## MSU Extension Publication Archive

Archive copy of publication, do not use for current recommendations. Up-to-date information about many topics can be obtained from your local Extension office.

Michigan Farm Estate Planning
Michigan State University
Cooperative Extension Service
Ralph Hepp, Mike Kelsey, Dayton Matlick
(N.D.)
104 pages

The PDF file was provided courtesy of the Michigan State University Library

## Scroll down to view the publication.

# MICHIGAN FARM ESTATE PLANNING

By RALPH HEPP, MIKE KELSEY, DAYTON MATLICK

# MICHIGAN FARM ESTATE PLANNING

**By RALPH HEPP, MIKE KELSEY, DAYTON MATLICK**

A series of articles taken from the pages
of the *Michigan Farmer*

# PREFACE

Everything on a farm can be divided into two categories: (1) your estate and (2) the people involved.

The people — their hopes, dreams, needs, and desires — are the basic reason for the estate. Work is done to develop the farm estate to benefit the people.

Farmers and their families are highly skilled at raising crops and livestock. However when it comes to the business end of agriculture, many farmers lose much of their hard earned cash and possessions through a lack of understanding of estate planning and the tools involved.

Just as tools are used to build fence, cut corn silage, feed cattle, and plant wheat, tools are also available to help you build your estate, pay no more taxes than required by law, organize your farm business, transfer property to sons and/or daughters, and pass your property on to your family when you die.

In this book we have tried to provide a background on estate planning tools, how their use will vary with different farm situations, the different forms an estate plan can take, and the individuals who can help you in developing a sound estate plan.

Although the articles making up this book were aimed specifically at Michigan farmers they also apply to other Michigan businessmen. Farmers from other states reading this book should realize that their state and local laws and regulations, especially in the area of taxes, may differ from the Michigan situation and proper allowances should be made.

We suggest that you read this book carefully, filling out the related forms. This will require thinking through your situation and talking it over with family members and business associates. When you have completed the last chapter and the last table you should be in a position to begin making specific plans with the help of professional estate planners in your community — lawyer, accountant, insurance agent, trust officer. In choosing professional assistance emphasis should be placed on individuals with experience with farm estates. How many of these professionals you will need to consult will depend upon your desires and the size and complexity of your estate.

Experience gained in researching and writing this book causes us to urge that you and your family remember that your estate only has meaning in terms of the people involved.

A legally correct plan that avoids all unnecessary taxes is useless unless it meets the needs of the owners of the estate and the people to whom they wish to pass it.

However it *is* possible to create a plan that will contain a sound business organization plus provisions for future growth and eventual transfer that maximizes your estate and also takes into full consideration the individual family members in an equitable manner.

An estate plan is desirable from the beginning of a farm business. As a "living" plan it changes with its owner's situation, even changing directions when necessary. It is never too early or too late to formalize an estate plan, but the earlier you begin, the greater the power of the plan in assisting you to reach your goals.

# TABLE OF CONTENTS


| Chapter | | page |
|---|---|---|
| | Preface | 4 |
| | Authors | 6 |
| | PART I: ESTATE PLANNING TOOLS | |
| 1 | Make the most of what you have | 8 |
| 2 | Who gets your property? | 10 |
| 3 | Probate: save time, money, and grief | 13 |
| 4 | New probate rules | 17 |
| 5 | Death taxes | 19 |
| 6 | You have a will, but you may not like it | 22 |
| 7 | Whose name should be on titles? | 26 |
| 8 | Gifts: flexible tools for property transfer | 29 |
| 9 | Life insurance should protect your farm | 34 |
| 10 | Trusts provide tax savings and management | 39 |
| | PART II: FARM TRANSFER | |
| 11 | When and how should you pass on the family farm? | 44 |
| 12 | "How" is a major factor in selling your farm | 47 |
| 13 | Tax considerations are "musts" for farm sale | 51 |
| | PART III: ORGANIZING FARM BUSINESS | |
| 14 | Organizing the farm business | 56 |
| 15 | Partnership: make rules to fit your situation | 59 |
| 16 | Corporations:how they function | 65 |
| 17 | Taxes influence choice of organization | 70 |
| | PART IV: RETIREMENT; BEGINNING PLAN | |
| 18 | Planning ahead can make later years more golden | 78 |
| 19 | An estate plan begins with you | 81 |
| | APPENDICES | |
| A | Family papers | i |
| B | Financial statement for estate planning | iv |
| C | Will planning worksheet | xii |
| D | Partnership agreement worksheet | xiv |

# AUTHORS

Ralph Hepp and Mike Kelsey brought over 20 years of combined experience in the field of estate planning to the series of articles contained in this book. Both are well known throughout the state for their many estate planning workshops. Their background and expertise — and patience — made this book possible.

Ralph Hepp received his PhD from the University of Wisconsin in 1966. From there he joined the Michigan State University staff where he now holds the position of associate professor and Extension specialist in the Department of Agricultural Economics. In 1973 Ralph was co-winner of the Outstanding Extension Program award presented by the MSU Extention Service.

Mike Kelsey is an Extension specialist and professor of agricultural economics. He received his PhD from Purdue University in 1959 and then joined the staff of Michigan State University.

At a recent state-wide Extension meeting, Ralph and Mike received the runnerup State Extension Team Award for their work on this series of articles.

Writing of the articles which appeared in the series was done by Dayton Matlick, editor, Michigan Farmer. Matlick received his B.A. in journalism from University of Kentucky in 1957. He served as field editor of the Kentucky Farmer, Tenessee Farmer and Homemaker, and Indiana Farmer before becoming editor of the Tennessee Farmer and Homemaker in 1960. He moved to the Michigan Farmer in 1962 and became editor in 1966.

Matlick has won most of the professional awards available in the field of agricultural journalism, including: Spotlight on Dairying Award, Award for Animal Agriculture, Soil Management Award for Editors, Oscar in Agricultrue, Soil Conservation Certificate of Merit, and the Chicago Board of Trade Professional Improvement Award for Editors.

# ACKNOWLEDGEMENT

To give added depth, breadth, and expertise to the Michigan Farmer series of articles on estate planning, a number of people professionally active in the field of estate planning were interviewed by editor Dayton Matlick. We gratefully acknowledge the contributions of the following individuals who gave so freely and generously of their time and experience:

Gordon Amendt, CLU, director of life and equity marketing, Farm Bureau Insurance Group, Lansing.

Julian Bouwer, vice-president, Home State Insurance Agency, Lansing.

Harry and Mildred Burns, farmers, Millington.

Frank, Bernadine, Larry, and Gloria Crandall, farmers, Bedford.

John Creden, senior vice-president and senior trust officer, 1st National Bank of Southwest Michigan, Niles.

Robert Drake, probate court judge, Ingham County, formerly deputy Supreme Court administrator for probate and juvenile courts, Lansing.

Glenn Ferrey, vice-president, Old Kent Bank Trust Department, Grand Rapids.

Donald Fox, attorney, Lansing.

Henry and Jim Gleason, farmers, Three Rivers.

Harry Haasch, administrative assistant, Lansing district office, Social Security Administration, Lansing.

Lyle Hepfer, certified public accountant, Lansing.

Glenn Jordan, probate court judge, Saginaw County.

Ronald Lange, probate court judge, Berrien County.

Karl Leppien, certified public accountant, Pidgeon.

Edward McArdle, attorney, Saginaw.

Gary Stone, professor, Michigan State University, College of Business, East Lansing.

Richard Wade, attorney, Three Rivers.

# PART I: ESTATE PLANNING TOOLS

# MAKE THE MOST OF WHAT YOU HAVE

## CHAPTER 1

FARMERS generally do an excellent job of building up real estate and personal property through sweat and careful planning. They figure a long time in order to reduce the cost per pound of gain on their livestock or get a good deal on that new tractor. Then many of them end up giving away between a third and a half of their life's earnings because of a lack of planning of a very special kind—estate planning.

Every farmer does some kind of estate planning, often in a haphazard way. The listing of beneficiaries on your life insurance, joint ownership of property, and joint checking and savings accounts are all bits and pieces of an estate plan. Welding all of these pieces purposefully into a well-organized plan with specific goals results in an effective estate plan.

In its simplest terms, estate planning is the acquisition, enjoyment, and eventual distribution of one's property to best provide for and protect himself and his family.

Although death is part of every estate plan, the goal of estate planning is life—first, the lives of the farmer and his wife, and later, the future of their children and heirs.

Unfortunately, many farmers let the spectre of death frighten them away from this essential area of family management. Either that or they are so wary of outsiders they won't seek the help needed to develop a plan.

Every property owner is personally responsible for what happens to his property after death. If he or she chooses not to make specific plans, the state has laws that will distribute it. These state statutes are designed to fit the "average" situation and no farm operation fits this category. This is well pointed out in a real example from rural Michigan. (In all examples, names have been changed to protect the parties concerned.)

Henry Jones died, leaving a small estate, including a farm with the title solely in his own name. Henry and his wife had worked together all their married lives to pay for the farm and Henry assumed, mistakenly, that his wife would receive all his property upon his death. Because Henry left no "will," state law took over and distributed half of the farm to his brother. The Joneses had no children. Mrs. Jones was forced in her 60s to obtain part-time work to support herself.

### IMPORTANT FOR EVERYONE

All property owners, regardless of age or size of estate, can benefit from having an estate plan.

Without care, large estates can be quickly eroded away. Take for example Mrs. Smith who died leaving her six children a $200,000 estate, consisting mainly of farmland. None of the children had any desire to own the land and all ended up selling the property.

By careful planning, Mrs. Smith could have made lifetime transfers of the land which would have greatly reduced the $50,000 actually paid in death taxes and other estate settlement costs.

Different problems, but perhaps even more important, occur in small estates. There the most must be made of the property available to provide for an adequate retirement for the parents and still educate the children, and maybe start a son in farming.

Age shouldn't be a limiting factor to estate planning, either. True, older farmers and their wives become worried as they approach retirement and, later, death. Unfortunately, at that time the effectiveness of planning is somewhat more limited than it would have been if they had started earlier in life. They simply have less time in which to manipulate their estate.

Young farm families especially should consider an estate plan. Even if they do not have a large estate, they have something more valuable than property. In case of an accident or fatal illness, the future of the surviving spouse and the young children should be considered. If death does not occur until later, there are still family goals to be formulated and plans made on how those goals can be reached.

### STRESS IS MAGNIFIED

Because women generally live longer than men, a widow often is faced with making a good life for herself and her children after the husband has passed away. Almost every widow caught up in the settlement of her husband's estate asks herself and others the same questions: "Why is the property transferred this way? Why didn't we foresee that these problems would arise? Why didn't someone tell us

what would happen to the property? Couldn't we have avoided some of these terrible costs?"

Death is not easy to understand, even when expected. The stress can be magnified by the uncertainty of property transfer procedures, estate settlement costs, and other problems. Death is inevitable; the unknown are the time of death and family circumstances. For the benefit of those who remain, estate planning should ease the uncertainty and readjustment. However, in order to plan—for both life and death—the farmer and his wife must be aware of and understand the problems and opportunities available for estate transfer.

## DEVELOPING A PLAN

A sound estate plan should take into consideration three different periods of time in your life, according to N. G. P. Krausz, University of Illinois professor of agricultural law:

**Your own lifetime.** The purpose during this period is to provide a satisfactory income and security for yourself and your family. The key, of course, is an efficient farm operation, but a wise estate plan can be a great help.

Some of the main tools for achieving this goal are: managing income taxes, achieving a sound retirement program, making legal arrangements for eventual farm transfer, and reducing death costs and taxes.

It is also the time to help one or more of your children get started in farming if they wish. It is important that heirs know about the plans that have been made so they can make plans of their own accordingly.

**Immediately after death.** The period immediately after your death will be a critical time because of the financial demands on your estate. These include: cost of the last illness, funeral expenses, claims of creditors, estate administration costs, and state and federal taxes.

Most farm estates consist mainly of land, livestock, and equipment, with little cash on hand. Yet much of these immediate expenses must be paid in cash within a short time after death. Without an estate plan that makes allowances for these cash needs, a forced sale of at least part of the farm assets will result. You worked hard to earn this property—why should your heirs lose it through low forced-sale prices?

**Extensive period of family adjustment.** After the immediate problems of settling an estate have passed, there are still the long-range problems as family life goes on. First, there is the security and income of the surviving spouse.

Then comes the equitable distribution of property among the children.

In many farm cases, equitable doesn't mean equal. Without an estate plan, it is very possible—even probable — that a farm-operating heir will not be adequately compensated for his contributions to capital improvements, labor, management, and care of the parents. Under state laws he would share equally with brothers and sisters who hadn't made similar contributions.

## MAJOR OBJECTIVES

With these three periods of your life in mind, the major objectives of estate planning would be to:

1. Transfer property during life while providing a sufficient, dependable income for you and your wife during retirement.
2. Reduce income and gift taxes.
3. Keep the farm in the family, if so desired, by helping one or more children to get started in farming.
4. Minimize state and federal taxes and estate settlement costs.
5. Distribute property according to your wishes, providing equitable treatment of the surviving spouse and other heirs.
6. Attempt to prevent ill feelings and bitterness among heirs resulting from a lack of knowledge or misunderstanding of the plan.
7. Prevent economic hardship for spouse and heirs from lack of money available for living expenses while waiting settlement of the estate.
8. Provide for enough readily-available cash to insure that the property will pass through estate transfer without becoming too heavily laden with debts.
9. Avoid loss of income and depreciation of the estate from the uncertainty over who will become the eventual owner(s) upon your death.
10. Accomplish charitable acts, if desired.
11. Protect minor children in case both you and your wife die in a common accident, by naming a guardian.
12. Select a qualified executor.

A good estate plan should be able to accomplish most of these goals. Don't worry if two or more of these objectives conflict in your particular situation. With careful planning, a fair compromise can usually be reached.

## MF SERIES

Much information is needed to do an effective job of estate planning. To help you better understand the estate transfer problems, opportunities, and processes, an extensive series of articles will appear in the MICHIGAN FARMER.

The articles will cover such diverse topics as: who gets your property at death, problems of probate, death taxes, use of life insurance in estate planning, wills, whose names should be on titles, farm transfers, farm sale, gifts, trusts, annuities and life lease, retirement, and how and with whom to plan.

