepared by a person eighteen years of age or older, of sound mind, possessing testamentary intent, and understanding and acting without duress or under any undue influence. The document must recognize an intent to distribute property after death and be signed at the end by the person making the will. A will can be formally prepared by an attorney experienced in estate planning and administration matters or by a property owner. State laws generally create any detailed list of requirements that must be met for a will to be considered valid. States do and do not require that people witness the signature of the person who prepared the will. Many states do not follow a procedure that allows a will to become “self-proving.” This means that the person preparing the will has followed a detailed procedure and signed a statement in the presence of a person who is authorized to administer oaths. Under many state rules, those who witness the signature also make these statements before a person authorized to administer oaths. State laws are the source of all requirements for the validity of will, and it is advisable to consult a reputable source of current information or someone in the state where you live who is familiar with these requirements to make sure that the outcome of the planning effort is an effective document.

Under the law of many states a surviving spouse may be granted a right to elect not to take the share of property that the will has made for that spouse. Under the Uniform Probate Code, for example, within six months after a person's death, a surviving spouse has a right to elect against what the will provides for the spouse and elect to take what state law has designated as a surviving spouse's share. This election requires the surviving spouse to give up his or her claim to certain property in return for a statutory share of one-third of certain other specifically identified property. In deciding whether to elect against a will, a surviving spouse should calculate what the spouse's share would be with and without an election. This will require a detailed examination of the type of property that is subject to the election, or which is not considered to be part of it. Then an actual calculation can be made of what the surviving spouse's share would be with and without the election. At this point the surviving spouse should have detailed information on which a better decision can be made. Timing when the election is made is an important factor. Most of such provisions require the election be made within a specific period. If not made within the period, the election opportunity is lost.

A surviving spouse's right to elect against a will can be forfeited for failure to financially support the deceased spouse, for desertion, and for participation in the willful or unlawful killing of the deceased spouse. In addition, the right to elect can be waived, as in an agreement made by two parties before they marry. Only a surviving spouse has the right to elect against the will. Other family members do not have this right.

Under prevailing state law a will can be challenged either before or after it is presented in probate following the person's death. Some of the people who can challenge the will are determined under state law and can include beneficiaries who are named by the decedent in one will but not in a different will that is presented as the decedent's final will, the intestate heirs of the decedent, and beneficiaries whose share would increase or decrease depending on which will is admitted to probate. Subject to specific provisions in state law, some common grounds for challenging a will are that the decedent was not of sound mind when the will was prepared, that someone unduly influenced the decedent to prepare his or her will with particular terms, fraud was practiced on the decedent, the decedent intended to give property away during their lifetime rather than at death, and the decedent's failure to properly execute the document.

In addition to cases where a will is challenged, a will can also be modified by state law as a result of certain events. For example, if a married person prepares a will that provides for his or her spouse, and the marriage is later ended by divorce, the termination of the marriage may void all provisions in the will for the divorced spouse. In a somewhat reverse situation, if a single person prepares a will and then marries after the will is prepared, the surviving spouse may be entitled to an intestate share of the decedent's property if it appears from the will or other evidence that the will was made in contemplation of the marriage to the surviving spouse; the will expressed the intention to be effective notwithstanding any subsequent marriage or the person preparing the will provided for the spouse by transfers outside the will and it was intended that these transfers be in lieu of a provision in the will.

If a person prepares a will and a child is born to or adopted by that person's family after the will is prepared and before the person dies, the share of the after-born or adopted child could be either an intestate share comparable to that of all of the children, a share mentioned in the will, or nothing if the person provided for the child by transfers outside the will and the intent of such transfers was that they were in lieu of a provision in the will. If a person participates in the willful and unlawful killing of someone, the slayer may be prevented by state law from receiving any benefit or acquiring any property from the estate of the person who was killed.

Transfers by a will have other advantages that are important to the estate and the heirs. A person with a will can name a guardian for the children and thereby save the time and expense needed to obtain a court-ordered appointment. Guardians have legal authority to hold property for a minor child until the child reaches eighteen years of age.

F. Transfers Through a Trust

Ownership of property *in trust* is a special form of ownership that creates a formal legal relationship between the person who holds legal title to the property and the persons who receive some benefit from it. To create a trust, an owner of property transfers ownership of it by written agreement to a person or an organization that is designated to act as a trustee. As a trustee, the person who holds the property is subject to a legal obligation to manage, protect and preserve the property for the benefit of a designated beneficiary. The beneficiary is designated by the person who creates the trust. The trustee maintains "legal" ownership or title to the property, and the beneficiary has a "beneficial" ownership interest in it. Since the trustee holds the property for the

benefit of the beneficiary, the trustee's personal creditors must respect the rights of the beneficiary to the property. Therefore, the property is protected from the claims of the trustee's creditors.

A trust created during an owner's lifetime is called a *living trust*, in contrast to a *testamentary trust* which is found in a will. Trusts are also known by the terms *revocable and irrevocable*. Each of these terms describes whether the trust agreement can be changed by the person who creates it. The creator is often referred to as the trust grantor. If the grantor retains the right to amend or change the trust after it is created, the trust is considered *revocable* because the grantor can revoke it after it is created. An *irrevocable* trust, on the other hand, is one that cannot be changed or revised after it is created. Trusts also are named for purposes they serve or the types of assets involved, such as a *charitable* trust or *marital deduction* or *credit shelter* trust. Each of these terms refers to specific federal estate tax planning opportunities that will be discussed in more detail in later chapters.

In today's estate planning world, transfers of property after death under terms of a living trust reflect the owner's lifetime decision to use the trust vehicle to own, control, and manage property, and to designate those who have a beneficial interest in the property. Commonly the grantor retains a lifetime right as a beneficiary of the trust, as well as the broader right to change or amend the trust or cancel it entirely. Following this trust beneficiary's death, the living trust terms provide for the transfer of ownership to some other beneficiary. Therefore, the trust becomes a vehicle by which the original owner of the property provides for a lifetime interest and also designates who will receive the property after the owner's death. When the trust is created, the property owner and trustee negotiate an agreement that controls the trustee's ownership of the property and its eventual distribution to a beneficiary. This process allows the grantor to make decisions about who will receive property after the owner's death and to instruct the trustee about uses that can be made of the property while the trustee is its owner.

Chapter IX deals with trusts in estate planning and discusses this topic in more detail.

G. Disclaimers

Although property is directed to pass to designated or identifiable heirs after a person's death, the heirs are not required to accept them. Heirs who choose to refuse acceptance of such transfer have disclaimed the transfer to them. In such cases the will or trust considers the beneficiary as having died before the property owner and whoever would inherit the property in that case will then inherit the property. Disclaimers are used in cases where the designated beneficiary has no need for the transfer and the beneficiary who stands next in line is an acceptable substitute for the person who is originally named as beneficiary. In some situations, a disclaimer by a beneficiary may lower estate and inheritance taxes, which makes the decision one that has financial considerations for the parties themselves.

H. Comparison of Transfer Methods

In general, comparison of these transfer methods can be made on three bases: cost to create, time required to complete the transfer, and transfer taxes applicable to it. To facilitate the discussion, this comparison is not made on the basis of any specific state law. Reference to such law must eventually be made, however.

On the basis of cost to create the transfer method, transfers under the intestate law are generally the least expensive method since taking no action triggers this method. Transfers by operation of law are generally inexpensive to create, often at little or no expense at all. Creating joint ownership of bank accounts, certificates of deposit, and other property is generally accomplished without cost. Real property that requires a deed or motor vehicles that require certificates of title may have cost or expenses associated with creating the documents.

Preparation of a will or living trust agreement can be the most expensive transfer method to create as it often involves the services of professional advisors to assist in making the needed decisions and in preparing the documents needed to carry out such decisions. However, it is not necessary that either of these documents be prepared by professional advisors to be valid. Individuals who are knowledgeable about the issues and options they confront when preparing documents, and who understand the requirements to create valid documents, can certainly do so without intervention by a professional. If, however, a professional is retained to provide this service, the cost of the professional's service can be reduced by the amount of time and effort put forth by a property owner in gathering information about property ownership, insurance plans, retirement benefits, and plans to distribute property after death. Work done by the property owner saves the professional's time in gathering the same information and should lower the final expenses that the property owner pays to complete the process.

In regard to the time required to complete the transfer, transfers by operation of law transfer are made immediately to the surviving owners when one or more joint owners dies. Next, in terms of relative speed of completing the transfer, is the transfer of property under a trust arrangement. The significance of the trust agreement is that title to property is held by a trustee who already has explicit instructions on how to transfer the property if certain events occur. If the owner of the property retains an interest in the trust property, the agreement designates the successor and the trustee completes the transfer according to the agreement's instructions. A potential delaying factor in such situations is a challenge to the validity of the trust agreement or one based on fraud or undue influence of a beneficiary who persuaded an owner to provide for the beneficiary to the exclusion of other potential recipients. Other potential delaying factors involve the potential need to determine the tax consequences involved with the transfer of property under any of the methods described above. These tax consequences involve the application of federal estate tax to property retained in the estate, federal gift tax applied to gifts made before the owner's death, and inheritance or other death taxes imposed by states on the transfer of property after the owner's death. In each case, expenses may be incurred to determine if the estate is subject to the tax, the value of property subject to tax, the party responsible for the payment of the tax imposed, and filing the required estate, gift, or inheritance tax return.

Generally, the most time-consuming method of transferring property after death is that of either a will or the intestate distribution statute. Both of these methods involve appointing a personal representative for the decedent's estate to take control and responsibility for property owned by the decedent at the time of his or her death. Once appointed, the personal representative gathers the estate assets, collects its debts, pays its bills, and manages the affairs of the estate, including the payment of applicable inheritance and estate taxes. This period is called the estate's administration. While each estate has its own unique problems and opportunities that affect the time needed to complete the transfer under this method, it generally takes 12 months or more to complete it.

The third point of comparison concerns inheritance and estate taxes that apply to the transfer. Transfers of property under a joint tenancy with the right of survivorship may be subject to state inheritance and estate taxes and, potentially, federal estate taxes as well. Under current federal estate tax law, tenant by the entirety property that passes from one spouse to another spouse is included in the gross estate of the deceased spouse, but it is also eligible for a marital deduction from the gross estate. In other words, although the tax statute requires that the property be included in the calculation, it also provides for its deduction from the same calculation.

Separately-owned property that passes under a will is generally subject to state inheritance and tax and potentially subject to federal estate taxes. Property that passes from a trustee to a designated beneficiary may be subject to state inheritance and estate tax and federal estate tax. Factors that influence the question of whether such property is subject to these taxes include the existence of an interest retained by the property owner who created the trust after its creation and the time period between the owner's creation of the trust and the owner's death. These taxes are discussed in more detail in Chapter V.

I. Student Exercises

Multiple-Choice Questions

Please read the following questions carefully, then select one of the three or four choices following the question that correctly answers the question asked.

1. Charles and his brother, Harold, own a 150-acre farm in Happy Valley. They inherited the farm from their mother who died in 1981. At the time of her death, the property was transferred to Charles and Harold as her sole surviving heirs under the intestate law. What is the tenancy that Charles and Harold enjoy in the 150-acre farm?
 - a. Tenancy by the entirety.
 - b. Joint tenancy with the right of survivorship.
 - c. Tenancy in common.
 - d. None of the above.
2. Bill and his wife Betty own all of their property as tenants by the entirety. Neither Bill nor Betty has a will and they have no children. In the event Bill and Betty die under circumstances where it cannot be determined whether Bill or Betty died first, which of the following statements correctly describes how the property will be distributed?

- a. Bill will be presumed to be the first to die. Betty will then be the sole owner and the property will pass to her heirs.
 - b. Betty will be presumed to be the first to die. Bill will then be the sole owner and the property will pass to his heirs.
 - c. The property will be divided into two shares. One share will pass to Bill's heirs and the other share will pass to Betty's heirs.
 - d. The property will pass to the to the state in which they live since Bill and Betty have no will and are not survived by children.
3. Gerald and Harriet were married in 1990. Gerald owned a dairy farm and several forested tracts in his own name before he married. After the marriage, he transferred some of the forested tracts to himself and Harriet as tenants by the entirety.

In 1998, Gerald died in a plane crash. In addition to his jointly owned property he owned \$150,000 of separately owned property and did not have a will or trust agreement. At his death, Gerald was survived by Harriet and Gerald's parents, Ben and Helen. Harriet and Gerald did not have any children from their marriage.

Which of the following statements correctly describes how Gerald's separately owned property will be distributed under the Uniform Probate Code's intestate distribution statute?

- a. Harriet will inherit all of Gerald's separate property as she is his surviving spouse.
 - b. Ben and Helen will inherit all of Gerald's separate property as his surviving parents.
 - c. Harriet will receive one-half of Gerald's separate property and Gerald's parents will inherit the rest.
 - d. Harriet will receive the first \$30,000 of the separate property, plus one-half of the remainder of the property. Gerald's parents will receive the other one-half of the property.
4. Which of the following statements correctly describes the role a trust can play in providing for the transfer of property after death?
- a. By transferring property to a trustee, the property owner can instruct the trustee to transfer the property to a designated beneficiary when specific events occur.
 - b. In creating a trust, the owner makes the trustee a joint owner of the property.
 - c. Under the terms of a trust, the property owner retains legal ownership of the property.
 - d. The creation of a trust does not protect the property from creditors of the trustee.
5. Which of the following events can have the effect of modifying provisions in a person's will?
- a. Divorce of a married person after a will is prepared.
 - b. Marriage of a single person who prepared a will while single.
 - c. Birth of a child after a will is prepared.
 - d. All of the above.

Short Essay Questions

Please read the following questions carefully and then respond to the question that is asked at the end of the situation. Your answer need not be long or involved, but it should be clear and concise. If you want to refer to important facts in your response, please feel free to do so.

6. Clifford is a retired businessman. Since his wife died last year, he is sad and lonely. Clifford's relationship with his nieces Cindy and Cathy is one of the bright spots in his life. Because of his advancing age and deteriorating health, Clifford wants to do something special for his nieces.

At his next stop at the local bank where he maintains several accounts, Clifford instructs the bank to add Cindy's name as an owner of a certificate of deposit and Cathy's name as an owner of another certificate. Neither Cindy nor Cathy know what Clifford did and neither know about the certificates Clifford changed. Under the bank's own rules, whenever two or more people are listed as owners of a bank account or certificate of deposit, these owners are considered as joint tenants with the right of survivorship.

Based on our discussion of transfers by operation of law, describe the tenancy relationship between Clifford and his nieces on the various certificates and comment on the rights of Clifford, Cindy, and Cathy to use the funds in the certificate during Clifford's lifetime.

7. Walter died in 1990. At his death, he was survived by one daughter, Mary, and two sons, Bill and Gregory. Walter's wife Martha died in 1986 and he did not re-marry after her death. Walter did not have a will.

When Walter died, his daughter, Mary, worked with him on the family farm. Mary decided to stay and continue the farm operation. Mary's brothers had no objection since they were not interested in the family farm.

In 1994, Bill died. Under Bill's will he left all of his property to his wife, Wendy, and his son, James.

In 1999, Gregory died. At his death, Gregory was survived by his sons Allen and Richard. Gregory's will left all of his property to his wife, Geraldine. In 1987, Gregory and Geraldine were divorced. In the event Geraldine died before Gregory, Gregory's will provided that his children inherit his property.

Mary now considers herself to be the sole owner of the property and its prospering farming operation as she is the surviving child of Walter and Martha.

Based on our discussion of the various ways property is transferred after death, comment on whether Mary is the sole owner of the property.

8. John and Mary own and operate a saw mill business in suburban Silver City. Some of the assets are owned as tenants by the entirety while others are owned by John and Mary individually. In addition, John and his brother Charles jointly own a 200-acre tract of land along the Silver River. John and his brother own the land as joint tenants with the right of survivorship.

John has several debts owed to local creditors. Each of these debts are John's sole responsibility. Mary is not obligated on these debts.

Based on our discussion of the characteristics of joint ownership, if John fails to pay his debts, describe the rights that John's creditor's have to enforce their debts against John's various properties.

Chapter V

Tax Aspects of Estate Planning

A. Overview and Purpose

People decide to plan their estates for a wide range of reasons. These can include preserving a business, completing a management plan that will allow a property owner to fully realize the value of a particular asset, supporting a charity or other entity that serves the public interest, or simply saving money by reducing expenses, saving taxes, or providing for a more efficient means of transferring property after the owner's death.

A common reason for deciding to embark on the planning process is to avoid estate and death expenses and taxes that arise when property is transferred after the property owner's death. Taxes are by no means the only issues that should be addressed in a thorough estate plan. Some of the tax issues are fairly common and well known, such as state and federal income taxes. Others, however, are less well known, such as federal estate and gift tax, state-imposed estate taxes, and federal generation skipping transfer tax. A reason these taxes are less well known is that they are limited in their application and therefore less frequently encountered in an average person's lifetime.

Recognizing that the transfer of property after a person's death is a trigger for imposing inheritance and estate taxes, many individuals plan during their lifetimes to avoid these taxes at their death. While planning can be an effective way to deal with these taxes, lifetime actions may trigger application of other tax laws (such as the federal gift tax) to lifetime transfers. Planning decisions must recognize the potential that these taxes will apply and then deal with them effectively in implementing decisions.

In this chapter we will discuss these taxes by emphasizing the nature of the tax, the tax rate, and the situations to which the taxes apply. In addition, we will focus our attention on opportunities under the various laws to make planning decisions that can minimize or even eliminate the tax when the property is transferred.

The Importance of Timing

In many parts of the discussion, the emphasis will be on the occurrence of planning or tax triggering events. Under current law, timing is an important consideration that will become clearer as the discussion unfolds. In a series of amendments made to the federal estate and gift tax law in 2001, changes were to be phased in before January 1, 2010. On January 1, 2010 the amendments provided that the entire Federal Estate Tax law is to be repealed. However, these amendments themselves are set to expire after December 31, 2010. When the amendments expire, the existing law will return and become effective. Since the amendments will expire after 2010, all changes in the old law that would have taken place, will be applicable in 2011 and later years. At present, many people believe that Congress will re-visit these tax laws and make other

adjustments to them and extend the period of the Federal Estate Tax repeal beyond December 31, 2010. Time will tell.

B. Lesson Objectives

When you have successfully completed this chapter you will be able to accomplish the following objectives:

1. Describe the state and federal income tax issues and considerations that arise from a person's death and that apply to the person's personal income tax situation and that of his or her estate.
2. Describe and compare the provisions of a typical state inheritance tax and the Federal Estate Tax.
3. Describe and compare the typical state inheritance tax provisions relating to gifts of property to the provisions of the Federal Gift Tax.
4. Describe the estate planning opportunities provided by the unified credit against federal estate and gift taxes and the marital deduction.

C. Federal Income Tax

1. The Decedent's Final Returns

When a person dies, the first income tax issue that arises involves the decedent's tax return for all prior years for which a return was not filed, including a return for the year in which the decedent died.

Example: If an individual dies in January or February before filing his or her tax return for the prior year, the person may have two outstanding income tax years to report, -- the prior year's return which was not filed and the tax return for the year that begins on January 1 and ends on the date of the person's death.

In the case of the decedent's personal income tax return, the personal representative of the estate files the return on behalf of a decedent who is a single taxpayer at death. If the decedent was married in prior tax years and the decedent's spouse survives, the surviving spouse can file a joint return for the prior years and the year of death if the spouse has not remarried before the end of the tax year. If the spouse has remarried before the end of the tax year, the deceased spouse's filing status is that of married filing separately.

For the prior years and the year of the decedent's death, the tax rates that apply to reported income are the same rates that apply if the individual were still alive. Income earned during the tax years is treated in the same way as it was treated before death. The return for a prior year is filed by the deadline for filing that return, such as April 15 for an individual taxpayer who reports on a calendar year basis. The return for the year of the decedent's death must be filed by the date the decedent's return would have been due had death not occurred. In the example above where the decedent died in January or February, the decedent's return for the year of his death would be due by April 15 of the year following his or her death. In the return for the

decedent's final tax year, all income received during the year is reported as income for a cash basis taxpayer. All expenses actually paid are reported as deductible expenses. An exception to this rule applies to medical expenses paid by the decedent's estate after the decedent's death, but incurred before the decedent's death. If the decedent's estate does not deduct the expenses in calculating federal estate tax and the expenses are paid within one year of the decedent's death, the expenses can be deducted on the final income tax return. In addition, medical expenses paid for a deceased spouse or dependent are treated as medical expenses in the year in which the expenses are paid regardless of whether it is before or after the year of the decedent's death.

If income is reported on an accrual basis, the final return will report the income that the decedent accrued, or earned, before the decedent's death. Those items for which the decedent became liable before death are treated as deductible expenses under the accrual method.

If a decedent has a right to receive income during lifetime, but does not actually receive it or report it as income in the decedent's final return, the income is known as income in respect of a decedent, or IRD when it is received. Such income is reported in the gross income of the decedent's estate in the year in which the estate actually receives it. A forest landowner growing crops or trees at the date of death does not normally give rise to IRD or income to be included in the final return. However, if the landowner receives rent in the form of a hunting lease and owns that lease at the time of death, the rental income is treated as IRD and is reported in the year in which the rent is received. If the landowner dies during the lease period, and the rent is paid after the owner's death only the rent that relates to the portion of the rental period that ends with death is treated as IRD. The remaining portion of the rent is treated as income to the estate.

Example: Al Roberts is a forest land owner who leased hunting rights for a one-year period beginning March 1. The rental amount is \$5 per acre or \$2,000 for a 400 acre tract. On June 30, Roberts died. Roberts was alive for 122 days of the rental period. As Roberts was alive for 122 days of the 365-day rental period, 122/365 of the \$2,000 is treated as IRD and the remainder of the rent is treated as income of the estate.

Cash rents are included in the landowner's final income tax return even though the rental period does not end until after the landowner's death.

If the administration of the decedent's estate is completed before the income is received and the estate transfers the right to a beneficiary who ultimately receives the income, the beneficiary reports the income in the year in which he or she receives it.

Example: If Joe Walton owns and operates a tree farm as a cash basis taxpayer, he reports proceeds from the sale of timber in the year when he receives it. If a sale is made before his death, but paid after his death, the payment is treated as income in respect of a decedent by Joe's estate. If the estate does not collect the bill during its period of estate administration and transfers the right to collect the debt to Joe's heirs, the heirs will report the income in the year they receive payment on the debt.

In filing these returns, the personal representative is entitled to take a full personal exemption and standard deduction even though the taxpayer was not alive for the full tax year. If a spouse survives the decedent and chooses to file a separate tax return that itemizes deductions, the decedent's final return must also itemize its deductions. Amounts withheld from the decedent's income in the final year are reported on the decedent's final return and credited against the final year tax. If any unfiled returns or the final year return generate a refund, the person filing the return, other than a surviving spouse filing a joint return, must file a statement of claim to the refund due. This may require filing an IRS form on which the claim is made or sending proof of the individual's status that gives the person a legal basis for making the claim.

2. Income Tax Status of the Estate

The second income tax issue that arises from an individual's death is the creation of a new taxpayer: the decedent's estate. These provisions are sometimes referred to as the income tax liabilities of a fiduciary, which refers to the personal representative of the estate. Some of the first decisions that a personal representative should take after being appointed is to apply for a federal employer identification number (EIN) for the estate and select the best tax year for the estate. This enables all agencies or individuals who file IRS form 1099 to properly report income to the estate rather than the deceased taxpayer or the personal representative. Obtaining a federal employer identification number is accomplished either by mail or by telephone. A personal representative of a Pennsylvania resident decedent can get an EIN immediately by calling the Internal Revenue Service Center that serves the representative's area. Internal Revenue Service employers will assign the EIN to the personal representative who completes IRS form SS-4 indicating the assigned number on the form, and then sends it to the IRS Service Center that serves your area.

Under federal income tax rules, the estate is entitled to deduct from its reportable income all distributions of income, to the extent of the estate's distributable net income, or DNI. When an estate distributes tangible personal property to residuary heirs under a will or trust, these transfers carry out DNI to the heirs unless the payments are paid in less than four installments and are in satisfaction of a bequest of a specific sum of money or specific items of property.

In addition to income in respect of a decedent, the decedent's estate reports income it receives as interest on invested estate assets, gain or loss on the sale of assets, and income from ongoing business operations. As a separate taxpayer, the estate pays federal income taxes at rates that are somewhat different from those paid by individual taxpayers.

Example: For 2002 tax purposes, income up to \$1,850 is taxed at the rate of 15% of the taxable income; income over \$1,850 but less than \$4,400 is taxed at the rate of \$277.50 plus 27% of taxable income over \$1,850. Income over \$4,400 but less than \$6,750 is taxed at the rate of \$966.00 plus 30% of taxable income over \$4,400. Income over \$6,750 but less than \$9,200 is taxed at the rate of \$1,671 plus 35% of the excess over \$6,750. Income over \$9,200 is taxed at the rate of \$2,528.50 plus 38.6% of the excess over \$8,450.

Estates are entitled to a \$600 exemption from income tax that allows estates with little or no income to avoid the tax entirely. This exemption is available throughout the period of estate administration, but is not available in the tax year in which the estate administration ends.

Living trusts are entitled to an exemption of \$300 if they are required to distribute all income currently or \$100 if distribution of income is discretionary with the trustee.

The general theory of estate taxation treats an estate as a conduit that passes income and deductions to heirs who then report it on their personal returns. In the final year of the estate's administration period, any excess losses or deductions that the estate has accumulated during the period of administration can be passed on to the beneficiaries of the estate who bear the burden of the excess deductions or losses. These beneficiaries can then use the losses or deductions in their personal tax situations.

If an estate sells assets acquired from the decedent during the course of the estate administration, it calculates gain or loss on the sale. The basis used to calculate gain or loss is the date of death value of the asset, or the value of the property on the alternate valuation date, if the estate elects to take advantage of the alternate valuation. If an estate distributes assets that appreciate in value during the estate administration to satisfy a bequest of money, the distribution triggers recognition of the excess value of the property over the value as of the date of death.

3. Basis of Assets Passing to Heirs From a Decedent

A third income tax concern deals with the tax situation of the heirs who receive the property from a decedent. The importance of this consideration is the income tax impact of applying the basis rules. If a person inherits property with a low basis and a high market value, then significant income taxes can be saved when the recipient of the property sells it in the future. Having a low basis and high fair market value can mean considerable income taxes when property is sold. Traditionally, people planning the transfer of their estates considered the basis changes that occurred when property was given away during lifetime and compared to passing the same property through an estate.

Estates of people who die before January 1, 2010

Property that passes to an heir from a decedent receives a step-up in basis to its value as of the decedent's date of death. If an estate elects an opportunity to value assets at the value they have in their particular use, that value, rather than the fair market value as of the date of death, becomes the basis of the assets that are specially valued and passed to other heirs. If an estate's land assets are subject to a qualified conservation easement transferred by the owner during the owner's lifetime and the estate excludes a portion of the value of the land subject to the conservation easement, when the owner dies the basis of the land will not be adjusted to the extent that the value of the property was excluded from the estate.

In comparison to the income treatment of the basis of assets that pass through an estate, if an owner gives property to someone during their lifetime, the recipient receives the original owner's

basis in the property. When the original owner dies after the gift is made, the death has no effect on the tax basis of the asset in the hands of the recipient. When the recipient later sells the property, the potential for capital gain or loss from the sale of the asset is real. A special rule applies in the case of a transfer of property to a recipient who dies within one year of receiving appreciated property and then provides that the property pass back to the original owner after the recipient's death. Under the general rule, the transfer back to the original owner increases the basis to the value at the date of the first recipient's death. However, the special rule replaces the general rule with one that sets basis as the value in the hands of the original owner who first gave away the property. This special rule prevents a property owner from gaining the advantage of a stepped-up basis in property by transferring it to someone who is near death and who will pass the property back to its original owner.

In the case of property owned jointly by husbands and wives, the same step-up rules apply at the death of the first spouse. If the surviving spouse can establish the value of the jointly owned property at the first spouse's death, the surviving spouse can step up his or her basis in the property.

Example: John and Mary purchase property for \$30,000 which they own as tenants by the entirety. The funds to purchase the property come from both John and Mary. When Mary dies the property is appraised at \$90,000. As John becomes the owner of Mary's one-half interest as the surviving tenant by the entirety, John's new basis in the property is \$15,000 from his one half of the original purchase price plus \$45,000 which represents Mary's one-half interest transferred to John. John's new stepped-up basis is \$60,000 after Mary's death. If John and Mary are joint owners of the property, but are not husband and wife, then a similar adjustment to the surviving owner's basis can be made, but it will be necessary to determine the exact proportion of the purchase price that each paid.

Estates of people who die after December 31, 2009

The rule that allows for a step up in basis of property that passes to heirs after an owner's death will not apply to estates of people who die after December 31, 2009. Instead of an increase in basis, the basis of property received by heirs will be treated as if the transfer to the heirs were a gift. The basis of the property will therefore be the **lesser of** the adjusted basis of the decedent or the fair market value of the property as of the date of death.

To offset this change in the income tax basis of property, two opportunities are available that allow property owners to have a selective increase in basis for some property. The first opportunity allows an increase in basis of up to \$1.3 million to be applied to property passing through an estate. This will allow a typical landowner to allocate the increase to property passing to specific heirs. If the decedent's basis in the property is less than \$1.3 million, then the heirs will have the benefit of the increase in basis. In the case of decedents dying after December 31, 2010, the \$1.3 million basis increase will be adjusted in multiples of \$100,000 for cost of living increases.

In addition, a second opportunity exists if the property that is transferred is considered to be “qualified spousal property.” This property is property that passes to a spouse as “outright transfer property” or as “qualified terminable interest property.”

O outright transfer property requires that the property pass to a surviving spouse without restrictions or conditions that could result in the transfer to the spouse being revoked, failing, or terminating. A typical example of such a condition would be to revoke a gift to a spouse who remarries. Conditions that require a spouse to survive for the short period of up to six months after the deceased owner’s death will not be treated as conditions that can revoke a transfer to the surviving spouse.

Qualified terminable interest property is property that passes from a decedent and in which the surviving spouse has a qualifying income interest for life. Such an interest is one in which the spouse is entitled to all the income from the property, payable at least annually, and no other person has the power to appoint any part of the property to another person other than the surviving spouse.

If the property passing to the spouse meets these definitions, then the basis of property passing to a spouse can be increased by up to \$3 million. If the property passing to the surviving spouse is jointly owned by the spouses, or is held under community property laws, the deceased spouse will be considered to be the owner of a 50% interest in the property. In cases where the decedent is a joint owner of property with people other than a spouse, the deceased owner will be considered the owner of the property to the extent of the consideration furnished by the deceased owner. A decedent who owns property in a qualified revocable trust will be considered the owner of the property. Under the amending legislation, these changes to the basis rules will expire after 2010 and the current rules will return.

D. State Inheritance Tax

State residents, and non-residents who own real or personal property in the state, may face a state inheritance tax on the transfer of property following the owner's death. The following discussion is couched in terms of a typical state inheritance tax approach and it provides background for the more detailed discussion that follows. The discussion is intended to be representative of what might be found in the project states, and is general.

Tax Rates

The typical state inheritance tax is imposed at one of more different rates where the rates may vary according to designated factors, such as the dollar value of the property transferred or the family relationship between the deceased person and the person to whom the property is transferred. Tax-free transfers may include transfers to recognized charities; to federal, state, or local governments; to a surviving spouse; transfers of life insurance proceeds paid to named beneficiaries; social security benefits; and veterans benefits.

Transfers taxed at the lowest tax rate imposed include transfers to decedent's grandparents, parents, lineal descendants, and husband or widower of child. Lineal descendants for inheritance tax purposes include natural children and their descendants, and adopted children and their descendants. Stepchildren and their descendants would be treated as natural children of the natural parent, but may not be treated on the same basis as natural children when it comes to determining if these children are lineal descendants of the stepparent.

Transfers taxed at one or more higher rates include transfers to other persons or entities who are not taxed at either the tax-free or the lower percent tax rate, such as transfers to decedent's brother, sister, aunt, uncle, nephew, niece, other family members, and all non-family members.

Most states do not impose a tax on gifts and other property given away during lifetime, but such transfers might be considered in the overall calculation of inheritance tax. For example, in Pennsylvania if property given away to any person is valued at more than \$3,000 at the time of the gift and the person giving property away dies within one year after giving it away, the value of the gift in excess of \$3,000 may be subject to inheritance tax in some states. The \$3,000 figure applies to gifts made to separate individuals without limit as to the number of individuals. If such a tax provision exists in the state where the owner resides, lifetime gift decisions must consider the size of the gift, the health of the gift giver and the consequences that surround the decision to make the gift. In some states an owner's intention to avoid inheritance taxes as the reason why the gift was made is irrelevant to the question of including certain gifts in the calculation of inheritance tax.

In determining whether a gift is made, the concept of gift includes transfers of valuable property where the person who transfers the property does not receive valuable consideration in return for the gift. In this sense a gift can be considered complete when nothing is given in return, or partial when some value is received in return for the property, but the value received is less than the value of what is transferred. For additional details, please refer to Chapter VII where the concept of a gift is discussed.

