Securing Your Legacy on the Land:

Planning Considerations When Transferring Your Property

Succession Planning: Part 4 of 5

A Q&A with Howard Weiss, Bank of America

By Hallie Mahowald

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This is the fourth in a series of question and answer sessions focused on succession planning between Western Landowners Alliance and Howard Weiss of Bank of America.

Howard Weiss is a Senior Vice President and Family Office Strategist at Bank of America, specializing in the family office and private foundation markets. He advises clients on how to establish and run family offices and also provides strategic advice to wealthy families in the areas of investment policy, wealth transfer, business succession planning, philanthropic management and family governance. In the area of private foundations, he assists clients with governance, investment policies and grant making. He is a member of the board of directors of the Morris Goldseker Foundation of Maryland and the Mary and Daniel Loughran Foundation in Washington, D.C. Weiss has published two books on wealth management: The Philanthropic Executive–Establishing a Charitable Plan for Individuals and Businesses and The 100-Year Wealth Management Plan. Weiss holds an MBA from the Wharton School of the University of Pennsylvania and a Bachelor of Science degree from the Ohio State University. He is also a Certified Financial Planner and holds a Master of Science Degree in Financial Planning from the College for Financial Planning.

He shared his expertise on succession planning with Hallie Mahowald of Western Landowners Alliance in this fourth of a five-part Q&A series.[1]

How does one begin the task of planning for the transfer of a family business, real estate and farm or ranch?

Right up-front, the business owners/land owners should define, as specifically as possible, the objectives they wish to achieve. It's likely one will have multiple objectives when transferring a business such as a ranch or farm. Here are examples of some common goals and objectives:

- Retaining ownership control within the family even if external operating managers are hired
- Minimizing wealth transfer taxes
- Ensuring adequate estate liquidity
- Avoiding costly probate
- Staged transfer or sale
- Life income for surviving spouse
- Fulfilling charitable intentions
- Achieving asset protection
- Maintaining family privacy
- Treating all heirs equitably

Realizing that you are not in a position to offer anyone specific tax advice, can you still convey some of the issues and concepts one's tax advisor will bring up at one

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time or another? In other words, can the reader start preparing to think about some of the decisions they will face?

Certainly. There are two primary decision points and then there is a range of other concepts to consider. The first primary decision point is balancing among testamentary transfers, lifetime transfers and asset freeze techniques. Testamentary transfers take place at death and are usually governed through a person's will or terms of a trust. Lifetime transfers take place during one's life and involve gifts, either directly to your heirs or to a trust. Asset freeze techniques can involve gifts in trust as well, but frequently occur around intra-family sales to individuals or to trusts. The value of the transferred property, for estate tax purposes, is fixed or frozen at the time of the transaction. The second decision point is derived from the first and involves the degree of lifetime control over one's property versus the family's overall tax savings to be achieved through wealth transfer techniques. The key issue here is that when you transfer property to your heirs, any further appreciation accrues to them and is not part of your estate. As a result, the family overall will save on wealth transfer taxes. The offset, however, is that you give up control over the property transferred.

As mentioned, there are also several other things the business owner/landowner might want to know before embarking on a wealth transfer plan.