For this series of articles, experts in estate planning throughout the state will be interviewed—lawyers, judges, certified public accountants, life insurance specialists, trust officers, and farmers.

MICHIGAN FARMER has never before undertaken a series of this scope, but we feel the importance of the subject warrants this level of involvement.

The series is not just aimed at providing theoretical information. Every effort will be made to present the material in such a manner that you can take a close look at your own situation and how an estate plan could help you accomplish your specific goals.

## DETERMINE NET WORTH

The next article in the series will answer the question, "Who gets your property at your death?" There probably will be surprises for some farm families.

To get the most out of these estate planning articles, you need to get involved. Before the next MICHIGAN FARMER arrives, determine the approximate worth of your estate.

Make a record of all real and personal property owned. Don't forget the value of life insurance policies, savings accounts, and cooperative stock. Retirement programs that have a death benefit value are also part of your estate. Place a realistic market value upon the property. Subtract debts from the total assets to arrive at a net value of your estate. Not only is this a valuable exercise in itself, but it will help you benefit more directly from future articles.

# WHO GETS YOUR PROPERTY?

## CHAPTER 2

EVERY PERSON who owns property has an estate that must be distributed at death.

Estate plans created by a property owner—or the lack of them—determine who will inherit his property. Many Michigan farmers will be surprised to find out how their property could be distributed after their death—and perhaps a little shocked.

In preparing this article, we looked around for someone who could guide us through the maze of legal terminology and who would also understand some of the problems involved with farm estates. A Lansing attorney agreed to talk over some of the terms and implications. He worked on farms as a youth and in his law career has had many farm clients. He currently serves the PCAs of Lansing over a seven or eight county area.

Distribution of property at death usually takes place three ways—through contracts, co-ownership, and a will.

### CONTRACTS

Part of each estate will probably be distributed through contractual arrangements with others.

An example would be a life insurance contract on the deceased, in which beneficiaries have been named to receive the insurance proceeds. By contract, this part of the estate passes directly to the named beneficiary.

Annuities and death benefits from a retirement program could be other contractual arrangements.

If no beneficiary is named in a life insurance policy or the beneficiary has previously died, the proceeds become part of the estate of the insured and are distributed according to the will, or if there is no will, according to state law. Unfortunately, this can cause a big jump in state inheritance taxes, which normally do not include life insurance payments. It pays to keep beneficiary provisions up-to-date.

Most life insurance policies will be subject to federal estate taxes. Only if a man or woman disposes of all the ownership rights to his insurance policy during his lifetime can the federal estate tax be avoided. The rights include the right to dividends, to borrow against the policy, and the right to change beneficiaries.

### CO-OWNERSHIP

A second way property can be transferred at death is through joint ownership of the property with one or more other persons. This type of ownership can occur in several ways.

"Tenancy in common" is a type of co-ownership in which two or more persons each own an undivided share in the real estate in which the actual division or settlement of the real estate has not been completed.

Upon his death, the tenant's share is passed on to his heirs according to his will or under provisions of state law if there is no will. Only the share of the property held by the deceased co-owner is taxed.

Suppose a farmer and his brother-in-law buy a piece of land and the deed reads "to John Green and Dick Waters and their heirs." A tenancy in common has been created. Neither John nor Dick owns a particular portion or a separate parcel of the land. Each is entitled to joint use and possession of the whole property. Also, either of them can sell or mortgage his undivided interest.

Any number of persons can be tenants in common. The undivided shares can vary in size or amount.

Some of the problems with being tenants in common come because all co-tenants have equal rights to manage the property. This can lead to family feuding, especially when there are several tenants in common. If the tenants can't come to an agreement, the argument could end up in court where the land could be divided or sold and the proceeds divided.

Holding property as tenants in common also places an extra burden on the mother and father to have wills. Without them, if either died, their share of the property would be distributed according to state law, with the children getting a big share of the property.

For example, if a farmer and wife own a farm as tenants in common, each can make a will leaving his half in trust, with the income only to be paid to the other for life, and on the death of the other the entire estate, then to the children. This plan avoids the estate tax on one-half the farm.

Joint tenancy with rights of survivorship differs mainly from tenancy in common in that the title of property held by two or more persons in this manner passes directly to the surviving tenants. In other words, the surviving tenants share ownership in the deceased's part ownership and, therefore, it will be part of this last person's probate estate and will be distributed under probate procedures.

The main advantage of joint tenancy is that ownership of the property vests immmediately in the other owner(s) upon the death of a joint tenant. It doesn't pass as part of the deceased's estate. This avoids probate, reducing costs and delay.

The convenience of having a checking account in joint tenancy may outweigh

the tax consequences. The survivor has almost immediate access to a joint tenancy bank account after death.

A jointly owned automobile can be titled with a stipulation providing that full rights go to the survivor. If that stipulation is not on the title, the survivor is assumed to own only half the automobile. In cases where the estate is not probated, however, a surviving spouse can obtain full ownership through the Secretary of State's office in a matter of about 30 days, according to a department spokesman.

Joint automobile ownership, though it might be beneficial from an estate planning viewpoint, means that both owners can be held liable in accident cases where damages exceed insurance coverage.

There is also a big difference in how the taxes are handled. In tenancy in common, only the share of the property passed on to the deceased's heirs is subject to state inheritance tax and federal estate tax. With joint tenancy, the whole property is subject to federal estate tax, less any amount of the estate where it can be proven that specific funds were contributed by the survivor.

"It is not enough to prove, for example, that two men worked together," our attorney said. "You must prove that the survivor actually contributed cash for the down payment or mortgage. This can be extremely difficult to do after years have elapsed unless careful records are kept.

"The farmer today is no longer, in most cases, a candidate for relief. Farms are bigger and property more valuable, even though cash can be scarce sometimes. At this point, the farmer is a prime candidate for the federal estate tax. Unless he plans to avoid it—not evade it—his estate will be hit hard.

"One of the worst ways to hold property of much substance is through joint tenancy. This concentrates the estate in the survivor. When the survivor dies, Uncle Sam lowers the boom.

"Let me give you an example of what I mean, although you will be getting into taxes in more depth in a future article in this series. The federal estate tax on two separate $100,000 estates would total $9,600. The estate tax on a single $200,000 estate, on the other hand, would total $31,500. The estate tax starts fairly low, but goes up rapidly with the size of the estate.

Tenancy by the entirety is a special case of joint tenancy, which can only exist between a husband and wife. Most of the provisions and comments applicable to joint tenancy apply in this case, too.

"The only advantage of tenancy by the entirety and joint tenancy lies in estates less than $120,000," he said.

"The problem of the wife proving that she contributed financially to the purchase of the property held jointly is worse than under joint tenancy, even though she may have worked by her husband all their married lives to build up the farm. An exception would be where she received an inheritance that was used to purchase or make a downpayment on a piece of land. But even this would have to be documented.

## WILLS

All property not distributed through a contractual arrangement or title ownership is part of the probate estate. At this point the will—or state law if the deceased had no will—determines the property distribution.

A will is usually the most important legal document any man or woman ever executes. Through it, he or she directs how the results of a lifetime's work will be shared and the manner in which the sharing will take place.

The will, in most cases, is the focal point of an estate plan. Ownership patterns, trusts, life insurance beneficiaries, etc., complete the plan.

Because of the importance of the will to effective estate planning, an entire article in this series will be devoted to it and to some of the factors that must be considered in creating a will that accomplishes family goals.

## STATE LAWS

In the absence of sound plans worked out by the parents and reflected in a will, their property will be distributed at death according to a rigid formula of law known as the Michigan Laws of Descent and Distribution. They apply only when there is no will. They are arbitrary and inflexible.

The state of Michigan has made these laws to meet the ends of impartial justice. They supposedly reflect how the Legislature thinks the "average" property owner would like to have his property distributed among his heirs. However, because these rules are arbitrary and inflexible, seldom will the wishes of the deceased be carried out through them.

The law specifies different ways of distributing the estate, depending on what heirs survive the deceased.

## MARRIED WITH CHILDREN

Property distribution for a married man or woman with child, children, or descendants is as follows: Real estate is divided one-third to the surviving spouse and two-thirds to the child or children, divided equally.

The spouse also receives one-third of the personal property and the children two-thirds, divided equally. If there is only one child, the child gets one-half and the spouse one-half of the personal property.

Grandchildren take their deceased parents share.

A widow is allowed all wearing apparel, ornaments, household furniture, and $200 of other personal property. She is entitled to one-year rent-free occupancy of the husband's dwelling and reasonable sustenance for one year.

## MARRIED WITHOUT CHILDREN

The property from a married man without child, children, or their descendants is distributed differently. The wife receives one-half and his parents or survivor one-half of the real estate.

The first $3,000 of personal property, plus one-half of the residue goes to the wife while the parents receive one-half of the residual. If his parents do not survive him, their share is divided equally among brothers and sisters. Nieces and nephews take their deceased parent's share except that if no brothers or sisters survive the nieces and nephews share equally. If there are no surviving brothers and sisters nor nieces and nephews, all the property goes to the surviving wife.

The real and personal property from a married woman without child, children or their descendants is treated identically to that of a married man without descendants except the property goes to the woman's relatives.

The child or children divide the property equally from a widow or widower with child, children, or descendants. Grandchildren take their deceased parent's share.

## UNMARRIED

In cases of an unmarried man or woman, or widow or widower without children or descendants, the distribution is as follows: If the parents survive, all to the parents or survivor. All property goes to brothers and sisters, divided equally, if no parents survive. Nieces and nephews take their deceased parent's share. If no parents, brothers, or sisters survive, the property divided equally is received in equal degree by next-of-kin. If no kin, all to the state.

## DOWER AND HOMESTEAD

The distribution of property to the widow under the Law of Descent and Distribution above applies unless she wishes to take advantage of the little-used Dower and Homestead rights. To do so, she must make her choice known within 60 days after entry of the order closing the estate to claims.

The Dower right allows a widow to use for life one-third of her husband's real estate. The Homestead right entitles the widow to remain in the house for one year rent-free, unless she owns a homestead in her own right.

A man cannot will everything to others and not consider his wife. If he does, she can ask that the will be put aside and that she receive her statutory share, which is approximately the share she would have received under the Laws of Descent and Distribution. Or she can choose to take the Dower and Homestead rights.

The latter rights are very complicated and seldom used unless the estate of the husband is heavily burdened with debt.

"I've been a lawyer for 35 years and I've never seen the homestead right used," our attorney said.

It may have surprised the wives among our readers to find out that if their husband had no will, she will not inherit all his property. We hope that husbands and wives will try to sit down at this point and examine the way they own their property, both real and personal, and then figure out who will be getting their property. Do you have an up-to-date will? If not, how will the state laws distribute your property?

What happens to the property if the husband dies first? What happens if the wife dies first? The next article will discuss probate of estates.

# THOSE LEGAL TERMS

TO EVALUATE your estate position properly, it is necessary to understand the general meanings of several terms that relate to the ownership of property.

There are two kinds of property, "real" and "personal."

**Real property** or real estate is land or any interest in land. This includes anything attached to the land, such as buildings, fences, growing crops, timber, oil and minerals, or water under the soil. However, when timber is cut, crops harvested, or oil recovered, it then becomes personal property.

**Personal property** is everything other than real property; a moveable item. It can be classified as either tangible or intangible.

Tangible property is physical property in the nature of goods, wares, or merchandises, such as clothing, furnishings, livestock, harvested crops, machinery, and equipment.

Intangible property is paper property, such as copyrights, patent rights, securities, notes, bank accounts, contract obligations, and mortgages.

"The title to farm personal property is important," says our attorney. "Take for example a farmer who has taken two or three sons into a loose family arrangement. They all work together and all take from a common pot. Who owns the personal property? No one knows. When the father dies, unless there are records to the contrary, it will be assumed that he owns all the personal property and the estate will be taxed accordingly.

"The same is true of a husband and wife team. Does she own half the livestock? All the livestock? No one knows.

"A written agreement needs to be signed by all parties setting down what is to happen to the personal property when one of the owners dies. It should be done before a lawyer to make sure the desired results are obtained. This should be an area of concern for all farms because of the large amounts of personal property needed to run the business: stored grain, livestock, machinery, equipment."

## OWNERSHIP

These various types of property can be owned in several ways. The two major ways are sole ownership and co-ownership.

**Sole ownership** applies to property owned by one person only. That person has absolute ownership rights and has unrestricted right to sell, deed, mortgage, or otherwise dispose of the property so held. Title to the property is held in "fee simple" ownership.

When real property is owned by a man, however, his interest is subject to his wife's dower and homestead rights, as explained in the accompanying article. In spite of the new "lib" movement, however, the man has no such rights regarding his wife's property.

## CO-OWNERSHIP

**Co-ownership** is property owned by two or more persons at the same time. Joint ownership, of whatever type, in effect subjects much of the individual's right of disposition of the property to the good will of each of the other owners. There are two basic forms of co-ownership—tenancy in common and joint tenancy.

**Tenancy in common** exists when two or more persons each own an undivided share in property. Each tenant has the righ to mortgage, sell, assign, or convey his undivided share. At death, a tenant's undivided share passes to his heirs and not to the other tenant or tenants-in-common, unless they happen to be heirs.

**Joint tenancy with rights of survivorship** exists where two or more persons own an undivided share in property together. Jointly, the tenants have the right to mortgage, sell, assign, or convey their ownership rights. However, in many cases one tenant cannot act in his own behalf.

At death, the deceased's undivided share passes to the other joint owners and not to the heairs, unless the joint owners happen to be heirs.

**Tenancy by the entirety** is a type of joint tenancy with rights of survivorship between husband and wife. It cannot be broken or changed by either the husband or wife without the other's consent.

In this article and others in this series, the purpose is to provide you with the information necessary to better understand estate planning and how it can benefit your own farm business. The articles will be specific enough to enable you to do considerable thinking and planning before you take your situation to experts for the final planning stage.

The series is not intended to provide you with a how-to-do-it situation where you will put together your own elaborate estate plan. You will need the advice of several specialists to do the job, ranging from a lawyer, to a tax consultant, to a life insurance specialist.