Provisions of the inheritance tax law may also affect lifetime transfers where the original owner does not give up complete control of the property. These situations include transfers that are restricted so that the recipient is unable to immediately use, possess, or enjoy the property, the original owner reserves the right to use the property during his or her lifetime, or the original owner reserves the right to alter, amend, or revoke the gift. In these cases, although the property may be designated to be received by a particular person, it may be subject to inheritance tax in the deceased owner's estate.

Property jointly owned by husbands and wives is generally not subject to state inheritance tax when one spouse dies and the other spouse receives the deceased spouse's share. If joint owners are not husband and wife, the transfer of a fractional share to the surviving joint owner may be subject to inheritance tax at the inheritance tax rate determined by the relationship between the deceased and surviving owner(s). The amount subject to tax is equal to the fractional share of the property that represents the deceased owner's share passing to the surviving owners

Property subject to inheritance tax is included at its fair market value, which is generally considered to be the value that a willing and able buyer would pay to a willing and able seller of the property. In many instances this value is determined by the market value of the item. Real estate values are determined by real estate appraisals or from sales of the property during the estate administration period where the selling price can generally be used as its value.

Land used in special uses may qualify for special value treatment under some state laws. To qualify for this special valuation land must meet the statutory conditions and comply with any post-death land use restrictions in order to continue to have the benefit of the special value treatment.

State inheritance tax is generally due within a fixed period after the death of a resident or non-resident who owns property subject to tax.

Estates whose assets include small business interests may have the opportunity to elect an installment payment arrangement to pay the inheritance tax on the small business interest. This may allow the heir who continues the business to do so without fear of having to sell the business to pay inheritance tax.

E. State Estate Tax

In addition to an inheritance tax, some states provide for an estate tax that is limited in its scope and application. In a number of other states, this estate tax is the only tax that applies to the transfer of property after an owner's death. This tax generally applies only to estates that are subject to federal estate taxes as explained below.

In the calculation of federal estate tax liability, every estate is entitled to take a credit against the tax due for state death taxes paid by the estate. The amount of the state death tax credit is calculated according to a graduated rate schedule that starts at a rate of 0.8 percent and increases to a maximum rate of 16 percent. The credit is calculated by multiplying the adjusted taxable estate by the appropriate rate for the size of the estate. Beginning in 2002, and continuing until 2004, this federal credit will gradually be reduced. For estates of people dying after December 31, 2004, the state death tax credit will no longer apply. In its place a deduction for the amount of inheritance and estate taxes paid will apply. The law that repeals the state death tax credit is scheduled to expire after 2010 when the current law will return.

States impose an estate tax to recover the excess amount of any allowable death tax credit over the amount of inheritance tax actually paid. As the federal credit is gradually reduced, states that relied on recovering the amount of the credit will be affected. For instance, if the amount of the credit is greater than the amount of inheritance tax paid, the state tax collects this difference as estate tax. If the inheritance tax paid is greater than the amount of the death tax credit, no estate tax is generally due. If a deceased person has property in more than one state, the value of the person's property in one state is compared to the value of the entire estate. This ratio is then applied to the state death tax credit to determine the amount that will be compared to the inheritance actually paid to that particular state. If the amount of state inheritance tax paid does

not exceed the amount determined by applying the above ratio, then the state inheritance tax applies to the difference. Recognizing that the state death tax credit allows estates that are subject to federal estate taxes to reduce these taxes, some states have made the state estate tax their only tax that applies to the transfer of property after a person's death.

F. Federal Estate Tax

The federal government imposes an estate tax on the transfer of property after a property owner's death. This tax is characterized as an excise tax, as it is a tax that applies to the privilege of transferring property after death. This compares to a transfer tax that is based on the value of property that is transferred to someone. Conceptually, both taxes are triggered by a property owner's death. In practice and application, however, the taxes differ.

Unlike the inheritance tax that may have few tax rates, the federal estate tax is calculated according to a graduated rate schedule that starts at a rate of 18% on the first \$10,000 subject to tax and increases to a maximum tax rate of 60% of those assets between \$10,000,000 and \$21,595,000. The maximum rate applies to estates of individuals who died **before January 1, 2002**. The complete rate schedule for this situation is described below.

For estates of people who die *after December 31, 2001* the maximum tax rate will be 50% of taxable assets that exceed \$2.5 million. Estates of people who die between 2003 and 2009 will face a gradual reduction in the maximum tax from 49% to 45% on assets that exceed \$2.5 million. Estates of people who die *after December 31, 2009* will not face an estate tax as it will not apply to estates of people who after that date. Remember, however that Congress has included in the law the statement that all amendments made in 2001 will not apply to estates of decedents dying after December 31, 2010. Therefore, under the 2001 amendments, the repeal of the federal estate tax will occur only during the year 2010.

Federal estate tax and federal gift tax also incorporate another concept known as the generation skipping transfer tax, or "GSTT". GSTT is designed to prevent the tax-free transfer of property from one generation to a generation of beneficiaries who are more than one generation below the generation of the person making the gift. Examples of these gifts are a gift from a grandparent to a grandchild or from an individual to someone who is at least two or more generations (or at least 37½ years) younger than the person making the gift. Transfers that are subject to GSTT include direct transfers by gift or inheritance, transfers at the termination of a trust, or distributions for the benefit of a grandchild from the income or principal of a trust. In cases where an owner wishes to make a gift to a grandchild whose parent has previously died, the grandchild moves up in generational rank to take the level of their deceased parent; such transfers avoid GSTT. GSTT is a separate tax from any estate or gift tax that is otherwise applicable. Under the 2001 amendments to the estate tax law, the generation skipping transfer tax provisions do not apply to transfers that occur *after December 31, 2009*.

(A)	(B)	(C)	(D)
Amount Subject to Tentative Tax		Tax on Amount in Column A*	Tax Rate on Excess Over Amounts in Column A*
Exceeding	But Not Exceeding	_____	Percent
\$	\$ 10,000	\$	18
10,000	20,000	1,800	20
20,000	40,000	3,800	22
40,000	60,000	8,200	24
60,000	80,000	13,000	26
80,000	100,000	18,200	28
100,000	150,000	23,800	30
150,000	250,000	38,800	32
250,000	500,000	70,800	34
500,000	750,000	155,800	37
750,000	1,000,000	248,300	39
1,000,000	1,250,000	345,800	41
1,250,000	1,500,000	448,300	43
1,500,000	2,000,000	555,800	45
2,000,000	2,500,000	780,800	49
2,500,000	3,000,000	1,025,800	53
3,000,000	10,000,000	1,290,800	55
10,000,000	21,595,000	5,140,800	60
21,040,000	--	12,097,800	55

The flat rate tax imposed under the GSTT is equal to the highest federal estate tax rate, which in 2002 is 50% of taxable transfers. Individuals have a \$1,100,000 GSTT exemption (for 2002) that they can apportion among several transactions. For estates of decedents and generation skipping transfers after December 31, 2003, the GSTT exemption amount will be equal to the **applicable exclusion equivalent of the unified credit** that is discussed below. Husbands and wives have their own exemption amount they can apply to obtain maximum results for their estate plans. In addition to the available exemptions, present interest gifts that qualify for the

annual exclusion from federal gift tax and tuition and medical expense exclusions from federal gift tax, which are explained below, are also exempt from GSTT.

Federal estate tax is due within nine months of an owner's death. The estate may petition for an extension of time to file the return, but interest on the unpaid tax continues to accrue during the extension period. In the case of estate taxes on active closely-held business interests, opportunities are available to pay the estate tax on the business interest in installments first of interest and then principal and interest for up to 14 additional years. The purpose of the installment payment arrangement is to allow a closely held business to continue operation without fear of having to sell the business to pay federal estate tax. A more detailed discussion of federal estate tax payment obligations and opportunities is found in Chapter VI.

Although the federal estate tax once was a formidable obstacle to individuals who wished to eliminate federal estate taxes in their estate plans, several simple planning opportunities have been available to property owners to manage the impact of the tax on the majority of estates. The following discussion describes these opportunities.

1. The Exclusion Equivalent to the Unified Credit Against Federal Estate and Gift Tax

The first of these planning opportunities is *the exclusion equivalent of the unified credit* which an owner has and can apply against federal estate tax liability in 2001. The exemption equivalent is \$675,000 in 2001. This exclusion equivalent is scheduled to increase until it reaches its maximum amount of \$3.5 million in the year 2009. In 2010, the federal estate tax law is repealed. After 2010, the repealing amendments expire and the law reverts to the form in which it would be under the law before the amendments. The following chart converts the credit to the amount of exclusion that is equivalent to it.

Year of Death or Gift	Exclusion Equivalent
2001	\$ 675,000
2002	\$1,000,000
2003	\$1,000,000
2004	\$1,500,000
2005	\$1,500,000
2006-2008	\$2,000,000
2009	\$3,500,000
2010	Tax is repealed
2011 and After	\$1,000,000

Each resident citizen taxpayer is entitled to this exclusion equivalent to the credit, but there are no current opportunities to allow owners to transfer an unused portion of the credit to another taxpayer, such as a spouse or family member. Deceased individuals who are neither U.S. citizens nor U.S. residents, but who own property in the U.S. subject to federal estate tax at their death are entitled to a reduced credit against federal estate tax set at either the minimum credit

amount of \$13,000 or a higher amount set by treaty between the U.S. and the decedent's country of citizenship.

The significance of the exclusion equivalent is that it determines whether the estate is subject to federal estate taxes. If the decedent's gross estate does not exceed the amount of property that, if subject to tax, would equal the amount of the exclusion available to the estate, then federal estate tax is not an issue in the transfer of that decedent's property.

Example: If a decedent's estate in 2002 has the full exclusion equivalent available, and the decedent's gross estate does not exceed \$1 million, the decedent's estate need not be concerned with federal estate tax. If the unified credit has been reduced through use of the credit to offset gift tax arising from taxable gifts, the total of all adjusted taxable gifts made after December 31, 1976 is deducted from the \$1 million figure. In addition, any portion of the specific gift tax exemption of \$30,000 for gifts made between September 8, 1976 and December 31, 1976 used will further reduce the \$1 million figure. For estates of decedent dying in later years, the exemption equivalent will increase.

In the above examples a crucial element is the concept of a gross estate for federal estate tax purposes. Please refer to the detailed discussion of this concept in Chapter VI.

2. The Unlimited Marital Deduction

In general

A second estate planning opportunity is provided by the estate tax marital deduction. Under this concept, one spouse can transfer property to his or her surviving spouse free of federal estate tax. The amount of the transfer is unlimited and enables the owner to pass property to his or her surviving spouse. Property that passes to a surviving spouse as surviving tenant by the entirety, as beneficiary of a will or insurance policy, or as the beneficiary of a retirement plan may qualify for the marital deduction if the surviving spouse has the unrestricted or unqualified right to use, possess or enjoy the property.

The Terminable Interest Rule

If the spouse's right to property can be revoked by passage of time, a specific event, or the failure of an event to occur, the marital deduction may not be allowed for the transfer. Examples of these events include re-marriage or the failure to support a designated family member. These transfers are considered to be terminable and ineligible for marital deduction treatment. If a spouse's right to receive property from a deceased spouse is conditioned on surviving for a period of time that is less than six months, such a condition will not be considered a terminable interest if the spouse survives for the designated period. The following discussion describes a

major exception to the terminable interest rule, known as “qualified terminable interest property.”

Qualified Terminable Interest Property

Certain transfers involving property in which the spouse is given only a life estate (refer to chapter IV) can elect marital deduction treatment as an exception to the rule that ordinarily denies the deduction for such transfers. These transfers are known as "qualified terminable interest property" or "QTIP's". To meet QTIP requirements, the transfer to the surviving spouse must be a qualifying income interest for life. Such an interest provides that the surviving spouse is entitled for life to all of the income from the property, payable at least annually. No person, including the surviving spouse, has a power to appoint any part of the transferred property to any person other than the surviving spouse during the surviving spouse's life. Any power over the property transferred that is retained must be exercisable only at or after the spouse's death.

Example: Harold Wilson and his wife Hattie own several tracts of land in their separate names. In Harold's will he provides that one of his separately owned tracts is to be placed in a trust and Hattie is to receive all of the income from the trust during her lifetime, payable to her quarterly. After Hattie's death, the trustee is directed to distribute the trust property to Harold's children Herbert and Harriet. Hattie's interest in the trust is a qualifying income interest and the trust arrangement qualifies for the marital deduction.

If the QTIP election is made, the qualified terminable interest property will be included in the surviving spouse's estate at death even though it will pass to the children specified by the first spouse's will. This particular concept allows a person to establish a fund to benefit a surviving spouse for life and gain marital deduction treatment without losing the ability to direct the balance in the fund when the surviving spouse dies.

Taxes and Expenses

Another situation in which eligibility for the marital deduction is an issue involves payment of estate expenses. If any portion of the property set aside for marital deduction treatment is used to pay estate or inheritance taxes, the portion used does not qualify for the marital deduction. Therefore, many estate plans calculate the amount of the marital deduction according to a formula that takes these expenses, as well as other factors, into consideration to avoid the loss of some or all of what was thought to be an available deduction.

Effect of the Marital Deduction

The effect of the unlimited marital deduction, for example, is to defer federal estate taxes from the estate of the first spouse to die to the estate of the second spouse. As a deferral vehicle, the deduction delays payment and collection of the tax to some future time. If the property is transferred or disposed of by the surviving spouse before death without incurring federal gift tax,

then the transferred property escapes federal estate tax. If the property increases in value prior to the surviving spouse's death, federal estate taxes may actually be higher.

A second factor concerning use of the marital deduction is its impact on use of the unified credit in the estate of the first spouse to die. If nearly all of an owner's property qualifies for marital deduction treatment at the death of the first spouse, then little if any of the deceased spouse's unified credit will be used at that time, since little if any federal estate tax will be generated in the first spouse's estate. In the calculation of federal estate tax, marital deductions are applied before determining the amount of the taxable estate. Therefore, the deduction can result in a very small taxable estate and little or no estate tax to which the unified credit can be applied. Since the unused portion of the unified credit cannot be transferred to anyone else, the unused portion and the property that could have passed tax-free under it are lost.

In the estate of the second spouse, where marital deduction treatment eliminated federal estate tax at the death of the first spouse, the second spouse's estate can use his or her own unified credit to offset federal estate taxes. Without a marital deduction to reduce the size of the taxable estate, the estate of the second spouse faces a greater probability of being subject to federal estate tax. To gain the greatest benefit from the unified credit and the marital deduction, coordination should be made between property ownership and post death transfers in order to fully utilize each credit in the estate of each spouse, thereby doubling the size of property that can pass estate tax free.

3. State Death Tax Credit and Credit for Tax on Prior Transfers

In addition to the unified credit, federal estate tax law provides for a credit for state death taxes paid and for taxes paid on prior transfers that occur shortly before another taxable transfer occurs. The state death tax credit is based on a percentage of the adjusted taxable estate for federal estate tax purposes. The amount of the credit increases according to the size of the adjusted taxable estate. The tax rate schedule for estates of persons who die in 2001 is shown below.

Beginning in 2002, and continuing until 2004, this federal credit will gradually be reduced by 25% in each year. That means that for estates of people dying after December 31, 2004, the state death tax credit will no longer apply. In its place, the estate will be given a deduction for the amount of inheritance and estate taxes paid.

The credit for federal estate taxes paid on prior transfers applies to situations where the decedent, shortly before death, received property in a transaction subject to federal estate tax when it was transferred to the decedent. In other words it applies to property transfers through two estates over a short period of time. For the credit to apply, the first taxable transfer must be within two years before and ten years after the current decedent's death.

The credit for tax on prior transfers considers the portion of the current decedent's estate that was subject to federal estate tax in an estate that transferred the property to the decedent. If the death of the current decedent occurred two years before or two years after the death of the decedent

Adjusted Taxable Estate	Amount of Credit	Rate on Excess
\$ 40,000	\$ 0	0.8%
90,000	400	1.6%
140,000	1,200	2.4%
240,000	3,600	3.2%
440,000	10,000	4.0%
640,000	18,000	4.8%
840,000	27,600	5.6%
1,040,000	38,800	6.4%
1,540,000	70,800	7.2%
2,040,000	106,800	8.0%
2,540,000	146,800	8.8%
3,040,000	190,800	9.6%
3,540,000	238,800	10.4%
4,040,000	290,800	11.2%
5,040,000	402,800	12.0%
6,040,000	522,800	12.8%
7,040,000	650,800	13.6%
8,040,000	786,800	14.4%
9,040,000	930,800	15.2%
10,040,000	1,082,800	16.0%

who transferred the property, the credit for prior transfers is 100% of the federal estate tax that is attributable to the property transferred to the current decedent. If death of the current decedent occurs more than two years after the death of the decedent who transferred the property, the credit for tax on prior transfers is 80% of the federal estate tax if death occurs within the third or fourth year; 60% if death occurs in the fifth or sixth year; 40% if death occurs within the seventh or eighth year and 20% if death occurs within the ninth or tenth year.

G. Federal Gift Tax

In addition to the Federal Estate Tax, the Internal Revenue Code imposes a tax on lifetime transfers of money or property through the vehicle of a gift. In the legal sense, a gift is the transfer of property for less than full and adequate consideration in return. As mentioned in

Chapter VII, a gift can be whole, as in the case where no consideration is offered in return for the gifted property, or partial, in the case where an item is transferred for consideration that is significantly less than the value of the transferred property.

For a gift to exist in the gift tax sense several factors must be in place. First, the person making the transfer must intend the transfer to be a gift rather than a loan or sale. Second, the owner must give up dominion and control of the gift to the recipient. If control of the property is not transferred, or the owner retains authority to change the disposition of the property either for his or her own benefit or for that of others, a gift of the property is not complete and the owner will retain ownership of the item. Third, the recipient of the property must be willing to accept it. A person cannot be forced to accept another person's gift and the final requirement of acceptance reinforces that concept.

In the case of gifts between spouses or the creation of a joint interest where only one spouse provides the initial property, federal gift tax law does not tax such transactions as gifts because a gift tax marital deduction is available to the spouses. Creation of joint ownership interests between individuals who are not married to each other may create a gift for purposes of the federal gift tax. To determine if a gift is made several factors are considered. If the joint owners acting alone can sever the joint ownership relationship and withdraw funds from the joint interest, a gift is considered to be made of a fractional share of the joint interest. In the case of a joint bank account in which only one individual has contributed funds, a gift is considered to be made when the recipient of the joint interest withdraws funds from the account for his or her own benefit. When joint interests are terminated during the lifetime of all joint owners and the owners receive their shares of the property, a gift is made to those joint owners who did not contribute a proportional amount to the creation of the joint interest equal to what they receive at the termination.

Federal gift tax also treats "no interest" and "low interest" loans in excess of \$10,000 as loans made in return for a promise to repay the borrowed amount and as gifts of the interest that would have been paid on the loan at market rates. If the loan is paid on demand, the amount of the gift is the difference between the interest paid and the interest that would have been paid at market rates. If the loan is repaid over an installment term, the gift is determined by comparing the amount loaned to the present value of the payments to be made under the loan.

For taxable gifts made before January 1, 2010, the federal gift tax rate begins at 18% of the first \$10,000 of taxable gifts and ranges up to 55% of taxable gifts in excess of \$10 million. For gifts transferred after December 31, 2009, gift tax rates are lowered and begin at 18% of the first \$10,000 of taxable gifts and range up to a maximum tax of 35% of gifts over \$500,000.

In addition, transfers of property subject to gift tax also have an equivalent exemption that can be applied to the transfer. Before the federal estate tax is repealed for estates of people dying after December 31, 2009, a federal gift tax exemption of \$ 1 million is available to federal gift tax transfers. Taxable gifts made after December 31, 2009 will also be entitled to a credit that will be calculated on the basis of the \$1,000,000 exclusion. After 2010, the law that amends the federal gift tax expires and the current gift tax law returns.

If an individual made taxable gifts in prior years, the amount of the credit used in those prior years reduces the size of the unified credit available to the taxpayer in the year of the current gift. When the gift tax is calculated, all prior taxable gifts are added to the current taxable gift. A tax based on the current tax rate schedules is calculated on the total gift and gifts in prior years. The amount of the gift tax due is the difference between the tax on the combined gifts as calculated under current rates and the tax on the prior gifts calculated the same way. The current year equivalent exemption is applied to this difference after it is reduced by any prior credit applied to offset gift tax liability. Taxpayers who made gifts between September 8, 1976 and December 31, 1976 were able to claim a specific exemption from federal gift tax of \$30,000. If an individual took advantage of that exemption during their lifetime, 20% of the exemption used reduces the amount of the currently available unified credit.

An unlimited marital deduction is also available in the gift tax law. This enables spouses to make transfers to each other of unlimited amounts of money or property without facing liability for this tax. To achieve the estate plan objective of utilizing the full equivalent exemptions in the estates of married individuals, establishing separately owned property for each spouse that will be subject to tax which the credit will be absorbed by the equivalent exemption is an important step toward that goal.

Federal gift tax liability is an obligation of the person who makes the gift. The gift tax return is due by April 15th of the year after the year in which a taxable gift is made. Calculating the value of taxable gifts requires the taxpayer to determine the fair market value of the gift at the time the gift is made. Neither an alternate valuation date nor a special use valuation opportunity are available for this tax. Although the gift tax requires considerable attention in an estate plan that includes lifetime transfers, it also presents several unique planning opportunities.

1. Annual Exclusion From Gift Tax Liability

The first planning opportunity is in the annual exclusion from gift tax liability. Annually, taxpayers are able to give up to \$11,000 in 2002 to any one person, or any number of people, free of federal gift tax. In other words a gift is not considered “taxable” until it exceeds \$11,000 to a single person in a calendar year. This annual exclusion amount is subject to adjustment for inflation in increments of \$1,000. Therefore, an owner who chooses to limit his or her annual gifts to amounts less than the annual exclusion amount faces neither tax liability nor the obligation to file a gift tax return. Exceeding the annual exclusion amount triggers the obligation to file the return and report all taxable gifts made in the period. For example, a gift of \$15,000 will be treated as a taxable gift of \$4,000. The exemption equivalent can then be applied against the tax calculated for the gift.

To qualify for the annual exclusion, the gift must be a gift of a present interest, which means the recipient must have the right to immediately use, possess or enjoy the gifted property. If restrictions apply and a present interest is not given, the gift is ineligible for the annual exclusion. Individuals who desire to bestow a gift on a minor often face a difficult decision. A minor child may not be able to legally control the property or may not have the financial experience to do so. Transferring property with restrictions designed to prevent a minor from exercising control may

be viewed as an interest that takes effect in the future rather than the present. How does an owner give a present interest to a minor who cannot fully use, possess or enjoy the property until he or she reaches the age of majority? The answer is found in specific gift tax provisions that identify certain gifts as gifts of present interests. To be considered a gift of a present interest, the gift must provide that the property will be expended for the benefit of the minor before the minor's 21st birthday. Any balance that is not expended for the benefit of the minor must pass to the minor at the minor's 21st birthday, or to the minor's estate if the minor dies before reaching his or her 21st birthday. Transfers in trust for the benefit of the minor that meet these requirements and transfers to custodians for the minor under the Uniform Transfers to Minors Act qualify for the annual exclusion as gifts of present interests.

Spouses have the opportunity to increase the amount of their annual exclusion by electing to "split the gift" which enables them to treat one-half of all gifts made in the calendar year as being made by each spouse, even though only one spouse provided the gift property. To qualify for this treatment, the spouses must be United States citizens, must be legally married to each other at the time the gift is made, must not remarry during the remainder of the calendar year, and must consent to the split gift treatment of all gifts made in that year. If spouses choose to split their gifts in a tax year and a gift to a single individual is above the \$11,000 per person per year limit, a gift tax return must be filed. In filing the return the spouses elect the split gift treatment thereby raising the annual exclusion amount to \$22,000 per person per year.

An important point to consider in making gifts within the limitations of the annual exclusion amounts is the ability to establish the value of the property at the time the gift is made. In some cases, a professionally produced appraisal may be needed to establish the value. Since determinations of value are very subjective, extreme caution should be used in making gifts near the \$11,000 figure or a safety cushion should be used to avoid situations where later challenges to value of gift result in a determination that the value of the gift at the time it is made is more than the \$11,000 or \$22,000 amount.

2. Exclusion for Gifts of Tuition or Medical Expenses

In addition to the annual exclusion opportunity, the federal gift tax provides two other opportunities to make tax-free gifts that are not limited by the annual exclusion amount. The first of these is a gift of tuition paid directly to an educational institution on behalf of another person for education or training provided to the person. In this context, the exclusion is limited to payments for tuition and cannot be used to offset the cost of books, supplies, residence fees and costs, lodging or similar expenses which do not constitute direct tuition costs.

The second opportunity is the direct payment to a medical care provider for care provided to another person. This exclusion can also be used to pay for medical insurance for another individual. Obligations that will be reimbursed by medical insurance, however, are not eligible for treatment under this unlimited exclusion.

Each of these unlimited exclusions is in addition to the \$11,000 annual exclusion otherwise available and is applied without regard to the relationship between the donor and the recipient.

H. Student Exercises

Multiple Choice Questions

Please read the questions carefully, then select one of the four choices following the question that correctly answers the question asked.

1. Which of the following transfers will be subject to federal gift tax?
 - a. The gift of a vehicle worth \$7,000.
 - b. The gift of real property from a husband to his spouse.
 - c. A child's gift of \$30,000 to her parents.
 - d. A parent's gift of \$5,000 to each of her seven children shortly before her death.

2. An exclusion equivalent to the unified credit allows a property owner to transfer property free of federal estate tax. How much will the exemption equivalent of the unified credit be for estates of people who die in 2003?
 - a. \$1,000,000
 - b. \$1,500,000
 - c. \$600,000
 - d. \$675,000

3. Which of the following tax laws is an issue to be concerned about in making transfers of large amounts of property from a grandparent to a great-grandchild?
 - a. State Gift Tax Law
 - b. Federal Excise Tax on Excess Accumulations
 - c. Generation Skipping Transfer Tax
 - d. State Estate Tax Law

4. William and Harriet are two happily married people who are concerned about what will happen to their property after they die. Each owns considerable property in his or her own name, as well as other property that is owned by them jointly. The value of their individual holdings is large enough to trigger application of the federal estate tax. Each person wants to have their own property be transferred to the other if one of them dies and the other person survives. Which of the following estate planning opportunities would enable them to transfer all of their property to their spouse after death without federal estate tax being applied?
 - a. The annual exclusion
 - b. The credit for prior transfers
 - c. The marital deduction
 - d. The state death tax deduction

5. Which of the following tax concepts is used in calculating income tax gain or loss on the sale of an item that was received as a gift from the prior owner of the property?
 - a. The tax basis of the property in the hands of the person selling it
 - b. The exemption equivalent of the unified credit

- c. The generation skipping transfer exemption
- d. Qualified terminable interest property

Short Essay Questions

Please read the question carefully and then respond to the question that is asked at the end of the situation. Your answer need not be long or involved, but it should be as clear and concise as possible. If you want to refer to important facts in your response, please feel free to do so.

6. Bill and Beth received several gifts of real estate from Bill's mother and inherited other real estate she owned after her death. In order to raise money to fund the cost of a college education for their four children, Bill and Beth are interested in selling these properties. When the properties received as gifts are sold, how will Beth and Bill's capital gain be calculated? How will the gain be calculated when the inherited properties are sold?
7. The Reddick family has owned a 150-acre tract of forest land in central Pennsylvania for more than 100 years. Currently Ralph and Rita Reddick own the land. Fred and Jayne, their two children, are anxious to acquire the land and Ralph and Rita want to give them the chance to do so as they are considering leaving the land to them in their wills. They are also considering giving some or all of the land to their children during their lifetimes, rather than after their deaths.

Based on these facts, what federal and state issues do you recognize as Ralph and Rita try to decide what to do with their land? What planning opportunities might be available to them to address some of the problems you've recognized?

8. Sarah Leigh Sholltitz is an elderly woman who has accumulated a significant amount of property, including substantial bank accounts and land holdings. Her doctors told her recently that her heart condition is worsening and her future is not very bright. Perhaps she will live another year or two.

Based on this assessment of her physical condition Sarah has decided to bestow some of her property on her family, which includes several children, grandchildren, and great-grandchildren.

If Sarah were to make gifts of her property today, what tax considerations would she have to consider before making the gifts?

Chapter VI

Calculating the Federal Estate Tax That an Estate Will Pay

A. Overview and Purpose

The discussion of federal estate taxes and state inheritance taxes appearing in Chapter V is an important start toward identifying the impact these taxes will have on a person's estate after death. In addition to understanding what these taxes are, it is important to recognize how these taxes are calculated in a specific situation. In this chapter the primary focus is on calculating the federal estate tax. This tax was selected as it will have the most significant impact on a person's estate if it applies to transfers under it. In the discussion of state inheritance taxes, reference is made to a typical calculation of state inheritance taxes. That general discussion addresses most of the standard questions that people face in calculating a state inheritance or estate tax. Not all issues that apply in each state were identified and discussed in Chapter V, or elsewhere in this book. It is also important to note that the calculation of property subject to state inheritance tax may not equal the value calculated as the federal gross estate. States that impose inheritance taxes are free to decide what types of transfers are or are not subject to their taxes.

B. Lesson Objectives

When you have successfully completed this chapter, you will be able to accomplish these objectives:

1. Describe what is meant by a “gross estate” under federal estate tax law.
2. Describe the general types of property that are included in the federal gross estate and the general rules for determining how and when these items of property are valued.
3. Describe special valuation rules that apply to land that is subject to conservation easement or that elects special use valuation.
4. Describe the impact that the Family Owned Business Deduction can have on estate plans that involve a family-owned business.
5. Describe the valuation opportunity that is available to owners of land that is subject to a qualified conservation easement.

C. Calculating the “Federal Gross Estate”

The *gross estate* includes all property the decedent owned in his or her name alone, one-half of all property owned jointly by the decedent and his or her spouse, a proportionate share of other jointly owned property equal to the decedent's contribution to the purchase and improvement of the property and proceeds of any life insurance policies which are paid to or for the benefit of the decedent's estate or for which the decedent is considered to hold the incidents of ownership.

Incidents of ownership of an insurance policy is a concept that describes the ability of the person, acting alone or in conjunction with any other person, to determine who or what receives the economic benefit of the insurance policy. Authority such as the ability to designate a beneficiary, to surrender or cancel the policy, to assign the policy or revoke an assignment, to

pledge the policy for a loan or to borrow against the cash surrender value of the policy is generally considered to be an incident of ownership. If the terms of the policy provide for the possibility of the policy or its proceeds returning to the decedent or the decedent's estate or the decedent has a power of disposition over the policy, either of which is valued at more than 5% of the value of the policy immediately before the insured's death, the holder of such power is deemed to have an incident of ownership.

The gross estate also includes the value of property interests over which the decedent held a **general power of appointment** at death. If a power of appointment is not considered to be a general power, it is considered a limited power of appointment. A power of appointment determines who will own or enjoy the property subject to the power and when they will own or enjoy it, and is created by someone other than the person who holds it. A general power of appointment for estate tax purposes is one in which decedents can appoint the property subject to the power to themselves, their creditors, their estates or creditors of their estates. A general power includes the unlimited right to use principal, income, or principal and income for the decedent's benefit. If a decedent has a power to use or consume that is limited by an ascertainable standard relating to health, education, support or maintenance, the power is not considered a general power. A power to use property for the comfort, welfare, or happiness of the decedent is not an ascertainable standard and therefore is a general power.

In addition to those powers that the decedent held at death, the gross estate will also include the value of property subject to a power of appointment that was transferred during the decedent's lifetime, but in which the decedent retained a life interest in the property or the right to revoke the transfer. If the decedent transferred the power but delayed the effective date of the transfer until after the decedent's death, the value of the property subject to the power is likewise included.

In addition to separate and joint property, the federal gross estate includes the value of property transferred during lifetime if after the transfer the decedent retained a right to use, possess, or enjoy the property or the income from it. Also, transfers where the recipient's right to possession and enjoyment is delayed until the decedent's death are included in the federal gross estate of the former owner. Transfers where the decedent retained a right to reacquire property transferred during life, that is valued at more than 5% of the value of the property will result in the entire value of the property, being included in the federal gross estate at the former owner's death. If the owner of property transfers it during lifetime, but retains the right to alter, amend, revoke, or terminate the transfer at the time of death, the value of such property, will be included in the deceased owner's estate. Common examples of revocable transfers are "in trust for" savings accounts and custodial accounts in which the person creating the account is the custodian of the account. A living trust in which the person who creates the trust reserves the right to revoke or terminate the trust is another example of a revocable transfer which is included in the gross estate of the deceased owner. General powers of appointment which are exercisable in favor of the person holding the power, the person's estate, the person's creditors, or creditors of the person's estate result in the value of the property over which the power is held being included in the federal gross estate of the person holding the power at death.

Gifts made by a decedent within three years of his or her death are not included in the gross estate of the decedent. If, however, the gift is considered a transfer with a retained lifetime interest, a transfer taking effect at death, a transfer with a right to revoke, or a transfer of a life insurance policy, the gift will be included in the gross estate of the deceased owner if made within three years of his or her death.

