Estate Planning Tools for Farm Corporation Owners
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No matter 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 show 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 on large farms.

The estate planning advantages of corporations can be particularly attractive for a farm business where family members have decided to farm together in a common operating unit rather than form a separate business entity for the junior family member. With proper planning, the corporate structure can be used in reserving resources for the senior generation in retirement, transferring assets and management control to younger family members, and minimizing expenses and taxes while transferring business resources.

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 under a partnership or corporate structure. However, the older generation normally does not want to sell the farm assets to the younger generation all at once, and the beginning family members cannot afford to purchase the farm assets in a leveraged buy-out. The family would rather transfer the resources gradually. Therefore, there is a need for multi-ownership and management 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 married couple 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.

Gifts above the annual exclusion and gifts of a future interest in property are deducted from the

$600,000 lifetime exemption equivalent for an individual that can be used during their lifetime and at their death by the estate. No gift or estate taxes are paid until the lifetime exemption is used-up.

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 to reduce the value of the estate that is subject to the federal estate tax.

Another advantage of making lifetime gifts is that they are valued at the time they are made and removed from the estate. If property is held until death, the value of the asset probably will have increased, causing an increased estate and potential 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.

Gifts of corporate stock do not result in a loss of control over the business unless the majority of the voting stock is transferred by gift or sale. As long as the senior generation retains voting control, they can be assured of continued employment in the corporation and control of 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 court cases have treated gifts of stock in corporations that have 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 seems wise to maintain a record of some dividend declarations and to examine carefully stock transfer provisions that restrict stock transfer under specified circumstances.

Restrictions to Estate Freezes

Restrictions have been placed on corporate owners (as well as other property owners) who transfer appreciating property to younger family members while retaining control of the property. If the transfer involves freezing the value of the business interest in the older generation's estate at the point of the transfer, while allowing the junior family member to claim the appreciation in the value of the assets in the future, the federal estate tax for the senior family member's estate could be reduced or eliminated.

The Revenue Act of 1987 and the Technical and Miscellaneous Revenue Act of 1988 bans estate freeze recapitalizations of business property, whereby the owner retains the income and control rights in the property, but tranfers appreciating property. The legislation is applicable for decedents dying after 1987, if the decedent owned (directly or indirectly) at least 10 percent of the voting power or income of an enterprise and transferred it after December 17, 1987. If a disproportionate share of the potential appreciation of the enterprise is transferred, but income and control in the enterprise is retained, the value of the property transferred can be included in the decedent's estate. Gifts of stock without transferring income or control rights for the stock will be included in the giver's estate as if the stock had not been given away.

Family farmers or other business owners need not be concerned about the limitations on estate freezing legislation if their estate is less than the $600,000 exemption under the federal estate tax law. Likewise, corporate owners who developed written transfer plans before December 17, 1987 and have not changed those plans afterward, are not effected by the law. The law does not effect corporate owners if they have relinquished control and income rights to the junior family members as the stock is given. In this case, there is no retention of the control, and the transfer methods that are implemented will not come under the retained life estate provisions of the federal estate and gift tax law.

The legislation, however, applies to corporate owners where the senior generation transfers stock by gift, but controls the enterprise and the income rights to the property. The legislation has four exemptions to the grossing-up of the transferred stock in the transferor's estate. These are tools that can be used in their estate and business plans that are within the law. A sale with qualified debt, an agreement for the sale or lease of property, an option or buy-sell agreement, and an employment contract provide alternatives for safe transfers while at the same time assuring the older generation of an income stream and control rights in the enterprise.

This discussion does not infer that the senior generation should not use a yearly gift program as part of their estate plan. It is still a useful estate planning tool. However, it must be recognized that complete control and income rights cannot be held, while stock is given to the younger family members, but income and management control must be shared if they want to remove the transferred stock from their estate. Other tools can also be used if the estate owner wishes to either reduce or stabilize the value of their estate.

Discounting of Minority Stock

Another potential advantage of transferring corporate stock involves the possibility of a "discounting" of minority holdings of stock for gift and sale 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 in a few 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 old, 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 an income tax deduction through interest expense for removal of loan earnings from the corporation. The debt security holders are taxed

for income tax purposes on interest earnings from the corporation, but are not taxed for the return of the loan principal up to the cost basis in the securities.

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. Tax authorities believe 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. Let's consider a $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 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 sacrificed $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 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.