The terms used above are explained in simple terms, but for the lawyer they are the very specific tools constructed over hundreds of years to provide predictable results. If your television went on the blink, you would call in a TV repairman because he has the special training and special tools to do the job properly. The lawyer, too, is a specialist.

This series will help you formulate ideas and make your discussions with your lawyer more meaningful and fruitful.

# PROBATE:

## With care you can save time, money, and grief

CHAPTER 3

6.5 BILLION DOLLARS! No, it's not the national debt, but the value of real and personal property owned by Michigan agriculture. The size of that figure may surprise you but, chances are, so would the total reflecting YOUR real and personal property. That includes land at today's values, machinery, livestock, savings accounts, and all other assets.

Within the next 70 years—a man's lifetime—much of this property, including at least some of yours, will pass through Michigan probate courts, possibly several times.

What is probate? How does it work? Why have it? An understanding of the answers to these questions can result in a savings in time, money, and grief for your family.

### WHAT IS PROBATE?

Probating an estate is the legal procedure used to (1) determine that a person is dead, (2) gather together all of the property of the deceased person, (3) pay all of his or her valid debts, including final taxes, and (4) distribute legal title of what is left to the person's heirs.

The three groups most interested in the probate proceedings, therefore, will be the beneficiaries, the creditors, and the state and federal governments. Probate was developed down through the years as a forum where all conflicting claims of these three groups can be resolved in an equitable manner. Probate comes from the Latin word meaning "proof." Originally probate referred only to wills, but now it has come to mean the process of settling an estate.

### TITLES TRANSFERRED

Probate forms an important link in our legal system. Without court administration, there would be no official record of whether the deceased left a valid will, who the heirs are, or the property interests of each heir. Also, in our system, title to real estate would be clouded without this official record. Prospective buyers would hold off until the title was cleared.

A probated will can be shown in any court as the basis of rights to property. An unprobated will has no legal standing.

Without provision for legally limiting the time for paying claims, creditors could continue to assert them against the property, heirs, or even later purchasers of the property.

Also, if death taxes are not computed and paid, they become a lien on the property and accumulate interest.

Without court supervision and approval of an estate's closing and distribution, only chaos would exist. Objections, claims, and clouded titles would plague the heirs for years to come.

The judge presiding over the probate court is an elected official. Three-fourths of his state-established $20,000 minimum salary is paid by the state; one-fourth by the district he serves (usually a county). The district may increase his salary—as is often done in heavily-populated areas—up to a $34,000 total.

None of the probate judges' salaries are derived from court fees related to the estate cases over which they preside.

Probate court is not limited to just estate cases, "Most of the time when the Legislature decides some new judicial procedure is necessary, it seems to fall to the probate courts," said Saginaw County Probate Court Judge Glenn E. Jordan.

In one way, probate court could also be called family court. It handles problems running the gamit from juvenile cases to name changes, to the appointment of guardians, to divorce. Only about one-third of Judge Jordan's cases deal with estates.

### PASSING OF PROPERTY

Do all estates have at least part of the property going through probate? There are three possibilities, according to Berrien County Probate Judge Ronald H. Lange.

"First of all, it is possible that property can pass without probate," said Judge Lange. This would be the case if, for example, all of the decedent's property had been held jointly with someone else, usually a spouse.

"Second, it is possible to go under what we call a small estate provision or semi-probate. If the estate is worth less than $1,000 and consists of personal property, it may be ordered by the court to go to the person who paid the mortician.

"If there is a widow or children under 16 who were dependent on the deceased for support and the value of the estate is under $5,000,

it can be signed directly to the widow.

"If the property is only a motor vehicle, by filing a death certificate and certain affidavits, the spouse can get the title transferred through the Secretary of State's office.

"In the final example of semi-probate, there is a special provision in the Liquor Control Act providing for the transfer of a liquor license between spouses."

Small estates are not subject to the claims of creditors. They are quicker than regular probate, too. The beneficiary files one document; the judge signs one order.

## PROBATE

Probate applies only to property owned solely by the deceased or his share of property owned as a tenant in common with others.

It does not apply to property which is transferred by contract, such as trusts and life insurance (unless the policy is made out to the estate). Probate also does not apply to jointly-owned real estate or to other intangible personal property where ownership rights have been transferred automatically at death. Examples of the latter are bonds payable on death to another and checking and savings accounts in the name of two or more people.

When a person dies, the bank immediately acts to freeze his or her personal checking account and safety deposit box, either personal or joint. An estate is often opened when the spouse petitions the court for access to the safety deposit box.

An estate can also be opened when an interested party brings or sends the will of the deceased to the appropriate probate court. This could be the spouse, one of the decedent's children, or the executor nominated in the will if he has the knowledge that he was named.

Whoever has the will is legally responsible for forwarding it to the court within 30 days after death of a testator (one who makes a will). Failure to do so can result in a $10-a-day fine. If a party of interest doesn't bring the will forward, after 60 days a creditor may petition the court that the will be admitted to probate.

After this initial move has been made, the court sets a day at which time the will is to be "proved." Usually notice of this hearing is published in the local newspaper so that all concerned parties will know that the proving of the will is to take place. At this initial hearing, several things can happen: the will is admitted for proof, heirs at law are determined, an executor can be appointed and his bond set, and a schedule developed for publication on claims. It is possible that a date will also be set for hearing claims of creditors.

If, after a person dies, all parties in interest agree, an estate can be opened "on waiver and consent" without the necessity of publication in the newspaper. Also, if these same parties in interest agree on a fiduciary and sign a waiver of notice and consent to his appointment, this could all be accomplished in two to three days, depending on how long it took the lawyer to draw up the necessary papers.

If the decedent dies intestate (without a will), the opening procedures are quite similar. A widow, next of kin, or representative of either can petition the court to appoint an administrator for the estate. If the heirs have not acted within 30 days from the death of the property owner, a creditor can petition the court to place the estate under probate.

There are many, various terms for the administrator or executor of an estate, depending on the circumstances under which he or she serves. The single, all-encompassing term is fiduciary. It refers to a person who is responsible for the management of the estate of another. For simplicity's sake, we will stick with this term.

## THE FIDUCIARY

Almost anyone can be chosen as fiduciary as long as he or she is of sound mind and at least 18 years old. Usually the judge abides by the wishes of the deceased as expressed in the will or, if there is no will, appoints an heir or someone agreed upon by the beneficiaries.

"There are only about four cases where the court won't go along with the fiduciary nominated in the will," said Judge Lange. "These are if the nominee declines, is mentally ill or senile, turns out to have an interest adverse to the estate, or is not a resident of Michigan or a trust company licensed in Michigan. The latter point is a provision unique to Michigan law."

What are the qualifications of a good fiduciary? One of the first things to consider is age. It would be rather foolish to appoint a contemporary. The law of averages indicates he may not survive you and if he does, he might not be mentally alert enough for the job.

A fiduciary should have a sound business head and be competent and trustworthy. It would help if he had knowledge of your type of farming enterprise since he will need to oversee its operation during the period the estate is in probate.

Often a family member or widow is named fiduciary. He or she would be familiar with the property and family needs. Also this is a way to avoid paying the fiduciary's fee. However, there are advantages to choosing a professional fiduciary that should also be considered. Many banks and trust companies in farming communities provide such services.

Their biggest single advantage is that handling estates is their job and they know how to transfer property with the least effort and in the shortest period of time. Most banks and trust companies have large staffs with experts in many areas of estate management and transfer.

This is especially important in the area of taxes. There are about 10 different possible taxes which may have to be paid by an estate. Each has its own special deadline and requirements for filing. Missing any one of these could result in heavy fines.

Another major advantage to hiring a professional fiduciary is that he is a disinterested party. As a result he can be impartial and less influenced by family disagreements than would be a family member.

"Who you pick for a fiduciary depends on how complicated your estate is," said Judge Lange. "If it is a modest estate, or merely a bank account—no complications—a family member and a good attorney should be able to do a good job. But if the estate is complicated, you should weigh the values of a professional fiduciary. If the farm business has outstanding accounts to be collected, a widow might find herself ignored. A bank, however, won't be ignored."

If a property owner feels it is important to have someone involved in settling the estate that knows the family and the family situation, it is possible to appoint a co-fiduciary.

## DUTIES OF FIDUCIARY

Once a fiduciary has been appointed by the court, he must file a bond to guarantee his performance and take an oath to faithfully carry out his duties. By making the proper provision in his will, a testator can avoid the necessity of the fiduciary's bond. This bond may cost

hundreds of dollars, depending on the size of the estate.

The fiduciary has 30 days from the time his letters of authority are issued in which to file an inventory of all the assets of the estate, although in complicated cases this time limit can be extended. This can be a difficult procedure because of the disorganized condition of many estates.

The fiduciary is required to list all assets of the estate in the inventory, including property exempt from probate. This list is used by the fiduciary in computing the necessary taxes. Non-probate assets may be subject to state inheritance taxes under certain circumstances and probably are subject to federal estate taxes under most circumstances.

"It is my opinion that a lot of property is lost to estates because the fiduciary and family members don't know where to look for the assets," said Judge Lange. "The least a person can do for his fiduciary is to keep an accurate, up-to-date inventory."

This inventory should include information on the location of all valuable papers, records and inventories of the farm business, records of off-farm employment and investments, the location of checking and savings accounts and safety deposit box, a list of all assets and money owed, and the names of persons close to the family and farm business.

## CLAIMS BY CREDITORS

While the fiduciary is compiling the inventory, another part of the probate process is also taking place. When the fiduciary was appointed, the fact that the estate was in the process of being settled was published in the newspaper. All creditors with claims against the estate were invited to present those claims. A time limit for accepting those claims was set by the court. This can vary between two and four months in length. Judge Lange says he uses 90 days as a general rule of thumb.

Claims of creditors are filed with the clerk of the court. At the hearing on claims the fiduciary provides the court with a list of creditors and his opinions on which claims should be paid. If a dispute arises, the creditor is entitled to his day in court. This can either be done before the judge or a jury trial can be requested.

There seems to be a general movement away from jury trials in probate disputes. Perhaps this is because of the extra time and money involved. The loser in the hearing or trial has to bear the costs of settling the dispute.

Once the claim period against the estate has been closed, no more claims are allowed. The court then rules on which claims will be allowed and which will be disallowed. If a creditor didn't get his claim in on time, he has no more legal claim on the estate.

If the estate is solvent, the creditors are then paid. If the debts are greater than the assets, claims are paid in a specific order until the assets run out.

First comes the widow's allowance. Under Michigan law, the widow is entitled to an allowance for a year. The size of the allowance will vary with the size of the estate. Judge Lange indicates that the most common amount in his court is about $100 a week.

Once the widow's allowance has been set, there are five classes of debts which are paid in order. If the money is exhausted on any one class, the lower class debts do not get paid. These are:

First class, necessary funeral expenses.

Second class, debts due the United States, usually taxes.

Third class, expenses of last illness.

Fourth class, debts due the state of Michigan.

Fifth class, all other debts.

It is interesting to note that it is impossible to close an estate being probated until clearance is obtained from the federal estate tax people. One of the main reasons some people try to avoid probate is the idea that they will be able to get around state and federal taxes. This is generally not true any longer. Congress acted to plug existing loopholes.

After the judge rules on the claims of creditors, the fiduciary must pay the allowed claims. He does this first from cash that is part of the estate. Then, if needed, he will sell the personal property of the estate. If this isn't sufficient to meet claims, the court will order real property sold under a special statutory procedure.

After the claims are closed and paid, the fiduciary files an accounting with the court, showing income to the estate, amounts paid out, and the amount left. The court then distributes the remainder to the heirs, according to the will if there is one.

Generally the actual property is distributed if this is possible. If it isn't, the property is sold and the money received is distributed.

"It is the desire of the probate court to do exactly what the deceased person would have done with his property had he been present to express his wishes," said Judge Jordan. "A properly executed will is the surest way to tell the probate judge what those wishes are."

Property distribution is not the only important aspect of a will, according to the Saginaw County judge. Guardianship decisions also fall on the probate court if there is a common disaster to both parents and no provisions were made in the will for care of minor children.

"Parents should make this choice," said Jordan, "not some judge who doesn't have any idea how the parents would have desired their children to be reared."

If there is no will, the state laws of descent and distribution are followed. (See March 15, 1972 issue of MF for further details on this point — "Who gets your property.") To the surprise of many families, this does not mean that the surviving spouse gets all of the property. If there are two or more children, the spouse gets one-third of the property. If there is one child or no children, the spouse gets half. Judge Jordan explained the reason:

"The laws of descent and distribution reflect the medieval attitude of the family of that day, in which husband and wife may not have been very close and men provided for their children before considerations of their wife."

He went on to say that hopefully in the near future some of these laws may be changed to more accurately reflect the situation more normally found today. Wives are partners with their husbands not just nurses of their children. The lack of modern descent laws makes it even more important that a will be drawn.

"The probate judge," Jordan said, "has few alternatives. He can help carry out the deceased person's wishes if they are clearly expressed in a will. If there is no will, he must follow the laws, which are largely obsolete for the modern farm family."

## COSTS

Two of the main areas that lurk in the back of many people's minds about probate are the cost and the time involved. Actual court costs of probate are not excessive. Judge Jordan estimates that not more than $100 in actual court costs are involved in settling most estates.

The total costs of probate vary with the value and complexity of

the estate proceedings In addition to the court costs, the fiduciary's fee is fixed by law at $50 plus two percent of the value of the probate estate. If the court finds that work of an extraordinary nature was involved, it has the power to direct reasonable additional payments.

The attorney's fees are not fixed by law, but rather by custom, stemming from the Michigan Bar Association. They generally average 5 percent of the value of the probate estate.

In practically all cases the fiduciary must employ an attorney to represent him in probate court. How much the attorney will be involved in administering the estate will depend on an agreement between the attorney and the fiduciary.

Additional costs may be incurred in handling the estate, such as appraisal fees and selling expenses if assests must be sold. In total, costs will average 8 to 9 percent of the value of the probate estate, not including taxes.

## TIME

"The probate process will be as involved as were the affairs of the person during his lifetime," said Berrien County Judge Lange. "If it is a 'clean,' simple estate — there are no disputes — the process shouldn't take more than nine months to a year. The major reason for taking that long is to allow creditors time to file their claims against the estate."