The significance of the gross estate for federal estate taxes is that it may be a different calculation than that made to determine state inheritance tax. As such, transfers that may avoid inheritance tax must be considered in light of federal estate tax requirements to be effective in avoiding federal estate tax requirements. Given the fact that two calculations are made, coordination in meeting both requirements is a central issue in planning these estates.

D. Valuing Property Subject to Tax - General Rules

Estate Tax Regulations and Gift Tax Regulations define **fair market value**, in effect, as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. This is often referred to as an “arm’s-length transaction.” Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property. An example of an arm’s-length transaction is an auction where the owner of property invites all interested parties to bid on the purchase of the property. Auction sale of estate property is a common way to determine its value, and it may be the transfer method that is mandated in the decedent’s will or living trust.

The general rule for valuing property subject to federal estate tax and most state inheritance and estate taxes is to determine the value at the time that the owner of the property dies. If the property is sold in close proximity to the date of determining value and the sale is an arm’s length sale, the sale price can be considered its fair market value. If the property is not sold, then value is determined by evaluating information from sales of other comparable properties. Comparing an existing property to another property permits the person making the value determination to estimate its value by evaluating sales of other properties.

E. Valuing a Business

Because of the potential complexity of this problem, readers who are interested in business-related issues, such as choosing an organization form when the business begins, should refer to a the soon to be published companion publication, *Organizing, Operating and Planning for the Transfer of a Family Business*.

Fractional Ownership Shares; Discounts for Lack of Control and Lack of Market

Considering all of the attention that is paid to the issue of valuation, the Internal Revenue Service has recognized that valuation is not an exact science. Sound valuation decisions will be based upon all relevant facts, as well as on common sense, informed judgment, and reasonableness in

weighing the facts and in determining their significance. Among the factors that are considered are the size of the block of stock being transferred in a corporation or share of a partnership. Two recognized discounts that are available are discounts for a minority interest and discounts for lack of marketability. The discount for a minority interest recognizes that a minority interest in a company that is not listed on a recognized exchange will be more difficult to sell than a larger interest. Equally true, a block of stock or a partnership percentage that offers control represents an added measure of value that can increase the value of property beyond that value obtained by simply dividing the net worth of the business assets by the outstanding ownership shares.

Valuing property interests for federal estate and gift tax purposes is a question of fact, and minority and lack of marketability discounts have been allowed in many situations. In a case involving shares of stock that were subject to securities law restrictions, the court allowed a lack of marketability discount. Minority interests in partnerships have also been allowed minority and lack of marketability discounts. Court have directed businesses to first determine the liquidation value of the partnership. Liquidation value is what remains after all partnership assets are sold, all debts and obligations are paid, and all expenses of the liquidation sale are paid. Once that is determined, the percentage interest in the partnership is applied to the liquidation value and minority and lack of marketability discounts applied, if applicable. Both minority and lack of marketability discounts may apply, no matter what type of business the partnership is involved in, as long as the discounts reflect a reasonable valuation of the particular interests.

The Internal Revenue Service's review of estate tax returns that apply discounting to general or limited partnership interests and other forms of intra-family transactions have been subject to close scrutiny on two specific fronts: (1) Should the partnership be given consideration as a legal entity for estate tax valuation purposes? and (2) Should any of the restrictions on the right to transfer partnership shares, which are often reflected in the certificate of limited partnership, be disregarded in establishing the value of the partnership share? An important starting point for reviewing the facts establishing the limited partnership is the presumption that intra-family transactions are inherently not arm's length transactions. A leading case that supports the IRS view in this area is the Estate of Elizabeth B. Murphy, deceased v. the Commissioner. In this case Mrs. Murphy took considerable steps toward developing an estate plan that was built around the premise of keeping control of a wide-ranging business enterprise in the Murphy family. The following case study describes the Murphy estate situation.

Example: Mrs. Murphy inherited control of the business from her husband, who had inherited it from his parents. As Mrs. Murphy was near death, her financial advisors convinced her to make changes to her asset holdings in order to lower her shares to less than a controlling percentage, and thereby qualify for minority and lack of marketability discounts. Mrs. Murphy, who was suffering from a diagnosed terminal condition at the time, made the changes and died less than three weeks later. When her estate tax return was filed, her personal representative claimed a minority interest and lack of marketability discount. The IRS challenged the

discounts. The Tax Court ruled that estate was entitled to a lack of marketability discount, particularly in light of a state law provision that prevented the sale of substantially all of the assets of a business unless more than two-thirds of the stock in the company favored such action. On the issue of the minority interest discount, the Tax Court deemed the estate ineligible for the discount despite the fact that Mrs. Murphy's holdings in the company slipped just below 50% at the time of her death. The Tax Court concluded that, despite the reduction below 50%, nothing actually happened to Mrs. Murphy's ownership of the company that can be said to result in the loss of control between the time she transferred shares of stock and her death less than three weeks later. She continued to serve as chairman of the board of the company and her children served in the same capacity in which they previously served. Noting that no changes took place after the transfer, the Court concluded that tax reduction was the only purpose served by the transfer. Under prevailing law, tax savings alone is an insufficient purpose for recognizing the stock transfer and giving it the legal affect that the estate sought to give it.

From the Murphy decision, the Internal Revenue Service (IRS) has drawn several conclusions that appear in technical advice memoranda responding to questions about valuing limited partnership interests. First, if the time period between events affecting the value of assets is short, it is likely that the IRS will disregard the creation of a business entity that seeks to qualify for the reduced valuation. Second, despite the creation of a family limited partnership, the Internal Revenue Code provides the IRS with authority to disregard common types of restrictions or limitations on the transfer of limited partnership interests that are often used to enhance eligibility for lack of marketability and minority control discounts.

Under these provisions, when property is valued for federal estate or gift tax purposes, the value of the property is determined without regard to any restrictions on the right to sell or use the property unless the restrictions are part of a bona fide business arrangement; the restriction is not a device to transfer property to a family member for less than full and adequate consideration in money or money's worth, and the terms of the restriction are comparable to similar arrangements entered into by person's in arm's-length transactions. Each of the three elements must be met and it is clear that their focus is one of essential fairness, commercial reasonableness, and a significant emphasis on the purpose or motive for carrying out the transaction.

In the case of both of these discounts, a question often asked is whether these discounting opportunities can be taken in addition to any of the special valuation opportunities described below. In several litigated cases involving the special use valuation opportunity the Courts have recognized that determining an asset's fair market value for special use valuation purposes necessarily would include whether the asset carries majority control or lacks it. Without this evaluation, the valuation determined cannot be said to be the asset's fair market value.

Given this recognition of the importance of control and market situations, the more difficult question becomes one of placing a figure on an appropriate discount amount to be taken in reaching fair market value. Based on reported decisions, discounts in the range of 25% to 35% are frequently allowed in cases where all requirements for eligibility are met. Eligibility will

depend on the facts and circumstances of each case. Building the evidence to support the outcome is an important obligation to undertake. For estates that otherwise face the potential of federal estate tax, such discounts can save considerable tax.

F. Special Use Valuation of Land and Real Estate Used in a Closely Held Business

1. Valuation Dates

A third estate planning opportunity is the value assigned to real property for estate tax purposes. The general rule for valuing property for federal estate tax purposes is its fair market value as of the date of the decedent's death. An alternate valuation date of six months after the decedent's death can be elected by the estate if the effect of selecting the alternate valuation date is to lower the value of the gross estate **and** lower federal estate tax liability. If property is sold during the six-month period in a freely negotiated sale that is not influenced by family relationship or other factors that lower sale prices, the sale price can be used as the value of the property.

2. Valuing Land in a Closely-Held Business at Its Use Value Rather Than Fair Market Value

In addition to the opportunity to use an alternate valuation date, certain estates are able to use a special use valuation formula found in section 2032A of the Internal Revenue Code. This formula determines value of real estate used in a trade or business based on its particular use. If an estate is eligible, it can reduce the taxable value of the real estate by up to \$820,000. This concept recognizes that the value of some properties will vary according to the use of the property rather than fair market value considerations. Not all land owners are willing to sell their land to the highest bidder. If the alternate valuation date election is made, the use value calculations will be made as of the alternate valuation date. As will be seen in the later discussion of federal gift tax, a special use valuation opportunity is not available for the federal gift tax.

For purposes of the special use valuation rule, land used for farming purposes is considered to be used in an eligible business activity. Farming purposes include planting, cultivating, caring for and cutting of trees or the preparation, other than milling, of trees for market. The Internal Revenue Service has ruled that merchantable timber and young growth should be treated as a crop and not as part of the real estate. However, the personal representative of an estate that includes such assets has a statutory opportunity to elect to treat the land as “qualifying woodlands,” which results in growing trees that are treated as part of the real estate for federal estate tax purposes. To be eligible for this election, the land must be used in timber operations and be an identifiable area of land for which records are normally maintained in conducting timber operations.

Example: In Private Letter Ruling 9924019, March 17, 1999, the decedent owner regularly performed maintenance operations with respect to timberland owned. The decedent inspected the acreage daily and cleared debris to prevent fire and to create better growing conditions. Harvesting timber, however, would not have been profitable. The decedent made all management decisions

that were consistent with good land management principles. In this case the decedent was considered to be using the parcel of land for planting, cultivating, caring for, and preparing trees for market. The IRS concluded that the timber land qualified for special use valuation where the personal representative made the election to treat the land as “qualified woodland.”

3. Requirements for Special Use Value Election for Federal Estate Tax

To qualify for the election to specially value land at its use value rather than its fair market value, several pre-death requirements must be met.

For 5 of the 8 years preceding the property owner's death, retirement or disability, the property owner, or a member of his or her “family”, must have “materially participated” in farming or other business in which the real estate to be valued was used. “Family” means an individual's ancestors, spouse, lineal descendants, lineal descendants of a spouse of the person's parent or spouse of any of the mentioned people. “Material participation” for purpose of this valuation election is determined in the same manner as determining net earnings from self-employment in a trade or business. It generally involves consideration of the labor and effort that the individual directed to the business activity.

Fifty percent or more of the value of the gross estate, less mortgages and debts applicable to real and personal property included in the decedent's gross estate, must be comprised of the adjusted value of real and personal property used in the business use.

Twenty-five percent or more of the value of the gross estate, less mortgages and debts on real estate included in the gross estate, must be comprised of the adjusted value of the real estate used in the business use.

If property is held by a partnership or a corporation, the decedent's interest in the partnership or corporation must meet other requirements. For a partnership, the decedent's interest must be 20% or more of the capital interest in the partnership, or the partnership had 15 or fewer partners. If owned by a corporation, the decedent's interest in the corporation must be 20% or more of the value of the voting stock in the corporation, or the corporation had 15 or fewer shareholders.

The purpose of the special valuation rule is to enable the owner of qualifying land to continue the use without the threat of being forced to end its business activity to pay estate taxes. Once the pre-death requirements are met, a series of post-death requirements also are applicable:

The specially valued property must pass to a qualified heir who continues the qualified use or faces an obligation to pay a recapture tax based on the tax savings generated by using the tax saving provision. A qualified heir is a member of the decedent's family as that term is described above.

A qualifying use ends in various ways. For example, a qualifying use ends when the qualified heir is no longer financially at risk in the closely held business as to profits because the heir does not have an ownership interest in the farming operation, or the heir, or a member of the heir's family does not materially participate in the qualifying use for a period of more than 3 years during the 8-year period that begins with the decedent's death. The following discussion of recapture taxes identifies the consequences of ending a qualified use.

4. Additional or “Recapture” Tax

If within 10 years after the decedent's death and before the qualified heir's death, requirements for continuing eligibility are not met, an additional tax is imposed on the qualified heir. The additional tax is generally calculated to be the difference of what the federal estate tax would have been had the special use value election not been made and the estate tax that was paid as a result of the election. This additional tax can be calculated on either the entire amount of the specially valued property or on only a portion of it, depending on the circumstances and events that triggered the additional tax.

All qualified heirs who inherit an interest in the specially valued property accept the obligation to continue the qualifying use and recognize their obligations by signing and filing an agreement that acknowledges their responsibility to pay the additional tax.

The events that trigger this recapture tax include:

- ?the qualifying use ceases during the recapture period;
- ?the land is sold to someone outside the qualified heir's family; or
- ?the qualified heir or a member of his or her family ceases to materially participate in the qualifying use.

A surviving spouse who is the qualified heir of qualifying property can lease the property to a member of his or her family without having the lease treated as a termination of the qualifying use of the property.

If a personal representative elects to treat growing timber as “qualified woodland” such that its value is considered part of the value of the land and the special use valuation election is made, then a qualified heir's decision to dispose of or sever standing timber, or the right to sever the timber, is treated as a sale or disposition of a portion of the qualified heir's interest in the property. This disposition triggers an additional tax. This tax is calculated as the sale of a portion of the qualified heirs interest in the specially valued property. The additional tax imposed in such a situation is the *lesser* of the amount realized on the disposition of the standing timber or the amount of additional estate tax that would be due if the entire interest of the qualified heir in the qualified woodland were disposed of, less any other additional estate taxes imposed. If the qualified heir subsequently disposes of the heir's remaining interest in the specially valued property, the amount of additional tax paid when the standing timber was transferred will be deducted from the amount of additional tax calculated when the second disposition is made.

5. Calculating the Special Use Value

By making the election to value the property in this manner, the qualified heir's tax basis in the property becomes the value calculated under the qualifying use. Use value in this context is determined according to one of two formulae. The first formula utilizes the average cash or crop share rental value of comparable land in the same locality minus real estate taxes. The figure obtained by this calculation is then capitalized by an average annual interest rate for federal land bank loans for the land bank district in which the land is located.

Example: At Helens death, she owned a 450-acre forest on which a brick farm house and barn were located. The acreage is in woodland consisting of mature northern hardwoods, mixed oak types, and 25 acres of black cherry trees, and is managed as a business. A fair market value for her farm is \$1,150,000. An adjoining property of comparable size and soil type has been rented on a cash basis for the last 10 years. Over the last 5 years, the average annual gross cash rent has been \$45,000. The average annual real estate tax has been \$5,500. After deducting the average real estate tax, the average rent net of taxes is \$39,500. The average rent net of taxes is divided by the average annual effective interest rate charged on federal land bank loans. For the year in which Helen died, this interest rate is 9.0%. The average cash rent net of taxes (\$39,500) divided by the average effective interest rate (9.0%) yields a special use value of \$438,888.88 ($\$39,500 \div 9.0\%$).

In valuing Helen's land for federal estate tax purposes, special use valuation rules will enable Helen's estate to reduce the value of the farm real estate from \$1,150,000 to \$438,888.

A second formula is used when sufficient information on cash or share rental of comparable land cannot be obtained. Under this alternative method the following five factors are considered in calculating the value of the land: capitalization of expected income from the activity; capitalization of the fair rental value of the land in the closely held business use; preferential assessment values for the land; comparable sales of other land that are not affected by non-agricultural uses; and any other factor that fairly values the closely held business property. It is generally considered that the five-factor method results in a higher use value than a calculation based on capitalization of comparable rents, thereby decreasing the benefit to be gained by electing special use valuation in such cases.

In Technical Advice Memorandum 9328004, the Internal Revenue Service advised that in an estate that included real estate used for both pasture and woodland purposes, the executor could elect to treat the woodland as "qualifying woodland." In submitting cash rental information from "comparable" land, the executor did not include other woodlands that had made similar elections. Therefore, the Service concluded that the estate was required to use the five-factor method described above because cash rent information was not comparable.

The decision in Estate of Rogers v. Commissioner 2000 T.C. Memo 133 is an example of the impact on an estate of its election to specially value, for estate tax purposes, standing timber growing on qualified woodlands. The decision of the United States Tax Court addresses two important points for timber land owners. First, the decision to treat timber land as “qualified woodland” under the estate tax law results in the standing timber being specially valued as part of the qualifying real property on which the timber is located rather than valuing it as other growing crops. Second, it is possible to use the rent capitalization method in valuing timber land that is subject to long-term timber leases designed to capture the value of the timber. The following summary provides important details about the decision.

Example: Carolyn J. Rogers died in 1992 -- she was a resident of Gainesville, Alabama. At the time of her death, her gross estate for federal estate tax purposes included five tracts of timber land located in the same county in which she lived. On her federal estate tax return the personal representative elected to treat some of the parcels as “qualified woodlands.” In addition, the estate elected to value the timberland under the special use valuation provision. The gist of the differences between the estate and the Internal Revenue Service involved the method and evidence used to value the timberland, which in turn affected the value of any tax due from the estate. Under the formula method the estate determined use value by referencing cash rents from comparable properties and then capitalizing the excess of the average annual gross cash rental over the average annual state and local real estate taxes for comparable properties. By using an expert who made a comprehensive study of the land being valued and other timber land in the county where the decedent resided and in surrounding counties, the expert identified comparable properties that were also subject to long-term timber leases. Using this information, the personal representative was able to convince the Court, over objections from the Internal Revenue Service, that the cash rental information was on what is considered to be comparable land and that it met the rigorous requirements of the estate tax law and regulations. The estate was entitled to use that information in determining the use value of the timber land. Furthermore, the Court held that the special use value determined by the formula method included the value of the timber on those tracts which had been subject to a qualified woodland election.

G. The Qualified Family Owned Business Deduction

1. In General

In the estates of people dying after 1997, Section 2057 offers additional federal estate tax relief for owners of family-owned businesses. The new provision, known as the “qualified family-owned business deduction,” has many features that are similar to the special valuation opportunity under Section 2032A. The qualified family-owned business deduction allows a federal estate tax deduction for “qualified family owned business interests.” Unlike Section 2032A, which involves real estate assets, the qualified family-owned business deduction can be taken against real or personal assets of the estate. Another key difference between 2032A and 2057 is that basis in property is not reduced when taking the 2057 deduction.

Under provisions in the 2001 amendments to the federal estate tax law, the family-owned business deduction will not apply to estates of people who die after December 31, 2003.

2. Amount of the Deduction

The amount of the deduction is capped at \$675,000 and is coordinated with the exemption equivalent to the unified credit against federal and estate gift tax. As described earlier, as the exclusion increases over the next several years, the amount of property that will pass tax free under the exemption equivalent also increases. The maximum family-owned business deduction allowed under Section 2057 is \$675,000, and when the deduction applies, the maximum property sheltered under the exemption equivalent is \$625,000 for total protection of \$1.3 million of business assets in an eligible estate.

Introducing the family-owned business deduction helps family businesses by allowing an additional amount of business property to pass free of federal estate taxes at the death of the business owner. This may enable the next generation family business owner to acquire the business interest at a lower cost and with a lower threat to sell business assets to pay estate taxes.

3. Eligibility Requirements

To be eligible for the deduction, there are four requirements: (1) the decedent must be a United States citizen at death; (2) the estate executor must make a 2057 election and file a recapture agreement; (3) the adjusted value of the qualified family-owned business interest must exceed 50% of the decedent's adjusted gross estate; and (4) the decedent, or members of the decedent's family, must have materially participated in the operation of the business in an aggregate of at least 5 years of the 8-year period ending on the decedent's death. Requirement (4) may create some difficulty where business assets may turn over quickly within any five-year period.

Qualified family-owned trade or business interests can be carried on as sole proprietorships or as other entities. In regard to other entities, the decedent, or a member of his or her family must own: (1) at least 50% of the entity, or (2) at least 30% of an entity in which members of two families own 70%, or (3) at least 30% of an entity in which members of three families own 90%. For corporations, the family must own the required percentage of the total combined voting power of all classes of stock entitled to vote and the required percentage of the total value of shares of all classes. For partnerships, ownership is determined by the percentage of capital interests of the partnership.

Certain interests *cannot* be qualified as family-owned business interests, such as: (1) interests in a business whose principal place of business is outside the United States; (2) interests in a business whose stock was readily tradable on an established securities market or secondary market within 3 years of the decedent's date of death; (3) the portion of the interest that is attributable to cash and/or marketable securities in excess of the reasonable expected day-to-day working capital needs of the business or certain passive assets; and (4) an interest in a business if more than 35% of the adjusted ordinary gross income, of the business for the year of the

decedent's death was personal holding company income as defined by section 543 of the Internal Revenue Code.

Certain assets are considered as passive assets and not eligible for the family-owned business deduction. These assets include: (1) assets producing interest, dividends, rents, royalties, annuities, and personal holding company income; (2) assets that are interests in a trust, partnership, or real estate mortgage investment conduit that are not in an active business; (3) assets producing no income; (4) assets giving rise to income from commodity transactions or foreign currency gains; (5) assets producing income that is equivalent to interest; and (6) assets producing income from "notional principal contracts" or payments in lieu of dividends.

4. Interest Passes to or is Acquired by a Qualified Heir

For purposes of the qualified family-owned business deduction, the person who acquires the qualified business interest must be a qualified heir. Such a person is a member of the decedent's family, and includes a person's ancestors, spouse, lineal descendants, lineal descendants of a spouse or parent, or the spouse of any of the lineal descendants previously described. In addition, and most importantly quite unlike the concept of a qualified heir for special use valuation opportunities, for qualified family-owned business deduction purposes, a qualified heir can also be any active employee of the trade or business who has been employed by the trade or business for at least 10 years before the decedent's death.

5. Additional, or "Recapture" Tax

As is the case of the special valuation opportunity under Section 2032A, the estate tax benefit of using the deduction can be recaptured in the form of an additional tax if within 10 years after the decedent's death and before the qualified heir's death certain events occur. This additional tax is imposed on the qualified heir and is based on the value of the qualified business interest that has passed to the qualified heir.

The events that trigger imposition of this additional tax include: (1) the material participation requirements are not met with respect to interests acquired from the decedent; (2) the qualified heir disposes of a portion of the qualified family-owned business interest to other than a member of the qualified heir's family or a qualified conservation organization; (3) the qualified heir loses U.S. citizenship or no longer is a U.S. resident; or (4) the principal place of business ceases to be located in the United States.

The adjusted tax difference attributable to a qualified family-owned business deduction is recaptured as the personal responsibility of the qualified heir to the extent of the heir's interest in the qualified family-owned, business if the recapture occurs within six years following the decedent's death. The percentage recaptured thereafter is annually reduced in 20% increments, until 20% is recaptured in the tenth year. Interest on the recaptured amount is also due at the rate set for underpayment of taxes for the period beginning on the date the estate tax liability was due under this chapter and ending on the date such additional estate tax is due. In the event of a

recapture of the full amount of the additional tax, the interest obligation will make a significant addition to the qualified heir's obligation.

H. Paying the Tax that is Due in Full or in Installments

In general, the federal estate tax return and payment of federal estate tax is due within nine months of a decedent's death. In certain cases, however, an estate has the option to elect an installment payment arrangement that includes interest at the rate of 2% on a portion of the unpaid tax and allows the estate to pay the tax due in installments for 14 years beyond the normal tax payment date.

To be eligible for this installment payment option, the decedent must have been involved in a closely held business at the time of the decedent's death. To qualify for the installment payment option, the business must be considered an active business enterprise rather than simply being the passive owner of business assets. In Letter Ruling 8437001, May 9, 1984, the Internal Revenue Service indicated that a decedent's proprietorship that owned timber land would not be considered an active trade or business where the decedent did not engage in acts associated with or designed to produce crops or increase yields. In cases where assets are leased by a decedent owner, the degree of the decedent owner's involvement in important management decisions and physical presence on the site are important elements in determining the nature of the decedent's involvement in the business. If the decedent did not personally participate in the activities of management and decision making, but an agent of the decedent did, the acts of the agent will be imputed to the agent's principal.

The form in which the business is organized can be a partnership if 20% or more of the partnership interest is included in the decedent's gross estate or the partnership has 15 or fewer partners. If the business is organized as a corporation, it will qualify if 20% or more of the corporate stock is included in the decedent's gross estate or the corporation has 15 or fewer shareholders. For estates of individuals dying after December 31, 2001, the number of shareholders or partners is increased from 15 to 45. In the case of partnerships and corporations, ownership interest in partnerships and corporations held by husbands and wives as community property, as joint tenants, tenants by the entirety or as tenants in common are treated as owned by one shareholder or partner. Stock or partnership interests owned by an individual and the individual's brother, sister, spouse, ancestor, and lineal descendants are treated as if the ownership interests are owned by the decedent.

In addition, a qualifying business interest must also exceed 35% of the decedent's adjusted gross estate as determined immediately prior to the decedent's date of death. Interests in residential buildings and related improvements on land that are occupied on a regular basis by the owner or lessee of the land or by persons who are employed by the owner or lessee for purposes of operating or maintaining the business are included in the 35% calculation. Assets that are included in this valuation include interests in a partnership, corporate stock, proprietorship interests, and leasehold interests in which the decedent participated in important decisions regarding the leased business and was actively involved in management and decision-making situations.

The election to pay federal estate tax is made on a timely filed federal estate tax return. Once the election is made, the installment payment arrangement will be based upon the unpaid tax that is due plus interest at the rate of 2% per year on the first \$1,100,000 of the taxable estate, which allows an estate in 2002 to have a favorable tax rate applied on the those taxable assets that exceed the amount excluded by the unified credit. Amounts that are beyond that amount bear interest that is calculated according to the rate of 45% of the rate that applies to the underpayment of tax

I. Student Exercises

1. Which of the following statements correctly describes the meaning of “incidents of ownership” as applied to the treatment of insurance policies under the federal estate tax law?
 - a. The person who has these “incidents of ownership” will receive the proceeds of the policy when the payable.
 - b. If a person has such “incidents” in a policy of insurance at the time of death, the value of the insurance proceeds will be included in the person’s gross estate.
 - c. Having an “incident of ownership” will result in no federal estate tax being applied to the policy proceeds.
 - d. “Incidents of ownership” require that the policy proceeds be shared equally among all of the lineal heirs of the deceased.

2. Which of the following statements correctly describes the impact of electing to treat land and growing trees as “qualified woodland” for federal estate tax value purposes?
 - a. Qualified woodland is not subject to federal estate tax.
 - b. Qualified woodland is taxed at the lowest rate of federal estate tax.
 - c. For qualified woodland the value of the land is considered to be zero and the value of the timber is determined according to its fair market value.
 - d. None of the above statements is a correct statement.

3. Which of the following statements about the concept of valuing property by its fair market value is a correct statement?
 - a. The value of various things is reported annually in *The Book of Capital Values* available in most public libraries.
 - b. The value of a thing is determined by the average amount of annual income, rent or profit that it generates over a five-year period of time.
 - c. The value of a thing is determined by what a willing and able buyer would pay to and be accepted by a willing and able seller of the property.
 - d. None of these statements is a correct statement.

4. If a business is owned by several people, which of the following statements correctly describes an important element in determining the value of an individual owner’s share of the business?
 - a. The value of an owner’s share will reflect whether the owner’s share is large enough to control action to be taken by the business.

- b. The value of any share is determined by dividing the assets of the business by the number of owners.
- c. The value of the owner's share will be determined by the value of the time and effort that the owner puts into the business.
- d. The value of any share will be determined by the value paid for it when the share is sold in a commercially reasonable way.

Short Essay Questions

5. Briefly describe the impact that each of the following estate planning techniques will have on the amount of property that will be subject to tax: Special Use Valuation, and the Family Owned Business Deduction.

6. George and Laura are the owners of a 500-acre farm business that includes a woodlot of about 150 acres that includes northern hardwoods and mixed oak timber types. The farm business is currently a proprietorship in which George and two of his children, a daughter and a son, are involved. The mix of other assets that George and Laura own includes:
 - a. A collection of gold and silver coins from countries around the world and an extensive collection of American coins and paper money.
 - b. Individual IRA's in each of their names.
 - c. A \$100,000 life insurance policy on Laura's life and a \$50,000 policy on George's life. Both George and Laura pay the premiums on the policies from a joint checking account they maintain. Each of them has designated the beneficiaries of the policies.
 - d. U.S. treasury bonds and treasury savings bonds that were issued before 1955.
 - e. Several pieces of machinery and equipment that were used in the farm business.
 - f. A number of Laura's paintings that were done over the last 40 years. Laura was an art major in college and continues to paint from time to time, particularly now that her children are grown and on their own.
 - g. Two complete sets of oak dining room furniture (table, six chairs, and a breakfront in each set) that George built by hand as his hobby. In addition to the furniture that is finished, George also has a supply of oak, cherry, and walnut boards in his workshop that are part of other projects that are not yet complete.
 - h. George's workshop also includes a variety of wood-working tools and equipment. It also contains supplies, paints, lacquers, and other furniture finishes that George uses in building furniture.

Based on this list of assets, develop a plan for determining the value of the property owned by George and Laura. All estate property is owned by George and Laura, husband and wife. Other assets are owned in a variety of ways -- some are considered separately owned, while others are not.

Chapter VII

Using Gifts in Estate Planning

A. Overview and Purpose

To many people, giving property away during their lifetime accomplishes several important goals. In this chapter we will examine these goals and their impact on estate planning objectives. Some of the items discussed in this chapter will apply the ideas and concepts discussed in Chapter V.

In the opening discussion we will examine legal issues that surround the concept of a gift. Understanding this concept will enable us to turn our attention to the question of their use in estate planning and the factors that favor use of gifts in particular situations. A popular form of gift is that to a charity. We will examine the nature of such transactions by describing the common types of charitable gifts used today. With that background we will review the income, inheritance, and estate tax issues that should be understood before turning to the use of gifts in estate plans.

B. Lesson Objectives

When you have successfully completed this chapter you will be able to accomplish the following objectives:

1. Discuss the legal requirements of lifetime gifts.
2. Discuss the role of lifetime gifts in solving estate planning problems and describe the situations to which a gifting program can be applied.
3. Describe and compare the various types of charitable gifts commonly used in estate planning today.
4. Discuss the income, estate, and gift tax issues to consider before making lifetime gifts part of an estate plan.

C. What is a Gift?

In the legal sense, a gift is a transfer of property to another person without any consideration or benefit given in return for the property. Gifts can be compared to sales and loans. A gift is distinguished from a sale in which parties to the sale exchange something of value with each other. A loan, on the other hand, has a clear expression of an intent to either return the property or repay the funds advanced.

Gifts can be made to total strangers, close family members, or institutions whose function is to promote the welfare of mankind and the community. A gift can be either total or partial. A gift can be either a gift of a present interest or a gift of a future interest.

A total or complete gift is a transfer in which the recipient does not give any consideration to the former owner of the property who transfers the property. A partial gift is one in which the recipient of the property transfers some consideration to the former owner, but the value of the consideration is less than the value of the property received by the recipient. A gift of a present interest is a gift that the recipient is able to enjoy now, while a gift of a future interest is one in which enjoyment of the gift property is delayed until some future time or situation.

Example: If a parent lends money to a child and charges the child a small amount of interest on the loaned funds, the parent has made a gift to the child of the difference between the market rate of interest that lenders normally charge on loans of this type and the rate of interest the child agrees to pay the parent.

Likewise, if someone decides to transfer valuable property to another person or entity and the documents that evidence the transfer refer to the fact that the recipient purchased the property for one dollar, the seller of the property makes a gift of the property by transferring it for less than its fair market value.

If a partial gift is one in which the value of the item given away is greater than the value of what is given in return for the item, how can I distinguish partial gifts from other transactions in which property is transferred but the value of what is given does not equal the value of what is received? Not all situations in which someone transfers something for less than it is worth are considered to be gifts, so it is important to distinguish these transactions. In such cases, three requirements distinguish gift transfers from other transfers.

D. Distinguishing Gift from Other Transfers

1. Intent to Make a Gift

The first requirement is that the owner who transfers the property intends to make a gift when the transfer is made. Since the intent to act in a certain way is important, evidence of a person's intent becomes important. Evidence of such intent may be found in a person's own written or spoken words or by evaluating a variety of typical situations that the person has behaved in the past. The importance of establishing a person's intent is seen in a variety of situations, such as where a person gives away something of great value and receives something of lesser value in return. In general, this situation would not be considered as a gift because the intent to make the gift is lacking. In some situations, a legal presumption arises that a transfer is not a gift.

Example: If a person creates a joint ownership interest of a bank account in which only his or her funds are deposited, the Uniform Probate Code law presumes that the joint owners intend for each owner to have access during their lifetimes to only that portion of the account which represents their contribution to the account. If only one person contributed funds, then only that person would be entitled to withdraw funds from the account while both joint owners are alive. During lifetime, it is presumed that the joint owner who contributes little or nothing to the account is to have access to only that which he or she contributed. At the death of

one of the joint owners, however, the right of survivorship feature of this form of joint ownership transfers ownership of the remaining balance of the account to the surviving joint owners.

To overcome this presumption and create a joint account in which each owner is entitled to access to the full fractional share of each owner, even if no contributions were made, the owner must establish the intent to do so by clear and convincing evidence. An owner who wants to overcome the presumption is able to do so, but the terms on which it is done must be clear and without doubt.

In addition to state property law presumptions regarding whether a gift is made, the federal gift tax law also impacts on specific transactions. For example, when a joint ownership interest is created in a joint bank account, for federal gift tax purposes a gift does not occur until money is withdrawn from the account by the recipient of the gift. If the recipient of the gift contributed some of the funds in the account, a gift does not occur until the recipient withdraws more money from the account than he or she had contributed to it. United States savings bonds are considered as gifts when the bond is surrendered by the recipient for his or her own benefit. Delivering a check to another person is not treated as a gift until the check is paid or transferred for value to someone else. A person who holds a power of appointment over property holds the power to determine who will own or enjoy the property over which the power operates. Powers of appointment are created by someone other than the person who holds the power. The exercise or release of a power of appointment is treated as a gift if the exercise or release was made without adequate consideration.