Assets Leased to the Corporation

The advantages of using a debt instrument are the same as leaving land ownership titled to the individual shareholders. Assume that at the time of incorporation, the farm owners left out a $300,000 parcel of farmland and leased it to the corporation. Or the land could be sold on a land contract to the children for 10% interest and a balloon payment in 20 years. Under either arrangement, the land would be leased to the corporation and a yearly payment of $30,000 or an appropriate rental rate made from the business to the parents or the children. If the land is sold to the junior family members the increase in value of the $300,000 parcel of land goes to the children.

If land is not transferred to the corporation, the parents will more than likely be willing to transfer control of the corporation to the younger family members earlier, since their security and source of income for the retirement years can come from the ownership of land. Gifts and sales of stock in the corporation can be accomplished without the antifreeze issues being raised because the control of the corporation is transferred to the junior family member.

Two Classes of Stock

Another estate planning tool for the corporation is two classes of stock, whereby part of the stock receives a fixed value that is specified when forming the corporation with the shares held by the older generation.

Such a plan involves using the two types of stock—common and preferred. The main diffeence 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 stockholders share in any assets that remain after paying the creditors.

Basically, the plan requires the donor parents to make gifts of the common stock while retaining the preferred stock. 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 the common stock has the voting rights and is owned by the younger generation, 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. This alternative is not affected by the limitations of an estate freeze because the control of the corporation is transferred to the younger family members, while the senior family members receive income from the preferred stock.

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 because of retained life estate provisions of the federal estate and gift tax law. 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 purpose.

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 shareholders.

Thus, the corporation faces somewhat the same cash payments as it did when debt securities were used or land was leased to the corporation. There is a yearly withdrawal from the business (dividends or lease payments) 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 desires to withdraw from the corporation during their lifetime. This is accomplished by requiring the shareholder to offer the 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 other specified event.

In addition, the contract-agreement normally specifies either an actual purchase price or 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 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 next 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 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 shareholder 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 Peter. 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.

Using insurance to fund a buy-sell agreement requires that the farm corporation have adquate cash flows to make the premium payments during the years prior to the transfer of the stock.

b) **Debt Instruments**—Another possible method for funding involves using 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 ratio 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 require that the farm corporations have the necessary cash flow to contribute to a sinking fund or have accumulated sufficient amount of earnings to provide for a buy-out of the departing stockholders' shares.

Retirement Programs

Retirement plans for shareholder-employees are more important with a corporate structure because of the difficulty in obtaining funds from a regular taxpaying corporation without paying dividends. Leaving land or any income producing property out of corporate ownership is another means to accomplish the objective of getting funds from the corporation.

Corporate retirement programs can shelter income from taxation during the contributing periods and defer paying taxes on the funds until retirement years. The shareholder-employees can contribute to an Individual Retirement Account (IRA) or the corporation can establish a corporate retirement program or a simplified employee plan (SEP) for the employees of the corporation. If the corporation establishes the retirement plan, all employees in the corporation may be required to participate in the plan.

There are many variations and many rules and regulations for tax-deferred retirement plans. The plans can vary greatly from one corporation to another and from one plan to another. Family-held corporation owners need the counsel from a qualified pension professional for adopting a plan that fits the requirements of the business and the family. In most cases, a small corporation participates in a ready-made, master or prototype plan sponsored by a trade association, insurance company, mutual fund or bank, rather than establishing their own retirement program.

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 is imperative when analyzing the decision to have good professional help. An analysis of your situation is the most important, but still the most neglected, phase of the incorporation process.

Other Available Publications

There are many other publications about estate planning that are available from your Cooperative Extension Service. Some of these are listed below.

E0451, *Record of Important Family Papers*, 8 pp., price 50¢, for sale only.

E1231, *Federal Estate & Gift Taxes*, 6 pp., price 35¢.

E1345, *Trust Uses in Estate Planning*, In Process.

E1346, *Life Insurance Uses in Farm Estate Planning*, 4 pp., price 20¢, single copy free to Michigan residents.

E1347, *Your Estate—Plan Its Transfer*, 4 pp., price 20¢, single copy free to Michigan residents.

E1348, *Michigan Inheritance Tax*, 6 pp., price 40¢.

E1684, *Insurance for Your Family*, 6 pp., price 25¢, single copy free to Michigan residents.

E2120, *Wills, Probate & Estate Planning*, 8 pp., price 85¢, for sale only.

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