Every dispute adds months and possibly years to the time required to settle the estate. Disputes are settled by the judge, or, if the parties elect, a jury trial can result.

Other problems can delay closing the estate, such as finding missing assets, determining the whereabouts of heirs, settling disputed titles, or determining a claim for wrongful deaths.

The last two examples can result in even more drastic delays because disputes of this type must be handled in the crowded Circuit Courts.

Although the average estate settlement takes between one and a half and three years, if disputes occur the time can stretch out to 10 years or more — another reason why it would pay any property owner to keep his or her affairs in order.

"An inheritance is a gift," said Judge Lange. "The real problem comes because so many people look on it as a right. We can't avoid all the human problems, but from a legal sense we can try to find an equitable solution. No one wins an estate fight, as the old saying goes, except the lawyers."

## WHAT CAN YOU DO?

We asked the judges for their opinions on what property owners could do to reduce the time, cost, and problems involved in probating estates. Below are some of their suggestions.

**"The probate process will be as involved as were the affairs of the person during his lifetime."**

**— Judge Ronald Lange**

❶ Make a will. Because of the nature of the farm business and the type of property involved, a will is essential to make sure your wishes are followed in the distribution of your property. To avoid problems, make sure the will is drawn up by a lawyer. In the will indicate your choice for fiduciary and also who you would desire to act as guardian of your children in case of a disaster involving both you and your wife.

Review your will as your family and financial conditions change, or when there is a major revision in tax laws.

❷ Make an inventory of all your assets, debts, valuable papers, and business affairs as outlined earlier.

❸ Review the inventory annually at tax time and update.

❹ Keep all loans to your children arms-length transactions. Have them sign a note for the money and later get receipts for their payments. It is even better if this can be done through an impartial third party. Lack of an adequate record of these loans and payments can result in misunderstandings, confusion, hard feelings and even double payments once one of the parties to the agreement dies.

❺ If you want the property or farm business to pass intact to your heirs you must arrange for enough cash on hand to settle the debts to creditors.

❻ One of the most important factors is to provide an emergency fund for the surviving spouse and children. One way is to have a joint checking account so there will be readily available cash. Also life insurance policies can be used to build part of this fund. Remember, however, that in some instances the payment from life insurance policies can be held up for a month or more. It was Judge Lange's opinion that families should consider an emergency fund that would cover general living expenses for a least three months.

At first glance, probate proceedings may appear to be overly complex and lengthy. However, to adequately protect the interests of the deceased, beneficiaries, creditors, and the state, they are a necessity.

Current efforts being made by the Michigan Supreme Court to streamline probate proceedings should greatly simplify the passing of property. These new procedures will become effective by the end of this year. Their effects on your property will be examined in next MF issue.

Probably one of the most important things to remember about probate is the statement by Judge Lange: "The probate process will be as involved as were the affairs of the person during his lifetime." If you leave a lot of business affairs at loose ends and are casual with your property, your heirs may reap a harvest of frustration, grief, and an unnecessarily reduced estate size when your property goes through probate.

# NEW PROBATE RULES

## Modernized to provide faster, simpler, more economical handling of estates

**CHAPTER 4**

Probate of an estate makes people shudder for three basic reasons. First, it is an unknown, a new experience for many families. Second, probate of an estate comes only after the death of a friend or relative. Third, everyone has heard at least one or two stories and rumors about how complex, time-consuming, and expensive probate proceedings are.

The death of a loved one or friend is a trying enough time. There is no doubt that the unknown area of probate, forced out of necessity on the heirs at this time, creates even more problems and anxieties.

It was a desire to make the probate court system more responsive to the needs of the public, while still protecting their rights, that caused the Michigan Supreme Court to recently put into effect a whole new set of procedural rules. These rules are designed to simplify and streamline operation of the state probate court system.

### INSTRUMENTAL FIGURE

One of the most important figures in the studying, drafting, and redrafting of the new probate court rules was Judge Robert L. Drake. Judge Drake was Deputy Supreme Court Administrator for probate and juvenile courts from 1963 until early this year. At that time, having completed the difficult task of overseeing movement of the new rules, he accepted an appointment as Ingham County probate judge, a position he had previously held for seven years.

The judge was born in Mancelona in Antrim County. His father, Leon Drake, was a district agricultural extension agent and a potato farmer. The family later moved to Otsego County and lived at Gaylord until Robert Drake was 12. East Lansing is now his home.

"There are two very fundamental, basic areas probate courts must handle in settling an estate," said Judge Drake. "First, we have to determine exactly which property belonged to the deceased individual, through some kind of inventory. Second, we make sure the right property gets to the right people. Although this is important when a person dies testate (with a will), it is even more important when they die intestate (without a will).

### NECESSARY TASKS

Certain things must be accomplished in the probating of an estate. If there is one, the will must be admitted to probate, an administrator or executor (generally called a fiduciary) must be named to ramrod the movement of the estate, bond for the fiduciary must be set, allowances must be set up for the widow and minor children, an inventory must be made, creditors notified and all claims against the estate handled, real estate muat be sold if necessary, tax information has to be filed and taxes paid, and the remaining property distributed to the rightful heirs.

Before the new rules went into effect in April, the bare minimum amount of time involved was about seven months. Any complications greatly extended that time period. For each additional published notice necessary, another month could be added. It was not unusual for heirs and interested parties to appear in court four or more times during the duration of the case. With the way families are spread out over wider areas these days this could create hardships and lack of information for individuals who could not attend because of time and distance.

Each court hearing was required to be proceeded by three published notices in the newspaper, plus letters sent to notify interested parties. Many of the steps outlined above required separate notices to the public through publication. For example, typically the naming of a fiduciary to handle an estate was done in a court hearing to which all parties were invited. However, in most cases this was only a formality with sometimes 30 or more different fiduciaries for as many different cases appointed within an hour.

The new court rules, which took affect in April, 1973, act to minimize the court niceties so that cases can more rapidly and easily be disposed of based on their merits. However the rules accomplish their goals in such a manner that all parties involved are actually better informed at all stages than they were under the old procedures.

### COMBINED STEPS

Under the new rules, whenever possible notice to the public of four different steps are made at one time: the identity and address of the proposed fiduciary, notice that a will was or will be admitted, notice of the time limit for presenting claims against the estate of the deceased, and notice that the estate will be assigned to the individuals entitled to it. The latter serves to alert heirs or parties not known or identified by the court to come forward and make themselves known.

Publication of the hearing at which

all of these steps will be taken is made once in the newspaper instead of the previous three times. In fact, often each of the four steps above were publicized three times, consuming a great deal of time.

Depending on the case, this first court hearing may be the only one required to settle the estate under the new rules. All the rest is accomplished through reports to the court, the heirs, and parties of interest. However, as was true under the previous rules, any conflict between parties can greatly complicate the settlement and require additional court hearings to resolve the differences.

## DUTIES OF FIDUCIARY

Under the new rules, the duties of the fiduciary are expanded. He is required to keep all parties informed of all developments in the case. This was formerly accomplished through the court hearing system. Utilizing developments in copying machines, it will now be done through the mails. For individuals who live some distance from the court house, the result will be a much greater level of information than they would have otherwise received.

Another increased area of activity of the fiduciary is that of inventory. This was previously accomplished by hiring a court-appointed assessor to assess the value of all property in the estate. However, in cases where the estate totaled over $60,000 federal tax officers usually ordered another assessment anyway. Now the fiduciary compiles the inventory and assesses the value of the property to the best of his ability. He utilizes facts available to him, such as assessed valuation of the property involved, current level of stocks and bonds as shown in the newspaper, and the bluebook value of used cars. In the case of unusual or unique property — such as antiques — the fiduciary can hire special estimates by qualified individuals. The inventory and assessment is submitted to the court under oath.

If any heir or interested party desires including the IRS, they can request a formal assessment from a disinterested third party. This will be so ordered by the court. In larger estates, this will be requested by IRS anyway so it saves the cost of the first inventory.

Under the new probate court rules, the minimum time in which an estate can be settled has been reduced to two months, although admittedly few cases will be handled so swiftly. If any additional notices must be published beyond that first major one, the time for each notice is reduced from four weeks under the old rules down to two weeks currently.

## ALTERNATIVE PROCEDURE

In addition to the basic new probate court rules, there is an even simpler alternative procedure available.

One of the problems with probate proceedings in the past has been their fragmented nature. Many things, such as the widow's allowance, continuation of the farm business, determination of claims, and sale of property, have all been considered separately. The result has generally been to heighten the level of confusion. The purpose of the alternative system is to provide all of these aspects within two meaningful documents which are then sent to all interested parties.

The first and main document initiates the proceedings. The second is involved in the actual final settlement of the estate.

"The first single combined document is referred to as the settlement schedule," said Judge Drake. "Included would be information with respect to assets, credits (including claims, priority allowances, and other expenses), requirements with respect to sale of real or personal property, and other relevant details.

It is intended that the settlement schedule will meet the needs for filing of tax information as well as for title and settlement purposes.

The settlement schedule alternative will only work when all interested parties consent to it. If one or more of the parties object to this approach, a hearing will be held by the court. At this hearing it will be determined whether or not the fiduciary will be allowed to continue with the alternative method.

At the time of the closing of the estate, the fiduciary submits to the court the final statement. It basically states that the estate has been settled as set forth in the settlement schedule, that all expenses and claims have been paid, and that all parties have been informed.

## OUT-OF-COURT

Under both of these new systems, all parties are encouraged to discuss their interests and problems over directly with the fiduciary and to settle as many of these out of court as possible. Of course, if an interested party doesn't feel he or she received satisfaction from the fiduciary, he can always petition the court in order to obtain their rights as they see them. The result of this approach should greatly reduce the number of hearings necessary to settle an estate.

## FOLLOW-UP PROCEDURES

It basically set up a system of accountability in the probate system. Certain deadline or time periods are set down which fiduciaries or lawyers must meet. If they go beyond their deadlines, they are notified by the court and given 30 days to fulfill their duties. This can be extended up to a maximum of 60 additional days. If at the end of this period they have not completed the requirements, the court can remove them from their position and appoint a new fiduciary.

The importance of this rule to the people of the state is revealed in the facts that in 1971 1,488 fiduciaries had to be removed and in 1972, 1,133 others.

Rapid movement of estates through probate is essential if the rights of heirs and other parties are to be protected properly.

The basic effects of the new probate court rules will be to speed up movement of estates, reduce confusion, cut the number of court appearances necessary for interested parties, reduce the cost to estates of the probate procedure, keep all parties well informed of developments, and, in general, make probate more responsive to the wants and needs of the people involved.

# DEATH TAXES

CHAPTER 5

ESTATE PLANNING can provide many benefits for Michigan farm families, ranging from an orderly plan for expansion of the farm business to protection of minor children to, later, retirement of the parents.

Strangely enough, however, it is the thought of death taxes—the government dipping into hard-earned property—that prompts many farmers to take a closer look at estate planning.

Although the reduction of death taxes is not THE primary goal, estate planning does provide a way of reducing the tax bite by $10,000 to $30,000 on many farm estates of $200,000 to $300,000 in size.

This shouldn't be thought of as tax evasion or something illegal, but rather a legitimate and proper use of all special tax provisions to minimize taxes.

As a property owner you are required to pay your share of taxes to support both state and federal governments. On the other hand, you have an obligation to your heirs to make sure that no more is paid than is due.

## INHERITANCE TAX

The Michigan inheritance tax is the lesser of the two main death taxes. As the name implies, it is a tax on the inheritance of property. The individual who receives the property after the death of the owner pays the tax. The rate of the tax, in turn, depends on the amount of inheritance received and the relationship or kin of the beneficiary to the former owner.

The state inheritance tax applies, whether there is a will or not, to all Michigan property if the deceased was a resident of Michigan when he died, or on all property owned in Michigan if the deceased was a nonresident.

Exemptions to the state inheritance tax have an important effect on the amount of tax due. For example, most property held jointly by two or more people is exempt. This includes bank accounts payable to either of the two owners; corporate stocks and bonds in the names of two persons, payable to either; and real estate in which the title is held in joint tenancy. It also exempts life insurance policies, unless the proceeds are payable to the estate of the deceased, and gifts for religious, educational, or charitable purposes, if the receiving organizations meet the legal restrictions.

## CLASS EXEMPTIONS

Persons taxed by the Michigan inheritance laws fall into three classes:

CLASS I: A surviving spouse, who has a $30,000 exemption of taxable property.

CLASS II: Close relatives, such as a grandfather or grandmother; father or mother; child; any lineal descendants, such as grandchild or great-grandchild; brother or sister, full or half blood; wife of son or husband of daughter, despite remarriage; legally-adopted children or children to whom the deceased acted in the relation of a parent, provided this responsibility was assumed before the child's 17th birthday and continued until the parent's death.

Transfer of property to anyone in Class II is exempt from inheritance tax up to $5,000 each.

**Rate of state inheritance tax on different sizes of estates left to persons in Classes I and II as of August 1, 1971**

| Value of estate | Rate of tax on property (%) |
|---|---|
| $ 0 to $ 49,999[1] | 2 |
| 50,000 to 249,999 | 4 |
| 250,000 to 499,999 | 5 |
| 500,000 to 749,999 | 6 |
| 750,000 and over | 8 |

[1] If there are exemptions, they are subtracted from the first $50,000. The 2 percent applies to the difference between the exemption and the first $50,000.

CLASS III: This class includes all other persons, corporations, associations, and distant relatives, such as aunts, uncles, nieces, and nephews. Beneficiaries in this class pay inheritance taxes on receipt of property valued at $100 or over at the rate of 10 percent on the first $50,000, 12 percent on the next $450,000, and 15 percent on the balance, if any.

Filing date for the state inheritance tax is nine months from date of death. This was changed as of August 1, 1971. Before that the time period was longer and there was a discount available for early payment. This discount is no longer in effect. If the tax is not filed on time, a penalty can be assessed.

EXAMPLE: Let's assume that Mr. Farmer died leaving a $200,000 ad-

justed gross estate, after debts and administrative costs were paid. Because of limited types of property taxed, we will assume that only $120,000 of the estate was subject to state inheritance tax, half to the mother and one-quarter to each of two sons.

