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# Estate Planning Tools For Farm Corporation Owners

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Regardless of how a farm business is organized--as a sole proprietorship, partnership, or a corporation--it is possible to develop a sound estate plan. However, studies indicate that the number one reason farmers incorporate is to accomplish estate planning objectives. Incorporating a farm business does not, in and of itself, solve the estate planning problem. The reason for the popularity of incorporating is that it offers a collection of attributes that may make it easier to accomplish estate planning objectives.

The estate planning advantages of corporations can be particularly attractive for a farm business where family members have decided to continue the farm as an operating unit beyond the retirement of the present owners. With proper planning, the corporate structure can be used in reserving resources for retirement, transferring property to family members, and minimizing expenses and death taxes while transferring property.

As capital needs for farming have grown, it has made it more difficult for the younger generation to start out farming on their own. As a result, there is increased desire by the younger generation to enter into the ownership and management of their parent's business rather than starting their own operation. However, the older generation normally does not want to sell the farm assets to the younger generation all at once and the younger generation cannot afford to purchase the farm assets. They would rather transfer them gradually. Therefore, there is a need for multi-ownership of the business, whereby the younger generation can gradually ease into the ownership and management of the farm business while the older generation gradually withdraws.

The following discussion covers some of the most common estate planning tools used with corporate farm ownership. In addition to these tools, estate planning tools common to all business organizations, such as jointly held property, trusts, and wills, can also be used.

## Use of Gifts

Of all the costs associated with the transfer of farm property from one generation to the next, federal estate and gift taxes usually have the greatest impact on large estates. Transfer of corporate stock by gift is one way of minimizing federal estate taxes. Federal gift tax laws allow a person to make $10,000 of outright gifts to each receiver each year without paying gift taxes, so long as they involve a present interest in the property given. The gift tax annual exclusion can be doubled to $20,000 if the gifts are made by a husband and wife to third persons, even though only one owned the property. A gift of a future interest in property does not qualify for the annual gift tax exclusion. A future interest is a gift where the recipient will not use, possess or enjoy the gift until some future date. The future interest exception to the annual exclusion is prompted by the belief that a gift of a future interest is more like a testamentary distribution of property than a current gift.

Corporate stock can be issued in convenient denominations such as $10, $100 or $1,000 per share to take advantage of the annual gift tax exclusion. Thus, incorporation may allow a major shareholder to transfer, tax-free, an ownership interest in the farm operation to the shareholder's children in order to reduce the value of the estate subject to estate tax.

Another advantage of making lifetime gifts is that they are valued at the time they are made. If appreciating assets such as land are held until death, the value of the asset will have increased, causing an increased estate tax liability. Thus, in an inflationary economy, it is likely that the taxable values of most farm assets may be lower today than in the future.

Lifetime transfers of corporate stock are more consistent with the retirement security and estate planning objectives than are direct gifts of assets used in the farm business. Parents who are sole or co-owners of property may be reluctant to make gifts of land, livestock, or machinery to children in order to achieve death tax savings. The potential loss of control is the single most important factor contributing to this reluctance. Also, the available collateral for farm loans is reduced when property is given away. If the parents give away a percentage interest in the farm to the children, it is necessary for the children to sign loan documents when using that property as collateral.

However, lifetime gifts of corporate stock do not result in a loss of control over assets essential to the economics of the farm business. Instead of specific assets being transferred, a portion of the entire farm business can be transferred. As long as the parents retain voting control, they can be assured of continued employment as officers of the corporation and control over corporate management. Possibly even more stock could be given away if part of the stock were nonvoting. In addition, reasonable restrictions, such as a first option to buy or a buy-sell agreement, can be placed on the retransfer of stock by individuals receiving stock by gift. All these factors help to ease any concerns the parents may have over retirement security. The farm can continue to be operated as a unit and the parents can gradually retire from the farm by gradually transferring ownership to the children as they share in the management and operation of the business.

Gifts of stock in a farm corporation aren't always the perfect estate planning tool. They sometimes have disadvantages, as well. Some recent cases have

treated gifts of stock in corporations with a history of no dividend declaration and highly restrictive stock transfer provisions to be gifts of future interests and hence not eligible for the federal gift tax annual exclusion. For that reason, it would seem wise to maintain a record of some dividend declarations and to examine carefully stock transfer provisions that restrict stock transfer under specified circumstances.