- The tax code contains some important numbers, which greatly impact one's planning. First, there is an $11.58 million lifetime estate and gift tax exemption for individuals, meaning that a married couple can leave $23.16 million to their heirs before it is subject to federal estate tax. Another aspect of the exemption is the concept of portability, where a surviving spouse can inherit or absorb any unused exemption of their deceased spouse. There is also an $11.58 million exemption that applies to generation-skipping transfers, where one transfers property to a beneficiary who is at least 37 ½ years younger than the donor. This tax is levied on such generation-skipping transfers in excess of $11.58 million. The tax is to prevent people from transferring a lot of assets to grandchildren and others so as to skip a generation from paying estate tax. A second key number is the annual gift tax exemption of $15,000, whereby individuals can transfer assets up to that amount annually without being subject to gift tax. A married couple can therefore transfer up to $30,000 annually to any one individual. I should mention that the current tax law sunsets in 2026 unless extended by Congress or made permanent.
- Using the above numbers, one has to decide the extent to which you want to transfer property during your lifetime versus at death. This is important since property gifted will require the recipient to maintain your present cost basis of the transferred property. As a result, should your heirs sell the gifted property, their capital gain would be based on the cost basis of the transferor, when the property was transferred. On the other hand, when property is inherited, there is a step-up in cost basis to its current value at the time of the transfer. Any future capital gains tax exposure would be based on the value when the property was inherited. There are several considerations that go into the decision related to timing of asset transfers, and one's attorney can properly advise as to the appropriate strategy for one's family.
- With the 2017 Tax Cuts and Jobs Act , many family farms and ranches are now beyond the reach of the estate tax, but that does not eliminate the need for efficient transfer strategies. Your attorney will still need to guide you as to the timing and benefits of lifetime versus testamentary transfers and the different methods to accomplish each.

- At the same time, gifting or inheriting assets is not the only way to transfer wealth. Frequently, wealth is conveyed through intra-family sales, particularly for family businesses, as not every family member may be engaged in managing or owning the business.
- Ensuring that your estate will have adequate liquidity is another issue, regardless of size. Even if taxes are not a key issue, you may want to equalize family distributions to heirs who may not be operating and owning the farm or ranch. This can bring up the need for life insurance as a funding vehicle. Insurance is sometimes needed to fund family buy-outs.
- If your total estate exceeds the $11.58 or $23.16 million combined exemptions, then you may need to exercise some of the more advanced wealth transfer techniques. Your attorney will also advise on some of the relief provisions in the tax code to pay estate taxes on a deferred basis and some of the breaks in valuation.
- More specifically, your attorney will also want you to arrive at a fair valuation for your property. Assuming the ranch is a significant percentage of your estate, stays in the family as an operating ranch and meets the various IRS qualifications, you are permitted to value it as a ranch and not as to its development potential. This is spelled- out in Section 2032A of the Internal Revenue Code.
- For substantial estates that are subject to estate tax and meet certain Internal Revenue Code requirements, tax payments can be deferred for 5 years with 4 annual payments of interest only. This can then be followed by paying the balance in up to 10 years of principal and interest. Again, landowners should consult their attorney regarding the requirements to take advantage of this feature when it could apply.

Let's first talk about just transferring one's property at death. What are some of the ways this is accomplished? Assume in this case, there will be a surviving spouse and children.

There is a wide range of options which will be influenced by who will be the succeeding manager and the other elements of a family's estate planning. I will try to simplify it and break it out into some component parts based on different scenarios.

If husband and wife jointly own the ranch or farm and the survivor will continue to manage and own the property, they could own it as joint tenants with right of survivorship or tenancy by the entirety in states that allow this. The property would then pass immediately to the survivor without passing through probate. Certain states may have community property laws that govern ownership between spouses. Another strategy is to employ a marital trust structure whereby the property is transferred to a trust for the benefit of the surviving spouse. The property receives a step-up in basis so income taxes upon a future sale will be mitigated. At the death of the surviving spouse, estate taxes would be due to the extent the survivor's estate is subject to any estate tax. A version of the marital trust is to attach a QTIP (qualified terminable interest property) provision, whereby the surviving spouse is entitled to all of the income but does not have the power to appoint (dispose of) the property at his or her death. Instead, the first spouse is able to do that within the terms of the trust. This technique is commonly used for second marriage situations and where the family is trying to restrict the wealth to the children and heirs of the first marriage. Another feature of marital trust planning is to have a bypass trust whereby you place some or all of the estate tax exemption equivalent

into a separate trust, which can then pass tax free upon the death of the surviving spouse. Your attorney, of course, can guide you through this process.