The mother would have a $30,000 exemption from her $60,000, leaving $20,000 at a rate of 2 percent or $400, plus $10,000 at the next higher rate of 4 percent, or $400. Her total tax would be $800.

The sons would have $5,000 exemptions each from their $30,000 inheritances. Two percent of $25,000 gives a tax of $500 each.

There used to be a difference made between real and personal property in computing the inheritance tax, but that no longer applies.

In addition, another tax—Michigan estate tax—absorbs the maximum credit for state tax allowed by the federal estate tax law. This latter tax is usually less than the inheritance tax and often is only a small amount on normal-sized farm estates.

## ESTATE TAXES

The federal estate tax is a far more sweeping and expensive tax than the state inheritance tax.

A federal estate tax must be filed if the decedent leaves a gross estate of $60,000 or more. Compared to the state inheritance tax, a wide range of property is included in the taxable estate.

Contrary to popular belief, joint property IS part of the estate for federal estate tax purposes. It is possible to avoid probate by holding property in joint tenancy. However, for federal tax purposes, the entire jointly-owned property is considered as part of the decedent's estate, not just half as you might think. One of the few ways of offsetting this situation requires the surviving joint owner prove that he or she furnished part or all of the original purchased price from his own earned funds. The latter point re-emphasizes the importance of keeping complete and accurate records of farm family transactions.

In general, life insurance proceeds are also considered part of the estate for estate tax purposes. About the only instance when this is not true is if the decedent retains no incidents of ownership. This means that the decedent didn't have the power to change the beneficiary, to surrender the policy for cash, to borrow against the policy reserve, to pledge the policy as collateral, or to assign the policy.

Retained life estates are also part of the estate for federal tax purposes. More generally, efforts to shift assets or property that leaves any degree of control in the decedent's hands will usually result in the property being subject to federal estate tax.

The gross estate of the decedent includes all property of the decedent whether real or personal, tangible or intangible. It also includes the decedent's share value of property held by tenancy-in-common.

The gross estate minus funeral expenses, administration costs, claims against the estate, and unpaid mortgages or other indebtedness is defined as the adjusted gross estate.

The taxable estate is the adjusted gross estate minus a standard $60,000 estate exemption, charitable contributions, and a marital deduction, if applicable.

The marital deduction applies to property inherited by the remaining spouse and is limited to the smaller of (a) the net value of the gross estate passing to the surviving spouse, or (b) 50 percent of the value of the decedent's adjusted gross estate.

Property is valued for estate tax purposes on the fair market value of the property at the date of the decedent's death, or the fair market value six months after the date of death. The federal estate tax must be filed within nine months from date of death.

Credits against the federal tax are allowed for payment of state death taxes, gift taxes paid during life, and federal estate tax on prior transfers. The federal estate tax will be reduced by the amount of any gift tax paid on a gift by the decedent of property included in his gross estate.

The estate tax is graduated and runs from a low of 3 percent to a high of 77 percent on a taxable estate of $10 million or more.

It is easy to see that an expert would be needed to get down to the fine details of planning a specific estate. The problem of dealing with estate taxes is further complicated by frequent changes in provisions, rates, and timing.

From this overview of the estate tax, let's turn to some of the things that can be done to reduce the amount of federal taxes paid by your estate.

Some of the tools that can be used in overhauling an estate to both fulfill the property owner's wishes and desires and also reduce taxes are:

(1) The marital deduction.
(2) Lifetime gifts.
(3) Trusts.
(4) Separate estates for husband and wife.
(5) Insurance.
(6) Annuities.
(7) Life estates.
(8) Land contracts.

Let's go back to our earlier example of Mr. Farmer who left an adjusted gross estate of $200,000. When he died, he left his whole estate to his wife in his will. She was entitled to the 50 percent marital deduction of $100,000 and the $60,000 basic exemption was taken. This leaves an estate of $40,000 with a gross estate tax of $4,800.

That wasn't too bad. But let's look at the next step. Eleven years later Mrs. Farmer died, leaving the $200,000 to her sons and daughters. When she died there was no marital deduction available; her estate had only the standard $60,000 exemption. The remaining estate was $140,000 and had a gross estate tax of $32,700. The combined federal estate taxes paid by husband and wife, in turn, were $37,500.

For comparison, let's look at the taxes paid by Mr. and Mrs. Thinker on the same size estate.

When Mr. Thinker died, leaving a

**Computation of Gross Estate Tax***

| Taxable estate equal to or more than— (1) | Taxable estate less than— (2) | Tax on amount in column (1) (3) | Rate of tax on excess over amount in column (1) (4) |
|---|---|---|---|
| | | | (Percent) |
| 0 | $ 5,000 | 0 | 3 |
| $ 5,000 | 10,000 | $ 150 | 7 |
| 10,000 | 20,000 | 500 | 11 |
| 20,000 | 30,000 | 1,600 | 14 |
| 30,000 | 40,000 | 3,000 | 18 |
| 40,000 | 50,000 | 4,800 | 22 |
| 50,000 | 60,000 | 7,000 | 25 |
| 60,000 | 100,000 | 9,500 | 28 |
| 100,000 | 250,000 | 20,700 | 30 |
| 250,000 | 500,000 | 65,700 | 32 |
| 500,000 | 750,000 | 145,700 | 35 |
| 750,000 | 1,000,000 | 233,200 | 37 |

* U.S. Estate Tax Return, form 706

$200,000 estate, his estate tax was the same as that of Mr. Farmer. His wife received half of his estate to take advantage of the marital deduction, reducing the estate at this point to $100,000. This $100,000 Mr. Thinker left to his children in a trust. The trust provided that his wife could receive the income from the trust during her lifetime and, if necessary, use some of the principal. Against this $100,000 trust the $60,000 standard exemption was applied, again reducing the taxable estate to $40,000, with a tax of $4,800.

The big benefit came when Mrs. Thinker died. Although she had the use of the $100,000 testamentary trust during the remainder of her lifetime, that trust was not part of her estate; the taxes had already been paid and it passed directly to the children as provided in the trust. Her estate consisted of the $100,000 she inherited from her husband. From this the $60,000 standard deduction was taken, leaving $40,000 for a tax of $4,800.

The total estate tax paid by both Mr. and Mrs. Thinker was $9,600. That is $27,900 less than was paid by Mr. and Mrs. Farmer on the same size estate.

No cases are as cut and dried as these were outlined, but the basic savings are there if farm families are willing to make the initial investment in time and money to create an effective estate plan.

### OTHER METHODS

From the death tax standpoint, one of the goals is to reduce the size of estates held by any one person at death by distributing these before death in various methods. The testamentary trust used above is just one of the tools.

Another tool is lifetime gifts. Under the federal gift tax law, each person is entitled to make one tax-free gift of $30,000 during his lifetime, and annual gifts of $3,000 a year per person before gift taxes are required.

If a family found itself, as so many do, with all of the property in the husband's name or in joint tenancy, they could use life gifts to straighten around their estate to avoid the big tax on the death of the surviving spouse.

If a husband wishes to make a gift of joint property to his wife, he should remember that half of that property is already hers. If he gives her ownership of $63,000 worth of property they hold in joint ownership, $32,500 of it already belongs to her because of a marital deduction under the gift tax law. By using the $30,000 lifetime gift to which he is entitled, plus the $3,000 annual gift, he can then transfer title to the $63,000 piece of property without paying gift tax.

The same would work in gifts by husband and wife to their children. In joint gifts they can pool their lifetime gift allotment of $60,000 and make annual gifts of $6,000 per person. Of course before moving in this direction they should first make sure that their own present and future needs are taken care of. Once a gift of this sort is made, there is no way of getting it back. In fact, if strings are put on the gift, it will be considered part of the decedent's estate and will be taxed as such.

### LIFE INSURANCE

Another little used gimmick that can reduce federal estate taxes is the purchasing of an insurance policy on the husband in the wife's name. Because he has absolutely no control over the policy or its beneficiaries, it is not considered part of his estate. If necessary, he can use his $3,000 gift allowance to enable her to pay the premiums. Such a policy could be extremely important in paying off debts, taxes, and expenses that might otherwise have caused the sale of the farm.

In each instance above we have used examples where the husband passed away first. This was because of the statistical precedent. Men do die younger than women and usually marry women younger than themselves. But the same basic principles also apply if the wife were to die first.

Before you can really evaluate where you stand in estate taxes, you need a complete inventory of all the property you and your wife own, plus a listing of how it is owned, joint or separate, and all of the debts. From there you can get a rough idea of where you stand taxwise if you should die today or in the near future.

Then you can take this information and some ideas in to discuss with a good CPA and/or lawyer with experience in estate planning. The experience is very important. You wouldn't take your color TV to a garage to be repaired. It takes someone devoting a lot of time to estate planning to keep up with the constant changes and developments.

### ESTATE TIPS

Three main things should be considered when planning for death taxes. First, tax savings alone should never be the sole basis of a careful plan. Always weigh carefully the desires and characteristics of the family against the possible tax savings. It could very well be that a plan that saves the maximum in taxes doesn't accomplish a property owner's real goals.

Second, be aware that ways exist by which you can influence death taxes paid by your estate. With proper exploration and especially early planning, you can accomplish your goals, AND save taxes.

Third, there is no such thing as a completed estate plan. Once you have one worked out to your satisfaction and that of your family, check back with your lawyer at least every three years to see if it is up to date—more frequently if there are major changes made in estate tax laws.

In this article we have been able to mention just a few of the major tools and how they can be used in estate planning. We are obviously limited by both space and the complexity of the subject. In future issues we will deal individually and in greater depth with such topics as life insurance uses, titles, farm transfer, sale of farms, gifts, trusts, annuities and life estates, and retirement provisions. The next article will deal with Wills.

# YOU HAVE A WILL BUT YOU MAY NOT LIKE IT

## CHAPTER 6

IT'S HARD WORK to build a successful farm business. As it expands, whether quickly or slowly, it gains in value, especially the land.

You put your life's blood into building up the assets, but what happens to them when you die? They are distributed, but perhaps not the way you would have liked. It all depends on whether you had a personal will.

It is impossible to die without a will of sorts. If you don't have a formally drawn up will or a handwritten (holographic) will, the state laws of descent and distribution take over. They act as an "average" will with the result that they don't take into consideration the problems and wishes of the individual. All your individually-held property is put in a pot, so to speak, stirred, and distributed according to the laws.

Take the Jones family for example. Mr. and Mrs. Jones had worked together on their small farm for all their married lives. They had no children and the title of the farm was in Mr. Jones' name. Jones died without a will, assuming that all he owned would then go to his wife. Unfortunately, under the laws of descent and distribution this is seldom the case. The laws required in this instance that the farm be divided in two, with half going to Mrs. Jones and half to Mr. Jones' nearest relative, a brother whom the Joneses had not seen in years. Maude Jones was forced in her sixties to get a part-time job to support herself even though she and her husband had worked together all their married lives to build their small estate.

"The average man assumes that if he dies without a will, his wife will get all his property," said Probate Judge Ronald Lange, St. Joseph. "This is true only of joint property. Under Michigan law as it presently exists, if there are two or more children, and no will, the wife gets one-third of the property. If there is one child or close relatives of the deceased spouse, she gets half of the property."

### POOR CHOICE

For the vast majority of farmers, the state "will," as represented by the laws of descent and distribution, provides a very unsatisfactory means of transferring property. Choice or individual preference is eliminated. The estate generally gets hit with the maximum state and federal tax bite. The deceased has no say in who will act as the fiduciary in settling his estate. If a man and his wife die without wills, in a common accident the courts will be forced to appoint a guardian for their children. This would perhaps not be the person the farmer and his wife would have chosen because of different ideals, attitudes, and life styles.

"It is the desire of the probate court to do exactly what the deceased would have done with his property had he been present to express his wishes," said Probate Judge Glenn E. Jordan, Saginaw. "A properly executed will is the best way to tell the probate judge what those wishes are."

A will is, very simply, a legal document by which a person disposes of his property, to take effect at his death. It affects only assets held in his sole name or his share of ownership of assets held in tenancy in common. It does not include things like life insurance policies or joint property, which are passed by contract.

"A will is one of the oldest instruments known to man and one of the most difficult to destroy legally," said Three Rivers attorney Richard Wade. "The primary advantage is that it changes the law to conform with the individual's needs and wishes."

In the thousands of years of its development, a language of wills has developed. Words convey very specific meanings to judges who have the responsibility of probating wills. For this reason it is highly advisable to have a will drawn up by a competent attorney with experience in drafting wills.

A last will may be made by any person over the age of 18 and of sound mind to dispose of all of his estate, both real and personal.

According to the lawyers, CPAs, and judges we interviewed, everyone who has property worth more than $5,000 in his own name, specific bequests to make, or minor children should have a will.

The advantages of a will are numerous and important to most estates.

### DISTRIBUTION

One of the first advantages usually considered is the power of a will to enable the owner to distribute his

property to best fit his situation and desires.

Through a will, the testator (one who makes a will) cannot only make unequal distribution of his property where he deems proper, he can also make specific requests that would be impossible without a will. For example, a father can make sure his oldest son gets his grandfather's watch, or a mother can hand down a special piece of furniture to the daughter who always appreciated it.

This ability to guide the distribution of property is very important in the case of young families with minor children. A husband can arrange through a will for his wife to receive half of the property directly and to have control of the rest through a trust for the children. Without a will, two-thirds of the property would be in the name of the children. The wife could not touch it without permission of the court. It would be necessary for her to become the legal guardian of the children with all of the related complications, such as reports to the court and bonding.

## TAX SAVINGS

A will can be used to take advantage of the various legal methods of reducing state and federal death taxes. Two principle means, as outlined in the article on death taxes in the last issue, are (1) dividing property to take maximum advantage of the marital deduction and (2) use of testamentary trusts. The latter avoids the large taxes that result on the death of the second spouse when much of the estate is in one person's hands.

Both husband and wife should have wills. There are many reasons for this, but one involves taxes specifically. If a husband and wife are both killed as a result of the same accident, but one survives the other, if only briefly, their property will be subject to double probate and extra taxes. A good will contains a special provision to protect the estate against such an occurrence.