2. Transfer of Dominion and Control

The second requirement of a gift is that the owner of the property must give up full dominion, ownership, and control of the item to the person who receives it. A person who is unwilling to give up control of an item and retains some control over or interest in property does not make a gift of the property. Without giving up all interest in or control over the item given away, a completed transfer is not made. In some situations a person may give up ownership and control of an item, but still retain possession of it after the transfer. This may indicate several things, such as the owner wants to retain the right to change his or her mind about making the gift, or the gift is intended to take effect only after the owner's death. In the first instance, the right to revoke the gift may indicate that a complete gift has not occurred. In the second instance, a gift that is delayed until after an owner's death is a gift of a smaller interest in property than a gift of a full interest. This smaller interest that follows after an owner's death is referred to as a remainder interest.

3. Acceptance of the Gift

The third requirement is that the recipient of the gift actually receives and accepts it. As in the case of the first requirement, no one can be forced to accept a gift if it is not their intention to do so.

In addition to these requirements, several other factors influence the determination of whether a gift is made. If property is transferred in return for something that cannot be valued in terms of money or money's worth, such as love and affection, or a promise of marriage, the transfer is viewed as a gift. Waiving or surrendering marital rights to property is also treated as a gift, except where a married couple actually obtains a divorce and settles their property rights by written agreement.

Gifts can be either directly or indirectly made. Direct gifts are gifts made to the recipient without first passing through another entity or person. Indirect gifts, such as gifts in trust, ultimately pass to the intended recipient, but only after passing through the trustee's legal ownership form.

E. How Are Lifetime Gifts Used in Estate Planning?

For estate planning purposes, lifetime gifts are used to shift ownership of assets out of the hands of a person who does not wish to be the owner of the property and into the hands of another who can benefit from ownership.

By doing so, the former property owner reduces the size of the assets under his or her ownership and control. This in turn reduces the potential size of the federal gross estate for federal estate tax purposes and the estate subject to inheritance tax. If the transferred property generates income or enjoys substantial appreciation in the future, the income and future appreciation are also credited to the recipient, rather than the former owner. To those property owners who face the possibility of having estate and inheritance taxes imposed on the transfer of property after their death, lowering the value of their total assets has a direct impact by lowering the taxes they pay.

When the exclusion equivalent unified credit applicable to federal estate taxes was much lower than it is today, property owners considered gifting as a means of lowering taxes. The dramatic increase in the equivalent exemption to the unified credit described in Chapter V has lowered the importance of this strategy for many property owners.

Example: A person who owns property valued at \$1,500,000 develops an estate plan that calls for lifetime gifts of \$10,000 to each of her five children and grandchildren in 2001 and continuing for the next five years. By completing this gift-giving program, the owner reduces the size of her estate by \$250,000.

If the owner had not made these gifts, the federal estate tax on the owner's gross estate of \$1,500,000, less the unified credit of \$192,800, would be \$363,000 (\$448,300 plus 43% of \$250,000 = \$555,800 - 192,800 = \$363,000). After having made the gift, the federal estate tax on the owner's gross estate of \$1,250,000, less the unified credit of \$192,800, would be \$255,500 (\$448,300 - 192,800 = \$255,500). By making the gifts, the owner saves \$107,500 in estate taxes on the property that is given away. If the property given away increases in value, the size of the savings could be greater.

In the case of married couples, transferring property ownership from joint ownership to sole ownership is an important tool in the estate plan intended to maximize use of the unified credit in the estate of each spouse. By creating a separately owned estate for each spouse, it is more likely that at each spouse's death, that spouse's own equivalent exemption will be used to shelter the transfer of property from federal estate tax. Having each spouse own separate assets and provide for the transfer of it in a way that is not subject to the marital deduction at the surviving spouse's death allows the unified credit to be applied and the assets to pass to other heirs free of federal estate tax. Transfers between spouses are subject to an unlimited marital deduction for federal gift tax purposes. This enables the couple to rearrange ownership of assets to save federal estate taxes at the death of the spouse and with no lifetime gift tax consequence. If property is jointly owned between spouses the joint ownership interest can be severed into two multiple owner or tenant in common interests that enable each spouse to claim an undivided one-half interest in property.

In the case of closely held business assets, gifts of shares of stock or partnership interests enable majority owners to shift control of a business to junior owners who are building their ownership share. The principal considerations here are the ease with which the transfer can be made and the estate tax consequence of having made the transfer. Businesses owned in corporate or partnership form also have the advantage of being transferred more easily than those owned as proprietorships. Transfer of proprietorship assets is generally accomplished on an asset by asset basis or as a "going concern" where all business assets are sold in a single sale. Transferring shares of stock that represent ownership of all business assets is significantly easier to accomplish. In contrast to the ease of transfer of stock or partnership shares, valuation of small business stock and partnership transfers generally requires valuation of the business as a whole in order to determine the relative value of stock shares or partnership interests. Proprietorship assets, in contrast, are valued individually and some may be valued quite easily, such as vehicles, equipment, or livestock.

F. Factors Involved in Gift Giving Programs

In evaluating a gifting program, property owners should consider the uncertainty of tomorrow's financial. Perhaps the most significant uncertainty confronting us today is the issue of long-term care. Will this be something an individual or family will confront? If it is, what options for planning are available and what factors influence a person's choice from among the various options? Saving death taxes may seem like a practical way to ensure the transfer of a large portion of the estate to intended heirs, but it also influences the property owner's current financial picture. At what point does saving future transfer taxes interfere with current financial needs and requirements?

Property owners who decide to embark on a gift-giving program have many things to consider. In deciding which assets to transfer, numerous other considerations enter into the deliberation. If assets such as farmland, forest land, or real estate used in a closely held business are involved in an estate, these assets may be able to take advantage of special valuation or installment payment opportunities for federal estate tax purposes. To the extent that these opportunities provide significant tax saving to the estate, retaining the real estate and passing it after death may provide

more desirable benefits to a property owner than giving it away during lifetime. Special use valuation and installment payment provisions require the business assets be a specified percentage of the gross estate. Transfers that affect these percentages must be coordinated to avoid loss of these opportunities through failure to meet the required percentage.

Assets that yield significant income to a high income tax bracket taxpayer may be ideal candidates for gifts. Income tax benefit comes from the lower level of taxable income and estate tax benefit derives from the smaller gross estate. Transfer of assets that are expected to appreciate in value transfers the property, as well as its future appreciation. Gifts to qualifying charities can yield an income tax benefit through provisions for an income tax charitable deduction as well as estate tax benefits through a charitable deduction for estate and inheritance tax purposes.

When an owner gives property to another, the owner transfers the owner's income tax basis to the recipient. In the case of a high-value, but low-income-tax-basis item, the low basis may affect the recipient's future plans to sell the property by imposing significant tax on the gain from the sale. Until January 1, 2010, passing assets to heirs through an estate to gain a step-up in basis of the property may be beneficial to the recipient.

Gifts to children under the age of majority, which is 18 years in most states, present trouble some gift-giving considerations. Making the transfer will benefit the adult owner, but the minor child who receives the property may be unable to legally control the property or may lack the maturity to deal with it responsibly. Coupling these concerns with the gift tax annual exclusion requirement of transferring a present interest in the gifted property to the child further complicates the problem.

Gifts to children qualify as present interest gifts if the property and the income it generates may be spent by or for the benefit of the children before their 21st birthday. Whatever balance remains is distributed to the children at that birthday. If a child dies before reaching age 21, the balance must be payable to the estate of the child or be appointed by the child under a power of appointment to someone else. Gifts of property passing to a trustee for the benefit of the minor beneficiary must meet these requirements in order to qualify as a present interest.

Gifts to minor children of a present interest can also be made under the Uniform Transfers to Minor's Act (UTMA). Under this act, the donor transfers the property to a custodian who is designated to hold the property for the minor child under the provisions of the Uniform Transfers to Minor's Act. By making this transfer and designating the custodian, the property is considered to be the minor child's. The custodian's role in this transfer is to facilitate transactions involving the property until the child reaches the age of 21 and to pay over to the minor child the balance of the custodian account when the child reaches age 21. If a child's parent transfers property under the UTMA, and designates himself or herself as the custodian for the minor child, several conflicting issues arise. For purposes of federal estate taxes, the role of a parent as custodian for his or her own child is viewed as the parent retaining ownership and control of the property such that the transferred property is included in the federal gross estate of the parent who dies before the property is transferred to the child at the child's 21st birthday. The UTMA clearly indicates

that transfer to a custodian under the act results in an effective transfer to the child. Reconciling this dispute and the accompanying confusion it can create may best be accomplished by naming an unrelated party as custodian for the child.

Another method of designating ownership of bank accounts for minor children is a tentative trust. This type of ownership lists a trustee as owner of the bank account and adds the designation "in trust for" a minor child. In this situation, unless there is clear and convincing evidence of a contrary intention, this account is considered to be the property of the trustee during the trustee's lifetime. If the parent of the child is the trustee, the parent is considered to be the owner of the property during lifetime. As such, tentative trusts are not considered gifts of a present interest of the money in the account. After the trustee's death, the balance in the trust account is the property of the beneficiary described in the account title. If more than one beneficiary is named, there is no right of survivorship between the beneficiaries, unless the account specifies this relationship.

Gifts to and between spouses are frequent examples of estate planning transfers motivated by the desire to save taxes through use of the unlimited marital deduction and the unified credit exemption equivalent. This technique is effective in creating the separately owned asset inventory that can pass free of gift taxes between spouses and free of estate taxes to heirs. If spouses maintain their assets in joint ownership, the death of the first spouse triggers application of the unlimited marital deduction for estate tax purposes, thereby jeopardizing use of the unified credit exemption equivalent by the first spouse's estate. In the calculation of federal estate taxes, deductions are taken before the taxable estate is determined. Therefore, maximizing the marital deduction results in a larger deduction and little or no taxable estate and little or no tax to which the unified credit can be applied. Since an individual loses the credit that is not used, the opportunity to pass property free of federal estate taxes can be lost.

G. Gifts to Charities and Other Institutions

In the context of estate planning, transfers to charities, whether during lifetime or at death, are treated in special ways. The tax considerations of such gifts involve income, estate, gift, and inheritance taxes. If the lifetime gift of property is eligible for an income tax deduction as a charitable contribution, the property owner may be able to achieve a savings at three levels. Death transfer taxes will be reduced because the size of this owner's estate will be reduced, no gift tax will be imposed because of the gift tax charitable deduction for gifts to charities, and income taxes will be reduced as a result of the income tax charitable deduction.

What type of gifts qualify for a charitable deduction? Gifts made in a calendar year to or for the use of the federal government or a state or local government body for exclusively public purposes are entitled to a charitable deduction. Certain Indian tribal governments are treated as states and, as such, gifts to these tribal governments qualify as deductible charitable contributions. Transfers to a corporation, trust, community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, organizations that foster amateur sports competition, and organizations for the prevention of cruelty to children or animals are likewise entitled to a charitable deduction. These organizations

qualify for a deduction as long as no part of their net earnings benefit a private individual and no substantial activity is undertaken to carry on lobbying efforts or participation in a political campaign. Transfers to other organizations such as fraternal societies, orders, or lodges that use property exclusively for religious, charitable, scientific, literary, or educational purposes also qualify for a deduction as long as no part of the net earnings of the organization benefit private individuals. If a transfer to a charitable organization is contingent on a particular act or occurrence, a deduction is allowed only if it is virtually certain that the transfer will become effective and the contingency can be ignored.

Gifts to charities can be of several different types, such as direct gifts, indirect gifts made to a trust, gifts of a full interest, and gifts of a partial interest. Direct gifts to charity of a full interest in property are measured by the value of the property at the time the gift is made. In this situation, the owner transfers property directly to the charity which takes over ownership and control of the item from that point forward. Direct gifts to charities of a partial interest in property may be either gifts of a fractional ownership share in the property, a remainder interest in real property, such as a home or land transferred in trust or a gift of a qualified conservation easement to a qualified organization for conservation purposes. Qualified conservation easements are discussed in more detail in Chapter VIII.

A gift of a remainder interest in property is known as a "charitable remainder trust". Once the decision is made to use a charitable remainder trust, the trust can take one of three forms: A remainder **unitrust**, an **annuity trust**, or a **pooled income fund**.

A **unitrust** provides for an annual payout from the trust of an amount equal to a fixed percentage, which must be at least 5%, of the net fair market value of the trust assets as valued each year. These annual payments are made to one or more persons who are living at the time the trust is created. At the death of the beneficiaries, or at the end of a term of up to 20 years, the remainder interest is held for the benefit of the designated charity or paid to it. A charitable remainder **annuity trust** is a trust from which a specified amount is paid at least annually to one or more persons who were living at the time the trust was created. The amount paid to the beneficiaries must be at least 5% of the initial fair market value of the property placed in trust. At the death of the last income beneficiary, or at the end of a fixed term of up to 20 years, the remainder interest must be paid for the benefit of a qualified charitable organization or paid to it. A **pooled income fund** is a trust maintained by a charity to which donors transfer property by contributing the remainder interest in the property to the charity. In such funds donors can keep an income interest for life or create an income interest in the property for the benefit of another beneficiary who is living at the time the trust is created.

H. Income, Inheritance, Gift and Estate Tax Issues of Gift Giving

Several chapters in this book describe tax issues involved with estate planning. In this section we will review the tax issues that are most directly involved with gift giving programs that are part of an estate plan. The following list of questions will review and highlight the issues:

1. Income Tax Issues

- Is the recipient of the gift a qualifying organization that permits the donor of the property to receive an income tax charitable deduction for the gift?
- What is the value of the gift for income tax deduction purposes?
- What is the income tax basis of the property in the hands of the former owner? What is its purchase price? What improvements or other adjustments to basis were made during the donor's period of ownership?
- What will the recipient of the property do with the gift after receiving it?
- Is the donor of the property eligible to take advantage of the one time federal income tax exclusion of up to \$250,000 (\$500,000 if a joint taxpayer) of capital gain from the sale of a personal residence?

2. Estate Tax Issues

- Within three years of the decedent's death did the decedent transfer a life insurance policy, transfer property in which the decedent retained a lifetime interest, make a transfer taking effect at death, or make a transfer in which the decedent retained a right to revoke it?

3. Gift Tax Issues

- If a gift is made, will the gift qualify as a gift of a present interest?
- If a gift is made, will the value of the gift exceed the amount of the gift tax annual exclusion? If the donor is married, is the donor's spouse willing to "split" the gift?
- Will the donor make a gift of tuition paid directly to an educational institution on behalf of a student at the institution?
- Will the donor make a gift in the form of payment for medical care and services or medical insurance provided to another person?
- Will the donor make a gift to his or her spouse that will qualify for the gift tax marital deduction?
- Will the donor make a gift to a qualified charity that will qualify for the gift tax charitable deduction?

4. Generation Skipping Transfer Tax Issues

- If a gift is made, is the recipient of the gift two or more generations younger than the donor, or is the recipient more than 37 1/2 years younger than the donor? If the gift is made from a grandparent to a grandchild, did the parent of the grandchild die before the gift is made?
- If a gift is made, will the gift qualify for the gift tax annual exclusion, or the special exclusions for tuition paid directly to an educational institution, or for the payment of medical care or service expenses?
- If a gift is made, to which generation skipping transfer tax can apply; does the donor have all or part of his or her generation skipping transfer tax exemption available to apply to the gift?

I. Student Exercises

Multiple-Choice Questions

Please read the questions carefully, then select one of the four choices following the question that correctly answers the question asked.

1. Which of the following statements does not describe one of the requirements of a valid gift for property law purposes?
 - a. The person who receives the property is willing to receive it.
 - b. The person who gives the property intends to transfer the property without receiving something of equal value in return.
 - c. The property given away is less than \$11,000 in value.
 - d. The person giving away property surrenders dominion and control over the property to recipient.
2. Jeffrey wants to transfer his land to his son Jerrold, but he is not ready to turn it over to him completely. Therefore, Jeffrey prepared a deed to the farm that transfers the farm to Jerrold but retains the right to live on the property for the balance of his life. Jeffrey signed the deed, had his signature notarized, and put it in his desk drawer without ever giving it to Jerrold or recording it with the Recorder of Deeds.

Based on these facts and our discussions of gifts, which of the following statements about the legal nature of Jeffrey's transfer to Jerrold is correct?

- a. Jeffrey's deed is a valid transfer since he signed the deed.
- b. Jeffrey's deed is not a valid transfer since the deed was never delivered to Jerrold.
- c. Jeffrey's deed reserved a remainder interest in the farm for the balance of Jeffrey's life.
- d. Jeffrey's attempt to retain an interest in the property after giving it to Jerrold is ineffective and Jerrold can ignore it.

3. George wants to share some of his good fortune with his neighbors in Happy Valley. After talking with the local high school officials, George decided to sponsor a high school student who wants to attend college, but doesn't have the money to do so. George agreed to pay the tuition for the student to attend George's alma mater. Tuition for undergraduate students at that University is \$22,000 per year.

Based on these facts and our discussion of gifts for federal gift tax purposes, which of the following statements about the federal gift tax is correct?

- a. Each tuition payment that George makes on behalf of the student is a taxable gift on which George is responsible to pay federal gift tax.
 - b. Since the gift is less than \$30,000 in any single year, the gift meets the gift tax annual exclusion.
 - c. If George pays the tuition directly to the university on behalf of the student, George's payment will be exempt from federal gift tax.
 - d. If George dies within three years of making any of these tuition payments, the payments made within that time will be taxable gifts.
4. Which of the following factors is NOT a reason to make gifts of property to qualified charities?
- a. Reduce the potential size of the donor's federal gross estate.
 - b. Obtain an income tax charitable deduction.
 - c. Increase income from private investments.
 - d. Transfer property without having to pay federal gift tax.
5. When a person gives property away to another person, what is the recipient's income tax basis in the property?
- a. The recipient's basis is its fair market value at the time of the gift.
 - b. The recipient's basis is equal to whatever consideration the recipient gave to receive the property.
 - c. The recipient's basis in the property is zero.
 - d. The recipient's basis in the property is the same as the basis of the donor of the property.

Short Essay Questions

Please read each question carefully and then respond to what is asked for at the end of the question. Your answer need not be long or involved, but it should be as clear and concise as possible. If you want to refer to important facts in your response, please feel free to do so.

6. Nicholas and Alexandra want to reduce the potential size of their federal gross estates by making gifts of property during their lifetime. The people they want to benefit by their gifts include their children, their families, and several charities, including a church and a university hospital.

Nicholas and Alexandra own two parcels of forest land. One was purchased in 1950 for \$50,000 and is now worth \$500,000. The second was inherited from Alexandra's father 30 years ago. Real estate development is surrounding the second farm and its value is increasing rapidly. Some people say it is worth \$4,000,000.

Among their other assets, Nicholas and Alexandra have several joint bank accounts, certificates of deposit, and they own stock in several companies that are traded on the national stock exchanges.

Several years ago Nicholas and Alexandra formed a corporation when the oldest of their children decided to come back to help manage the forest land. Since then the child has been an excellent contributor to the business and she wants to stay and eventually manage the business on her own some day. Two other children are in the family, but neither child is interested in the business.

Based on our discussion of the factors that influence gift-giving decisions, evaluate Nicholas and Alexandra's situation and suggest which assets they might give to their children, to the church, or to the university hospital.

7. Geraldine decided to open a new bank account after she received the proceeds from the sale of her farm. Because she is elderly, she decided to name her daughter joint owner with the right of survivorship, even though her daughter had not contributed any funds to the account. Geraldine chose her daughter to be joint owner because her other two sons live out of the area and Geraldine has a better relationship with her daughter than with her sons.

When the account was opened, Geraldine's daughter signed the bank signature card, but Geraldine maintained the account cards needed to withdraw money. Based on our discussions of gifts, what right does Geraldine's daughter have to withdraw funds from the account during her lifetime and after Geraldine's death?

8. Thomas, an elderly widower, is in failing health. After his wife Martha's sudden death he became lonely and fell ill. Knowing that his health was failing, Thomas asked his oldest son, Ken, to help him distribute some of his property. Thomas asked Ken to draw four checks, each in the amount of \$25,000, from his checking account and pay them to Ken and Thomas's other children. In addition, Thomas asked Ken to issue a check in the amount of \$20,000 to Thomas's neighbors, the Mullin family. Thomas wants to help the family send their oldest son to college next year. Thomas's final instruction was to issue a check in the amount of \$15,000 and pay it to Martha's favorite charity.

Ken carried out all of Thomas's instructions and delivered the checks. Four months later, after a bout with pneumonia, Thomas died in his sleep.

Based on our discussions of the tax implications of gift giving, what tax issues do you recognize in this situation?

Chapter VIII

Conservation Easements: Valuing Property Subject to a Qualified Conservation Contribution

A. Overview and Purpose

Forest landowners planning their estates may consider selling or donating a conservation easement as a way to receive income and estate tax relief and at the same time ensure that their land remains as forest. A conservation easement is a legally binding agreement that permanently restricts the development and future use of the land to achieve a conservation objective. An easement can either impose limitations on an owner or create obligations that a landowner must meet to avoid sanctions or penalties for the violations. Conservation easements are created for a variety of purposes, including:

1. Retaining or protecting for the public and economic benefit the natural, scenic, or open space values of real property;
2. Ensuring its availability for agricultural, forest, recreational or open-space use;
3. Conserving or managing the use of natural resources;
4. Protecting wildlife;
5. Maintaining or enhancing land, air or water quality; or
6. Preserving the historical, architectural, archeological or cultural aspects of real property.

Landowners who grant easements give up some of their full ownership rights in the property. The result is shared ownership involving the owner of the land and the holder of the conservation easement.

The agreement between the landowner and the organization that holds the easement will be embodied in an easement agreement. Elements of this easement agreement should include its purpose, how it achieves certain conservation objectives, and all restrictions and obligations placed on the land uses. Landowners should also recognize the importance of considering what rights they wish to retain in the property after the easement is granted. The nature of the landowner's rights will affect the owner's qualification for income tax and estate benefits. A conservation easement should be individually tailored to the desires of each property and its owner.

An easement has important economic considerations attached to it if it is donated to a government body or a charitable corporation or trust that is exempt from taxation under Internal Revenue Code requirements and is created for the purpose of promoting conservation goals. Such transactions offer the landowner an opportunity for an income tax deduction against current income when the donation is made and additional deductions in calculating federal estate tax.

There are numerous legal and economic considerations about easements that landowners should be aware of. This chapter discusses the requirements for forestland qualifying for a conservation easement and the tax advantages that apply. To receive favorable tax treatment there must be a qualified real property interest, a qualified organization to receive the easement, and a qualified

conservation purpose that yields a significant public benefit. The following discussion will describe basic aspects of conservation easements, the income tax deduction requirements and a discussion of the estate valuation deduction requirements.

B. Lesson Objectives

When you have successfully completed this chapter you will be able to accomplish the following objectives:

1. Explain what the concept of a conservation easement is and how it affects a property owner.
2. Discuss the income and estate tax benefits arising from donation of a conservation easement.
3. Discuss the requirements for the donation of a conservation easement to qualify for income and estate tax benefits.

C. Conservation Easements

Conservation easements (CE) have become an attractive tool for achieving land conservation objectives. Rising real estate values of the past 25 years and the resulting higher property taxes threaten sale of forest and farmland for development. Most landowners want to do what is right for their land, but their decisions must also make economic sense. A conservation easement is one tool that can be used to accomplish both objectives. It is a voluntary action of the landowner intended to save various types of taxes, preserve the inherent productivity and character of property, and ensure that the lands remain in their current use forever, free from the threat of development. A conservation easement is a legally binding agreement that permanently restricts the development and future use of the land to ensure protection of its conservation values. As described above conservation purposes are many and varied, so landowners have a wide variety of ways that conservation easements can be used.

The rapidly growing conservation land trust movement was sparked by changes to the Internal Revenue Code that promote tax incentives for the preservation of land. Many conservation easements are held by or acquired by land trusts and turned over for management to government agencies. The conservation easement is a formal document that is recorded in the same office where documents that prove ownership of land are recorded. Because the transfer of the easement is a transfer of an interest in the land, it continues in effect after the owner who donated the easement transfers the remaining interest to someone else. Conservation easements are attractive to both land use planners and landowners for a number of reasons, including: (1) it is voluntary (it is not a regulation, but is restrictive); (2) each easement is tailored to the desires of each property and individual owner; (3) it keeps the property in private hands and on tax rolls; and (4) it costs less than an outright acquisition of full ownership of the land. Tax benefits depend on whether the easement was donated or sold, the income of the landowner, and the difference between the land value before and the land value after the easement.

When considering whether to grant a conservation easement, landowners should carefully consider the terms of the easement they will grant and the organization to which they will grant it. Many different organizations exist. Each may have a different objective or perspective on preserving land. Therefore, it is very important for landowners to fully explore the organization's philosophy about land conservation. Only then can an owner decide if it matches the owner's philosophy. Major mistakes and considerable heartache can be avoided, by making well informed and well reasoned decisions.

D. Tax Aspects of Conservation Easements

1. In General - IRC Section 170

Lifetime transfer of a **qualified conservation contribution** is the contribution of a qualified real property interest to a qualified organization exclusively for a conservation purpose. Such transfers qualify the landowner to take an income tax deduction under Section 170 of the Internal Revenue Code (IRC) for the value of the contribution. As will be seen below, such transfers also enable the landowner's estate to take an additional deduction under Section 2031(c) of the IRC against the value of the remaining property interest retained by the landowner at the owner's death. In order to take advantage of the deduction against the value of the property in the decedent's estate, the transfer must first qualify for the income tax deduction.

A **qualified real property interest** can be one of several different property interests. It can be the landowner's entire interest in the property, other than a qualified mineral interest. A qualified mineral interest is the landowner's interest in subsurface oil, gas, or other minerals and the right of access to them. A qualified real property interest can also be a remainder interest in property, or a perpetual conservation restriction on the use that can be made of the property. For the most part, the terms, **easement, conservation restriction and perpetual conservation restriction** have the same meaning.

A **qualified organization** to be eligible to hold the conservation contribution must have a commitment to protect the conservation purposes of the donation, and have the resources to enforce the restrictions. Such an organization is either a governmental unit, an organization created and operated primarily or substantially for one of the conservation purposes specified in Section 170, a charitable organization that meets the public support test of the IRC, or a charitable organization that is controlled by an organization that meets any one of these requirements.

A **qualified conservation purpose** can mean one of several different things: (1) it can mean the preservation of land areas for outdoor recreation by, or the education of the general public; (2) it can mean the protection of the natural habitat of fish, wildlife, plants, or similar ecosystems; (3) it can mean the preservation of open space, including farmland and forest land, where such preservation is for the scenic enjoyment of the general public, or the action is pursuant to a clearly defined and described federal, state, or local government conservation policy, and the action will yield a significant public benefit; and (4) it can mean preservation of a historically important land area or a certified historic structure.

Qualified conservation contributions that will generate the greatest interest in private forest landowners are likely to be those intended to preserve open space. In order to qualify for the favorable income tax treatment of section 170, the contribution must meet additional requirements described in the third item of the preceding paragraph. In this statement are three distinct standards, viz. **clearly defined and described public policy, scenic enjoyment, and significant public benefit.**

Preservation of land for the scenic enjoyment of the general public is directed at preventing development or use of the property that would impair the scenic character of the local rural or urban landscape or would interfere with a scenic panorama that can be enjoyed from a park, nature preserve, road, water body, trail, historic structure, or land area, and such land area or way is open to or used by the public. Access by the public can be accomplished by visual access to or across the property, rather than physical access. How much visual access is needed satisfy the public access requirements may depend upon the nature of the scenic character to be preserved.

A clearly defined and described government conservation policy is one that is intended to protect the types of properties that are identified by representatives of the general public as worthy of preservation or conservation. A general statement of conservation goals by a single official or legislative body is not sufficient, but legislation or ordinances that provide for site-specific conservation projects would meet the requirement. Acceptance of an easement by a government agency tends to establish that the donation is consistent with a clearly delineated government policy, but without more it may not meet the requirement. The more rigorous the review process by the government agency, the more the acceptance of the conservation contribution tends to establish the requisite clearly defined and described government policy.

A conservation contribution must demonstrate that it will yield a significant public benefit in order to qualify for the section 170(h) income tax deduction. This requirement attempts to identify whether the primary benefits of the contribution flow either to the landowner or to the public. In determining the nature and extent of the benefit a variety of factors are considered in light of the facts and circumstances associated with the contribution. For example, preservation of an ordinary tract of land would not in and of itself yield a significant public benefit, but the preservation of ordinary land areas in conjunction with other factors that demonstrate such benefit or that preserve a unique land area for public enjoyment would yield a significant public benefit. Preserving woodland along a public highway pursuant to a government program to preserve the appearance of the area to maintain the scenic view from the highway would, absent countervailing factors, yield a significant public benefit.

Although the requirements of a clearly defined and described government policy and significant public benefit are independent of each other, they are related. The more specific the government policy with respect to the particular site to be protected, the more likely the government decision will tend to establish the significant public benefit associated with the contribution. For example, a state statute allowing for preservation of forest reserves is an example of government policy, but additional information would be needed to identify the public benefit to be gained from a conservation contribution on the forest reserve land. In contrast, a statute that names a specific river

as a valuable state resource and is accompanied by appropriations to acquire conservation contributions would more easily meet both requirements.

Example: A particular state contains large tract forests that are desirable recreation and scenic areas to the general public. The forest's scenic values attract millions of people to the state each year. However, due to the increasing intensity of land development in the state, the continued existence of forest land parcels in excess of 45 acres is threatened. A property owner grants a perpetual easement on a 100-acre parcel of forest land that is part of one of the state's scenic areas to a qualifying organization. The easement imposes restrictions on the use of the parcel for the purpose of maintaining its scenic values. The restrictions include a requirement that the parcel be maintained forever as open space devoted exclusively to conservation purposes and wildlife protection and that there be no commercial, industrial, residential, or other development use of the parcel. The law in this state recognizes a limited public right to enter private land, particularly for recreational pursuits, unless such land is posted or the landowner objects. The easement specifically restricts the landowner from posting the parcel, or from objecting, thereby maintaining public access to the parcel according to the custom of the state. The owner's parcel would provide the public with the opportunity to enjoy the use of the property and appreciate its scenic values. The conservation contribution would qualify for an income tax deduction under IRC section 170.

A certified appraiser determines the value of the land before and after the easement. Under section 170, if the easement is sold the landowner is liable for capital gains tax on the value of the easement. If the easement is donated the landowner can deduct the value of the easement against taxable income. This deduction is up to 30% of adjusted gross income up to 6 years. Estate tax benefits come into play since the asset value of the land subject to the easement is reduced.

2. IRC Section 2031(c)

Land that is owned by a decedent and subject to a qualified conservation contribution may be entitled to take advantage of a special opportunity to exclude a portion of the value of the land subject to the easement from the gross estate of the deceased property owner. In order for this Section 2031(c) deduction to apply, the conservation contribution must qualify under Section 170 described above. Note that the reverse is not true. A Section 170 qualified conservation contribution need not qualify for Section 2031(c) treatment.

In order to be eligible for the section 2031(c) exclusion for the estate of a person who died after December 31, 2000, the land must be: (1) located in the United States or any possession of the United States; (2) be owned by the decedent or a member of the decedent's family during the three-year period ending on the decedent's date of death; (3) be a qualified conservation contribution of a qualified real property interest granted by the decedent or a member of the decedent's family under Section 170 described above; and (4) restricted by an easement that prohibits all but minimal commercial recreational use of the land.

The exclusion amount can be up to 40% of the value of the land, but is subject to maximum limits of \$400,000 in estates of decedents dying in 2001 and increases to \$500,000 for estates of decedents dying in 2002 or later. This benefit is available to each land owner.

Example: A property owner owns a tract of forest land that is worth \$1,500,000. In 1999, the owner donates a qualified conservation contribution to a qualifying organization and takes an appropriate income tax deduction. The transfer of the contribution reduces the value of the land to \$900,000. In 2001, the landowner dies. At his death, the land is valued at \$1,000,000. By electing to take advantage of the exclusion, the executor can exclude \$400,000 of value from the land for purposes of calculating the owner's federal gross estate.

If at the time of the easement contribution the value of the easement is less than 30% of the value of the land without the easement, less the value of any retained development rights, the amount of the exclusion is reduced according to a formula that reduces the exclusion by two percentage points for each point that the percentage falls below 30%. For example, if the value of the conservation easement is 20% of the original value of the land, less the value of any retained interests, the amount of the maximum exclusion is 20% ($40\% - 2(30\% - 20\%) = 20\%$).

To the extent this deduction reduces the value of the property, the income tax basis of the property is not adjusted after the owner's death.

3. Post-Death Easement Donation Opportunities

In the event the land owner had not made a qualified conservation contribution before death, Section 2031(c) provides an opportunity for the estate's personal representative and the heirs to make a contribution after the owner's death and still take advantage of the Section 2031(c) exclusion in the decedent's estate. An important consideration that must be addressed in this case is whether title of the decedent's land passes to the owner's heirs or to his personal representative following the owner's death. This will determine who has authority to grant the desired easement.