Annual gifts of corporate stock are an advantage for estate planning. However, in these inflationary times, gift programs involving transfers of stock under the federal gift tax annual exclusion may not be able to play as large a role in the intergenerational transfer of a farm corporation as you might think.

Let's take a $1 million estate as an example. If it is assumed that all assets are in the corporation, it is likely that the value of the corporate assets will increase 8-10% per year from inflation alone. This increase in the value of stock would most likely stem from an increase in land values. Thus, the value of the corporation could increase $80,000-$100,000 per year from inflation alone. In addition, there will be a yearly increase in the value of the corporate stock from annual corporate earnings. That is, all the earnings would not be paid out in the form of dividends, bonuses, salaries, interest payments and other business expenses. Therefore, the annual increase in the value of stock would likely be even greater than $80,000-$100,000.

Thus, it takes a big family just to give away (tax-free) the annual increase in value from inflation and retained earnings for a large estate. If the stock weren't discounted, it becomes even harder. In addition, there is also the danger that the gifts will be declared a future interest and hence not be eligible for the federal gift tax annual exclusion.

This discussion does not infer that parents should not make use of a yearly gift program as part of their estate plan. It is still a useful estate planning tool that should be used. However, you should recognize that other tools must also be used if you wish to either reduce or stabilize the value of the parent's estate.

## Discounting of Minority Stock

Another potential advantage of transferring of corporate stock involves the possibility of a "discounting" of minority holdings of stock for gift and sales valuation purposes. Such a "discounting" means that a minority stock interest is valued at a lower figure than the average value per share based upon the value of the underlying corporate assets. This would allow a larger portion of the donor's estate to be transferred within the gift tax exemption than if the corporate assets themselves had been given away.

Not only may estate taxes be saved by transferring ownership of a donor's stock, but also the donor's property may be reduced in value for estate tax purposes. Thus, if stock in a family farm corporation is given away to the point where the donor no longer retains operating control, the stock that remains in the donor's hands may very well be discounted in value in relationship to the market value of the underlying assets, for estate tax purposes in his or her estate.

However, minority holdings of corporate stock in closely-held family corporations may not always be discounted for gift and estate tax purposes. In some cases, the stock holding of the donor-testator is valued upward not only by reason of the donor's control, but because of family group control of other stock in the corporation. This argument appears to have been accepted only in a few unusual situations.

## Combinations of Common Stock and Debt Securities

At the time of incorporation, it is possible to issue both common stock and debt securities in the form of notes, bonds, or debentures in exchange for the parents' property that is transferred to the corporation in a tax free manner. The use of debt securities can help accomplish some of the following common estate planning objectives of farm families. These include:

1) Provide an assured retirement income for the parents in the form of investment income rather than earned income. For persons over 65 years of age, investment income is very advantageous because it is not subject to the self employment tax and it does not affect social security benefits.

2) Debt securities reduce the value of the common stock and the investment needed by farm heirs to gain voting control over the corporation. Consequently, they can probably gain majority control over the corporation in a shorter time period.

3) Provide a tax deductible means through interest expense for removal of loan earnings from the corporation. The debt security holders are taxed on interest earnings from the corporation, but are not taxed for the return of the loan principal.

4) Part of the estate value of the parents is fixed (that part which consists of debt securities). This is especially helpful if farmland or other appreciating assets are in the corporation.

5) Creates another estate planning alternative for parents--they can give off-farm heirs debt securities rather than shares of stock in the corporation. This should please (1) off-farm heirs who normally prefer the certainty of income associated with debt securities over the risks of stock ownership, and (2) farm heirs who usually have a desire to keep stock ownership entirely in their hands rather than letting it go to outside interests.

6) Achieves the objectives of multi-class stock arrangements while still preserving Subchapter S election eligibility.

There may be somewhat of a danger in using combinations of common stock and debt securities in Subchapter S corporations. The position has been taken by tax authorities that if an instrument purporting to be a debt obligation had many of the characteristics of equity capital, it might be considered a second class of stock--thus disqualifying the corporation for the Subchapter S election.

There is also a danger in using combinations of common stock and debt securities in regular corporations. It is possible that tax authorities will contend that a debt obligation is really an equity interest if it has too many features of stock. If the debt instrument is treated as a form of stock, principal and interest payments will be considered dividends --which, of course, will result in double taxation.