In fact, due to the passing of joint property, the wife may need a will even more than her husband. Although much of the farm property may be held in joint ownership, when the husband or wife dies, the surviving spouse then holds the total estate in fee simple ownership. Because of the much larger size of estate left by the surviving spouse, the benefits from having a will — and the penalties from not having one — will be proportionately greater.

## GUARDIANSHIP

"Consider, for example, what would happen if both you and your wife died without a will," said Judge Jordan. "The court would have the duty of deciding on the guardianship of your minor children. Parents should make this choice, not some judge who doesn't have any idea how the parents would have desired their children to be reared."

Although the naming of a guardian in a will is only a recommendation to the court, it is usually followed if the court regards the nomination as reasonable for the interests of the children.

It is possible to have two guardians, one responsible for the children and their care, the other responsible for the financial affairs of the children, perhaps a trust.

Without wills specifying their choice for guardian it is possible that a couple's children might be raised by a close relative — brother or sister of one of the deceased parents — whose child-raising abilities the parents had highly criticized during life.

## FIDUCIARY

Every estate must have an executor (with will) or administrator (without will) who is responsible for managing the property for the estate, guiding it through probate court, and settling inheritance and estate taxes.

If you do not designate the person you would like to carry out these duties, the court will appoint someone to administer the estate. Naming a person who is familiar with your affairs, qualified, and trustworthy gives you one more method of controlling the distribution of your property. This can either be a family member or an outsider, like a trust company. A combination of family member with a trust department or CPA as co-executors may be an excellent compromise. (See article on probate in the April 15 issue for details.)

The testator can avoid a sizeable cost to his estate by specifying in his will that the executor or fiduciary serve without a surety bond. This, of course, would require confidence in the character and ability of the fiduciary named.

Through your will, you may also give your executor powers of management and investment which an administrator doesn't have. Under these conditions your fiduciary can sell or lease property without applying for permission to the court each time. He can also continue your business or dispose of it, and do any number of other things you specify. Without a will setting forth these powers, he may not be able to take these steps and will be able to take others only with the permission of the court. With a will, the choice is yours.

## CAN BE CHANGED

Once a will has been drawn, signed, and witnessed, it can — and probably periodically should — be changed. This allows the property owner to keep pace with changing family and property situations.

"I feel everybody should have at least three wills in their lifetime," said Judge Lange. "When they are first married and before their property has accumulated to any great degree, husband and wife should have wills leaving everything to the surviving spouse. Later on, when the children are partially grown and the couple's property has begun to accumulate, they should have wills leaving part — say half — to the spouse, with the other half in a trust for the children's education which the surviving spouse would control. When the parents reach retirement age, because of changing family and property circumstances, they should usually consider a third will."

The judge further urged that wills be periodically reviewed, especially if there are any general revisions of the tax laws.

## CHARITIES

Through a will it is also possible to leave sums of money or property, outright or in trust, to your favorite charity, hospital, or church.

Another advantage of transferring property by will is that the property owner can retain full control of the property until his death.

## DISADVANTAGES

One of the main disadvantages possible in a will is that it may be poorly prepared and fail to carry out the wishes of the property owner. The making of a will alone doesn't guarantee a satisfactory way of transferring property. It is the planning that goes into a will that counts; how it fits into the entire estate plan. Other important "mechanical" aspects are choice of words, contingency clauses, freedom of ambiguity, avoidance of contradiction, and special bequest provisions.

The law permits an owner to direct the use of property for many years after his death. This sometimes causes hardship to beneficiaries because of changing economic and family circumstances.

The long life of people today creates another possible problem. If a farmer waits until he dies to transfer his property to his children, they may be uncertain as to how and to whom the property will eventually go. Neglect, inefficiency, and indifference in running the farm may result. A firm understanding should accompany the will, supplemented perhaps by a land contract with the farming beneficiary or some other method of transferring the farm property during the lifetime of the owner.

In contrast, one of the important advantages of making a will should be that it forces the families involved to sit down and discuss their estate transfer problems. The process of working together creates an atmosphere of better understanding. Without this understanding, family friction among beneficiaries can be serious, especially when emotional feelings are high.

### LIMITATIONS

Although a farmer can control his property for a period of time after his death, there is a law against perpetuities. This would prevent, for example, a farmer from leaving his property to his eldest son with the stipulation that in each generation after that it be passed to the eldest son. The law against perpetuities requires that the property be vested in someone within 21 years after the death of two individuals living at the time the instrument or will takes effect.

The exception to this rule involves trusts and charities. You can establish a trust in which the income from your property goes to maintain a scholarship fund, or provide income to a church or charity.

A second major limitation of the power of the will provides that a will cannot take precedence over the amount of property a spouse may receive under the laws of succession. It is possible that a man may leave his wife out of his will, but she in turn can choose to take her share of the property under the laws of descent and distribution. If she does so, the remainder after she takes her share is distributed according to the terms of the will. In effect, it means that a wife cannot be disinherited unless she so chooses.

A will also cannot take precedence over an antenuptual agreement—a written agreement made between spouses before their marriage. This situation is most common with a second marriage where children and property were brought into it from the first marriage.

### JOINT WILLS

One of the main things we were warned against over and over by judges, lawyers, and CPAs was the joint will. Husband and wife sign one document as their will. This becomes a contract and when one spouse dies, the other is bound to all the terms of the will. In many cases there are reasons why the surviving spouse would like to change the will or put it into a different form because of changing family and financial needs. With a joint will this would be impossible.

"Never has a joint will," said CPA Lyle Hepfer, Lansing, reacting strongly to the point. "In fact, well-drawn wills should have a provision that states 'although my wife and I are making similar wills at this time, they are not to be considered joint wills, but each reserves the right to change their will at any time.' That paragraph, or one like it, would be good to have in every will."

### SUMMARY

A will is just one of the many

## LEGAL ASPECTS OF WILLS

Every person over the age of 18 and of sound mind may, by last will, dispose of all his estate, both real and personal.

A will cannot take precedence over (1) an antenuptial agreement in writing or (2) the amount of property a spouse may receive under the laws of succession.

A formally executed will (1) must be signed at the end by the testator himself or someone in his presence to sign his name (usually if he was physically unable to sign). (2) The signing must be in the presence of at least two witnesses. (3) The testator must at the time of signing the will advise the witnesses that the instrument is his will. (4) The two witnesses at the testator's request and in his presence must affix their signatures and should write their addresses in their own handwriting at the bottom of the will.

A supplement to a will, consisting of revisions, additions, or alterations made after the will has been been made, is known as a codicil. The codicil must be executed, signed, and witnessed in the same manner as a will. Corrections should not be made in a will by erasures, insertions, or crossouts. All corrections or other changes should be made by codicil.

It is possible to create a holographic will. This is a will that is entirely written, dated and signed by the hand of the testator himself. It doesn't need to be witnessed.

One of the problems with this type will is that there are rigid requirements in form for wills set out by state law. Failure to comply with these requirements could invalidate your will. Also the legal terminology was formulated to relay specific meanings. A lack of knowledge of these meanings could create results far from those you intended.

### DEFINITIONS

The person who makes a will is called the testator (male) or testatrix (female).

A person dies intestate if he or she left no will, but testate if he made and left a will.

A beneficiary is a person benefiting under the terms of a will; an heir is a person entitled to receive part of an estate when there is no will.

A person's issue are all of his or her descendants: children, grandchildren, etc.

A testamentary trust is one provided for in a will.

tools of estate planning. Through preparation of a well-designed will you can insure that your property will be distributed at your death as you wish. One of the main advantages of a will is that it can help you plan for the unexpected and look after the welfare of your family in case you or your wife—or both — die while your family is young and your business still growing.

Once the single copy of the will is signed and witnessed as required by law, put it in a safety deposit box or file it with the probate court or your trust company so it will be safe. Remember that it isn't a finished product, but should be reviewed regularly.

"Wills should be changed as conditions change," said Judge Jordan. "Kids grow up. Friends and relatives die. You accumulate more property. Even a person who is alive and poor can end up dead and rich —if the cause of his death involves negligence and a lawsuit for personal injury against the negligent person."

Who should have a will? You should, Mr. Farmer, and so should you, Mrs. Farmer.

# WHOSE NAME SHOULD BE ON TITLES?

CHAPTER 7

A TITLE is more than a piece of paper conveying ownership of a tractor or 100 acres of land. It isn't something to be stuck in a drawer and forgotten. Rather, a title is an important part of your total estate plan. In fact, an adequate estate plan cannot be constructed separate from the titles involved and the information on them.

Titles can affect how property is transferred, who will get it, and the eventual costs of estate settlement and taxes. All of these results depend on the way the property is owned—sole ownership, joint tenancy, or tenancy in common. Each of these three ownership methods has its advantages and disadvantages and must be weighed in light of specific estate management plans.

## PROPERTY OWNERSHIP

**Fee simple (sole) ownership** is ownership of property by one person who has an unrestricted right to sell, mortgage, or otherwise dispose of it. A will is needed to direct transfer of the property at the death of the owner. Without a will, the state laws of descent and distribution will determine who receives the property.

Under sole ownership, full control of the property remains with the owner until his death.

The transfer of sole ownership property at death is subject to probate costs, Michigan inheritance tax, and federal estate tax.

**Joint tenancy** with rights of survivorship is a form of co-ownership between two or more individuals in which property passes from the deceased tenant to the survivor(s) with only a small amount of legal formality. This type of co-ownership may exist between related or unrelated persons and cannot be broken without the consent of all concerned parties.

Tenancy by the entirety is a special kind of joint tenancy that can exist only between husband and wife. This type of tenancy cannot be broken by either spouse without the other's consent.

Property held in these types of co-ownership will pass to the survivor(s) even though the deceased joint tenant has directed by will that his equity in the property should go to someone else.

On the death of one joint tenant, full ownership of the property vests immediately in the other(s). It does not pass as part of the deceased's estate. This avoids probate and administration on this part of the decedent's property, thereby reducing cost and delay. Property held in joint tenancy is also not subject to state inheritance tax.

However, contrary to common belief, joint property IS subject to federal estate tax. Unless some of the purchase price was paid by the surviving owner—and he or she has the records to prove it—the federal estate tax falls on the entire value of the property.

**Tenancy in common** differs from joint tenancy mainly in that there is no right of survivorship. Each co-tenant has a right to transfer his undivided interest by selling it, giving it away, or by transferring it to persons of his choice at his death. If not disposed of by will, at death the interest goes to the heirs according to the state laws of descent and distribution.

All co-tenants have equal rights to manage and live on the property.

The taxation of property held tenancy-in-common is treated differently at death, also. Only the share owned by the deceased tenant-in-common is taxed in his estate and not the full amount of the property—as is often the case with joint tenancy. The fractional share owned by the deceased is subject to probate and administration costs, and state and federal death taxes.

Inheritance laws create a tenancy in common when there is more than one heir.

## JOINT TENANCY

Joint tenancy (or tenancy of the entirety) is one of the most popular means of owning property, especially farm real estate. Property owners operate under the impression that by using joint tenancy they will reduce taxes on their estates, avoid probate, and eliminate the need for a will. In many cases, farmers operating under these beliefs will be wrong on all three counts.

From the standpoint of reducing the death tax bite on an estate, the main purpose in tax planning is to even out the flow of property so that it all doesn't end up in the hands of the surviving spouse. Unfortunately, depending heavily on joint tenancy to transfer property creates the very situation you are trying to avoid.

As pointed out in the May 6, 1972

MF article on death taxes, when property is owned jointly, the taxes are relatively light on the death of the first spouse due to the 50 percent marital deduction and the $60,000 exemption. However, if all the property is held jointly, it accumulates in the hands of the surviving spouse with a resulting high tax.

"How titles are handled depends entirely on the estate," said Lyle Hepfer, Lansing CPA. "It is my theory that if you have a $120,000 combined estate of husband and wife or less, it should probably be joint. When one of them dies, the 50 percent marital deduction would cut the taxable estate to $60,000. Use of the $60,000 standard exemption would result in no tax. On the death of the second spouse, the $120,000 would all be in one person's estate. The standard exemption would result in a federal estate tax of $9,340 on the remaining $60,000.

"But when you get up in the $200,000 estate category, because of the graduated nature of the tax it is a much more serious situation," said Hepfer. "Federal estate tax on the first death will be $4,800. This jumps to nearly $32,000 on the second death, for a total of roughly $37,000. If this property had not been held in joint tenancy with rights of survivorship, the owners could have developed a plan to divide the estate some way. The result could have been a combined husband-wife federal tax of $9,600, or a savings of $27,000."

Although it is possible to avoid probate and state inheritance tax on property held in joint tenancy, most families are unable to get everything in joint tenancy with rights of survivorship. Some of it gets missed or forgotten. If the remaining estate is $5,000 or more, the family will still wind up in probate, although the related costs will be smaller because the bulk of the property would have transferred directly.

In addition, it is almost impossible to avoid probate on the death of the surviving spouse unless she turns to living trusts or some other means of transferring her property.

## "JOINT" PROBLEMS

Depending on joint ownership instead of sole ownership and a will can result in some special problems. Take for example a situation where a man dies leaving all of his property to his wife through joint tenancy. If she remarrys and puts her property into joint tenancy with her new husband, when she dies the children by the first marriage are in effect disinherited.

Still another possible disadvantage to consider is that all or most of the property may come from one side of the family—such as a family farm—and end up on the other side. This is particularly important if there are no children.

Joint tenancy is susceptible to people problems, too. If you put your wife on the deed as joint owner and have a falling out with her, perhaps even a divorce, it is next to impossible to get your property back in your own name.

Should parents have their property in joint tenancy with their children? Consideration should be given to the reasons for doing this before the step is taken. Parents lose complete control over their real property if it is joint. They could not, for example, sell or mortgage the property without the children's permission. Maybe at an older age or in case of the inability to manage property this would be desirable. Again, the family situation and the estate transfer objectives are the keys.

Transfer of the farm as a going business can also be inhibited by depending solely on joint tenancy. If you have four children, a joint deed with them would give each a one-quarter interest at your death. Usually these units would be too small to be farmed as separate units. One of the children would be forced to assume a tremendous debt load to buy out the others if he wanted to maintain the family farm. However, if you had used a combination will and land contract to create an arrangement with the son who wanted to continue the farm, the whole transfer problem could have been worked out before your death and the children all treated equitably.