A second consideration is whether state law allows the donation of a conservation contribution without specific language authorizing this transfer in the deceased owner's will or other written document that controls the transfer of property after the owner's death. State law requiring that such authority be expressly granted will eliminate this option where an owner fails to plan his estate during his lifetime. Owners who are concerned about allowing such post-death decisions to be made might be better off making these decisions during their lifetime rather than waiting for a post-death decision to take advantage of the opportunity.

Student Exercises – Multiple Choice Question

- (1) A private forest landowner is considering participating in the Forest Legacy Program by donating a conservation easement on his forest land. Which of the following objectives would not be served by the donation of the easement?

- a. Gain income and estate tax advantages
 - b. Preserve the productivity of the forest land.
 - c. Ensure that the forest land permanently remains in that use.
 - d. Each of the land owner's heirs will receive an equal share of the owner's land following the owner's death.
- (2) Which of the following elements is not one of the elements that is needed for a transfer to be considered a qualified conservation contribution under the Internal Revenue Code?
- a. The contribution must be made by a qualified land owner who is less than 65 years old.
 - b. The contribution must be considered a qualified real property interest.
 - c. The interest must be contributed to a qualified organization.
 - d. The contribution must be made for a qualified conservation purpose.
- (3) Which of following statements would not be a qualified conservation purpose in the case of a conservation contribution made by a private forest land owner that is intended to preserve open space?
- a. The general public must be able to enjoy a benefit of the contribution.
 - b. The contribution is made under the terms of a clearly defined government conservation policy.
 - c. The land that is the subject of the contribution must contain critical habitat of three or more endangered plant species.
 - d. The benefit received by the public must be considered to be substantial.
- (4) In order for the estate of a land owner to take advantage of an estate tax exclusion of a portion of the value of land subject to qualified conservation contribution, several requirements must be met. Which of the following statements is not one of the requirements?
- a. The land being valued must be located anywhere in the world.
 - b. The deceased owner or a member of the decedent's family must have owned the land for at least three years before her death.
 - c. The contribution must be considered a qualified conservation contribution under income tax law requirements.
 - d. The land must prohibit all but minimal commercial recreational use of the land.
- (5) An owner's land is worth \$2,000,000. Following the owner's death in 2002, the owner's personal representative and heirs decided to grant a qualified conservation easement on the land that will pass to the heirs under the deceased owner's estate. The state in which this land is located allows this procedure if the land owner authorized the estate personal representative to make this decision. In this case, the owner did authorize the owner to do so. By making this contribution, the value of the land will be reduced by 40%. As a result of making this contribution, the value of the land will be reduced to \$1,200,000.

Based on Section 2031(c) of the Internal Revenue Code, what is the maximum amount of the Section 2031(c) exclusion of the value of land subject to the conservation easement that can be taken from the gross estate of the decedent?

- a. \$0
 - b. \$1,200,000
 - c. \$2,000,000
 - d. \$500,000
- (6) Willis Ruth is a single individual whose total wealth is approximately \$900,000. In 2002, one of his assets is a wooded tract of land that is valued at \$400,000. Ruth is considering donating a conservation easement on the land to C.A.R.E., the Concerned Area Residents for the Environment. C.A.R.E. is a non-profit corporation that has qualified as an Internal Revenue Code 501(c)(3) charitable organization. C.A.R.E.'s principal purpose is to preserve historically important land areas and structures that are located in the community. The land on which the conservation easement is being considered for placement was the scene of an important civil war battle in 1863.

Based on the benefits and opportunities of granting conservation easements, discuss the advantages and disadvantages to Ruth of making the conservation easement donation.

Chapter IX

Lifetime and Testamentary Trusts Commonly Used in Estate Planning

A. Overview and Purpose

In this chapter we will examine the legal concept of a trust and explore its use in typical estate planning situations. The discussion starts with a description of trust terms and concepts. The next area of focus is to examine the use of trusts in typical estate planning settings. A brief review of the inheritance, estate, and gift tax aspects involving trusts will be included in the next discussion. The final area of consideration will look to the application of a trust to woodland estate planning situations specifically.

B. Lesson Objectives

After successfully completing this chapter you will be able to accomplish the following objectives:

1. Understand the meaning of basic trust terms and terminology.
2. Explain the nature of a trust relationship in comparison to other types of property ownership.
3. Explain the application of trust concepts in estate planning.
4. Review and consider the application of the trust concept to an estate plan in which an active farm is included.

C. The Concept of a Trust

A trust is a special legal relationship that the law describes as a "fiduciary" relationship. A person who undertakes the responsibility to act in a fiduciary relationship accepts the duty to act primarily for another's benefit in carrying out the task that he or she assumed. If property is transferred to a person or entity acting as a fiduciary, legal title to the property is held by the trustee, but title is held for the benefit of another and not for the benefit of the fiduciary. The relationship of a trust creates legal ownership in the hands of the trustee and an accompanying obligation on the part of the trustee to maintain ownership of the property for the benefit of another.

1. Elements of a Trust

A trust has several elements. *First*, someone or some entity must be designated to act as the **fiduciary**. A fiduciary can be either an individual or a corporation that has legal authority to act as a fiduciary built into its charter. In common practice such powers are part of banking company charters, but all financial institutions do not have such powers. The person or entity who acts as the fiduciary is the **trustee** in the trust relationship. The person who creates this relationship and establishes the trustee as a fiduciary is the **grantor or settlor**. *Second*, for a

trust to come into existence, the grantor must transfer property to the trustee with the intention to create a trust. *Third*, the trust relationship is created for a specific purpose that does not involve committing a crime, violating a person's personal or property rights, or violating a rule of conduct supported by a clear public policy. *Fourth*, the trust must designate the person or persons benefitted by this relationship. **Beneficiaries** can be individuals or organizations, such as corporations or associations. *Fifth*, the trustee takes title to some item of real property or tangible or intangible personal property under the trust relationship. This property is known as the **trust res or corpus**. Without property to manage, the trust relationship does not exist. Although a trust requires that property be managed for the trust to come into existence, a grantor can describe the trust organization and structure in advance of actually transferring property to the trust. When property is transferred to the trust at some future time, the structure and organization of the trust and the roles of major participants are already identified.

2. Trust Compared to Other Forms of Ownership

A trust relationship is fundamentally different from several other common relationships affecting individuals and their property. Unlike a debtor-creditor relationship, a trustee has an affirmative obligation to avoid combining trust property with personal property. Property held in trust, although titled in the name of the trustee, is not subject to the claims of the trustee's creditors or otherwise subject to the trustee's obligations. If the trustee combines trust assets with personal assets, the trustee violates the duty owed to beneficiaries and faces personal liability for any loss or damage suffered by them.

The position of trustee is one that is subject to numerous requirements that recognize its special relationship to beneficiaries. Actions that are detrimental to beneficiaries, that expose the trustee to conflicts of interest, or that reflect the trustee's inability to act, are grounds for removal of the trustee, by court order if necessary. If such action is taken, the trustee is personally liable for any loss that occurs as a result of the conduct. Personal liability places the trustee's personal assets at risk to pay claims from beneficiaries. In deciding whether to accept appointment as a trustee or any other form of fiduciary, exposure to potential personal liability is an important consideration.

D. Creation of Trust and Trust Terminology

Creation of a trust can be done in a will where property passes from the personal representative of a deceased owner's estate to the trustee for management, during lifetime by the execution of a declaration of trust under which the grantor transfers property to the trustee, by a trustee's declaration that property held by the trustee is held in trust, or by the exercise of a power of appointment which creates the trust. In each of these cases a written document describes the essential elements of a trust, such as the grantor's intent, identification of the trustee and successor trustees, the trust purpose, identification of beneficiaries, and any special duties or instructions that the trustee is to follow in carrying out the terms of the trust responsibility. If a trust is to involve a parcel of real property, a written document must evidence the creation and administration of the trust. This is to ensure that the intent to create the trust relation and the authority of the trustee to deal with the land are clearly stated. If a trust involves management of personal property, a written document is not required for the creation of the trust, but the

importance of the relationship would favor preparation of a written document in all cases where a trust is created.

Trust terms and terminology reflect the special characteristics surrounding its creation.

*Example: A trust created in a will is referred to as a **testamentary trust**. If the terms of the will provide that a transfer of property be made from the estate to the trust, the provisions of the will that describe the transfer are referred to as **pour-over provisions** since they pour over funds from the estate to the trust. In contrast to a testamentary trust, a trust created during a person's life is referred to as a **living trust** or **inter-vivos trust**.*

*A trust created during lifetime and in which the grantor reserves the right to cancel the trust is referred to as a **revocable trust**. A common example of such a trust is a **revocable living trust** or **living trust**. Living refers to the fact that the trust was created during a person's lifetime. Revocable refers to the fact that the person creating the trust retained certain interests or rights in the trust, including the right to revoke it. If the grantor wants to create a trust and give up the right to revoke it in the future, the trust is referred to as an **irrevocable trust**. In such situations, the property owner intends to give up ownership and control of the property to avoid the property being included in the owners estate at his or her death. A common example of such a trust is an irrevocable life insurance trust. In the Chapter X discussion of how life insurance is treated under federal estate tax, a key issue is who owns the policy or has "incidents of ownership" in the policy. In an irrevocable life insurance trust, a policy of insurance is transferred to the trustee who is considered to be the owner of it. The trust agreement designates the trust as the beneficiary of the policy. Once the policy proceeds are paid to the trust, the trustee's obligations to the beneficiary will take control to manage and distribute the policy proceeds. This concept is discussed in more detail in Chapter X.*

*Trusts are also referred to by the purpose they serve, such as a **marital deduction trust**, which is a trust created to manage property passing to a surviving spouse which qualifies for the marital deduction under the federal estate tax law. Likewise, a **credit shelter trust** is a trust under which the grantor designates property to pass to the trustee in an amount equivalent to the amount of the grantor's unified credit for federal estate tax. Property which qualifies for marital deduction treatment as qualified terminable interest property (see earlier discussion in chapter VI), or Q-TIP property, may pass under a **Q-TIP trust**. In making gifts of certain property, an owner can separate ownership during lifetime from ownership that follows after the owner's death. This creates a life interest, or life estate, and a follow-on interest, or remainder interest. A transfer in trust of a remainder interest in property to a charity may be made in the form of a **charitable remainder annuity trust** or a **charitable remainder unitrust** to qualify for the gift tax charitable deduction.*

A popular estate planning use of trusts is to invest income-producing property in a manner that provides lifetime financial security to the beneficiary without causing an undesired federal estate tax problem for any of the beneficiaries of the trust. This technique is often referred to as an **A-B trust**, or a **marital trust and a by-pass trust**. In this technique an amount of property passes to a surviving spouse in a way that qualifies it for the marital deduction from federal estate taxes. The amount of property that passes to the spouse should be sufficient to provide financial security for the spouse. If this property passes to the spouse in trust, the trust is known as the **A-trust**, or **marital trust**, since the trust qualifies for the marital deduction.

The **b-trust**, or **by-pass trust**, is funded in an amount tied to the exemption equivalent of the grantor's unified credit against federal estate tax. Chapter VI discusses this concept. Income from the by-pass trust can be paid to the surviving spouse during his or her lifetime, or to other beneficiaries, but the spouse has limited authority over the trust principal so that the principal is not included in the spouse's estate at his or her death. When the surviving spouse passes on, the principal by-passes the deceased spouse's estate and passes to other beneficiaries, such as children of both spouses. A key objective of using this technique is to enable the estate of each spouse to fully use its own exemption equivalent amount. This doubles the amount of property that passes to intended heirs tax-free.

In other cases, terms that describe a trust reflect special features of the trust and such terms often become short-hand expressions for these trusts. For example, a **crummy trust** is a trust in which the beneficiary of the trust is given specific powers to withdraw property from the trust in order to qualify the beneficiary's interest in the trust as a present interest for purposes of the gift tax annual exclusion. The term "crummy" is used to refer to the Ninth Circuit Court of Appeals decision in the case of Crummy v. the Commissioner of the Internal Revenue Service, 397 F.2d. 81 (1968) that recognized this technique as an effective estate planning tool. Another example is a **sprinkling trust**, which is a trust in which the trustee has discretionary authority to distribute funds among several beneficiaries. In other words, the trustee can choose who will be benefited by the distribution.

If a person contributes funds to another person to help the other person purchase property, an **implied resulting trust** can be imposed on the purchased property to protect the interest of contributors whose contribution is not recognized by an ownership interest in the property. A similar concept is found in a **constructive trust**, which involves a person who is persuaded to part with his or her own property by the fraudulent acts of others or the abuse of a confidential relationship. In the case of a constructive trust, imposing the trust becomes a remedy to assist the person who gave up property to get its return or be compensated for its loss. The remedy becomes effective by imposing the trust on property owned by the fraudulent party such that the property is held, in trust, for the benefit of the injured property owner.

In a number of situations **statutory trusts** are imposed on property to protect the interests of special classes of people. The Packers and Stockyards Act, for example, imposes a statutory trust on livestock and poultry sold to livestock and poultry dealers to protect the interests of sellers in receiving payment from the purchasing dealer. By imposing a **statutory trust**, the dealer holds the purchased items in trust for the benefit of the unpaid sellers. Creditors of the

dealer cannot attach the purchased items since the statutory trust takes them out of the category of the property owned by the dealer.

E. Using Trusts in Estate Planning

1. Managing Property

A trust is useful in several estate planning contexts that involve the management of property. As the essence of a trust relationship is the transfer of property to another to manage the property for the benefit of a third person, a trust is an ideal vehicle for managing property of a minor child, a person who is disabled or incompetent, or someone who wants to be free of the personal obligation to manage property. In all three of these situations, the trustee fills the role of the property owner in collecting income, paying bills, and making decisions. Periodically, the trustee accounts to the beneficiary to show the results of the trustee's efforts. In keeping with the grantor's instructions, the trustee may make periodic distributions of the principal portion of trust property to the beneficiary. The circumstances under which such a distribution is made are found in the trust agreement defining the trustee's duties and responsibilities.

In these cases, the benefits of trustee management must be such that the benefits outweigh the cost of having a trustee manage these affairs for the trust grantor. These costs can include the cost to create the revocable living trust and to transfer property to it. If a bank or trust company trustee manages the property, the trustee is likely to charge a fee for the services provided. In calculating this fee, a percentage of the assets under management can be used.

In the case of a person who is disabled such that he or she is unable to deal with their property, the property may be frozen until a person is given the legal authority to act on behalf of the disabled person. Guardianship is the legal procedure that results in appointment of this third person. Guardianship proceedings are frequently used in cases involving property passing to minor children, those under the age of majority in the state where they reside, or disabled individuals who suffer from a physical or mental difficulty that prevents them from managing their affairs. A trust is an alternative means of providing the same protection and management that a guardianship provides. For a trust to be effective as a replacement for a guardianship, a property owner must take steps to influence the situation during his lifetime.

Example: A person who is concerned that advanced age may prevent the person from managing his or her affairs can create a trust during lifetime and transfer property to it. If the person should become disabled at a later date, the owner's property is in the hands of a trustee who should be fully instructed as to the steps to take to protect the owner's interest in his or her property, pay debts and expenses, and generally manage the person's affairs. In the case of a property owner who intends to benefit a minor child with property after the property owner dies, the owner may provide in his or her will that property passing to the child be held in a testamentary trust until the time set by the owner for the distribution of the property to the child. As the age of majority in most states is 18 years, some property owners may not feel that 18 is an appropriate age for someone to receive

significant property and be free to deal with it as he or she pleases. By placing the property in the hands of a trustee, the owner can direct the trustee to hold the property well past the beneficiary's 18th birthday and be distributed at some later time when the beneficiary is presumably better able to manage property.

The property owner who places property in the trust is not free to indefinitely delay distribution of it to the beneficiary. In many states, a legal requirement, known as the Rule Against Perpetuities, requires the property owner to provide for distribution of property from the trust within a period that is measured by the lifetimes of all beneficiaries who are alive when the property is transferred to trust, plus an additional 21 years.

2. Speed the Transfer and Continuous Management of Assets After the Grantor's Death

a. Management Considerations

The second major use of trusts is to speed the transfer of property after a property owner's death while continuing to manage those assets in the post-death period. In the opinion of some property owners, the process of transferring property after an owner's death is too long, drawn out, and expensive. Fees must be paid to personal representatives of estates, accountants, appraisers, auctioneers, and attorneys who represent the personal representative and the Register of Wills (as filing fees to probate a person's will or to appoint an administrator for someone who dies without a will). Individuals who own property in several states also face the need to file the deceased person's will in each of the states where real or tangible personal property is located when the decedent died. This further complicates the costs and expenses involved in settling an estate of this kind.

An alternative to the transfer of property under a will or without a will is to create a trust during the owner's lifetime, transfer property to it when the trust is created, add property to it afterward, and instruct the trustee to transfer the property held by the trust to designated beneficiaries after the owner's death. In many situations where this technique is used, the property owner retains significant rights in the property during his or her lifetime, including the right to income from the property, the right to use the trust principal if necessary, and the right to terminate the trust if the owner changes his or her mind about using this technique. Trusts of this type are *revocable living trusts*. If such a trust is created, at the owner's death the trustee exercising his or her authority will transfer the property to the designated beneficiary to fulfill the terms of the trust agreement. The trustee is responsible for filing any inheritance or estate tax returns. If all of the decedent's property is transferred under a living trust, the trustee will be responsible for paying the debts and expenses of the decedent. The use of a living trust is particularly helpful in situations where property is located in several states. By transferring out-of-state property to the trustee and providing for the distribution of the property after the original owner's death, the owner can bypass the probate process in these other states. This may not eliminate the need to file inheritance or death transfer taxes in each of the states where property is located, but it will enable the transfer to be completed in less time. Since the trustee owns the property and has the required instructions regarding the disposition of the property after the original owner's death, the trustee is fully authorized to complete the transfer to a designated person.

In regard to the time needed to transfer property under a will compared to a revocable living trust, most delays in transferring estate property relate to valuing assets, resolving disputes with creditors or debtors of the estate, awaiting acceptance of filed inheritance and estate tax returns and resolving disputes between the estate and unhappy heirs. As a revocable living trust can be challenged on grounds of the grantor's competence at the time of creating the trust or acts that unduly influenced a grantor to create a specific type of living trust, many of the same factors that delay the distribution of an estate can delay the distribution of a trust. The person who is responsible for filing returns and paying federal estate and state inheritance tax is personally responsible for the proper payment of these taxes. If estate funds are distributed before assurance is received that the tax paid is accepted as the full amount due, and it is later determined that additional tax is due, the personal representative has the choice of either collecting the needed additional money from heirs or paying the tax from his or her own pocket. In most cases, the time needed to transfer property under a will and through a living trust will be the same.

b. Privacy Considerations

When a will or petition is filed in the office of the register of wills or some other local official, the documents are items of public record. Anyone interested in reviewing public records is free to do so, just as any other public record in the court house. In regard to privacy, the living trust agreement is not filed in the office of the register of wills in the county where the deceased property owner resided at the time of his death. If the trustee is directed to transfer real estate from the trust after the trust grantor's death, however, it may be necessary to file the trust agreement in the office where land ownership records are retained to establish the trustee's authority to transfer the property. Filing a document in the land records office makes the document an item of public record and available for inspection thereby losing this measure of privacy.

A second aspect of the revocable living trust privacy issue is the fact that a living trust can be challenged on grounds that the trust grantor lacked the mental capacity to create the trust, or that the trust was procured by fraud or undue influence of another. If state law recognizes that a living trust is subject to a surviving spouse's right to elect against the provisions of the living trust for the surviving spouse and to claim the share the surviving spouse is entitled to by statute, the living trust will not shelter the trust from these claims.

3. Tax Planning and Saving

The third major reason for the use of trusts in estate planning is the opportunity it provides for tax planning and saving. In this context, it is not that trusts are eligible for tax benefits that other types of ownership are not entitled to, but rather that the special form of ownership under a trust allows an owner to achieve an intended purpose while still achieving tax benefits. One of the most familiar types of trust used in estate planning is the commonly called **A-B Trust, or marital trust/by-pass trust arrangement**. The purpose of this technique is to allow an owner to take advantage of passing a portion of property to a surviving spouse under the marital trust by virtue of the marital deduction in the estate of the first spouse to die. The remaining portion of

the owner's property passes to beneficiaries under the by-pass trust after first allowing the surviving spouse to have a limited interest for the spouse's lifetime. In this case the surviving spouse's entitlement under the trust must be such that the trust principal is not considered under the control of the surviving spouse and not part of the surviving spouse's estate at his or her death. For example, an interest in only the income generated by the trust is a limited interest that ends at the spouse's death. The purpose of using this technique is to provide the surviving spouse with a limited interest in the by-pass trust that will provide financial protection and security, but limited access to principal which would unnecessarily increase the size of the spouse's own gross estate for federal estate tax purposes. The spouse's limited interest would end at his or her death and the remaining portion of the property will then be distributed to other beneficiaries with out another tax being imposed.

Example: Consider the situation of an individual who maintains an investment inventory of \$3,000,000. If the individual intends to use this fund to provide financial security for a surviving spouse with an eventual gift to children of the owner, the owner has two choices. The first choice is to own all of the property as tenants by the entirety so that at the death of the first spouse all of the property passes to the surviving spouse. The surviving spouse can provide that the property transfer to the children after the spouse's death. Under state inheritance tax law the transfer of ownership to the surviving spouse as the surviving tenant by the entirety could be exempt from tax. The marital deduction for federal estate taxes removes the fear of federal estate taxes in the estate of the first spouse to die. At the surviving spouse's death, the spouse's estate will include the entire value of the property for state inheritance and federal estate taxes. If only an exclusion equivalent and a state death tax credit are available to offset potential federal estate taxes, a federal estate tax of some amount will be due.

As an alternative, the owner could transfer the property under two trusts, the first of which would be equal to the deceased owner's exclusion equivalent. The first trust provides the surviving spouse with a limited income interest for the spouse's life and passes the remainder of the property to the children after the spouse's death. The second trust would equal the balance of the separate property of the decedent. The second trust would provide the surviving spouse with an income interest in the trust and the right to invade the principal of the trust as the spouse deems necessary to satisfy the spouse's needs. As the surviving spouse has extensive power over the second trust, it will be included in the second spouse's estate for federal estate tax purposes. For federal estate tax purposes, the first estate will be protected from tax by the decedent's exclusion equivalent. The second trust will be protected from federal estate tax in the estate of the first spouse to die because of the unlimited marital deduction. Since the property will be included in the second spouse's estate at death, the spouse can use his or her own exclusion equivalent to offset federal estate tax at the death of the second spouse. If the value of the surviving spouse's property is greater than the exclusion equivalent to the spouse's

unified credit, federal estate tax may be imposed at the second spouse's death. As a result of using this technique, the property owner can expect to pass a greater portion of the \$3,000,000 in property to his or her children by using the A-B or marital trust/by-pass trust approach and eliminate the threat of federal estate taxes imposed at the death of the second spouse. The key to this result is that at the death of each spouse, the exclusion equivalent was fully used by the decedent.

F. Review of Inheritance and Estate Tax Impacts of Trusts

The tax impacts of using trusts in estate planning relate to the situation in which the trust is employed. If a property owner retains the right to revoke a trust created during lifetime or retains a right to income from the trust property, the property could be subject to state inheritance tax and would be included in the decedent's gross estate for federal estate tax purposes. These impacts refer to the general categories of property that are subject to inheritance and estate taxation.

If an owner wants to avoid having the property included in his or her gross estate for federal estate taxes, the owner can create an irrevocable trust. By doing so the owner makes a gift for federal gift tax purposes of the value of the trust interest which is created for the benefit of other beneficiaries. Through use of the annual exclusion for gifts of present interests and the exemption equivalent of the unified credit, the impact of federal estate and gift taxes can be managed. For state inheritance taxes, an irrevocable gift of property in trust made within one year of the owner's death may be subject to inheritance tax

If a property owner wishes to transfer property in a way that qualifies for the marital deduction, the owner has several choices to design a trust that gives the spouse an interest to such a degree that the property qualifies for it. These choices include a trust with broad authority over the trust principal or a "qualified terminable interest property" trust. Such a trust must provide that the spouse is entitled for life to all of the income from the property, payable at least annually. No person, including the surviving spouse may have the power to appoint any part of the transferred property to any person other than the surviving spouse during the surviving spouse's life. Any power over the property must be exercisable after the spouse's death.

If an owner desires to transfer a remainder interest in property in trust to a qualified charity, the trust can be structured as either a charitable remainder annuity trust or unitrust. An annuity trust pays designated beneficiaries a specified amount annually, which is at least 5% of the initial fair market value of the property. A unitrust pays designated beneficiaries a fixed percentage, which is at least 5% of the net fair market value of trust assets as valued each year.

G. Use of Trusts in Forest and Woodland Estate Planning

In planning a forest or woodland estate, trusts can fill any of the roles that trusts play in other estates. As in other situations, if an estate planning objective of the property owner can be accomplished through the use of a trust, then a trust should be considered as part of the estate

plan. The important question to ask is, "What will be accomplished in my estate plan if I place any of my assets in trust?" If use of a trust does not achieve an objective, or makes it more difficult to achieve the goals and objectives previously set, there should be little or no reason to use it or any other device that does not contribute to the success of the plan.

Unlike other estates the typical forest or woodland estate owned by a private landowner may consist of one large asset in the form of land and several other assets in the form of machinery and equipment. If the forest activity is part of some other enterprise, then a whole set of issues and questions regarding these other business assets may arise. The decision to place real estate assets in a trust is an important one. If the purpose of doing so is to improve investment performance and maintain the business for eventual distribution to heirs who want to continue it, accomplishing those goals will depend on whether a trustee can be found with the background and knowledge to understand it and operate the business profitably. Since many investment managers are more adept at managing financial investments that are easily converted to cash, running a forest or woodland business to maximize its income potential is often a difficult challenge. Land dedicated to timber production has a considerable period of time before the investment in the growing trees will pay off. Managers of such properties must have considerable skill, excellent sense of timing, and considerable business acumen to obtain top market values when the timber is eventually sold.

Institutional trustees, such as banks, managing businesses placed in trust often require that someone familiar with the business operation be named co-trustee with the bank. If a trustee considers the trustee's obligation to be to maximize the income potential of property placed in the trustee's care, the trustee may want to be protected from legal challenges by beneficiaries who could claim that the trustee failed to protect their interest by failing to maximize income. This protection may come in the form of specific instructions to the trustee to maintain a business.

H. Revocable Living Trusts

Although revocable living trusts are discussed in various places throughout this chapter, this section is intended to pull together various comments and considerations regarding use of such trusts. As a popular estate planning device many people consider these trusts as part of their estate plans and this discussion becomes important.

This device is promoted as a simple, inexpensive and private way to avoid the delay and cost of transferring property under a will and, in many cases, it can deliver those benefits. A revocable living trust is also a beneficial way to continue effective asset management if the property owner becomes disabled or incapacitated. Privacy is also an important issue to many people, but the privacy issue may be lost if it is necessary to record the trust agreement in a public office to confirm the authority of the trustee to sell real estate or to take other action where proof of such authority is required.

In regard to saving expenses by creating a living trust, the principal savings come in two areas, filing fees incurred in the probate system and less need for professional services to complete the transfers. While the need for services may be lower, most trustees will incur some expenses in

transferring property after the grantor's death. Certain other steps that will undoubtedly incur some expenses will have to be taken. For example, if inheritance and estate tax returns must be filed after the grantor's death, the trustee may incur legal expense for gathering the information needed to prepare and file the returns. Transferring property may also require legal fees to prepare the necessary documents to complete the transfer. If legal fees are based on time and effort spent providing service to either a trustee or a personal representative, the fees charged should be a fair reflection of both cost to the payer of the fee and benefit received from the service.

On the fee question, whatever fees are saved in transferring property under a revocable living trust will be offset by costs incurred to prepare the trust documents, transfer property to it, and monitor the assets in the trust throughout the owners. Typically the process of drafting a living trust also includes drafting a will and possibly other documents to authorize people to act on behalf of someone else in cases where the person is unable to act on his or her own. This is done to ensure that there is some document drafted by the owner that controls the disposition of his or her property after death. In the event that an item of property is purchased but not owned by the trust, the owner's will becomes the vehicle that provides for its transfer, with the beneficiary often being the trustee of the trust.

The fee savings question becomes one of incurring lifetime expenses to save post-death expenses. Some people argue that drafting any of these documents does not require professional assistance, and fill-in-the-blank forms are readily available. As you have progressed through this topic to this point you appreciate the complexity of the issues. Do you feel that the complexity makes it advisable for people to use professional services although not required to do so? Decisions to create revocable living trusts motivated solely by a desire to save fees and expenses in transferring property after death will be more effective if the decisions are made with a full understanding of the fees to be charged and the method by which they will be calculated.

Some items of property may require special consideration before being transferred to revocable living trusts. Real property subject to a mortgage, or whose equity is needed to finance an activity, may find that the trustee's ownership of the property is objectionable. Since a trustee's representative capacity differs from the trustee's individual capacity, the trustee's only income sources may come from private sources. This will complicate the decision whether to grant the requested loan. Motor vehicles owned by the trust that require liability insurance may require the insurer to question whose driving record is rated for premium purposes, the actual driver or the trustee?

I. Student Exercises

Multiple-Choice Questions

Please read the questions carefully, then select one of the four choices following the question that correctly answers the question asked.

1. Which of the following terms describes a trust that **cannot** be canceled after it is created?

- a. A testamentary trust
 - b. A constructive trust
 - c. An irrevocable trust
 - d. A resulting trust
2. In creating a trust, several elements are necessary. Which of the following statements is not one of these elements?
- a. The intent of the trust grantor
 - b. Identification of a trustee and/or successor trustee
 - c. Trust property transferred to the trustee
 - d. A taxpayer identification number
3. Trusts are used in estate planning to achieve important planning objectives. Which of the following objectives is not an objective that the use of a trust can achieve?
- a. Obtain an estate tax advantage that is not available to any other form of ownership.
 - b. Avoid the need for creating a guardianship if the trust grantor becomes disabled during lifetime.
 - c. Provide a vehicle for the transfer of the grantor's property after the grantor's death.
 - d. Transfer property for the benefit of a minor child in a way that protects the property until the minor is able to deal with the property.
4. In comparing the transfer of property after death through an estate to the transfer of property under a revocable living trust, which of the following statements would be a correct statement?
- a. The role of a personal representative of an estate is similar to the role of a trustee of a trust.
 - b. Transfer of all property from a trust is accomplished in one-half of the time it takes for the transfer of property from an estate.
 - c. Transfers of property through an estate are subject to legal expenses, while transfers from a trust are not.
 - d. Transfers of property from an estate are subject to fees of the personal representative, while trustees are not permitted to charge fees for their services.
5. Which of the following transfers in trust is subject to a federal gift tax at the time the trust is created?
- a. Resulting trusts
 - b. Testamentary trusts
 - c. Q-TIP trusts
 - d. Irrevocable trusts

Short Essay Questions

Please read each question carefully and then respond to what is asked for at the end of the question. Your answer need not be long or involved, but it should be as clear and concise as possible. If you want to refer to important facts in your response, please feel free to do so.

6. Evelyn owns approximately \$1,555,000 in separately owned property. She is married to Ralph, who is her second husband. Evelyn and Ralph have two children from their marriage, Richard and Robert. Evelyn has been sick for a number of years and Ralph is in excellent health. If Evelyn were to pass away before Ralph, Ralph's accumulated retirement funds will enable him to live comfortably without using any of Evelyn's money. After they both pass away, Evelyn and Robert would like their estate plan to get as much of Evelyn's separate property to their children as they can without paying a large amount in inheritance and estate tax.

Based on our discussions of trusts, what trust techniques might Evelyn and Ralph use to accomplish their goal?

7. Continue with Evelyn and Ralph's situation. Evelyn is considering transferring one half of her property during lifetime to her revocable living trust. The trust will be managed by Evelyn during her lifetime. If she becomes disabled or incapacitated, Ralph is the successor trustee. During her lifetime, Evelyn has the right to all income from the trust. At her death, Ralph is entitled to income from the trust for the rest of his life. At his death, Richard becomes the trustee and he is instructed to distribute the remaining portion of property in the trust equally to himself and his brother.

If Evelyn takes this step rather than have her property pass under her will, what advantages, if any, will she gain by doing so?

8. Geralyn has just been approached by someone in her family to act as trustee under of a testamentary trust that includes an active farm operation that has a considerable stand of timber that consists of northern hardwoods and a considerable stand of black cherry. Geralyn grew up on a dairy farm and is a graduate of a College of Agricultural Sciences with a degree in Agricultural Business Management. While in that degree program, Geralyn took several forest management courses that give her a working knowledge of forest management concepts and ideas. If Geralyn asks for your advice regarding whether she should accept the appointment, how would you counsel Geralyn about the legal relationship a trustee has under a trust to the grantor and the beneficiaries? Identify any special problems you feel she may have as trustee of this trust.

Chapter X

Life Insurance in Estate Planning

A. Overview and Purpose

In this chapter we will examine the role played by insurance in a typical estate plan. We will begin our discussion by referring to key insurance terms in order to understand the differences in insurance products and roles the products can play. From that point, we will examine the various types of insurance products that are available in today's market place. After identifying the products, we will examine how these products can be used in an estate plan. Before deciding on their use, we will examine the tax impacts of using the product in estate planning. Finally, we will address the question of how much insurance to buy, and several factors that insurance buyers can use in deciding the amount of insurance coverage to purchase.