Another scenario is where one or more, but not all, of your children will inherit and operate the property. To be fair to all of your heirs, you may establish a buy-sell agreement at a stipulated price with the proceeds going into your estate to be further distributed. The sale could be outright or on an installment basis. Sometimes this sale is funded through a life insurance policy. A variation of this scenario is where one child may have a majority interest and manage the property with siblings owning minority interests in the farm or ranch. In this case, you would likely require a means of equalizing the amounts of your estate to compensate the non-operating family members.

Let's assume that one would like to begin transferring ownership to the next generation during their lifetime. What are some efficient ways this can be accomplished?

One would first need to make sure the property is titled in the right form. In our Part 3 discussion on Alternative Ownership Structures, we reviewed a number of options for owning and titling property. Let's assume you select the LLC (limited liability company) form, which provides you with marketability and liquidity discounting capabilities. You can also retain operating control by being the managing member and the operating agreement can restrict the ownership. An advantage of this form is that you can gift units to your heirs during your lifetime. The true amount gifted is likely to be less than the actual transfer for gift tax valuation, since the units are discounted. As an example, assume you are able to obtain a valuation discount of 30%. If you transfer $10,000 of value, you are only claiming a $7,000 gift. Moreover, spouses can combine gifts. As each person has a $15,000 annual exclusion on gifts, husband and wife can transfer $15,000 individually and $30,000 collectively of gift tax value to any individual. This technique is an efficient way to transfer ownership among a wide range of family members including children and grandchildren, assuming that is your goal.

A second way to transfer assets during lifetime is to go beyond the $15,000 annual gift tax exclusion and use some of your $11.58 million lifetime exemption. Essentially, you can transfer that amount during lifetime or at death. Some wealthy individuals like to utilize this lifetime option in case the tax laws change in the future.

A third way some individuals conduct lifetime transfers is to set up a family descendants or dynasty trust. One needs to consult with expert estate planning counsel for the legal particulars, but here is a quick overview. One would initially transfer property or funds to a trust, which is designed to last through several generations or in some states, it can last in perpetuity if that is one's intention. Note, the amount transferred is subject to gift tax if you have used up your lifetime exemption. You can also apply some or all of your GST (generation skipping tax) to the trust. The assets transferred will not be part of your estate. Individuals frequently establish the trust as a "grantor trust", where they pay the income tax on the trust's earnings. This is another way to transfer wealth among the family. One type of transaction these trusts could then engage in, is to purchase assets from the family, such as the family farm or ranch. This is frequently accomplished by selling the property on an installment basis for some cash or even no upfront cash, and a promissory note. Installment payments would then be made on an agreed schedule. Each payment would include principal, interest and a pro-rata capital gain component. This technique is used predominantly by wealthier families who would otherwise

be subject to considerable estate taxes throughout the generations. A sale is also a good way to replenish the parents' estate so that they are better able to equalize their estate among all of their heirs, particularly those not involved in managing a family business. It can also be part of a retirement plan.

Should the landowners wish to keep the property in the family but only some of their heirs will live on and manage it, what problems can that cause for the remaining heirs and what are some strategies to resolve these?

That is or could be the biggest issue facing first generation ranch and farm owners. First, even if the property is owned equally by all of your heirs, those who do not manage it may not wish to retain it. They could make the claim that if they sold and reinvested the proceeds, they could achieve a higher level of income and even growth. This is especially so if the farm and ranch does not generate a substantial amount of cash flow. A second issue is when the surviving spouse does not operate the ranch or farm and requires a source of income beyond the property. As such, the estate needs to have assets well beyond the property with adequate liquidity overall. Such assets could include a marketable securities portfolio, retirement plans or annuities. Social Security, of course, would kick in at some point. The family's liquidity could also be augmented and funded by life insurance. Still other sources of income might be rental properties. These additional assets and investments can then be a source of distribution to those heirs who may not inherit the ranch, so as to equalize the estate going to all parties. I should also mention that if the taxpayer is going to be subject to estate tax, he or she should make sure that the insurance policy is not owned by the decedent or his/her estate; otherwise, it could be subject to estate tax. Many families establish a separate life insurance trust to own the insurance policy. Proceeds are then paid to the trust and the trustee can use those funds to provide liquidity to the estate and be available for distribution to the surviving family members. The important element with insurance planning is to make sure the decedent is not the owner because if he/she is the owner, the proceeds become part of the taxable estate. If the policy is not owned by the decedent and by a trust for example, it is considered to be outside the taxable estate.