## PERSONAL PROPERTY

Title to farm personal property is generally considered to belong to the husband. "If the wife has any money at all in the farm and this money is used to buy livestock, machinery, land, or any other property, every effort should be made to keep an accurate record," said Hepfer. "If you don't have a record, it's considered to belong to the husband and will all be taxed at his death."

It is difficult—near impossible—to establish the contributions of a wife or son to the farm business once the father or husband dies.

Developments in tax cases indicate a change in attitude toward the wife's share of farm personal property. Check with your attorney about the possibility of creating joint tenancy for farm personal property. It's a hazy area in law, but a recent Indiana court decision gave a farm wife a share of the farm personal property when she proved she was physically active in the farm work.

## ALTERNATIVES TO JOINT

In a later article on farm transfer, we will stress the importance of beginning to transfer the farm to your heirs during your lifetime. If you do decide, however, to transfer your property at death and your estate is $120,000 or larger in value, you may find other ways of holding property more desirable than joint tenancy. These include having the husband retain full ownership of the property so he can take full advantage of the marital deduction and use of trusts to reduce taxes; tenancy in common; or developing a plan to create separate estates with each spouse holding part of the land and part of the personal property.

**As a general rule, taxes are less when the assets of husband and wife are about equal and each transfers at least part of the estate to descendants in trust with a life interest left for the surviving spouse.**

## GIFTS

If too much of your property is currently held in joint tenancy, one of the best tools for dividing the titles into separate holdings or converting to a tenancy in common is use of gifts. This was covered briefly in one of our previous articles but is such an important tool that the next article in the series will be devoted to the subject of gifts and their use in estate planning.

Frequently overlooked in the co-ownership of property is the possibility of a gift in the creation of a joint tenancy or a tenancy-in-common. If $20,000 in stock was purchased out of net farm income and the title was put in co-ownership with another person, such as one of the children, there would be a gift of one-half or $10,000. (Note: if the gift is large enough a gift tax may be due.)

The general rule provides that a taxable gift may occur at the time property is paid for by one person and title is taken in co-ownership with another. An exception to this rule provides that for joint tenancies in real property between husband and wife, created after 1954, taxa-

tion of any gift involved may be deferred until the tenancy is terminated.

If the tenancy is terminated by death of either the husband or wife, or in any way so the property is distributed back in the same way as originally held, then no gift tax would be due. If the termination of the joint tenancy is in any other manner, such as converting a joint tenancy into a tenancy-in-common, a taxable gift may result.

### SEPARATE ESTATES

Opportunities for building separate estates exist in many farm operations and should be utilized over a long period of time. For example, if a wife works even part-time, the money she earns can be invested in the farm and appropriate records kept of her contributions. The same is true of a son or other farming partners.

If the wife has an inheritance of $10,000, which is used to pay for part of a $30,000 piece of land, it would be possible to give her an undivided third interest in the land. The rest could be put in the husband's name.

There are also opportunities for the next generation to become involved in this planning procedure. Transfer at death by the parents usually results in business ownership by the younger partner too late in his business career. The next generation should have the opportunity for gradual purchase of the business during their most productive earning years. Expansion property in a partnership should probably be purchased by the younger couple and titled in their names.

### SHIFTING PROPERTY

As parents get older, they may want to transfer title to non-income-producing property to their offspring to reduce their estate size. If they have a cottage on a lake worth $40,000, they can make use of the gift tax provisions to give it to their children. If they are in the 28 percent tax bracket, they can effectively reduce their federal estate tax by $11,200 through the gift.

Owning titles to land in several different states can be a pain in the neck to your descendants, too, unless special provisions are made. Each state has its own rules and regulations and requires separate probate for property within its borders.

If a husband dies, leaving out-of-state property to his wife through joint tenancy, there is no problem. But when the wife dies, the property could easily be part of her estate and subject to probate. Alternatives of selling the property during life, giving it to descendants during life, or placing the titles in trust would avoid this problem of multiple probate proceedings.

### INSURANCE OWNERSHIP

Another way of separating property in an estate to take advantage of tax breaks is through insurance. Whoever owns the insurance policy has the policy value included in his or her estate for federal tax purposes.

If the husband has a good-sized life insurance program, he can transfer his larger policies to his wife as owner and beneficiary. This can be done most easily if the policies haven't been owned very long and, as a result, the cash surrender value of the policies is still low. Otherwise some gift tax may be due.

If the wife owns the policies, when the husband dies they are not part of his estate for tax purposes. If the wife should die first, leaving the policies in a testamentary trust to the children, the policies are taxed at cash value. When the husband dies in turn, the trust receives the full face value of the policies with no further taxes due.

If a farm family is planning to purchase additional life insurance, they should strongly consider the advantages and disadvantages of having the wife buy the policy on the life of her husband. Talk this over with your life insurance agent.

### OTHER PROPERTY

People have title to all kinds of property. The convenience of having the family checking account and savings account held jointly with rights of survivorship may outweigh the tax consequences. This may also be true of the family automobile, although some of our information sources have strong negative feelings on this subject.

"If you (the husband) have an automobile, you should consider keeping it in your own name," said Richard Wade, Three Rivers attorney. "If you have two, put one in your name and the other in your wife's name. Don't have joint titles. If you have an accident with your own car and you are proved to be at fault, the judgment can't touch jointly-held property. It can involve joint-tenancy property, though, if you or your wife have an accident with the other spouse's car."

An advantage of joint ownership with rights of survivorship of the car is that the survivor can obtain title from the Secretary of State's office by providing proof of death of the deceased joint tenant. This can take as little as one day at the Lansing office of the Secretary of State, or as long as several weeks at more remote locations.

The best choice between joint tenancy, tenancy-in-common, or sole ownership depends to a large extent on the size of the estate and your goals. If your estate is under $120,000, joint tenancy may be an acceptable method for holding title to property. Or you may want only part of your property, such as the family residence, jointly held between husband and wife.

As your estate increases in size and becomes potentially subject to higher estate taxes, joint tenancy may become a less satisfactory method of owning property. Analysis of titles held individually and jointly by a couple is an integral part of any good estate plan. Only then can steps be taken to change these titles to fit the long-run goals of the family.

How many titles do you have now, including everything from land to snowmobiles? Where are they kept? Whose name or names are on them? What will happen to farm personal property when the husband dies?

Maybe it's time to gather all those titles from their various hiding places and examine them in the light of your present farm operation and future estate. As is true in all estate planning, the earlier in your life you start building in a specific direction, the easier it will be for you to guide the development and growth of your estate toward your goals.

# GIFTS: FLEXIBLE TOOLS FOR PROPERTY TRANSFER



DURING an individual's lifetime, or that of a married couple, property of all kinds is accumulated. The goal of estate planning is to insure maximum enjoyments of the property and later to transfer it according to the wishes of the owners. Through careful planning, this can be done with the least possible cost to the estate from settlement expenses and taxes.

The greatest gains from sound estate planning come when the transfer starts before death, while the owners still have the ability to guide and affect the outcome. One of the most flexible tools for property transfers during the lifetime of the owners is the gift.

### WHY GIFTS?

"In addition to expresing love and affection, gifts during life can serve other purposes," said University of Illinois agricultural law specialists N. G. P. Krausz and A. R. Allen. Other purposes outlined are:

1. They give children training in the management and conservation of property and may aid them to obtain an education.

2. The gift of an interest in the farm encourages a son to remain on and improve the farm and thereby lessens the father's management burden as he grows less active with age.

3. They reduce the size of the estate that must pass through court administration, thereby cutting probate costs as well as estate and inheritance taxes.

4. Through gifts of income-producing property, income can be shifted from one family member to another in a lower tax bracket to accomplish income tax savings. When trusts are used, further income tax savings can be accomplished.

Although giving your property away may sound simple at first, there are definite rules that govern what you can and cannot do, as well as what you should and should not do. First, let's look at some examples of gifts and then at the rules and guidelines behind them.

### UNNEEDED WINDFALL

Widow Crop Farmer is in a comfortable condition financially. She not only has enough to take care of present and predictable future expenses, but is saving a little each year. Recently, her brother-in-law passed away and willed her $70,000 net in blue chip stocks. She doesn't need the money and is faced by the question of what she should do with it.

How about her four grandchildren who will be attending college in a few years? Although her two sons could provide for their children's education, it would take funds needed in their current farm business expansion program.

She utilized lifetime gifts to transfer the recently acquired stock into a trust fund to be used by her grandchildren for their education. Her windfall gain ended up helping the whole family at a time that produced the maximum benefit.

Mr. Dairyman has another use for gifts. He owns a farming operation valued at about $200,000, with $50,000 of that in personal property. He has a son who, after serving his military obligation and working a year on the farm, has decided he wants to buy into a partnership arrangement. Although Mr. Dairyman wouldn't admit it, this is what he has been hoping for all along. Additional business size is needed, but the decision has been made to grow into a larger business rather than to purchase at this time.

Although Mr. Dairyman doesn't have a large estate, he wants to help his son get a good start in farming. He used the gift transfer method to begin this project by giving his son a half ownership in the $50,000 of partnership personal property. Present plans also call for the purchase of the neighbor's farm when it becomes available. This will be put in the son's name with partnership funds used to make interest and principal payments. Over the expected 15-year life of the partnership, through his half interest in the partnership, Mr. Dairyman will be giving his son part of the land's purchase price.

### GIFT GUIDELINES

Although these examples may not illustrate all the reasons for making gifts, they do show some important principles that should be considered before gifts are made:

FINANCIAL SECURITY — From the giver's standpoint, each was able to make gifts of property or cash without jeopardizing his own fi-

nancial security. When a true gift is made, there can be no strings attached. Principal and interest are given up forever, thereby reducing the future security of the donor. If strings or controls are kept by the giver, at his death the gift will be subject to estate and inheritance taxes.

Although it may sound selfish, you are also considering the welfare of your family when you maintain an adequate level of funds and income to meet current living expenses and unexpected money needs, such as illness and hospitalization.

The size of estate needed to maintain financial security isn't known. It will vary with the individual and his circumstances. However, the giver's age, earning ability, retirement income sources and amounts, inflation, and annual income needs are important considerations in arriving at this unknown.

RECIPIENT'S JUDGMENT — Regardless of the means employed, a gift boils down to the donor transferring property, property rights, or interests to someone else. The donor has given up something, has lost control.

Before gifts are made, the donor has to accept the fact that the recipient may use the money or gifts in a manner that may not seem wise from the donor's point of view.

In effect, the donor must respect the financial judgment and responsibility of the person receiving the gift. Otherwise, it could be very disheartening to see hard-earned savings used for purchases that don't meet the giver's approval.

TRANSFER PLAN — Lifetime gifts should be part of a broader property transfer plan and complement, not compete with, this program. This principle is illustrated in Mr. Dairyman's case. Some day, his son will be the complete owner and manager of the business. Gifts were used through a partnership business arrangement to start and carry on this eventual transfer.

The gifts were one phase in the long-run plan. Other transfer methods may be needed to complete the plan.

BENEFIT OR BURDEN? — The giver should make sure property transferred through gifts would be beneficial to the recipient. There are instances where gifts could create financial, mental, or emotional burdens. If these conditions exist, the donor should turn to alternative receivers, such as other relatives or charity.

HAVE A REASON — Donors should have a purpose or reason for making gifts. Generally, the giving produces benefits for the giver, receiver, or both.

TAXES — You shouldn't make gifts without first considering the federal gift tax. But even with the gift tax, you may be able to legally reduce or avoid income tax, capital gains tax, and/or federal estate tax and achieve estate planning goals through the wise use of gifts.

Take for example Mr. High Income, who is in the 50 percent tax bracket and has an obligation to support his aged mother. He needs to earn two dollars from an investment before giving his mother one dollar. But if he transferred investments to his mother, with her exemptions it might be possible that two dollars earned would be all available for her care, support, and maintenance.

An estate subject to large federal estate taxes may benefit tax-wise from a scheduled transfer of property through gifts. Federal gift taxes would have to be considered, but, in general the gift tax rates are lower and exemptions higher than the federal estate tax. Gifts to minimize taxes need to be handled correctly to accomplish this objective.

## GIFT TAX

The federal gift tax applies to everyone, although the rules for nonresidents are somewhat different than for U.S. residents. Responsibility for gift tax payment is imposed on the donor, but the recipient may be called upon to pay the tax if the donor doesn't pay.

A distinction is made for gifts under the federal gift tax law between a present interest in property and a future interest.

Present interest means immediate possession, enjoyment, and use of the property given. Complete ownership and control is transferred to the recipient. Future use is a legal term and basically refers to a situation where use, possession, or enjoyment are limited, usually put off to some future date.

A transfer of property for the benefit of a minor who is not 18 years old on the date of the gift is not considered a future interest in property if the terms of the gift satisfy the following conditions:

1. Both the property itself and its income may be expended by or for the benefit of the donee (recipient) before he attains the age of 18;

2. Any portion of the property and its income not disposed of under (1) will pass to the donee when he attains the age of 18; and

3. Any portion of the property and its income not disposed of under (1) will be payable either to the estate of the donee or as he may make a general power of appointment if he dies before attaining the age of 18 years.

## GIFT TAX RETURN

The gift tax applies to a transfer of property by way of a gift whether the gift is in trust or otherwise, whether the gift is direct or indirect, or whether the property is real or personal, tangible or intangible.

The tax also applies to property transfers under a sale agreement where the value of the property sold is greater than the amount received for the property. The difference between the market price and the selling price is considered a gift. If the gift is large enough, federal gift tax is due. Reduced purchase price, low or no interest rates, and easy terms could be considered in the nature of a gift if they differ markedly from normal business transactions.

If a combination sale and gift is used, the agreement should be carefully worded in writing to prevent misunderstandings between heirs at a later date.

A gift tax applies to property transfers when the gift is complete. A gift is considered complete if the donor has parted with possession and control over the property so that he has no power to change its use or condition, either for his own benefit or that of others.

It takes three elements to make a taxable gift: Intention on the part of the donor to make the gift; delivery of the subject matter of the gift; acceptance of the gift by the donee.