There are many useful references in books and on the Internet for people who want to know more about life insurance policies and purchase decisions. The following web sites were consulted in preparing this chapter: “What You Should Know About Buying Life Insurance,” found at www.pueblo.gsa.gov/press/nfcpubs/knowlife.txt and “Financial Guide: Life Insurance: How Much and What Kind to Buy,” found at www.gofso.com/Premium/LE/08_le_bi/fg/fg-life_ins.html.

B. Lesson Objectives

When you have successfully completed this chapter, you will be able to accomplish the following objectives:

1. Distinguish among the various types of life insurance policies generally available to consumers today and the terminology that relates to these policies.
2. Discuss the role of life insurance in an estate plan.
3. Consider the state inheritance and federal estate, gift, and generation skipping transfer tax treatment afforded life insurance proceeds paid to a named beneficiary and to an insured's estate.
4. Distinguish between situations in which a person has incidents of ownership in an insurance policy from those in which a person has no incidents of ownership.
5. Describe the process consumers can follow and the factors they can apply in deciding how much insurance to purchase for their personal situation.

C. Insurance Terms and Definitions

Life insurance is one of the most common financial assets that people acquire during their lives, but it is unlike any other purchase that people generally make. When you pay the premiums, you're buying the future financial security for your family that only life insurance can provide. As a common financial asset, many people are familiar with basic policy types and insurance terminology. While many people feel they are knowledgeable about insurance, they often

overlook the new types of insurance products and techniques developed over the last 20 years to serve a variety of financial planning needs and situations. Policy choices are much wider than simply deciding between whole life policies and term policies. To begin the discussion let's turn to some basic insurance terms and definitions.

Accidental Death Benefit—A provision added to a life insurance policy for payment of an additional benefit in case of death as a result of accidental means. It is often called "double indemnity."

Annuity—A contract that provides income either for a specified period of time or for a person's lifetime. Although annuities are financed by life insurance companies, annuities are the direct opposites of life insurance policies. Life insurance policies are payable at a person's death. Annuities are payable during lifetime.

Beneficiary—The person or entity, such as a trust fund, named in the policy as the recipient of the insurance proceeds in the event of the death of the insured person named in the policy.

Cash Surrender Value—The amount available in cash upon surrender of a policy before it becomes payable by death or maturity.

Convertible Term Insurance—Term insurance that offers a policyholder the option of exchanging it for a permanent plan of insurance without evidence of insurability.

Cost Index—A way to compare the costs of similar plans of life insurance and help you shop for a policy. One index is called a *net payment index* and it gauges the cost of carrying your policy for the next ten or twenty years. The lower the number, the less expensive the policy will be. The other type of index is a *surrender cost index*. This index measures cash value of a policy. This index may be a negative number and again the lower the number, the less expensive is the policy. These two indexes apply to term and whole life insurance policies

Face Amount—The amount stated on the face of the policy that will be paid in case of death or at maturity. It does not include dividend additions or additional amounts payable under accidental death or other specified conditions.

Grace Period—A period (usually 31 days) following each premium due date, other than the first, during which an overdue premium may be paid. All provisions of the policy remain in force throughout this period.

Guaranteed Interest Rate—The minimum interest rate that can be credited to a policy. On whole life and universal life policies, the guaranteed minimum is usually from 4% - 5.5%.

Guaranteed Insurability—An option that permits the policyholder to buy additional stated amounts of life insurance at stated times in the future without evidence of insurability.

Insured—The person on whose life an insurance policy is issued. The owner of the policy need not be the insured person on the policy.

Lapsed policy—A policy terminated at the end of the grace period because of non-payment of premiums.

Level Premium Insurance—Insurance for which the cost is distributed evenly over the premium payment period. The premium remains the same from year to year, and is more than the actual cost of protection in the earlier years of the policy and less than the actual cost in the later years. The excess paid in the early years builds up a reserve to cover the higher costs in the later years.

Mutual Life Insurance Company—A life insurance company whose board of directors is elected by its policyholders. Generally, these companies issue participating policies that entitle policyholders to share in surplus earnings through dividends reflecting the difference between premiums charged and the cost to the company of providing the insurance.

Non-Forfeiture Values—The value, if any, either in cash or in another form of insurance, available upon failure to make the required premium payments.

Nonparticipating Policies—Insurance on which no dividends are paid.

Optional Benefits—Benefits which are in addition to basic life insurance protection. Waiver of premium upon disability or some other event. Accidental death benefits are optional benefits.

Paid-up Additions—A dividend option that allows dividends on a participating policy each year to purchase small amounts of single premium life insurance on which no further premiums will be necessary.

Paid-up Insurance—Insurance on which all required premiums have been paid. Paid-up policies may be confused with vanishing premium option policies described below.

Participating Policy—Insurance on which the policyholder is entitled to share in the surplus earnings of the company through dividends that reflect the difference between the premium charged and the cost to the company of providing the insurance.

Policy Dividend—A return of part of the premium on participating insurance resulting from actual mortality, interest, and expenses that were more favorable than the corresponding assumptions used in determining the premiums.

Policy Loan—The amount that can be borrowed at a specified rate of interest from the issuing company by the policyholder using the value of the policy as collateral. If the insured dies with the debt partially or fully unpaid, the amount borrowed, plus any accrued interest, is deducted from the amount payable.

Renewable Term Insurance—Term insurance providing the right to renew at the end of the term for another term or terms, without evidence of insurability. The premium increases at each renewal as the age of the insured increases.

Rider—An amendment to an insurance policy that modifies the policy by expanding or restricting its benefits or excluding certain conditions from coverage.

Settlement Option—One of the several ways, other than immediate payment in a lump sum, in which the insured or beneficiary may choose to have the policy proceeds paid.

Stock Life Insurance Company—A life insurance company owned and controlled by stockholders who share in the company's surplus earnings. Generally, the company issues nonparticipating life insurance policies.

Term Insurance—A plan of insurance that covers the insured for only a certain period of time (the term), not for his or her entire life. It pays death benefits only if the insured dies during the term of the policy.

Term Rider—Term insurance that is added to a whole life policy at the time of purchase or that may be added in the future.

Underwriting (or Risk Classification)—The process of classifying applicants for insurance by identifying characteristics as age, sex, health, occupation, and hobbies. People with similar characteristics are grouped together and are charged a premium based on the group's level of risk. The process includes rejection of unacceptable risks.

Universal Life Insurance—A flexible premium life insurance policy under which a policyholder may change the death benefit from time to time (with satisfactory evidence of insurability for increases) and vary the amount or timing of premium payments. Premiums (less expense charges) are credited to a policy account from which mortality charges are deducted and to which interest is credited at rates that may change from time to time.

Variable Life Insurance—Life insurance under which the benefits relate to the value of assets behind the contract at the time the benefit is paid. The assets fluctuate according to the investment experience of a separate account managed by the life insurance company.

Waiver of Premium—A policy provision that sets certain conditions under which an insurance policy is kept in full force and effect by the company without the payment of premiums. It is used most frequently for those policyholders who become totally and permanently disabled, but may be available in other cases.

Whole Life Insurance (or Straight Life or Permanent Life)—A plan of insurance for the whole of life, with premiums payable for life.

D. Types of Insurance Policies and Products

Life insurance is acquired by purchasing a policy, which is a contract between the insurance company and the policy owner. As a contract, its terms have special significance in defining the rights and responsibilities of the parties. When a policy is purchased the owner joins a risk-sharing group or life insurance company. The company agrees to pay the designated beneficiaries at the time of the insured's death an amount specified in the policy. This promise is made in return for the owner's promise to pay the agreed premium over the period specified by the policy.

Insurers gather information about applicants, such as age, gender, health, occupation and hobbies, so they can group together people with similar characteristics and calculate a premium based on the group's level of risk. Those with similar risks pay the same premium. This process is known as risk classification, and by providing equal treatment for equal risks, it allows insurers to treat policyholders fairly.

There are two basic types of life insurance - term and whole life insurance - and several variations of each type.

Term insurance is protection that insures a person for a specified period of time, usually 1, 5, 10 or 20 years, or up to certain age, such as 70. It is a policy that provides pure protection against an insured event occurring during the policy term. A term policy pays proceeds to the designated beneficiary if the insured person dies during the period the policy is in force. At the end of the term, the policy terminates, unless the policy has a renewable provision included in it. Under a renewable term policy, the insured need not provide evidence of insurability to renew it. Each time it is renewed, however, premiums can be adjusted higher.

Term insurance that is **convertible** can be exchanged for a whole life policy without providing proof of insurability, but at a higher insurance premium. Term insurance is initially cheaper than whole life insurance for the same amount of insurance coverage. It gives the largest amount of immediate coverage per dollar of premium spent. Term insurance is frequently used by consumers who need large amounts of coverage for known periods of time, such as home buyers or parents of young children.

Whole life insurance is protection that can be kept in force as long as the insured lives and the owner pays the premiums. By choosing to pay premiums that remain the same throughout the policy period, the owner averages out the cost of the policy over the insured's lifetime.

An important feature of whole life insurance is its **cash value**. Cash value continues to grow on a tax-deferred basis. If the policy is canceled and cash value is paid to the owner on a lump sum basis, the owner reports as income the amount by which the cash value, plus any dividends received, exceeds policy premiums paid. Insurance policies include tables that describe exactly how much cash value is in the policy. Cash value of whole life insurance policies can be used many ways.

Example: Using the policy as collateral, the owner can borrow the cash value from the insurance company.

If a premium payment is missed, the company, with the owner's authorization can draw from the cash value to keep the policy in force. Cash value can be used to purchase a paid-up policy that may lower the level of protection, but also remove the obligation to pay further premiums. Cash value can also be used to purchase an annuity that provides monthly income during lifetime. If a policy owner no longer wishes to continue the policy, the owner can surrender the policy to the company and receive its cash value remaining after surrender fees or charges are deducted.

There are several variations on whole life insurance plans. One is **modified life**, which is a policy with a premium that is relatively low in the first several years of a policy, but goes up in the later years. This policy is attractive to people who want whole life insurance, but who want to pay lower premiums in the early portion of the contract.

Limited-payment whole life insurance policies provide protection for the life of the insured, but premiums are payable over a shorter time period—such as 20 years—until the death of the insured. Since premiums are paid over a shorter period of time than for regular whole life policies, premiums are generally higher in such cases.

Single-payment whole life insurance provides protection for the life of the insured in exchange for the payment of the total premium in one lump sum amount. Under recent amendments to the Internal Revenue Code, policies that are paid-up in fewer than seven years are classified as "modified endowment contracts" and are subject to adverse income tax consequences if the owner makes loans against the cash value or withdrawals.

Combination term and whole life plans combine both types of insurance coverage in one policy. Through the life of the policy, coverage can be influenced by the rising cost of term coverage or a gradual conversion of term coverage to whole life coverage. In this context, the policy owner and insurance agent can plan to achieve their desired goal.

In recent years, a number of new insurance products have been developed to take advantage of consumer interest and financial opportunities available to insurance companies. These products are known as **universal life insurance, variable life insurance, and adjustable life insurance.**

Universal life is a policy that includes an investment program and a term insurance contract. These policies allow policy owners to pay premiums in virtually any amount, subject to certain minimums. The policyholder can also change the amount of insurance more easily than under traditional policies. In a universal life policy, the amount of the cash value reflects the interest earned at the prevailing interest rates. The level of cash value is "interest sensitive," which means that the amount accumulated varies according to the general financial climate. Rates are usually guaranteed for one year, and then a new rate is determined. Rates can go no lower than a guaranteed rate specified in the policy.

Variable life allows death benefits and cash values to fluctuate according to the investment experience of a separate account managed by the life insurance company. Policy holders have the opportunity to obtain higher cash values and death benefits than with policies calculating benefits based on a fixed rate of return. On the other hand however, policy holders also assume the risk of negative investment performance.

Two types of variable life policies exist: scheduled premium variable life and flexible premium variable life. Premium payments under a scheduled premium policy are fixed as to the timing and amount. Policyholders who own a flexible premium policy may change the timing or amount or both of their premium payments.

Adjustable life policies allow the policyholder to change the policy as his or her needs change. For example, if the owner wants to increase or decrease coverage, the owner can change the premium payment or change the length of time that the policy is in force. If the death benefit or amount of insurance is increased, the insured may have to provide evidence of insurability.

Other forms of insurance that are widely available include **second to die policies and split-dollar policies**. In a second to die policy, the insurance company's obligation to pay the policy proceeds is conditioned on the death of two people. Therefore, the obligation to pay does not arise until the second of the named insured dies. Second to die policies can be either term or whole life policies or any of the whole life variations, such as universal life. In addition, such policies can have other policy options. An advantage of second to die coverage is that the premium cost of such coverage is generally lower than the premium cost for single life policies. With two lives being underwritten, the poor health of one insured can be offset by the good health and life expectancy of the second insured.

Split-dollar life insurance policies are used to provide insurance coverage for major shareholder-employees of closely held or family owned business corporations. In such plans, the business advances a portion of the insurance premiums to the shareholder-employee. This amount may be the portion of the premium that reflects the increase in the cash value of the insurance policy during the period represented by the premium paid. At the insured's death, the corporation receives a portion of the insurance proceeds, such as the amount of the cash surrender value of the policy for the year in which the shareholder-employee dies, and the balance is paid to beneficiaries designated by the shareholder-employee.

E. How is Insurance Used in Estate Planning?

As the variety of insurance products indicates, insurance can play a very versatile role in an estate plan that addresses lifetime needs and opportunities and provides for the transfer of property after a person's death. First and foremost, insurance can provide significant funds at a time when they are needed most. Insurance proceeds may be the source of substantial wealth that is passed on to designated beneficiaries, whether family, non-family or charitable. Second, insurance can be used to create a fund that pays taxes, debts, or expenses generated during lifetime or created by the death of the insured. An insurance fund can also provide financial security for a surviving spouse or other person who is financially dependent on others or whose

special needs require significant financial resources to deal with problems they present. Third, in the context of a closely held or family-owned business, insurance may provide the funds that younger generation owners need to acquire a business interest from a deceased parent or other family member and continue the business. In the context of family-owned businesses, not all children may have the interest or ability to successfully continue the business. Insurance proceeds can also be used to equalize the treatment of children who inherit a share in the business with children who are not involved in the business, but to whom the deceased owner wants to bestow a significant benefit.

Regardless of the objective chosen the recent amendments to the federal estate tax law will decrease the number of situations to which these taxes will apply. In turn, this will affect those estate planning situations in which insurance was used to fund the payment of large tax bills. As the tax bills decrease, the impact on the need for insurance will depend on an individual's own situation. If Congress allows the estate tax to return to effectiveness on January 1, 2011, individuals may find themselves in a situation where a return to threats of large tax bills may occur. For many people this uncertainty will be a major obstacle for meaningful planning over long periods. The next chapter will address some of the estate planning strategies that can be used to address this uncertainty.

F. Inheritance, Estate, and Gift Tax Impacts of Using Insurance

For state inheritance tax purposes, receipt of life insurance proceeds following an insured's death, whether from separate insurance policies or policies that are part of a retirement plan, may or may not be subject to state inheritance tax. A different result could apply if the proceeds are paid to the deceased person's estate rather than a named beneficiary. Therefore, it is important to check on the treatment that applies in a specific state.

For federal estate tax, several issues arise concerning insurance proceeds. For estate tax purposes, proceeds of life insurance policies paid to or for the benefit of the decedent's estate or over which the decedent is considered to hold the incidents of ownership are included in the decedent's gross estate for estate tax purposes.

Proceeds payable directly to the personal representative of the decedent's estate or payable to a person who is subject to a legally binding obligation to pay taxes, debts, or other charges enforceable against the estate are considered payable to or for the benefit of the estate. The concept of incidents of ownership of a policy looks to the deceased owner's ability, acting either alone or in conjunction with another, to determine who or what receives the economic benefit of the policy. Authority such as designating a beneficiary, surrendering or canceling the policy, assigning the policy or revoking an assignment, pledging the policy for a loan or borrowing against the cash surrender value of the policy is generally considered to be an incident of ownership. If the policy provides it or its proceeds can return to the decedent or the decedent's estate, or the decedent's estate has a power of disposition over the policy, the holder of such power is considered to have an incident of ownership if either of these powers is valued at more than 5% of the value of the policy immediately before the decedent's death. These powers are

referred to as **reversionary interests**. A person who has incidents of ownership can irrevocably assign the policy to another to avoid the inclusion of policy proceeds in a gross estate.

In Chapter IX, the concept of an **irrevocable life insurance trust** was introduced. The objective of this approach is to make the trustee the owner of a life insurance policy that will eventually fund the trust when the insured person dies. By having the trustee be considered the policyowner, the individual who sets up the arrangement avoids having the proceeds of the policy being included in his or her gross estate for federal estate tax purposes while still having some control over the ultimate destination of the policy proceeds when the trust agreement is prepared. Once the policy proceeds are received, the trustee manages the proceeds for the benefit of the persons named in the trust agreement and distributes the funds according to those terms. If a surviving spouse is given an interest in the benefits of the trust care should be taken to avoid the trust proceeds from being considered as part of the spouse's estate where it may create a significant tax. The earlier discussion in Chapter IX of a by-pass trust is relevant to this discussion as well. Under the terms of the trust agreement the trustee can be given authority to purchase assets from the estate and provide cash to the estate. Drafting the irrevocable life insurance trust agreement is an important component in making this plan a success. Care must be taken to draft the plan to achieve the desired goals while avoiding the pitfalls that could create unintended and undesirable results.

A second estate tax consideration involves gifts of insurance policies within three years of the decedent's death. Under current estate tax law, such gifts, as well as several others, are included in the gross estate despite the transfer of the property before death. Policy proceeds will generally be included in the gross estate of the decedent who dies within three years of transferring the policy even though the recipient of the policy pays the insurance premiums during the three-year period. Therefore, if a policy owner assigns or transfers the policy to another person to avoid having the policy proceeds included in his or her estate, the three-year rule becomes an important consideration.

For gift tax purposes, the lifetime transfer of life insurance policies is a potentially taxable transfer if the value of the gift exceeds the gift tax annual exclusion. Gifts of insurance policies can be either direct or indirect. A transfer from a policy owner, who is also the insured, to another is an example of a direct transfer. Similarly, if a person purchases a policy of insurance on his or her life and names another as the beneficiary, a gift occurs regardless of whether the beneficiary is named directly, or as the beneficiary of a trust. Examples of indirect transfers are payment of another's insurance premium, transfer of employer provided group term coverage from the employee to another, split-dollar insurance coverage arrangements between a corporation and another who is not an employee of the corporation, such as the spouse of an employee. In these gift situations, a central concern is the value of the gift in relation to the annual exclusion amount that determines if a taxable gift is made.

For gift tax purposes, insurance policies are valued at their fair market value that is its actual cost or replacement cost. The value of a particular type of policy is determined by establishing the cost of comparable policies issued by other companies. If the policy is a whole life policy in force for some time, however, it may be necessary to determine the terminal reserve value of the

policy and then adjust that amount by adding unearned premiums and dividend accumulations and deducting policy loans from the total. The value of certain types of policies may also reflect their unique character. Since term insurance policies have no terminal reserve value, their fair market value is the value of their unearned premium at the date of the gift. Newly issued single premium policies are valued at the amount of the premium paid. If a policy has been in force for some time and is paid-up, its value is the single premium or charge that would be charged by the issuing company, at the date of the gift, for a policy with the same face amount and based on the insured's age at the time of the gift. Employer-provided group term insurance coverage is valued at the amount of the unearned premium on the date of the gift. Whole life insurance subject to a split-dollar arrangement is valued as other whole life policies, but the amount of the employer's interest in the policy is deducted.

A second gift tax consideration is that the recipient of the gift must have a present interest in the gift property for the annual exclusion to apply. Outright gifts of insurance policies to recipients qualify as present interests if the recipients have the unrestricted right to the use, possession, and enjoyment of the policy, even though the death proceeds may not be payable to a later time. Transfers of life insurance policies in trust must also meet the present interest requirement to qualify for the annual exclusion. To create the present interest, gifts in trust can provide for the beneficiary's right to withdraw an annual amount small enough to avoid being treated as a taxable gift or a general power of appointment over the trust if the failure to exercise the right to withdraw is treated as the lapse of a general power of appointment.

For generation skipping transfer tax (GSTT) purposes, a trust includes any arrangement (other than an estate) that, although not a trust, has substantially the same effect as a trust. Insurance is specifically subject to this treatment. Therefore, life insurance policies that are not held in trust, but that have substantially the same effect as a trust (income to a person for life, with principal paid to others at the person's death) may be subject to GSTT.

In considering the impact of generation skipping transfer tax on insurance, several issues arise. The first involves the effective date of GSTT provisions. GSTT does not apply to a trust that was irrevocable on or before September 25, 1985, and that had no additions to the trust after that date. Additions after September 25, 1985 may result in a portion of the trust being subject to GSTT. Constructive additions to an exempt trust occur where release, exercise, or lapse of a power over a portion of the trust is treated as a taxable transfer. This may result in the portion of the trust subject to the power being treated as an addition to the trust.

Gifts of property below the annual exclusion amount for gift tax purposes are also exempt from GSTT provided they are treated as direct skips. Direct skip gifts can be gifts made directly to a skip person or to a trust for the benefit of one or more skip persons and in which no non-skip persons have an interest. Direct skip gifts below the \$10,000 annual exclusion amount (\$11,000 after 2001) made to a trust after March 31, 1988, may also be exempt if the trust is structured so that during the life of the individual beneficiary no portion of the principal or income of the trust may be distributed to or for the benefit of any person other than the beneficiary. If the beneficiary dies before the trust is completely distributed, the trust must provide that the

remaining trust assets are to be distributed to the beneficiary's gross estate and potentially subject to estate tax at that time.

Therefore, a gift by a grandparent to a trust established for a grandchild that qualifies for the annual exclusion by reason of the grandchild's present interest in the trust may also qualify for the GSTT exemption. If the trustee chooses to purchase life insurance with the trust principal, the funds used to pay insurance premiums will avoid GSTT. Since the funds are received by the trust as nontaxable gifts, the policy proceeds will likewise be nontaxable for GSTT purposes.

Nontaxable gift situations may benefit from considering second to die life insurance policies that take advantage of the lower premium costs which such policies often offer. As such policies pay proceeds only at the second death, the financial circumstances of intended beneficiaries must be able to deal with that fact. Similar results may be obtained by using split-dollar arrangements between the insured's employer-corporation and an irrevocable life insurance trust. In an appropriate situation, combining both techniques may drive premium costs down even further.

G. How Much Life Insurance Should I Buy?

Buying life insurance, like many other financial purchases, is an individual decision, based on particular circumstances and needs. For example, term insurance is useful on a temporary basis if a person is young and wants to provide for a spouse and young children should he or she die unexpectedly. For young, healthy people, it is relatively inexpensive. For older, more established people, the cash value and fixed premiums of a whole life policy might be more attractive. The flexibility afforded by universal and variable life policies may respond to individual needs more effectively. For older persons, insurance may be very difficult to get, especially in the case of someone who suffers significant illness or injury that makes insurance very expensive, or even impossible to buy. The *Financial Guide's* "Life Insurance: How Much and What Kind to Buy" website considers five typical situations in which life insurance might be considered and how the situation might impact on the amount of insurance to purchase. These five situations include:

1. Families or single parents with young children or other dependents
2. Adults with no children or other dependents
3. Single adults with no dependents
4. Children
5. Retirees

Without considering other factors, of these five groups the group with the greatest need for life insurance is the first group. People in the second group may view insurance as an important tool to replace the income support lost by a spouse's death or as a means to provide a supplement to a surviving spouse's retirement plan. Children have perhaps the lowest need for life insurance. Retirees may have less need for life insurance unless they view it as a source of funds for a variety of estate taxes and expenses such as, planning for retirement purposes, funding payment of death taxes, purchasing shares of stock or partnership shares in a business, creating the instant estate, or making special gifts to special people. This classification process simply helps

someone to consider how their individual circumstances and situations impact on their need for life insurance.

In deciding how much insurance to buy, the first step should be to determine your insurance needs. What purpose or role do you expect the insurance to serve in your overall estate or financial plan? Up to this point we've discussed several roles that insurance can play, such as creating the estate that will pass to the beneficiaries, providing financial security for a financially dependent spouse or beneficiary, providing a fund from which major bills such as a mortgage or a deceased owner's share of a business can be paid, or payment of an anticipated expense, such as a college education. Life insurance also plays a role in retirement planning by allowing individuals to maximize their existing retirement benefit plans.

After deciding the role insurance is to play, the next step is to review your present resources to determine your financial situation. Completing the estate summary and estimate of annual income and expense found in Chapter XIII is an excellent way to organize and analyze your personal financial situation. Once you have the information organized, look for key points in the summaries.

Example: If your assets exceed your liabilities by a significant amount, your financial situation may be pretty good. How will the death of the sole property owner, or one spouse, affect that situation? What taxes will be imposed on the transfer of property from the deceased owner to whoever is intended to receive it? How will taxes be paid? Will it be necessary to sell valuable assets to pay the tax? Will the sale of these assets affect the surviving spouse's income level? If the income level is reduced, will it be sufficient to maintain the life style enjoyed while both spouses were alive?

In considering these questions, the annual income and expense estimates in Chapter XIII are convenient and helpful guides to determining the present situation and estimating the effect of the loss of one spouse's income on the survivor's financial situation. If additional resources must be found to cover expenses or maintain income levels, a review of alternatives will identify the potential sources of additional resources.

After examining the role that insurance can play and examining the present asset and anticipated income and expense situations, the next area to consider is the amount of personal or family resources that can be devoted to purchasing insurance. Without considering the ability to pay factor, a purchase decision can quickly become a financial mistake that leads to canceling the insurance and significant loss of premium and insurance protection. If ability to pay is limited, it may mean that the purchase decision should be to purchase the best available insurance product that provides the desired level of protection and financial benefit. Insurance products can be expanded or modified in the future, and it is generally better to accomplish part of a goal than to leave it completely unaccomplished.

The decision to purchase insurance should be made only after a thorough consideration of these three factors: the role of insurance, the financial situation at present, and, as anticipated in the future, your ability to pay.

Once the decision is made to purchase insurance, the buyer's attention should focus on purchasing the best policy from the best company with available premium dollars. This consideration looks at two factors: the policy that is being offered and the company that is offering it. To help buyers compare insurance policies a cost index has been developed and an insurance company can calculate an index for a particular policy. This allows buyers to compare the cost index from one policy to the index of similar policies from other companies. In making the comparison, a policy with a lower index is generally a better buy than a policy with a higher index. Additional information about the cost index method of comparison can be obtained from an insurance agent, an insurance company, or a state insurance department or office. In making comparisons between policies, remember the following rules:

- Cost comparisons can only be made between similar life insurance policies.
- Index number comparisons should only be made for the insured's age, for the kind of policy you intend to buy and for the amount of insurance you plan to purchase.
- Small variations in index numbers might be offset by other policy features or differences in the quality of service you get from the company or the agent.
- Base a decision not only on a low index number, but also on whether the policy meets your needs; whether you can afford the premium; and whether you understand its cash values, if any, its dividends, if any, and its death benefits.
- The cost index cannot be used to compare existing policies to newly issued policies. Therefore, it cannot be used to determine whether a current policy should be replaced by a new policy.

After obtaining the cost index information from the companies in which you are interested, a buyer also should examine the strength of the company issuing the policy. An essential assumption in using life insurance is that the company is financially sound and will be available to pay the policy when the time comes to do so. This company analysis can be done by consulting one or more of the insurance rating services that analyze and rate life insurance companies in the United States. These services include Best's Ratings, Moody's Investors Service, and Standard and Poor's. Best's Ratings are prepared by A.M. Best for over 1,400 life insurance companies and their ratings range from its highest rating of A+ to the lowest rating of C. Generally, over 200 companies receive the A+ rating. Moody's Investor Service rates fewer life insurance companies than A.M. Best and its ratings range from a high rating of AAA to a low of C. Standard and Poor's ratings of life insurance companies range from a high of AAA+ to a low of D. It is important to remember that the rating scales vary from one company to another. An A+ is the highest rating issued by A.M. Best, but third from the highest in the Standards and Poor's rating system.

Before deciding on the policy and company that best accomplishes your goals and fits your budget, it would be useful to read the insurance contract carefully. At this point in reading through this chapter and at this point in the book you are probably saying to yourself, "Why

would someone ever want to read an insurance contract if I am not going to understand what it says”? While it is certainly true that insurance contracts are complex and difficult to understand, the fact remains that much valuable information can be learned from reading over them. As a contract, the terms and conditions set forth in the policy are very important in defining the rights and responsibilities of both the company and the policy owner. If policy terms and conditions are unclear, important elements of an informed purchase decision may be missing from the decision-making process. Reading through the contract will help to highlight key questions that must be resolved before a final decision can be made.

To summarize the many factors and issues, before purchasing a policy, buyers should follow these 10 rules developed by the American Council of Life Insurance:

1. Understand and know what your life insurance needs are before purchasing any policy. Choose the company that offers policies that address those needs.
2. Buy life insurance from a company that is authorized to do business in your state.
3. Select a competent, knowledgeable, and trustworthy insurance agent.
4. Shop around and compare the cost of insurance policies.
5. Buy only the amount of life insurance that you need and can afford.
6. Be certain to inquire about lower rates for special groups, such as non-smokers.
7. Read and understand your insurance policy.
8. Inform your beneficiaries about the kinds and amounts of life insurance that you own.
9. Keep insurance policies, a separate list of the companies that issued the policies and a list of policy numbers in a safe place.
10. Check insurance coverage and designated beneficiaries periodically, to be sure that coverage is proper and the beneficiaries are people you want to benefit.

H. Student Exercises

Multiple-Choice Questions

Please read the following questions carefully, then select one of the four choices following the question that best answers the question asked:

1. Which of the following statements is incorrect?
 - a. The beneficiary of a life insurance policy is the person who receives the proceeds of the policy after the owner's death.
 - b. Cash surrender value of a life insurance policy is the amount payable by the insurance company to the beneficiary.
 - c. Term insurance does not have cash value.
 - d. Annuities are contracts that pay income to someone during their lifetime and are unlike insurance policies that pay proceeds after a person's death.
2. Which of the following terms describes a life insurance policy that accumulates cash value?
 - a. A convertible term policy
 - b. A permanent life insurance policy

- c. A renewable term policy
 - d. A participating policy
3. Which of the following terms describes an insurance policy that covers the lives of two people and that is payable only after both people have died?
 - a. A variable life insurance policy
 - b. A universal life insurance policy
 - c. A split-dollar life insurance arrangement
 - d. A second to die life insurance policy
 4. If a deceased person is considered to have the "incidents of ownership" of an insurance policy at the time of his or her death, the policy proceeds will be included in the decedent's gross estate for federal estate tax purposes. In which of the following cases would the decedent not have incidents of ownership?
 - a. The decedent is authorized to designate beneficiaries of the insurance.
 - b. The decedent pledged the policy as security for a loan.
 - c. The decedent is authorized to cancel the policy at any time during his lifetime.
 - d. The decedent paid none of the policy premiums and had no authority to deal with the policy in question.
 5. Gifts of life insurance policies valued for less than \$11,000 may qualify for the annual exclusion from federal gift tax. Which of the following statements correctly describes a requirement for application of the annual exclusion?
 - a. The gift must be made within three years of the owner's death.
 - b. The recipient must live for three years after the gift is made for the annual exclusion to apply.
 - c. The recipient must have the unrestricted right to use, possess or enjoy the insurance policy after the gift is received.
 - d. The donor may make only three such gifts in a calendar year.

Short-Essay Questions

Please read the following questions carefully and then respond to the question that is asked at the end of the situation. Your answer need not be long or involved, but it should be clear and concise. If you want to refer to important facts in your response, please feel free to do so.

6. John and Mary operate a farm and woodlot with the help of their daughter, Marcia, and their son, Michael. John and Mary have two other children, Martin and Martha. Neither of these other children are interested in working in the business. They are financially independent and involved in their own careers.

If John and Mary intend to transfer the land, business assets, and equipment to Marcia and Michael, almost the entire estate will be transferred to these two children. If John and Mary don't want to ignore their other children, discuss the role that life insurance can play in enabling John and Mary to provide for post death transfers to Martin and Martha.

7. In 1986, Harold Humphries purchased a \$100,000 whole life insurance policy on his life and named his wife, Harriet, as beneficiary. At the time, Harold was not aware that Harriet secretly desired to end their marriage of five years. Harriet's heart belonged to another, but Harold didn't know this.

When he purchased the policy, Harold retained the right to name the beneficiary and to borrow against the cash value of the policy. Harold considered the cash value a valuable investment that also provided insurance protection in the event of his death.

In 2000, Harriet confronted Harold and told him of her desire to end their marriage. Harold was heartbroken, but he knew he could not change Harriet's mind. The divorce became final on December 1, 2000 and Harriet married the man she secretly loved.