You mentioned earlier that one can also employ asset-freeze techniques when transferring property. Can you give us some examples of those?

Installment Sales. The most straight-forward asset-freeze technique is to engage in an installment sale during one's lifetime. With an intra-family installment sale, each payment would include interest, capital gain and return of capital. There is a variation of the straight installment sale which entails a self-cancelling note (SCIN) upon the death of the seller. There are estate and income tax ramifications of a straight versus self-cancelling note, on which your attorney can properly advise. An installment sale carries some important benefits including the following:

- The price is fixed at inception with any future appreciation accruing to the buyer or heirs.
- The asset is removed from your estate and is replaced by the installment note at the fixed sale value.
- One's capital gain is spread over a number of years.

- At death, the present value of installments due is included in one's estate; however, if there is a SCIN, the note is not included in one's estate as the remaining amounts due will not have to be paid. However, any remaining capital gain is taxable income on the decedent's final 1040.

Grantor Retained Annuity Trust. A second technique is a grantor retained annuity trust (GRAT). Here one places assets into a grantor trust (where the grantor pays the income tax) for a designated term. One receives an annual annuity payment for the term of the trust and the beneficiary receives the principal remaining in the trust at maturity. Here are some of the key features and benefits of the GRAT:

- Generally, one would gift LLC or FLP (family limited partnership) units to the GRAT as units are easily transferable.
- One should only do this transaction with property one would expect to appreciate in value.
- Should the grantor pass away during the term of the GRAT, the remaining payments are brought back to his/her estate. Therefore, for it to work, one needs to outlive the term of the trust.
- When established, there is a gift tax on the present value of the remainder interest but it can be structured in ways to minimize this exposure by varying the annuity payment and the term. The present value of the remainder interest uses a discount rate authorized by the IRS and it publishes updated interest rates monthly.
- As such, each GRAT consists of the present value of the annual annuity payments and the present value of the remainder interest. Accordingly, to the extent the assets appreciate beyond their expected valuation, this appreciation accrues to the beneficiary.

Sale to An Intentionally Defective Grantor Trust. A third technique is commonly used by wealthy families that have established dynasty trusts as we discussed earlier. By definition, when one establishes a trust, it retains a certain status related to estate tax and income tax inclusion. For example, the trust will not be included in the grantor's estate so long as he or she did not have any incidents of ownership such as the ability to receive lifetime income or the right to possession of the property. As for income taxes, there is also a set of requirements to have the trust as the income tax payer. Some of these involve the creator retaining one or more powers over the trust that will make the income taxable to him or her. A common retained power is the ability to substitute or swap assets within the trust. To summarize, the tax code delineates certain retained powers that would either cause the trust's assets to be included in the creator's estate or cause the trust's income to be paid by the grantor or creator. Frequently, the creator may wish to continue paying the income taxes so long as the assets can be moved out of his or her estate. Therefore, a trust can be defective for transferring the income tax liability but not for estate tax purposes. Hence, we have the term intentionally defective grantor trust. Some of the attributes of this technique are as follows:

One would first establish a family dynasty trust, which would be in the form of a defective grantor trust. As mentioned, the assets in this trust are excluded from one's estate, but the income earned is taxable.

One would contribute an initial gift to the trust and many practitioners suggest this should be around 10% of the value of an impending asset sale to the trust. This initial gift is subject to the gift tax laws but one can use some of one's lifetime and GST exemptions to cover it.