Debt securities in addition to yearly gifts are a possible way to "cap" the value of the parent's estate at its current value. Again, let's consider our $1 million estate. Assume that the parents own all the farm property and incorporate the farm business, taking in exchange $300,000 worth of debentures with a 10% rate of interest and 20 year maturity, plus $700,000 worth of common stock.

Does this plan stabilize the estate value for the parents? Yes, if you assume that the parents spend the $30,000 yearly interest payment, so that it doesn't further increase their estate, and make gifts of stock to their heirs for the remaining increase in stock appreciation.

However, in order to "cap" the parents estate under this plan there was a $30,000 withdrawal of interest payments from the corporation. This $30,000 ended up in the parent's hands and it was assumed that they spent it. In other words, the corporation itself sacri-

ficed $30,000 to go to the parents that instead could have been used for some other purpose such as further investment or an increase in stockholder-employee salaries. If the assumptions were changed and the parents didn't spend the $30,000 and they died that year--their estate would have increased in value by the savings.

Thus, there's really no magic involved. In fact, this plan is similar to an actual sale. Assume that at the time of incorporation, the parents left out a $300,000 parcel of farmland and sold it on a land contract to the children for 10% interest and a balloon payment in 20 years. Under such a plan, there still must be a yearly withdrawal of $30,000 from the business and it goes to the parents. The increase in value of the $300,000 parcel of land goes to the children.

## Two Classes of Stock

Another estate planning tool for the corporation is two classes of stock whereby the property value is essentially fixed at current values on all shares owned by the older generation, even though their death may come years later. This is especially attractive to farmers with a large net worth consisting mainly of appreciating property and /or substantial annual corporate earnings.

Such a plan involves the use of the two types of stock--common and preferred. The main difference between them is that preferred shareholders are entitled to certain preferences over the common shareholders. Generally, they enjoy the right to receive dividends at a specified rate before any dividends can be distributed to the common shareholders. The preferred shareholders are also given a preference over the holders of common stock to assets of the corporation upon liquidation. The common shareholders share in any assets that remain after payment of the creditors.

Basically, the plan requires the donor parents to make gifts of the common stock while retaining the preferred share. The preferred stock should include a dividend preference, a liquidation preference, and be subject to redemption at a fixed price. This freezes the maximum value of the preferred stock at its redemption price and liquidation preference, and all corporate asset growth is channeled to the common stock.

If all common stock is owned by the younger generation, all preferred stock is owned by the older generation, and the normal order of death occurs, the result is that the older generation will have a smaller estate tax liability than if they shared in or realized all of the increase in asset value.

However, even though this technique provides some real opportunities for estate tax savings, it should be noted that it involves a very complex area of tax law that is open to varying interpretations. Whether or not the plan actually limits the capital appreciation of preferred stock will probably not be known until the stock is valued at death for estate tax purposes.

In order to satisfy the tax authorities, dividends will probably have to be paid on the preferred stock. Of course, dividends are paid out of corporate after-tax earnings and are subject to taxation when received by the stockholders.

Thus, the corporation faces somewhat the same situation as it did when debt securities were used. There is a yearly withdrawal from the business (dividends) and it goes to the parents. If the parents don't spend the dividend money, their estate value will increase.

## Corporate Buy-Sell Agreements

Corporate buy-sell agreements are often used to help transfer ownership of the farm corporation from one generation to the next. Such an agreement can also establish a market for the stock if a shareholder ever desires to withdraw from the corporation during his lifetime. This is accomplished by requiring the shareholder to offer his stock to the remaining shareholders or to the corporation itself at some stipulated price. This insures that nonfamily members are kept out of the family business.

A corporate buy-sell agreement is a contract whereby the corporation and/ or a shareholder(s) promises to buy the stock, and the shareholder promises to sell, upon the happening of a specified event. Usually this event is the shareholder's death. However, there might also be provisions for sale upon the disability or retirement of one of the shareholders. Or the event may be simply a shareholder's desire to withdraw from the corporation. It is also possible that the buy-sell agreement may be merely an option to purchase upon the happening of some specified event.

In addition, the contract-agreement normally specifies either an actual purchase price or else a procedure or formula that must be followed in determining the price. One commonly used procedure is to require either the Board of Directors or else all the shareholders to get together each year to set a price at which all parties would be willing to buy or sell their stock during the subsequent 12-month period. Also the terms under which payment will be made may be specified. For example, the purchase price could be paid in cash or else in installments over a period of several months or years at a specified rate of interest.