In March 2001, while traveling to town to pick up parts for his machinery, Harold was involved in an accident and suffered fatal injuries. At Harold's death he was survived by his brother, Hank, and his sister, Hildie. No children were born to Harold and Harriet during their marriage. Harriet, now married to her new husband, Herb, also survived.

After Harold's death, Hank and Hildie went through Harold's papers and found the insurance policy. Hank notified the company of Harold's death. The insurance company then notified Harriet that she was the beneficiary of the policy and made arrangements to pay the proceeds to her.

Based on our discussion of state inheritance tax and federal estate tax, discuss the impact of these taxes on Harold's estate and on Harriet.

8. Over the years, Jerome Jaxsenn and his wife Jennine have often considered the need to purchase additional insurance. The needs they want to cover include the cost of inheritance and estate taxes and providing significant gifts to their two children, both of whom owe considerable amounts in student loans for their professional educations. If either Jerome or Jennine were to die, the survivor would be financially able to manage on their own.

The difficult questions concerning insurance coverage have always been, "How much insurance should we buy, and from which company should it be purchased?" Based on our discussion of the types of insurance policies, comment on the types of policies that would fit the Jaxsenn's needs. Briefly outline the steps they should take as they evaluate their purchase of a new insurance policy.

Chapter XI

Planning an Estate That Involves Forest Land

A. Overview and Purpose

This chapter is intended to bring together many of the concepts and ideas discussed in other chapters and identify their application to a forest land situation. In the book, frequent reference is made to particular ideas and aspects of estate planning for these interests. This chapter will put the pieces of the puzzle together.

The discussion opens with a review of the important background information that property owners and their families should gather before beginning the planning process. This discussion will build on the broader treatment of issues that precedes it and will identify several key decisions that are involved in the plan. Each decision should be made in the early stages of plan preparation. The next portion will address application of planning strategies, concepts and techniques that are most appropriate to estates with forest land assets. The discussion will end by identifying some practical problems that arise in planning the estates of Harry and Betty.

B. Lesson Objectives

After having successfully completed this chapter, the student will be able to accomplish the following objectives:

1. Discuss and identify the important pre-planning decisions that a property owner must make before initiating the estate planning process.
2. Describe three essential decisions that are involved in estate plans involving forest land.
3. Discuss the application of property transfer, estate, and inheritance tax, gift tax and income tax considerations to estate planning situations that involve forest lands.
4. Identify the practical problems that arise in estate planning and the techniques that are available to deal with them.
5. Review the situation of a forest land owner and identify basic and business planning strategies available to the property owner.

C. Pre-planning Decisions

One of the most important points that is raised throughout the chapters of this book is that planning is the crucial ingredient to the success of any estate plan. Planning is done at several levels and each level of planning should be done in a way that coordinates with other planning decisions. Without this type of planning, decisions on property ownership, transfer methods, tax avoidance and tax payment can be haphazard. Such decisions often fail to achieve important plan goals and objectives and may be costly to the property owner and the owner's family. If reviewing earlier chapters that discuss the importance of planning will be helpful to you (particularly Chapters IV, V, VI, VII, and VIII), feel free to return to those chapters before proceeding with this chapter.

In the pre-planning phase a property owner's first step, taken in conjunction with family members, is to gather information about estate assets that planners need to evaluate present situations and recommend actions. The second step involves preliminary discussions of the family's goals and objectives in the estate plan. Typical objectives involve a combination of personal or family decisions, property decisions and financial or tax decisions.

In the personal or family decision category, important issues involve whether to set a goal of taking care of family members, or others. Who is to be benefitted by the plan and in general terms what property are they to receive? For forest land owners, these issues also involve key decisions about the forest land assets and future plans for it. Is there a forest management plan in place? Does the plan describe a clear, direct and attainable goal in regard to the forest assets that are owned? If the plan was prepared much earlier does it allow for changed circumstances or situations that are more likely in today's situation? Are the people who are likely to inherit the property after death familiar with the plan? What responsibilities will they have to see that the plan is completed? Will they apply the plan as it was intended to be applied? Does someone in the family want to continue to manage these assets? Is the person who will manage the forest capable of doing it successfully? Does the person have access to a complete set of advisors who can assist in making effective decisions about the forest land?

In the category of property decisions, the property owner must consider the available transfer methods to get the property to the intended beneficiary. This decision evaluates the owner's present situation and considers changes to the current arrangement that will contribute to accomplishing plan goals and objectives. Several choices are available, such as lifetime sales, lifetime gifts of a whole or partial interest, transfers to a living trust, or transfers by will. Some choices may be more efficient and less costly than others. Recognizing the choices, how they work and what they involve are central considerations in this phase of the discussion.

A third set of decisions involves financial or tax considerations affecting the property owner. Most estate planners focus on an analysis of the owner's present situation in order to identify the tax implications that arise from taking no action to plan the transfer of property after death. The reason for doing this is simple. Most people who have substantial assets and have not taken any steps to plan their estate are clearly at risk to see their property go to unintended or less deserving heirs or to pay substantial estate or inheritance taxes. By pointing out the risk such people face, planning efforts can focus on addressing these problems and avoiding them wherever possible.

Timing the planning decisions has become one of the most important elements of the plan. Let's summarize some of the key elements of the 2001 amendments that apply over the next nine-year period:

- 1) Changes to eligibility requirements for reducing the value of land subject to a conservation easement are effective immediately upon passage of the 2001 amendments (June 7, 2001).
- 2) The exemption equivalent of the unified credit rises to \$1 million on January 1, 2002 and continues to increase to \$3.5 million through 2009.

- 3) In estates of people dying after December 31, 2001, installment payment of estate taxes will be available to businesses having up to 45 partners in a partnership or shareholders in a corporation
- 4) Gifts made after December 31, 2001 and before January 1, 2010 are subject to a lifetime gift exemption of \$1 million. Gifts made after December 31, 2009 will be entitled to a gift tax exemption equal to the tax determined by applying the tax rates to the amount of \$1 million.
- 5) For estates of decedent dying in 2002, 2003, and 2004, the amount of the current state death tax credit is reduced by 25% per year and is eliminated for estates of people dying after December 31, 2004. In estates of people dying after December 31, 2004, deductions for amounts paid for state inheritance or death transfer taxes will be provided.
- 6) The maximum rate of federal estate and gift tax is reduced to 50% of assets in excess of \$2.5 million on January 1, 2002. The maximum rate continues to decline one percent per year for estate of people dying in 2003 through 2007 and then stabilizes at that level (45% of assets in excess of \$2.5 million) through the end of 2009.
- 7) The Family Owned Business Deduction does not apply to estates of people dying after December 31, 2003.
- 8) The federal estate tax and the generation skipping transfer tax does not apply to transfers after December 31, 2009.
- 9) The maximum federal gift tax rate is reduced to 35% of gifts over \$500,000 for gifts made after December 31, 2009.
- 10) After December 31, 2009, property passing through an estate no longer receives a step up in basis to its date of death values. Basis increase of \$1.3 million for any property and \$3 million of qualified spousal property are provided. Both basis increase limits are indexed for inflation adjustment.
- 11) The estate law is repealed for estates of decedents dying after December 31, 2009.
- 12) Amending provisions (1) through (11) described above have no application to estates of people dying after December 31, 2010.

Everyone assumes that Congress will act to extend the repeal or take other action, but there is no guarantee of that. From a planning perspective this situation would seem to imply that more planning decisions will be made on short-term considerations rather than long term. In some cases property owners are likely to put off planning decisions until a later time, despite the risks of doing so.

We should point out that while Congress has taken dramatic action in regard to the tax impacts of after-death property transfers, taxes are not the only reason why people are interested in these issues. All of the non-tax reasons for acting remain as important as they once were.

D. Several Key Decisions in Any Plan That Involves Forest Land

As background information is gathered for each of the areas mentioned above, the owner's attention should be drawn to several key decisions that must be made in the plan. The first decision deals with the potential taxes that could be applied to the estate in the absence of any further planning decisions being made. Over the next nine years the number of estates that are subject to federal estate taxes will decline. What happens to estates of people dying after December 31, 2010 remains to be seen. If an owner's estate potentially faces only state inheritance or estate taxes, the tax implications are easier to deal with. Maximum state inheritance tax rates are often much less than federal estate and gift tax rates were before the repeal. In addition, some state laws do not impose taxes on some types of property, such as insurance proceeds, even if the decedent's estate is the beneficiary or the decedent was the owner of the policy.

Another key decision deals with the future of the forest land and any business activity associated with that land. What does the owner intend to happen to the business? Will the forest land continue to be an important component of the business? Should the business be maintained at all, or even some, cost to the heirs who inherit it? Should the people who inherit the business be given the chance to decide what to do with it? Business owners who feel strongly enough about continuation of the business to make it a central feature of their estate plan may have several opportunities under both state and federal law to lessen the financial impacts of inheritance and estate taxes on meeting their goals. Valuing land at its use value rather than fair market value is an opportunity that even small estates can use to save inheritance taxes as some state inheritance tax laws recognize this technique. For those estates that qualify and elect to take advantage of this opportunity, many provisions require that use of the land remain in a qualifying use or face the loss of the tax saving gained by using the provision. Special use valuation of forest land for federal estate tax purposes requires that farmland being valued be transferred to or purchased by certain qualified heirs who are found in a defined class of people. Failing to find a member in that class of people who is willing or able to acquire the property and continue the use results in losing the opportunity to use this provision. Once the qualified heir inherits or acquires the property, that heir must continue to be at risk financially and materially participate in the qualifying use on the property for the recapture period or face the loss of the savings gained through use of this valuation provision. The requirement of material participation limits the qualified heir's choices in the recapture tax period.

The Family Owned Business Deduction will be repealed in the near future and remove it as an effective tool. For those who take advantage of it, however, key aspects need to be understood. Eligibility requirements for the Family Owned Business Deduction are similar to the requirements for special use valuation, but there are key differences. Both require that the decedent or a member of the decedent's family must materially participate in the family-owned business for five or more of the eight years before the decedent's date of death, retirement, or

disability. Both provisions require that a qualified heir continue the qualifying use or family-owned business or face having a “recapture tax” imposed on the qualified heir who triggers a recapture event during the ten-year “recapture tax period” that will continue often the tax is repealed. An important difference between the two provisions is that a qualified heir can include an “active employee” under the family owned business deduction rules, an opportunity that is not available under the special use valuation provisions.

If use of these opportunities reduces the amount of tax due, but does not eliminate it, there are other opportunities under some state inheritance tax and federal estate tax laws that allow payment of the tax in installments over time. Under the federal provision this can be up to 14 years and 9 months from the decedent’s date of death. These approaches are intended to enable an estate to ease the burden of inheritance and estate taxes imposed on the business assets and lessen the need to sell business assets to pay inheritance taxes in a timely manner.

Another key decision is to decide who is to receive the property after the owner's death and the most efficient and effective way to accomplish the transfer. Lifetime decisions concerning ownership forms impact on the transfer of property after an owner's death. Joint ownership with the right of survivorship and living trusts are examples of lifetime decisions that involve the property owner in the process of deciding what will happen to his or her property after death. Drafting a will is a similar planning decision that focuses its attention on the amount of property owned by a person at his or her death, although the owner has the right to change the will at anytime during his or her life. A final consideration involving the transfer of property is that the failure to act during lifetime is also a decision to allow the transfer of property to be made under provisions of the intestate law of the state where the property is located. In effect, each of us already has an estate plan in place. The plan can be either one that is specifically prepared for our personal situation, or one that others have prepared for us on the assumption that this is what we would have wanted to do.

E. Strategies to Employ in Planning Forest Land Estates

The following discussion of planning strategies is divided into two parts, the first being those strategies to apply in all cases. This part will be referred to as the “basic strategies.” The second part refers to those strategies to employ where use of the forest land can meet the requirements for being considered a trade or business. This part will be referred to as the “business strategies.”

Each of these strategy discussions will focus on the objective of reducing federal estate taxes that are determined to be a threat to this estate.

Basic Strategies:

Exemption Equivalents of the Unified Credit.

Objective: Shelter as much property as the law will allow each property owner to shelter.

Perhaps the most important strategy to employ in planning forest land estates that are subject to federal estate tax is to take full advantage of every opportunity to use the exclusion equivalents

and available credits in the estate of each spouse. Once a taxable estate exhausts the exclusion equivalent to the unified credit, state death tax credit, and allowable deductions, the estate will be subject to tax at an increasing rate of tax. If both spouses take full advantage of their exclusion equivalents, saving federal estate taxes will be significant. Owners can increase their use of the exclusion equivalent by transforming ownership of jointly owned assets into individually owned assets that approximate the value of the exemption equivalent. At the death of each spouse this property can pass to heirs other than the surviving spouse if the spouse has independent means, or it can pass to a trust in which the spouse has only a limited interest that will not result in the property being included in the spouse's estate at his or her death. The purpose of this approach is to create a gross estate at the death of each spouse to which the exclusion equivalent can be applied. Full use of the exemption equivalents in the estates of two spouses will protect up to \$7,000,000 of estate assets for decedents who die during 2009.

Taking/Keeping Property Out of a Gross Estate

Objective: Consistent with plan goals and objectives, keep as much property as possible out of the calculation of the gross estate for federal estate taxes.

A technique that should be considered by any estate that is close to or above the amount of the exemption equivalent and state death tax credit is to carefully examine those property ownership situations in which property can provide benefits to an intended beneficiary, but that will not be included in the beneficiary's own estate when that arises. For example, creating ownership of a life insurance policy in an irrevocable trust will allow the policy proceeds to benefit those intended without having to include the policy proceeds in the estate of the person whose life is insured. Using a by-pass trust to take advantage of the first spouse's own exclusion equivalent while providing lifetime income support to a surviving spouse is another example of careful planning to benefit a surviving spouse while taking full advantage of allowable exclusion and credits in each estate.

Conservation Easements

Objective: Reduce the size of the federal gross estate and serve a conservation purpose through the transfer of a conservation easement

Another example of other action that impacts on estate transfer and tax issues is the role that a conservation easement or transfer of qualified conservation contributions may have in an estate plan. Such transfers can be sold, gifted, or a combination of sale and gift (sometimes referred to as a "bargain" sale).

Transfer of a conservation easement may have the double benefit of reducing the size of the estate at the time of the transfer and later when the remaining interest in the property is valued for estate and inheritance tax purposes. In terms of valuing property that is subject to such an easement, the limitation of the property's use will be an important factor in determining the fair market value of the property as of the date of the owner's death. In areas where land is subject to pressure from development, these restrictions can be expected to reduce the fair market value of

restricted land compared to unrestricted land. Lowering the fair market value will lower the value of the estate subject to inheritance tax and the inheritance and estate tax as well. The sale of an easement, however, will have current income tax impacts for the landowner that must be evaluated before a decision is made.

Owners who sell conservation easements must consider the income tax impact of the sale and the best use of the funds received from the sale. If the funds are invested or used to purchase additional land, the size of the owner's estate may not be dramatically reduced, or may even be increased. One estate planning opportunity that involves the use of these funds is to distribute the funds among children who will not inherit the land at the owner's death. A second opportunity is to use the sale proceeds to purchase insurance on the life of the property owner and name the children as beneficiaries. This provides an opportunity to leverage the sale proceeds for the benefit of the children. For this second technique to be successful, however, the incidents of ownership of the insurance policy on the property owner's life must be held by someone other than the property owner. This will avoid the insurance proceeds being included in the deceased owner's estate that would defeat the tax savings purpose of the plan. If a property owner is in ill health, such that he or she cannot purchase life insurance at normal rates, any attempt to buy life insurance may be impossible or uneconomical.

Qualified conservation organizations that meet Internal Revenue Service requirements offer an income tax charitable deduction to those who donate qualified conservation contributions from their property to the organization. This enables owners of valuable land to follow a path to preserve the use of land while gaining a measure of income tax saving.

In the case of these other opportunities, it is important to remember that a careful analysis must be made of the benefits and disadvantages associated with these techniques before proceeding. As mentioned earlier, the desire to save taxes may lead to decisions that save taxes, but also create other problems. Before reaching a decision, it is important to thoroughly and carefully evaluate choices and the advantages and disadvantages they offer to the owner's specific situation.

General Gift-Giving Considerations

Objective: Reduce the size of the federal gross estate by fulfilling the personal desire to support a deserving person or charitable institution.

A technique to consider in estates that are subject to federal estate taxes involves opportunities to lower the size of the federal gross estate by gift-giving programs. Such programs are intended to transfer property during lifetime to heirs who would eventually receive the property after the owner's death. To implement a gift-giving program several considerations must be addressed. First, to be considered a gift the owner must give up dominion and control of the property. Understandably, some people will be unwilling to do that. Therefore, those who are reluctant to part with control of their property are not good candidates for gift-giving programs. Second, the \$11,000 annual exclusion amount per person, per year for federal gift tax purposes and the soon to be applicable lifetime gift exemption limit the amount by which an estate can be reduced

quickly. Third, in order for the annual exclusion to apply, a gift must be a gift of a present interest. To satisfy this requirement, special care must be taken to make gifts to minors or certain gifts in which the beneficiaries have “Crummey” withdrawal powers. Failing to meet the guidelines may result in loss of the exclusion. Fourth, state inheritance tax law may provide for treatment of gifts that is coordinated with the federal gift tax annual exclusion. Fifth, gifts to charities provide some unique opportunities to people who are interested in reducing the size of their estate and obtaining tax benefits. Gifts to charities can take many different forms and be made during lifetime or after death, and can be made in a full or partial interest. Sixth, a gift of property transfers the current owner's income tax basis in the property to the recipient. A recipient who intends to sell the gifted property may face substantial income taxes on gain recognized from this sale. Seventh, for federal gift tax purposes, there is no special use valuation opportunity similar to that which exists in the federal estate tax law. Gift taxes are calculated on the date of gift fair market value of the property given away.

Strategies Available to Forest Land Involved in a Trade or Business

A number of strategies can be employed to assist in continuation of a recognized business activity that involves forest land.

Business Organization

Objective: Facilitate the transfer of an active trade or business at lowest transfer costs, or at most a manageable cost to the recipient.

If there is someone who is interested in and capable of continuing the business, the first strategy is for the owner to consider restructuring the way the business is owned to allow other people who would be expected to inherit the property to share in its value today and build an ownership interest for the future. Separating the ownership interests transfers assets out of the original owner's estate and sets up the opportunity to take lack of marketability and minority interest discounts that will further reduce the size of the estate and lower taxes. Whether the choice is one of the partnership forms, one of the corporation forms or the hybrid limited liability company, organizing the business provides important opportunities to shift ownership of assets from senior owners to younger generation owners and reduce the size of the senior owner's estate at his or her death.

Special Use Valuation

Objective: Reduce the size of the federal gross estate through valuing the property at use value rather than fair market value; assist qualified heirs in obtaining ownership of real estate used in a closely held trade or business.

Another strategy to employ is to evaluate the benefits offered by opportunities to value property for inheritance and estate tax purposes at use value rather than fair market value levels. Reducing the taxable portion of the estate by up to \$820,000 under current rules can save considerable amounts of tax. As the exemption equivalents rise, fewer and fewer businesses will

turn to this tool. Those who do will be committed to continuing the family business. In considering how this opportunity will be used, an important question to ask is, will the qualifying requirements can be met? Is it realistic to think that the qualifying use will continue long enough to avoid losing the tax benefit gained by use of the provision? If there is some doubt about this, the next question to ask is whether the qualified heir is aware of the obligation to pay the recapture tax if it is triggered

Family Owned Business Deduction

Objective: Lower the size of the federal gross estate; assist a qualified employee to acquire assets and continue the business. Remember that this opportunity is lost after 2003.

The family owned-business deduction has several opportunities. First, it supplements the unified credit and shelters a combined maximum amount of \$1,300,000 from federal estate tax. Second, it provides an alternative means of reducing the value of the real and personal property business assets in the estate. Third, it also provides an additional opportunity in those cases where requirements for special use valuation and family owned business deduction can be met. If the requirements for special use valuation can be met, it is likely that the requirements of the family owned business deduction can also be met. The reverse situation is not true, however, if the only available qualified heir is a non-family member employee. Fourth, in many cases, estates can seek opportunities to combine these deduction amounts to achieve even greater reductions in the amount of property subject to tax. This strategy also has a limited lifespan that will likely lead to decreasing interest in it.

Installment Payment of Federal Estate Tax

Objective: Lessen the burden of the federal estate tax by stretching out its payment over time while taking advantage of favorable interest rates on the unpaid balance.

If use of these techniques lowers the tax but does not eliminate it completely, the portion of the tax due that is attributable to the business interest can be deferred under installment payment arrangements that are available under the federal estate tax law and some state inheritance tax laws. Although the obligation to pay the tax may not be very pleasing, a long term payment plan at attractive interest rates may lessen the impact of the payment obligation.

F. Practical Problems in Forest Land Estate Plans

The most common problem associated with planning estates is the complexity of the issues and the techniques that are involved. The inheritance, estate, gift, and income tax issues are often independent of each other such that steps to save taxes at one level may not save taxes at another level. The income tax treatment of proceeds from the sale of a conservation easement and the lack of coordination between the annual exclusion for federal gift tax purposes and the treatment of gifts for state inheritance tax are very good examples of this problem. Being a complex issue with many facets and implications, some people are turned away thinking they could not possibly understand it. In addition, they do not feel comfortable with many of the advisors who

offer their services to business owners and operators. A common complaint is that advisors do not understand forest management problems and, therefore, their advice cannot possibly be valuable.

A second problem that relates to estate planning in general is the fact that most people are apathetic when it comes to something that is perceived to be a future issue. Opportunities can be lost through a failure to act while there is still time to do so. Another aspect of this problem is the psychological barrier that discussions of death and dying create for some people.

One experience that seems to motivate people to overcome this barrier is seeing a large portion of another person's estate lost to inheritance and estate taxes, or their property transferred to someone who is considered undeserving of it. The drive to avoid taxes is a common motivator and often the most successful one. Seeing someone else's problem prompts others to act to avoid being placed in the same situation someday. This attitude is often expressed in terms, of "I don't want that to happen to me." While no one wants to put themselves in jeopardy, control of the situation is in the hands of the owner. Taking action can achieve results. Making informed decisions improves results.

Each of these problems can be overcome by a person who is willing to learn about the subject and take the action needed to affect their personal situation. Getting started is the most difficult part, but once started completing the plan is easier to achieve.

G. Student Exercises

Short Essay Questions

Please read the following fact situation carefully and then respond to the questions that are asked at the end of the situation. Your answer need not be long or involved, but it should be clear and concise. If you want to refer to important facts in your response, please feel free to do so.

The fact situation to which these questions refer is also found at the beginning of Chapter II.

This pattern describes the situation of Harry, Betty, and their four children. Harry lives with his wife, Betty, and their four children ages 17 through 29. Harry and Betty work together in a farm business for over 35 years. They started by farming the 200-acre main farm and implemented a forestry management plan for the 85-acre woodlot all of which Harry inherited from his parents when they both died in 1969. A few years later, Harry and his brother, Joe, inherited a parcel of land as the sole heirs of their older brother, Dick. Dick's property included an additional tract of 150 acres, 75 acres of which was wooded and located adjacent to a real estate development. All of these wooded acres included mixed hardwood species of an average age of 50 years. The average value of the wood on the wooded acres is \$1,500 per acre.

After Dick's death, Harry took over farming operations on Dick's land and began to examine the potential opportunities that the additional wooded acreage presented. Being familiar with

managing forest acreage to achieve its maximum potential, Harry began to include the added acreage in his current plan.

Joe had no interest in the operations on Dick's property, as he was a successful businessman involved with his own business.

Residential development now completely circles the main 200-acre farm and the additional 150 acre parcel. As a result, land values soared upward. Harry has been approached by several people about selling the farm, but he graciously expresses no interest in selling. Developers are particularly interested in the wooded portion of the tract as it provides an ideal setting for a wooded residential development. Three years ago the combined value of the main farm and woodlot and Harry's interest in the additional parcel was \$3,165,000. The 150-acre parcel alone was worth \$1,600,000.

Harry and Betty considered that they owned the main farm and additional properties jointly, although the deeds to the properties list Harry's name alone as owner. The 150-acre parcel was distributed to Harry and Joe after Dick's death and ownership of the land passed to them through Dick's estate. In addition to the farmland, Harry and Betty accumulated over \$900,000 of machinery, livestock, and equipment in their farming operation.

Harry prepared a will thirty years ago and this plan transfers all of his property to Betty after his death. Harry also assumed one or more of his children would return to farm and keep the family tradition alive. Family tradition was something that made Harry very proud. He wanted the land to stay in the family and he didn't view himself as the person who should make decisions about its future.

Harry and Betty's oldest child works on the farm after earning a degree in dairy science with a minor in forestry. This child has big plans for the future of the farming operation. The second oldest child travels throughout the country as a public accountant for a national firm. This child is not interested in the production side of agriculture, but is very aware of the value of Harry and Betty's holdings. The third oldest child graduated from college this year and is deciding what the next step should be toward some type of a professional career. The youngest child is a high school senior who wants to go to college to earn a degree in wildlife science

Harry and Betty do not spent much time wondering what will happen to their property if either or both of them die. Why should they fill out information about their property and pay outrageous fees to lawyers or others who are only interested in finding out what they own? It's none of their business! At one time Harry considered a partnership with the child who is on the farm, but nothing was done about it. Harry didn't think the child was ready to enter a partnership, and she knew she wasn't really interested either.

Harry and Betty carefully guard their property because they are concerned about their financial future. Medical care costs are rising and it is difficult to set aside a specific amount of property to feel secure about their future. Giving their property away is not a subject that either want to

discuss. Harry and Betty work hard for what they have. Why give property away to someone who could waste it, or squander its value?

Neither Harry nor Betty had an accurate idea of the financial value of what they owned. They considered only their bank accounts and certificates of deposit as available funds. In these accounts they had a total of \$65,000 that was in joint names.

Harry never thought much about insurance or retirement planning and has less than \$20,000 in life insurance protection. His income from farming is modest, but Betty and the kids are taken care of to his satisfaction.

Harry and Betty are concerned about the future of the farm and timber business and the value that the growing trees will bring in the next few years. The children are concerned about these issues as well. There has been only one family discussion about the businesses and what Harry and Betty would like to see happen to it when they are gone.

The following set of questions will ask you to put yourself in the position of Harry and Betty. The focus of the questions is to ask you to consider the steps that Harry and Betty could take during their lifetime to avoid some of the problems that a sudden and unexpected death would have on their family.

1. If Harry and Betty begin to plan their estate, what personal, property, and financial factors should they consider in setting their family goals and objectives?
2. If Harry dies accidentally and Betty survives, which estate and inheritance taxes will be imposed? What do you estimate the amount of these taxes to be?
3. In planning Harry and Betty's estate, what basic and business planning strategies would be available to manage the farm business and deal with the tax issues they face?
4. In transferring the property after Harry's death, what choices do Harry and Betty have to plan for the transfer? Which transfer method would be the most efficient?
5. Which of the basic and business estate planning strategies would you employ in the situation of Harry and Betty to deal with the problems and issues that you see in the fact pattern?

Chapter XII

Planning Estates that Involve Forest Land Assets

A. Overview and Purpose

In this chapter more planning strategies and ideas are discussed in the context of their application to a particular situation. The purpose of this approach is to give you more exposure to a wide variety of situations, the problems they create, and the potential solutions that can be fashioned to address them. This discussion will give you the chance to explore a variety of solutions. Unlike earlier chapters that included a set of problems at the end of the chapter, this chapter consists of problems themselves for you to read, review, and then carefully consider. Some of these examples were adapted from *Pennsylvania Forests*, *Forest Farmer*, *National Woodlands*, and the *Practical Accountant* magazines.

Refer to the earlier chapters for valuable information that can help you evaluate the situations and understand the strategies being discussed.

B. Lesson Objectives

Following completion of this chapter, you will be able to accomplish the following tasks:

1. You will be able to identify and evaluate the estate goals and objectives that are presented in a wide variety of situations.
2. Based on your evaluation of these goals you will be able to suggest various estate planning strategies that can be employed in the situation to accomplish some or all of the goals you have identified.
3. You will be able to evaluate the impacts of various strategies on accomplishing the potential goals and objectives that you identified.
4. Based on your evaluation of the impacts on potential goals, you will be able to fashion a list of considerations that will aid in deciding which goals should be given priority and which strategies will have the greatest likelihood of accomplishing them.

C. Problems

Preliminary Note: Because many of the tax issues that are discussed in these problems will vary over time, unless the fact situation otherwise directs you to consider the situation in a different time period, consider 2002 to be the time when the planning decisions are made in these cases.

Example 1: Annual Exclusion Gifts

Mr. and Mrs. Jones have four adult married children. Mr. Jones owns 500 acres of woodland in his own name, which has an average value of \$2,000 per acre (FMV = \$1 million). Mr. Jones (the donor) can give each child (donee) \$11,000 in value each year tax-free. That is, he can give each child either 5 acres outright (not including potential subdivision, engineering, survey costs)

or a fractional undivided interest in the property worth \$11,000, for an annual total of \$44,000. A real estate appraisal by a competent professional should be ordered as a means of certifying the value of the property. He can also give each child's spouse a similar 5 acres or a \$11,000 undivided interest annually.

Example 2: Split Gifts

Assume the same facts as in the previous example. After obtaining the real estate appraisal and verifying the value of the land, Mrs. Jones agrees to make a split gift of Mr. Jones' woodland property to the children. Each child will now receive a gift of either \$22,000 in undivided value or 10 acres. This can be increased to \$44,000 or 20 acres by making split gifts to each child and to his (her) spouse.

Example 3: Planning with an irrevocable Life Insurance Trust

A basic question is, "Why choose to use an irrevocable life insurance trust?" The primary reasons for selecting an irrevocable life insurance trust are to: (1) structure ways that result in the trust being the owner of the policy, and (2) provide that the distribution and use of the proceeds will be subject to controls put in place by the person creating the trust.

Bill has a \$1 million life insurance policy insuring his life. At present Bill controls the economic benefit of the policy because he retains the right to name the beneficiary of the policy and the right to cancel it if he wishes. If he were to die under this set of circumstances, the insurance policy will be included in Bill's gross estate. In planning Bill's estate, he decided to keep assets such as this one out of the calculation of his gross estate. Bill could accomplish that goal by transferring ownership of the policy to someone else or to another entity, such as a trust. If he does that Bill will face a three-year period within which the policy proceeds could still be brought in to the calculation of his "gross estate." In contrast, if Bill decided to create an irrevocable life insurance trust for the express purpose of making the trust the owner of the policy, then whatever policies the trust purchases after the trust is created are not subject to the three-year period during which the policy proceeds could be brought back into the calculation.

How can Bill fund payment of the policy premiums? Bill can make annual exclusion eligible gifts to the trust, provided that the beneficiaries of the trust have a present interest in the trust. Bill can accomplish this by structuring the trust with Crummy withdrawal powers (see chapters IX and X). Giving the beneficiaries "Crummey withdrawal powers" allows the exclusion to apply to gifts made to the trust. If beneficiaries do not exercise their withdrawal or demand rights, then the trustee can use the funds to pay the policy premiums.

Example 4: Split Purchases and Sales

This technique involves two variations: (a) assets purchases by multiple purchasers, and (b) assets sales of remainder interests to children. Asset purchases by multiple purchasers involve transactions in which one purchaser purchases a life interest in an item of property and the other purchaser acquires a remainder interest. The determination of the purchase price to be paid by

each party is made using actuarial-based life expectancy tables. The objectives of this method are to avoid creating a taxable gift when the property is acquired and to eliminate estate tax liability when the life estate ends and the remainder interest vests. Sale of a remainder interest in property involves an owner of property who sells a remainder interest in property while retaining a life estate in it. When the owner's life estate ends, the value of the seller's interest has been fully realized and nothing remains to be transferred to the seller's estate after death.

Upon their retirement in April 1992, a couple in the 50% marginal estate-tax bracket and their daughter agreed to make a split purchase of a personal residence. The purchase price was \$500,000. The parents, ages 64 and 62, purchased a life estate that expires at the death of the survivor of the two. According to the Section 7520 valuation tables, the life estate factor is .81254 and the remainder factor is .18746. Assuming a rate of appreciation of 7% annually over the parent's 21.2-year joint and survivor life expectancy, the residence would be worth \$2,099,500 on the death of the surviving parent.

Example 5: Appreciating Property

Take the case of the John and Mary Smith, a hypothetical 45-year-old couple who, in looking at current tax laws, think their \$300,000 in net worth leaves no estate taxation to worry about. After all, should John die his holdings can be passed along tax-free to Mary under the unlimited marital deduction rule. And when she dies, the assets currently are well within the maximum \$1,000,000 allowed to pass tax-free to the next generation.

But what about increasing values? If either John or Mary lives to age 80, the estate will have zoomed to almost \$900,000 based on 3% inflation. At 6% inflation the now modest \$300,000 would become almost \$2.4 million in 35 years! Also bear in mind these projections do not take into consideration other assets the Smiths will probably accumulate during their lifetime. There is also no guarantee that property value will always rise.

Example 6: Charitable Remainder Trusts (CRT)

Bob Sykes is 65 years old and is about to retire. With nearly \$2 million in total assets (\$500,000 in timber), Bob and his wife, Jane, are considering a number of planning strategies. Beyond providing a comfortable retirement income for themselves, they have two main objectives: provide for their two daughters and make a generous contribution to their local church, of which they have been members for nearly 40 years.