One then sells the asset (e.g., real estate, farm or ranch) to the trust in exchange for a promissory note at the IRS's Applicable Federal Rate (AFR). These rates are published by the IRS monthly.
Frequently the asset is in the form of LLC units which carry a discounted valuation for liquidity and marketability.
To the extent the appreciation on the property exceeds the AFR, wealth is transferred estate tax-free to the trust and its beneficiaries, keeping in mind the note has to be repaid over time.

Needless to say, this technique involves a number of tax rules and regulations so readers should consult with their appropriate tax advisors. It is beyond the scope of our discussion to get into all of the relevant tax rules and nuances. Of particular importance are the range of retained powers mentioned above.

Partnership Freeze. Yet another technique that features some of the concepts of the grantor retained annuity trust and the sale to an intentionally defective grantor trust is called a partnership freeze. This also features some general aspects of a business structure with preferred and common interests within an LLC. The details of this strategy go beyond the scope of our discussion, but it is something you can explore with your tax advisors. The technique is frequently used by real estate owners.

I have one final comment before leaving this topic. A low interest rate environment is ideal for structuring intra-family sales, GRATs and sales to defective trusts. Low rates are obviously great for the buyer in an installment sale, but it also provides a low hurdle rate for GRATs and sales to defective grantor trusts.

Our final question involves revocable trusts. Revocable trusts appear to be popular among some investors and landowners. Can you summarize why someone establishes these and what advantages they provide?

As the name implies, this is a trust one establishes during lifetime and can be revoked. There is a trustee and one can serve as one's own trustee if one wishes. The assets distribute upon death in accordance with the provisions of the trust and bypass the probate process. The trust, however, is included in one's taxable estate. The income is also taxed to the grantor. Here are some of the key features and benefits of revocable trusts:

Many people like the revocable trust because it provides the family with privacy. Unlike a probate proceeding which is public, the affairs of a revocable trust remain private.
Another key feature is that a revocable trust can contain a provision that deals with incapacity whereby a designated trustee can succeed should one become disabled or incapacitated.
One should also know that this type of trust does not offer creditor protection for the family as other trusts may.
Finally, it is sometimes beneficial to put real estate owned in another state into this type of vehicle so as to avoid an ancillary probate proceeding.

Any final thoughts or information you want to share to sum up the most important considerations for landowners when it comes to transferring one's property?

Even though more families will now escape federal estate taxation with the passage of the 2017 Tax Cuts and Jobs Act, transferring wealth still requires considerable planning and it is

possible we will see some of the attractive components of this Act reversed in the future. Nevertheless, these are some of the key takeaways:

- Carefully prioritize your important objectives, whether they are to avoid probate expenses, equalize your estate among heirs or provide an income stream for your surviving spouse.
- Decide the extent to which you want to transfer your property during your lifetime or at death.
- With the advice of your tax counsel, determine how best to structure the ownership of your farm or ranch. It could even involve two levels of ownership. For example, the property could be owned through a limited liability company, which in turn, could be owned by a trust.
- Do you want the ranch ownership shared among family members, including those not involved in the operation of the business? If not, how will you equalize things within the family?
- Understand your estate liquidity risks, and determine the need for and the role of life insurance, especially if you are able to obtain it at an attractive cost.
- Keep in mind you can not only gift property to the next generation, but can also structure intra-family installment sales.
- Where you have trusts, you also have to consider naming trustees and have a process for installing successor trustees. Additionally, you should consider how many trustees you need and their make-up among family, professionals and corporate trustees.
- Wealthy landowners with estates beyond $25 million, are able explore advanced techniques that enable one to efficiently transfer property among generations. Your estate and tax advisor can guide you through this process, incorporating some of the concepts discussed earlier.

Howard M. Weiss

Senior Vice President and Family Office Strategist
Philanthropic and Family Office Group

howard.weiss@bankofamerica.com
239-254-3289 (o)
410-960-5025 (m)

If you have additional questions around succession planning that you would like to see answered in an upcoming session, please contact Hallie Mahowald: Hallie@westernlandowners.org.

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