A corporate buy-sell agreement offers several estate planning advantages. The agreement can offer an immediate market for the shares of stock in a stockholder's estate. Also, if the agreement calls for an immediate cash payment in exchange for the stock upon the death of a stockholder--it can be an important source of liquid funds to pay estate taxes and other estate settlement costs for the decedent's estate. If the price in the agreement has been updated yearly, there is a chance that this price will be adopted for estate tax valuation purposes.

Finally, an agreement eliminates the risk of the corporation being barred from a Subchapter S election because a nonconsenting stockholder became a stockholder in the corporation.

There are 3 different types of buy-sell agreements.

**a) Cross Purchase Plan**--This is an agreement by two or more stockholders whereby in case of death or withdrawal the other stockholders agree to purchase the stock. For example, assume a farm corporation has two stockholders, Joe and Pete who are also brothers. Joe and Pete each agree that, upon his death, his estate must sell his stock holdings and the survivor must purchase the stock from the decedent's estate.

This type of agreement is relatively simple and quite useful when the number of stockholders is small. However, it can become quite complicated when there are many stockholders.

**b) Stock Redemption Agreement**--Under this agreement, the corporation itself agrees to buy (redeem) all of the decedent's stock rather than having each of the remaining stockholders purchase a portion of the decedent's stock as is done in cross purchase agreements. For example, assume Pine Valley Farms Inc. has two stockholders, Joe and Pete. Pine Valley Farms Inc. agrees to buy the shares of the first stockholder to die. In turn, Joe and Pete each agree that his estate will sell or tender for redemption the shares he owns.

**c) Combination or Hybrid Agreement**--This type of agreement combines

the advantages and disadvantages of both a cross purchase agreement and a redemption agreement when the situation necessitates such an arrangement. As an example, assume Pine Valley Farms has two shareholders-Joe and Pete-- each owning 1,000 shares of stock. There could be a cross purchase agreement for 550 shares of stock and a stock redemption agreement for the remaining 450.

A key to any type of buy-sell agreement is the method of funding. If proper plans haven't been made to obtain funds to pay for the stock--the buy-sell agreement is practically worthless. The method and cost of funding each of the arrangements will, of course, be different. However, there are several common methods that should be mentioned.

a) **Life Insurance**--In cross purchase plans, each stockholder owns an insurance policy on the life of each of the other stockholders. Upon the death of a stockholder, the surviving stockholders collect the insurance proceeds and use the fund to purchase the decedent's stock. A disadvantage of this plan is that the insurance premiums paid by the stockholders are not tax deductible. Also, if there are several stockholders, the total number of insurance policies required is quite high--therefore the premiums can be quite costly.

If the agreement involves a corporate redemption, the corporation itself carries a life insurance policy on each stockholder whose stock is to be purchased. Upon the death of a stockholder, the corporation collects the insurance proceeds and uses them to purchase the decedent's stock.

b) **Debt Instruments**-- Another possible method for funding involves the use of a debt instrument which allows the purchase price to be paid over an extended period of time. In each case, the corporation or shareholders may desire to obtain some form of collateral for the payment of the purchase price. Such security may include a first mortgage on real estate, a lien on machinery, or it may simply involve the shares of stock being sold. If the security isn't adequate, the seller may impose restrictions on the business such as limits on expansion or capital expenditures, the maintenance of a minimum ration of assets to liabilities, limits on the salary of key employees, etc.

c) **Contributions to a Sinking Fund or from Accumulated Earnings**--In some cases, the purchase price may come from accumulated earnings in the business or else through periodic contributions to a sinking fund. However, these two methods may not be very practical for farm corporations since most farm businesses do not have the necessary cash flow to contribute to a sinking fund nor do they normally accumulate a sufficient amount of earnings to provide for a buy-out of all stock holders' shares.

## Compare Alternatives

With the objective for incorporating and a better understanding of the annual taxation and estate planning tools possible with a corporate structure, tradeoffs and comparisons can be made among the three different business organizational structures. Can the corporation satisfy the family objectives? Where is the corporation structure inferior to the partnership or sole proprietorship for your situation?

No doubt you recognize that the evaluation of whether you should or should not incorporate the farm is a complex and technical area. Therefore, it becomes imperative--when analyzing the decision to have good professional help. An analysis of the situation--your situation-- is perhaps the most important, but still the most neglected phase of the incorporation process.

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