After consultation with their financial advisors and forestry consultant, the Sykes decide to harvest a portion of their mature, high-quality hardwood with a current market value for the trees of \$230,000. For simplicity, we'll look at the transaction net of the forester's fee and other costs associated with the sale. The net current market value is \$200,000. Let's assume that Bob and Jane purchased their woodlot in 1965 and that the value of the timber, at that time, was negligible. Again for simplicity, let us assume that their basis is zero. Therefore, if Bob and Jane sell the timber outright, they'll lose 20% (\$40,000) to capital gains taxes, realizing only \$160,000 from the sale. If the \$160,000 is invested at 6% interest per year, they will receive

\$9,600 in interest income on which they will pay income tax. Instead, they decide to place the timber in a charitable remainder trust, naming their church as beneficiary. The value of the charity's remainder interest is considered a charitable gift for income tax purposes. The creation of the charitable remainder trust with the timber in it constitutes a "constructive severance" for purposes of title to the trees. Later, the trustee sells the timber for its full market value of \$200,000 with no capital gains tax due.

The Sykes can structure the trust into which the proceeds of the timber sale will be placed in one of two ways:

1. Annuity Trust: The trust will pay out a fixed dollar amount each year.
2. Unitrust: The trust will pay out a fixed percentage of at least 5% of the net fair market value of the assets in the trust valued each year.

The Sykes chose the unitrust option that provides for an annual payout of 7%. If the Sykes choose the payout to continue during Bob's lifetime only, the value of the charity's remainder interest is 35% of the gift. This figure is taken from IRS valuation tables. If the Sykes choose a payout that continues until the death of Bob and Jane, the value of the charity's remainder interest drops to 21% of the gift.

The charity earns interest on the amount in the trust and through prudent investment can enjoy an increase in asset value. In the first year of the trust, the payout to the Sykes is approximately \$14,000 plus a portion of the interest income and capital appreciation that the trust enjoys. This amount will also be subject to income tax. In this arrangement, the Sykes are receiving greater income than they would have received had they invested the money themselves. Since a unitrust pays a fluctuating income based on the value of the assets in trust, revalued annually, as the trust assets increase/decrease in value, Bob and Jane receive a higher/lower income.

To provide for their daughters, the Sykes gift a portion of their CRT payout to a "wealth replacement" trust, with their daughters as beneficiaries. Bob's younger brother, Pete, is trustee of this separate and distinct trust. Pete, as the trustee, then uses the gifted cash to purchase life insurance on the lives of Bob and Jane. As beneficiaries of the trust, the two daughters will eventually receive the insurance proceeds. This arrangement keeps the life insurance out of Bob and Jane's estate so that it will not be subject to estate taxes at their death.

What is the net result of using the CRT? The Sykes have a higher income and realize the full value of their hard-earned assets, enabling them to enjoy a more comfortable retirement. They are also able to leave more to their children. Because they made a charitable contribution of only the timber to be harvested, the children also inherit the family woodlands. At the Sykes' death, their church will receive the trust principal that remains as a charitable gift and will set up an endowed scholarship fund in the Sykes' name.

Example 7: Marital Deduction Planning

With a little bit of planning, trusts of various types can be used to dramatically increase the amount you and your spouse leave to your children free of estate taxes. Over the next 10 years the exclusion equivalent to the unified credit rises from \$1 million in 2002 to \$3.5 million by 2009, is repealed in 2010, and then is resurrected in 2011 at the \$1 million level.

Suppose you leave your entire \$10 million estate outright to your spouse. After your death, in 2009 your estate incurs no taxes because of the marital deduction. But upon the death of your spouse, also in 2009, only \$3.5 million is sheltered from estate taxes by the exclusion equivalent to the unified credit. Your children will pay federal estate taxes on the remaining amount and any appreciation occurring between deaths. The unfortunate result in many cases is that the family may have to sell assets (the woodlot or liquidate the timber) to pay the taxes. If death occurred before 2010, the federal estate tax rate would be about 45% of net taxable estate. Assuming that amount is \$6 million, the tax would be approximately \$2.7 million.

But suppose instead that you willed the exclusion equivalent to your unified credit to a credit shelter trust. The balance of your estate would pass to your spouse. From the credit shelter trust your spouse would be entitled only to the income it generates. At your death in 2009 there would be no taxes at your death as the unified credit and the “marital deduction” will eliminate the tax. After the death of your spouse, also in 2009, the assets in the credit shelter trust won’t be part of your spouse’s estate, so they’ll pass estate tax-free to your children. Another \$3.5 million is also untaxed at your spouse’s death due to your spouse’s own \$3.5 million exemption. The result is that \$7 million in value passes free of estate tax. To obtain these savings, your spouse should have the same credit shelter trust in his or her estate plan that you do. Also, each spouse should have \$3.5 million of assets in his or her own separate name to take advantage of the tax savings of such a trust.

Example 8. Planning for an Estate That is Above the Equivalent Exemption Amount

Sam and Betty are the parents of two children, Bernice and Buddy. They jointly own 400 acres of land that is located in a growing residential area. One hundred fifty acres of that land includes a stand of high value timber that will be ready for market condition in three years. Sam has bought and sold timber for many years while operating a timber management company in this area. The value of Betty and Sam’s prime residential land is \$3,000,000. The value of their timber land is \$2,000,000. The value of their stone farmhouse and outbuildings is \$1,000,000. Miscellaneous vehicles, machinery and equipment involved in the business are valued at \$100,000. Sam maintains a separate account for his timber management company. He and Betty maintain joint checking and savings accounts at the Hometown Bank and Trust Company. At Betty’s death the accounts contained \$6,000 in the savings account and \$1,800 in the checking account. In addition, Sam and Betty jointly owned \$336,000 in a variety of mutual fund accounts and a cash management account with their broker that is valued at \$24,000. The current timber market is at its highest level in the past 10 years and future prospects for timber prices are bright.

While enjoying their present situation, Betty dies suddenly. Sam is very much affected by her death, but he struggles to continue to operate the business with the help of his children, Bernice and Buddy. Both children have expressed interest in continuing their father's timber management business and in managing the timber land. Sam and Betty had discussed the need to plan their estates many times, but they simply did not make it a priority item in order to get it done. They had simple wills prepared by one of Sam's nephew over 25 years ago, but the wills have not been updated since then. Under her will, Betty leaves all of her property to Sam if he survives her by five days. If he does not survive, Betty donates her property in several shares to her local church, a local hospital and the Hometown Land Conservancy where the land will be used to provide open space benefits in the community.

What is the legal impact of Betty's death? Since all of their property is owned jointly as husband and wife, most states would recognize that the surviving spouse becomes the owner of the property after the first spouse dies. Sam has the property appraised to set the value of Betty's one-half interest that passes to him after her death. Although the value of Betty's gross estate is considerable, i.e., approximately \$2.68 million, Sam will be allowed to take a marital deduction for the value of Betty's interest that passes to him after her death. For state inheritance tax purposes, Sam's survival may eliminate inheritance tax as well.

At Betty's death, the unlimited marital deduction has saved Sam a considerable amount of money. Bernice and Buddy are now considering how they can plan for their future in the business and they recognize that without special planning that future will be affected by the estate and inheritance taxes their father's estate will pay after his death. In order to reduce taxes they convince their father to consider several options. First, the current business should be organized into some type of business arrangement that will allow the children to begin to build up an equity interest in the business. This could involve a corporation, a partnership, or a limited liability company. The objective here is to transfer assets to the children during Sam's lifetime through a series of annual gifts and to allow them to receive the largest amount of the business property at discounted tax cost when Sam dies. As Bernice and Buddy are already involved in the business with their father, they envision that they will be able to take advantage of the special use valuation opportunity to specially value the qualified forest land and also the family-owned business deduction. Bernice and Buddy intend to continue to operate the business and they are committed to doing that.

Example 9: Planning with Qualified Conservation Contributions

John and Mary own 264 acres of land. The property is located about 10 miles northwest of a small city of 60,000 people. The property has 3,000 feet of frontage along the Lazy River, a hilly topography and substantial amounts of mature timber in its woodlands. A dwelling, parts of which were built in the mid 19th century, and related out buildings are the only structures located on the property. The dwelling was included in a survey of historic properties conducted by the local county government. The woodlands and river banks support several species of wildlife, such as white-tail deer, beaver, turkeys, grouse, fox, migratory birds, Canada geese, and a variety of other birds, 48 species of which have been observed on the property.

Although agricultural activities remain the predominant use of land in the county, significant residential development has occurred because of the county's proximity to major employers and easy access to nearby urban centers. Development has occurred on land between John and Mary's land and the small city. Land that is adjacent to this land is undeveloped and is committed to agricultural, forestry and low density residential uses. Under the county zoning ordinance, John and Mary's land is zoned as part of a rural agricultural district, as agricultural and forestry uses are the predominant uses in the area. State law includes an Agricultural and Forest District Law that has as its purpose the conservation, protection, development, and improvement of the state's agricultural and forest lands for the production of food and other agricultural and forestry products. This law states that it is the state's policy to preserve and protect agricultural and forestry lands as valued natural and ecological resources that provide essential open spaces and clean air sheds, as well as for aesthetic purposes.

State law also provides that preservation of open land is in the public interest and is to be encouraged. An organization was created to promote identified public interests and to encourage private gifts of money and property for the purpose of preserving natural, scenic, historic, scientific and recreational uses in the state. Statutes authorize the use of easements to maintain the character of open space lands and authorize the organization to accept gifts, such as easements if the gift is consistent with the state's objectives.

John and Mary are concerned about the future use of their land. They want to preserve its rural character and they want to prohibit industrial or commercial activities except those that can be conducted from the existing or permitted buildings. They also want to prohibit exploration for or extraction of subsurface materials as well as the alteration of the property's topography. John and Mary want to retain the right to divide the property into two parcels, the smallest of which is to be no less than 100 acres. One single-family home and associated outbuildings and roads may be constructed on each parcel. The existing home will be one of the homes as long as it remains standing. No structure can be built closer within 1,000 feet of the Lazy River. Management of the timber would be required to be conducted in accordance with sound forestry management practices, subject to the approval of the state. Conservation and management of the property would also include a natural habitat for wildlife. John and Mary are interested in making a qualified conservation contribution on their land. How will the requirements of Section 170 of the IRC apply to this situation? What benefit will Section 2031(c) offer John and Mary if their planned contribution qualifies for it?

Assuming that the organization to which the easement will be transferred meets the requirements of the Internal Revenue Code, the landowners will get an income tax deduction for the value of their contribution as determined by an appraisal by a qualified professional. Restricting the use of their land will also affect the property value of federal estate and state inheritance tax value. In the estate of the decedent, the Section 2031(c) opportunity to reduce the value of the restricted land may also be available. Details on the requirements to gain the income tax and estate tax deductions are further described in Chapter VIII.

Example 10: Evaluating Alternatives

Consider the following situation. Woody is 65 years old and his wife, Mary, is 62. They have two children and four grandchildren. Their combined net worth is \$5 million, \$4 million of the net worth consists of timberland owned by Woody and Mary as tenants by the entireties. Of the remaining assets, Woody owns \$600,000 in his name alone and Mary owns \$400,000. Woody and Mary have jointly decided that it is their goal to minimize the impact of federal estate and gift taxes on their estate. Neither of their children is interested in managing the timberland, but several of the grandchildren are interested in it. Two grandchildren are enrolled in forestry degree programs. All grandchildren are under the age of 21 at this point. Woody and Mary are willing to separate their joint ownership interest into two tenant in common interests which they will then transfer in any way that they care to, including to individual living trusts. What are some things that Woody and Mary can do to accomplish their objectives?

Alt. 1: Using living trusts and coordinating their provisions

- a) Each living trust provides that at the death of Woody (or Mary), assets that remain after the payment of all debts, expenses, taxes, fees, and costs will be divided among two trusts in amount that is equivalent to the exclusion equivalent to the unified credit and distributed to one of the trusts. Woody and Mary's children are the beneficiaries of the income from this trust. Following the death of both Woody and Mary, this trust is to be divided equally between the children if they survive at that time. However, if one or both of the children die before Woody and Mary pass away, any children or grandchildren of the deceased child who survive Woody and Mary will receive the share that their deceased parent/ grandparent would have received if they had survived Woody and Mary.
- b) The remaining portion of their property will be distributed to a second trust that is structured as a qualified terminal interest property trust (QTIP) for the benefit of Mary (or Woody in the case of Mary's trust). As a qualified terminable interest property trust, all of the income from this trust is to be paid to Mary (or Woody) quarterly for all long as they live. Upon the trustee exercising his discretion to act, the trust principal is available to Mary (or Woody) if it is needed to satisfy reasonable support and comfort during their lives. After the death of Mary (or Woody) the remaining principal in this trust will be divided equally among their children who survive them, or among the children and grandchildren of any of their children who predecease them. Under this plan, both exclusion equivalents have been sheltered, but considerable tax remains to be paid if death occurs before the exclusion equivalents rise because the trusts will only shelter the exclusion amount that is equivalent to the unified credit. As time goes on and the exemption equivalents rise, Mary and Woody can increase their separate property holdings to take advantage of the increases.

Could that result be improved? Without someone, other than Mary or Woody, who is interested and able to carry on the forest management business, special use valuation, the family-owned business deduction, and the installment payment arrangement are not available and would not offer an opportunity to lower the size of the taxable estate. Gifts to charities and gifts of

conservation easements would offer an opportunity to lower the size of the taxable estate of either Mary or Woody. Transferring the timber to a charity and retaining a lifetime annuity for Mary and Woody would allow both of them to gain additional income they can use to fund the purchase of insurance for the benefit of their children.

Alt. 2: Direct gifts to grandchildren; dealing with the generation skipping transfer tax

Should Woody and Mary consider distributing property to their grandchildren as some of them are interested in managing the forestland? An important consequence of doing this would be the generation skipping transfer tax (GSTT). But there are planning opportunities available to them there, also. One important feature is the GSTT exemption of \$1,100,000 available to each of them. Another technique is known as a “Reverse Q-TIP.” In this situation the original grantor of the trust transfers property to a trust that provides that all income is to be paid to the grantor’s spouse during the spouse’s lifetime. At the spouse’s death the property is to be transferred to the grantor’s grandchild and great-grandchildren. The grantor can elect to have the transfer qualify for marital deduction treatment as a Q-TIP trust, but also can elect to treat it as a “reverse Q-TIP” that will enable the grantor to consider the property as his own for purposes of the GSTT, particularly the authority to designate the property to which the grantor’s \$1 million GSTT exemption applies. An effective strategy to follow in regard to gifts to grandchildren and beyond is to take full advantage of this exemption and apply it to property that can be expected to appreciate in value.

Alt. 3: Charitable giving

Gifts to charities can also be applied in a situation like that which applies to Woody and Mary. This type of gift allows Mary and Woody to save several different types of tax, including income, estate, and gift taxes. Gifts to charities come in many different forms, i.e., charitable remainder trusts (interest of a designated beneficiary precedes the gift to the charity), or charitable lead trusts (where interest of the charity precedes interest of another designated beneficiary). Charitable remainder trusts can be one of three types: a remainder annuity trust (income from property is paid to designated beneficiary, remainder to the charity), a remainder unitrust (a fixed portion of the trust principal is paid to designated beneficiaries, remainder to charity), or a pooled income fund. A pooled income fund is an arrangement by which the donor contributes an irrevocable remainder interest in property to a public charity, retaining for himself an income interest for life. In such a fund, the property contributed is commingled by the charity with property transferred by other donors.

Gifts to charities can also be considered as charitable gift annuities. In such cases, a property owner transfers the property to a charity that agrees to pay the owner an annuity for life. This arrangement is designed to provide a benefit to the charity in the amount in excess of the value of the lifetime payments reserved for the beneficiary. Another variation is a qualified terminable interest property (Q-TIP) trust with a charitable remainder. This vehicle blends the benefits of the marital deduction with a charitable gift of the property after the surviving spouse passes on.

What is the best type of property to give to a charity? Since a gift to a charity will not be burdened with fears about the income tax consequences of selling “high value and low basis” property, gifting should consider highly appreciated property where part of the benefit is to save the capital gain tax. This helps to motivate owners to make these gifts to charities where avoiding the capital gain tax is significant. Is forest land a good candidate for a gift to a charity? Since a charity will sell the asset to raise cash to pay the retained benefit to the grantor, any attempt to maximize the timberland value could be lost. Would that matter to someone who has spent considerable time and effort managing the value of the forest land to gain its full potential?

Example 11: Forest and Estate Planning Pitfalls

The following cases illustrate outcomes if (1) you fail to plan, (2) a very simple plan is used, (3) a marital deduction formula is used, and (4) the estate values are balanced between you and your spouse with a marital deduction formula used by each. Initially, assume that one of the spouses holds full ownership to \$4 million of assets and dies in 2002. When the spouse dies, there are three other surviving children. The surviving spouse dies in 2002 without remarrying. There have been no taxable lifetime gift transfers. State law governs the actual distribution of the assets, but applies a generic solution for these examples under which the first \$100,000 and one-half of the remainder is transferred to the surviving spouse and whatever remains is transferred to children. The growth (income) from the assets is exactly consumed in the interim 10-year period, so that at the end of the period, the full principal amount remains intact. Amounts are rounded to the nearest thousand.

Case One - If a person dies without a will (unplanned estate in 2002), under the intestate law described above that person’s surviving spouse will inherit \$2,050,000, of the deceased spouse’s estate. The amount inherited by the spouse qualifies for the marital deduction which then leaves a taxable estate of \$1,950,000. The children will inherit the property remaining after the spouse’s share is determined. After the application of the exemption equivalent to the unified credit and state death tax credit, a federal estate tax of approximately \$295,000 would be due when the estate tax return is filed, no later than nine months after death. State inheritance taxes may also be imposed. In 2002, the surviving spouse’s estate is \$2,050,000. If the spouse’s estate remains at that level and the full exclusion equivalent amount under the unified credit is available, the spouse’s estate will be concerned with federal estate tax. Note, that \$1,000,000 of property could be sheltered by the surviving spouse. The remaining portion of the spouse’s estate will generate a net tax due of approximately \$300,000 at the spouse’s death. State inheritance may also be imposed.

Case Two - Consider the same situation but instead of an unplanned estate, the property owner executes a simple “I love you” will that gives all of the assets to the spouse. This decision results in no tax at the first death since the entire amount qualifies as a marital deduction. This plan improves on case one by deferring tax at the first death. It gives the spouse full access to the assets with opportunities to consume the funds or to plan for their eventual use and distribution. At the second death, however, there is a tax of approximately \$1.3 million on the \$4 million estate since there is no marital deduction available and the exclusion equivalent was wasted when the first person died. This levy will likely cause liquidity problems on most tree farms that

cannot take advantage of special use or qualified family owned business deductions. In comparison to case 1, this option results in greater financial security for the surviving spouse, but at greater tax cost.

Case Three - The third case involves dividing the assets between the spouses and uses a basic marital deduction formula in the will that makes the estate share going to the children at the owner's death equal to the amount shielded by the tax credit that remains available - \$1,000,000 in this case. It also uses the marital deduction to defer estate taxes on property that is directed to pass to the surviving spouse. This plan fully uses the tax credits at both deaths, defers tax at the first death, and offers the surviving spouse additional opportunities to plan. When the second spouse dies, approximately \$1.11 million in federal estate taxes would be due. The differences in the outcomes of cases two and three can be attributed to use of the exclusion equivalent and the lower tax rates being applied.

Case Four - Using the same example of a \$4,000,000 estate, the property owner decides to divide the value of the estates between the spouses such that each estate can be equalized with the other. When the first spouse dies in 2002, the net federal estate tax due on the decedent's \$2,000,000 estate after the exemption equivalent to unified credit and state death tax is calculated will be approximately \$295,000. State inheritance tax may also be applied. When the surviving spouse dies, a similar outcome could be expected. Directing that the exclusion equivalent to the unified credit and state death tax credit be placed in trust for the benefit of the surviving spouse but limiting the spouse's authority over the fund so that it does not become included in the spouse's estate will assure that the financial benefit is there if needed. Additional planning opportunities permit the survivor to explore special use valuation, a program of gifting, and other means for reducing the taxable estate below the amount that is sheltered by these provisions.

Chapter XIII

Let's Plan Your Estate

A. Overview and Purpose

After studying the previous lessons, you realize that estate planning is not a matter of just having a simple will prepared, although this may be all that is needed in some situations. To develop an estate plan, a complete analysis of family objectives, net worth, and income needs is necessary; after completing such an analysis, the estate planning tools discussed in this course can be chosen. Information also needs to be available to assist the executor in administering the estate.

A will may be the heart of the estate plan, but many things must be studied to determine what goes in the will. How large is the estate? How is property owned and who provided the major monetary consideration? How many children are in the family? Are there minor, physically handicapped, or retarded children? How much insurance is there and who owns it? Is there a business involved? Does the owner intend for family members to take it over? What will be incurred and what taxes will be imposed in settling the estate? Are there antiques or family heirlooms the owner wants specific family members to receive? This chapter will walk through the process of gathering information needed to evaluate the present situation and begin the planning process. Before doing the actual planning an owner needs to know more about personal objectives and assets. This chapter will pull together this information. There are no student exercises at the end of this chapter, but students are strongly encouraged to fill in the schedules and forms described in the chapter.

B. Lesson Objectives

When you have successfully completed this chapter you will be able to accomplish the following objectives:

1. Determine your personal and family objectives for an estate plan.
2. Inventory all of your assets and evaluate your ownership interest in them.
3. Evaluate the financial size of your estate.
4. Estimate the federal estate and Pennsylvania inheritance tax that would be applicable to your current estate.
5. Evaluate the income needs of your present family and potential survivors if one spouse should die and identify income sources to meet these income needs.

C. Determining Objectives

The first and most important step is to determine family objectives. The following is a partial listing of objectives. Check those that apply to your situation and add others that may not be listed. Make some notes that provide added details to each objective.

_____ Retirement security for parents during their lifetime.

_____ Guardianship for minor, physically handicapped, and retarded children.
(Name person to be guardian, plus other details.)

_____ Family heirlooms and antiques for the children.
(Detail what and to whom.)

_____ Turn business over to family members and have it continue into the future.
(Name individuals.)

_____ Provide for some gifts to children.

_____ Provide for some gifts to church or charity.

_____ Minimize estate expenses and taxes.

_____ Desire that each child be treated equally in the estate.

___ Desire that each child be treated fairly, but not necessarily equal.

___ Education for all children.

___ Achieve a conservation objective by limiting the future use or development of my land.

___ Other

D. Taking the Inventory

The second step in estate planning is to make a complete inventory of all property that will be subject to the plan. Do not forget antiques and heirlooms, insurance policies with named beneficiaries, personal property, and stocks and bonds. The ownership of property is an extremely important issue and should be carefully evaluated.

Some people have very complicated estates, while others have simple ones. The forms provided in this lesson are organized to permit a simplified analysis or a very detailed analysis of a family situation.

Form number 1 is a must for the attorney. It outlines briefly the family status and identifies key family members.

Form number 2 is a summary of the family assets and liabilities so the attorney or estate counselor knows your estate size. With this information, a rough estimate of federal tax obligations can be made. You may use Form 5 (six pages) to aid in summarizing assets and liabilities.

Form number 3 provides income and expense estimates. These are necessary to determine whether insurance or other assets are needed. It will influence whether and how trusts should be used. It will certainly influence a gifting program that parents are considering.

Form number 4 is designed to help the executor or heirs administer the estate. On this form list the location of important papers and the names of your professional advisors. If your attorney comes from a large city, he may be difficult to locate if your family does not know who you retained. If you used several banks, your money may lie there for years, if your executors are not aware of it.

Form number 5 entitled "estate evaluation" consists of six pages. These pages provide details on your assets and liabilities. You may or may not use all of these pages depending on how complicated your estate is and how much information your estate counselor or attorney needs. You should keep a completed set for your own information. It will be helpful in completing form number 2.

Keep in mind that your attorney or estate planning counselor needs complete details of your family situation to do an effective job of planning your estate. In addition, the forms are designed to assist you and your executor in managing your estate more effectively, thereby saving you time and money. Too often, a surviving spouse or family member named as an executor must spend hours searching for information needed to settle an estate. Does your family know what insurance you have or how many properties you own? What attorney do you want to handle your affairs? What stocks, bonds, or savings do you own? The inventory is your way of providing an accessible source of information that answers these important questions.

Contact information for people who helped me to develop my plan:

Name

Address

Estate Summary – Form 2

Assets - Personal	Gross Estate Values			
	Husband	Wife	Joint	Other
Bank Accounts				
Stocks and Mutual Funds				
Bonds				
Life Insurance				
Real Estate				
Automobiles				
Personal Property				
Retirement Account				
Other				
Business				
Real Estate				
Personal Property (machinery, livestock, etc.)				
Bank Accounts				
Receivables, Notes, Contracts, etc.				
Other				
Grand Total Assets				
Liabilities				
Mortgages and Contracts				
Chattels and Notes				
Insurance Loans				
Consumer Loans				
Accounts Payable				
Other				
Grand Total Liabilities				
Gross Estate				

Note: Form no. 5 (6 pages) is designed to provide more specific detail on your assets and liabilities. If you are having trouble completing this form, you may wish to complete form 5 first. There is some detail on form 5 that your attorney will need. This will apply especially to real estate on page 3 of form 5.

Income Information - Form 3

	Estimated Spendable Income	
	Current	Future
<u>Source</u>	<u>Husband & Wife</u>	<u>Surviving Spouse</u>
Salaries	\$ _____	\$ _____
Rentals	_____	_____
Retirement	_____	_____
Social Security	_____	_____
Business Net Income	_____	_____
Investments:		
Savings	_____	_____
Stocks and Mutual Funds	_____	_____
Bonds	_____	_____
Other	_____	_____
Annuities	_____	_____
Other	_____	_____
Total Annual Spendable Income	\$ _____	\$ _____

	Estimated Annual Expenditures	
	Current	Future
<u>Housing</u>	<u>Husband & Wife</u>	<u>Surviving Spouse</u>
Mortgage or Rent	\$ _____	\$ _____
Taxes	_____	_____
Insurance	_____	_____
Repairs	_____	_____
Utilities	_____	_____
Other - Furnishings, etc.	_____	_____
Food	_____	_____
Clothing	_____	_____
Taxes	_____	_____
Medical (Dr., Dental, Drugs, Hospital)	_____	_____
Transportation & Travel (Tips, Boats, Campers, Golf, Auto, Plane, etc.)	_____	_____
Insurance	_____	_____
Gifts and Contributions	_____	_____
Personal	_____	_____
Total Estimated Expense	\$ _____	_____

Estate Valuation (Page 1) - Form 5

A. ASSETS - Family Non-Business

Bank Accounts

<u>Type</u>	<u>Name of Bank</u>	<u>Address</u>	<u>Average Balance</u>			
			<u>Husband</u>	<u>Wife</u>	<u>Joint</u>	<u>Other</u>
Checking			\$	\$	\$	\$
Savings						
Total			\$	\$	\$	\$

Stocks and Mutual Funds

<u>Name</u>	<u>NO.</u>	<u>Year Purchased</u>	<u>Purchase Value</u>	<u>Current Value</u>			<u>Other</u>
				<u>Husband</u>	<u>Wife</u>	<u>Joint</u>	

TOTALS

Form 5 (Page 2)

BONDS

Type and Serial Number	NO.	Year Purchased	Purchase Price	Maturity Date	Current Value			
					Husband	Wife	Joint	Other

LIFE INSURANCE

Company	Policy No.	Insured	Owner	Beneficiary	Cash Value	Face Value
---------	------------	---------	-------	-------------	------------	------------

TOTAL - HUSBAND	XXXXXXXXXX	XXXXXXXX	XXXXXXXX	XXXXXXXXXXXXXXXXXX	\$	\$
TOTAL - WIFE	XXXXXXXXXX	XXXXXXXX	XXXXXXXX	XXXXXXXXXXXXXXXXXX	\$	\$

REAL PROPERTY (Not including business)

Description	Address	Date Acquired	Purchase Price	Improvements	Depreciation	Current Value			
						Husband	Wife	Joint	Other

RETIREMENT ACCOUNTS Keogh, IRA, Annuity, etc.

Type	Value in Account		Ownership	Husband	Wife	Joint	Other
	Company or Bank						
				\$	\$	\$	\$
TOTAL				\$	\$	\$	\$

Forms 5 (Page 3)

PERSONAL PROPERTY (not including business)

<u>Item</u>	<u>Description</u>	<u>Cost</u>	<u>Depreciation</u>			<u>Current Value</u>		
			<u>If Any</u>	<u>Husband</u>	<u>Wife</u>	<u>Joint</u>	<u>Other</u>	
Automobiles		\$	\$	\$	\$	\$	\$	
Home Furnishings								
Jewelry								
Collections								
Cash on Hand								
Other								
\$	\$	\$	\$	\$	\$	\$	TOTAL	

B. ASSETS - BUSINESS

REAL ESTATE

<u>Tract 1 - Location</u>	<u>Total</u>	<u>Forested</u>	<u>Cost Basis at Acquisition</u>		<u>Value of</u>
	<u>Acres</u>	<u>Acres</u>	<u>Land</u>	<u>Timber</u>	<u>Improvements</u>

<u>Tract 1 - Ownership</u>	<u>Date</u> <u>Acquired</u>	<u>How Acquired</u>			<u>How Owned</u>				<u>Current</u> <u>Value</u>
		<u>Purch.</u>	<u>Gift</u>	<u>Inheri.</u>	<u>Sole</u> <u>Prop.</u>	<u>Joint</u>	<u>Part.</u>	<u>Corp.</u>	

<u>Tract 2 - Location</u>	<u>Total</u>	<u>Forested</u>	<u>Cost Basis at Acquisition</u>		<u>Value of</u>
	<u>Acres</u>	<u>Acres</u>	<u>Land</u>	<u>Timber</u>	<u>Improvements</u>

<u>Tract 2 - Ownership</u>	<u>Date</u> <u>Acquired</u>	<u>How Acquired</u>			<u>How Owned</u>				<u>Current</u> <u>Value</u>
		<u>Purch.</u>	<u>Gift</u>	<u>Inheri.</u>	<u>Sole</u> <u>Prop.</u>	<u>Joint</u>	<u>Part.</u>	<u>Corp.</u>	

FORM 5 (page 4)

B. Assets - Business (Cont.)

<u>Tract 3 - Location</u>	<u>Total Acres</u>	<u>Forested Acres</u>	<u>Cost Basis at Acquisition</u>		<u>Value of Improvements</u>
			<u>Land</u>	<u>Timber</u>	

<u>Tract 3 - Ownership</u>	<u>Date Acquired</u>	<u>How Acquired</u>			<u>How Owned</u>			<u>Tenants in Common</u>	<u>Current Value</u>
		<u>Purch.</u>	<u>Gift</u>	<u>Inheri.</u>	<u>Sole Prop.</u>	<u>Joint</u>	<u>Part. Corp.</u>		

Business Personal Property

<u>Type</u>	<u>Owner(s) (Specify Corp. or Partnership)</u>	<u>Original Cost</u>	<u>Depreciation</u>	<u>Undepreciated Value</u>	<u>Current Market Value</u>
Machinery & Equip.		\$	\$	\$	\$

Trucks

Livestock

Inventories

Other

Business Bank Accounts

<u>Type</u>	<u>Name of Bank</u>	<u>Address</u>	<u>Sole Prop.</u>	<u>Partnership</u>	<u>Corporation</u>	<u>Other</u>
-------------	---------------------	----------------	-------------------	--------------------	--------------------	--------------

Checking

Saving

Total

FORM 5 (page 5)

C. Debts Owed You: Contracts, Mortgages, Notes, Accounts Receivable

<u>Type and Security</u>	<u>Debtor</u>	<u>Date Acquired</u>	<u>Original Value</u>	<u>Maturity Date</u>	<u>Unpaid Balance in Whose Name</u>			
					<u>Husband</u>	<u>Wife</u>	<u>Joint</u>	<u>Other</u>
\$	\$	\$	\$					
Total					\$	\$	\$	\$

D. Liabilities

**Mortgages & Contracts -
Real Estate**

<u>Property mortgaged</u>	<u>Name of Creditor</u>	<u>Date Due</u>	<u>Amount Due</u>			
			<u>Husband</u>	<u>Wife</u>	<u>Joint</u>	<u>Other</u>
	\$	\$	\$	\$		

Total

**Chattel Mortgages & Notes -
Personal Property**

Total

FORM 5 (page 6)

Insurance Loans

Total

Consumer Loans

Total

D. Liabilities (Cont.)

Accounts Payable

<u>Items</u>	<u>Name of Creditor</u>	<u>Date Due</u>	<u>Amount Due</u>			
			<u>Husband</u>	<u>Wife</u>	<u>Joint</u>	<u>Other</u>
Taxes, Real Estate			\$	\$	\$	\$
Taxes, Income						
Taxes, Estate						
Unsettled Claims						
TOTAL			\$	\$	\$	\$

Armed with these forms and your understanding of the issues involved in estate planning, you are now better equipped to make the important decisions that lie ahead of you as you plan. Good luck to you as you proceed!