## COMPLETION OF GIFT

If a person gives a stock certificate to someone, the gift is considered completed, for tax purposes, on the date of delivery.

However, if two people (not spouses) have a joint bank account from which either the original owner or another can draw, the gift is considered complete when the noncontributing individual withdraws for his own benefit and is not obligated to pay the money back to the original owner.

The same is true of savings bonds. If one person buys a savings bond and has it made payable either to himself or someone else, not his spouse, there is a gift when that

second person cashes the bond without an obligation to account for the money to the original purchaser of the bond.

The transfer of a life insurance policy is subject to gift taxes the same as the transfer of any other kind of property. If the insured gives up his rights to the policy, a gift has been made when he releases ownership of the policy. The value of the gift is usually the cash value of the policy. As mentioned in earlier articles, this is an effective way of transferring large amounts of money into your wife's estate without payment of federal estate tax on the face value of the policy when you die.

If your wife should die before you, she could leave the policy in trust to your children. That way when you die the full amount of the policy goes into the trust and is not subject to tax as part of your estate. Since you no longer have any control over the gift, however, you should have a sound, lasting relationship with your wife.

### VALUATION OF GIFTS

Valuation of property, in general, for purposes of the gift tax return refers to the fair market value at the time of the gift. It is the value at which such property would change hands between a willing buyer and a willing seller. The value must be determined in a market when the public would commonly purchase that item.

Gifts of real estate create a problem in valuation because, generally, there is no established market price. Expert appraisals are desirable in most cases to provide the primary means of establishing the value for tax purposes. Other supporting evidence can be obtained from local tax assessment values, market activity, local sales, rentals, and recent mortgages.

Similarly, the value of an interest in a business should be based on a fair appraisal of all the assets of the business. In addition, other aspects such as dividend-paying capacity, good will, and earning capacity should be taken into consideration.

### ANNUAL EXCLUSION

The gift tax law allows an annual exclusion from taxable gifts of $3,000 for each person to whom a gift is made. There is no limit to the number of annual exclusions that can be taken by each donor or as to the number of years the annual exclusion can be taken for any one recipient.

In addition, each giver or donor is granted a specific exemption of $30,000 which he can use at any time. This is a lifetime exemption and can be used in one year or over a number of years.

The annual exclusion and specific exemption are independent of each other. Use of one in no way affects the other.

If the donor and his or her spouse elect to treat gifts by one spouse to a third party as being one-half from each, they can pool their annual exclusions and specific exemptions. This may be done even though only one of them owned the money or property given. This would enable married couples who have made no previous gifts to make tax-free gifts up to $60,000, plus $6,000 per year to any number of recipients.

In case of gifts made in trust, the trust beneficiary rather than the trustee is regarded as the donee. Thus an annual exclusion is allowable on the account of each beneficiary who receives a present interest.

(Note: There is no annual exclusion for a gift of a future interest in property.)

No gift tax is imposed on charitable transfers. All gifts to public, religious, charitable, or educations organizations may be subtracted from "total amount of gifts" to arrive at taxable gifts.

### MARITAL DEDUCTION

Gift tax also provides for a marital deduction. This is similar to the marital deduction of the estate tax and simply means that half of the gift from one spouse to another is tax free. The $30,000 exemption and the $3,000 annual exclusion can still be applied to offset the half of the gift to the spouse that is subject to tax.

For example, if a single man, who had made no previous gifts, gave someone $50,000, the gift tax would normally be about $950, if he used his annual exclusion and lifetime exemption. If a married man gave $100,000 to his wife, claimed the marital deduction, and utilized his annual exclusion and lifetime exemption, the gift tax would be about $950. This is especially important to efforts in estate planning. In an earlier article on taxes the advantages of having property divided in separate estates for husband and wife with only a small amount of it held jointly were pointed out. The gift can be an effective tool for accomplishing this reorganization of your property.

Even though they are tax free, marital and charitable deductions must be listed in gifts reported during the year.

### TENANCY BY THE ENTIRETY

Tenancy by the entirety is the same as joint tenancy between husband and wife with the right of survivorship. There are special regulations that prevail between husband and wife regarding real property transfers. You should seek the advice of a lawyer or CPA regarding specific transactions.

Briefly, the creation of tenancy-by-the-entirety property is not a gift at the time of creation, regardless of the proportion of the amount spent for the property by each spouse—during calendar years after 1954. However, the donor spouse can elect to treat the transaction as a gift—before the property appreciates—in the calendar year in which the transaction took place.

There is a gift when the tenancy is terminated other than by the death of a spouse, if the proceeds received by either spouse is greater than the proportion that would be due them considering their original amount of investment.

This rule also applies to contributions made for the purpose of making additions in the form of improvements and reductions in indebtedness.

As part of your estate plan you should figure out whether you would be better off paying the gift tax at the time new property is purchased, to give your wife a full share, or whether you should wait until the property is sold or passed at your death.

### TAX RATES

Gift tax rates are about three-fourths of the estate tax rates. However, the computations and the exemptions differ so much that the gift tax on a transfer during life often will be considerably lower than the estate tax on a transfer of the same amount of property at death.

Gift tax rates are set down in the accompanying table.

A gift tax return (IRS Form 709) is due from the donor when he, during any quarter of the calendar year, made gifts to any one donee of more than $3,000 for present interest in property. Penalties are provided for willful failure to file a return on time or for willful attempt to evade payment of the tax.

The return is due not later than 45 days following the close of the quarter in which gifts are made.

It is filed with the District Director of Internal Revenue in the district in which the donor resides. Any gift tax due is payable at the time a return is filed. Upon prior approval from the district director, payment of the tax can be extended up to six months if the due date results in undue hardship.

## COMPUTING THE TAX

Let's return to the case of the dairyman who gave his son a present interest in one-half of a $50,000 partnership. If he had never used his $30,000 specific exemption, he could elect to use it at this time. Subtracting the annual exclusion of $3,000 from the $25,000 gift leaves $22,000. Taking this from the $30,000 exemption means Mr. Dairyman would pay no tax on the transfer and would have $8,000 left of his exemption for use at a later date.

If the dairyman had already used his $30,000 exemption, he would have paid tax on the $22,000 left after his annual exclusion was subtracted. This would be $1,410.

A characteristic of the gift tax is its cumulative nature. Gifts are taxed according to graduated rates. Therefore the more gifts a person has made in past years, the higher the tax rate will be on gifts made during the current year. The gift tax is collected annually, so to figure the tax for any year, it is necessary to know the amount of gifts made in prior years.

Let's assume that Mr. Dairyman had used his $30,000 exemption and had made $50,000 in taxable gifts in previous years. The taxable gift in the current year is again $22,000 ($25,000 minus $3,000). But the tax is different than the previous example. Here is how it is computed:

| | |
|---|---|
| Taxable gifts for preceding years | $50,000 |
| Taxable gifts for current year | +22,000 |
| Total taxable gifts | $72,000 |
| Tax on $72,000 (see table) | 9,645 |
| Tax on $50,000 (see table) | − 5,250 |
| Tax on $22,000 at higher tax % | $ 4,395 |

In the last two examples the tax paid could have been further reduced if the gift had been given jointly with Mr. Dairyman's wife.

# GIFT TAX RATE TABLE

| Taxable Gifts From | Taxable Gifts To | Tax = | + % | Of Excess Over |
|---|---|---|---|---|
| .................. | $ 5,000 | $ 0 | 2¼% | .................. |
| $ 5,000 | 10,000 | 112.50 | 5¼% | $ 5,000 |
| 10,000 | 20,000 | 375 | 8¼% | 10,000 |
| 20,000 | 30,000 | 1,200 | 10½% | 20,000 |
| 30,000 | 40,000 | 2,250 | 13½% | 30,000 |
| 40,000 | 50,000 | 3,600 | 16½% | 40,000 |
| 50,000 | 60,000 | 5,250 | 18¾% | 50,000 |
| 60,000 | 100,000 | 7,125 | 21 % | 60,000 |
| 100,000 | 250,000 | 15,525 | 22½% | 100,000 |
| 250,000 | 500,000 | 49,275 | 24 % | 250,000 |
| 500,000 | 750,000 | 109,275 | 26¼% | 500,000 |
| 750,000 | 1,000,000 | 174,900 | 27¾% | 750,000 |
| 1,000,000 | 1,250,000 | 244,275 | 29¼% | 1,000,000 |
| 1,250,000 | 1,500,000 | 317,400 | 31½% | 1,250,000 |
| 1,500,000 | 2,000,000 | 396,150 | 33¾% | 1,500,000 |
| 2,000,000 | 2,500,000 | 564,900 | 36¾% | 2,000,000 |
| 2,500,000 | 3,000,000 | 748,650 | 39¾% | 2,500,000 |
| 3,000,000 | 3,500,000 | 947,400 | 42 % | 3,000,000 |
| 3,500,000 | 4,000,000 | 1,157,400 | 44¼% | 3,500,000 |
| 4,000,000 | 5,000,000 | 1,378,650 | 47¼% | 4,000,000 |
| 5,000,000 | 6,000,000 | 1,851,150 | 50¼% | 5,000,000 |
| 6,000,000 | 7,000,000 | 2,353,650 | 52½% | 6,000,000 |
| 7,000,000 | 8,000,000 | 2,878,650 | 54¾% | 7,000,000 |
| 8,000,000 | 10,000,000 | 3,426,150 | 57 % | 8,000,000 |
| 10,000,000 | .................. | 4,566,150 | 57¾% | 10,000,000 |

"Taxable gifts" are determined by deducting the $30,000 specific exemption (allowed only once, but cumulative until used up) and by deducting an annual exclusion of $3,000 per donee of gifts of present interests. The amount remaining is subject to tax as listed.

## WHAT TO GIVE

An important consideration in gift giving is what property to give. In most cases, this is related to the reasons for gifts, property available to give, and the results desired.

Widow Crop Farmer gave property that would produce educational funds through dividends or the sale of a few stock shares. A gift of land would not have returned enough rental income for the educational needs. Also, this could have resulted in high capital gains taxes from sale of the land and would have taken use of the land away from the sons' business.

Gifts of property to avoid or minimize taxes should be considered carefully so the objective is accomplished. If the objective is a reduction in income taxes, give the investment that returns a relatively high ordinary income.

Generally speaking, property with a high cost basis should be given, according to agricultural law professors Krausz and Allen. They gave this example: A 40-acre tract that cost $350 an acre and is now worth $400 an acre should be given in preference to a tract purchased for $100 and now worth $400 an acre.

The reason is that the tax basis (cost plus improvement less depreciation taken) carries over to the receiver of the gift. If the basis is low, depreciation deductions will be small, and if the property is later sold by the recipient of the gift, income tax will be high because of high capital gains.

Leaving low basis property in the farmer's estate has the advantage of creating a new higher tax basis at his death. The fair market value at that time becomes the new basis, and a subsequent sale by the heirs incurs little or no income tax.

## PRECAUTIONS

Farmers, like other property owners, sometimes are reluctant to give up complete control of property. They occasionally use deeds in escrow or deeds with retained life estates to retain possession and control of the property during their lifetime. Neither of these provides tax advantages and are not recommended in estate planning to reduce death taxes. In special circumstances, however, they may be useful. If power or control is retained when the gift is made, or if a life estate is reserved by the giver, the gift will be subject to estate and inheritance taxes.

Another problem is the presumption by the federal government that

all gifts made within three years of death were made in contemplation of death and are therefore subject to federal estate tax. There are two major ways of getting around this problem. First, if it can be proven that this was just an extening gifts over a period of years. It will probably be allowed. Second, if the gift was made for a specific timely situation, such as educational expenses or starting someone in business, it could also possibly be approved.

But as the donor ages, the chances of makng a successful argument are reduced and the whole gift may be subject to estate and inheritance taxes.

Another problem is that if the income from a gift is used to satisfy the legal support obligation of a parent, the income is taxable to the parent even if some one else makes the gift.

## JUST A START

Due to exclusions and exemptions allowed by the gift tax law, a program of gifts over a period of years can transfer a sizable amount of property with no gift tax. Even if gift taxes are incurred, they will usually be less than estate and inheritance taxes on the same property. Gift tax rates start at the bottom of the scale, while estate taxes on property given away come from the top tax bracket.

Properly used, gifts can be an extremely important tool in your overall estate plan. To get maximum benefit from gifts, they should be considered as one method of reaching your overall objectives and should be carefully planned out with your lawyer and/or CPA to avoid unexpected and undesirable consequences.

# LIFE INSURANCE SHOULD PROTECT FUTURE OF YOUR FARM

CHAPTER 9

WHEN A FARMER DIES, there is an immediate need for cash to take care of things like medical and nursing bills, funeral expenses, settling of debts, and payment of taxes and probate fees. If the necessary cash is not available, the farm business he worked most of his life to build may have to be liquidated, at least in part, to meet these obligations.

By the nature of farming, cash is a scarce commodity. In his earlier middle farming years — the period of growth — a farmer puts all of his spare cash back into his operation. Certainly he isn't poor, but his limited liquidity puts his business in jeopardy if he should die suddenly. Lack of liquidity can result in a shrinkage of 30 to 50 percent in a farm estate.

The word "liquidity" represents a very important concept to sound estate planning. It refers to the amount of readily available cash in an estate or possessions that can easily and quickly be converted to cash.

How can a farmer protect his business and his family against this lack of liquidity? One of the major tools used in estate planning to accomplish this goal is life insurance.

By its very nature, life insurance is designed to (1) provide protection for the named beneficiaries, or (2) set up a rigid savings program, or (3) create a combination of both.

Uses of this tool in a farm business are many and varied. Before we go into these, however, let's take a look at the different basic kinds of life insurance.

### TYPES OF INSURANCE

TERM INSURANCE is the simplest kind of life insurance contract available providing financial protection. Basically it is temporary insurance.

It insures a person's life for a stated number of years — or term — that the policy is in effect, such as 5, 10, or 15 years. It usually has no cash or loan value and is payable only if the insured dies within the specified period.

Protection ends when the stated term expires. If the policy is renewable, it can be extended to a new term without the insured individual providing further proof of health through a medical examination. If it is not renewable, the insured, in effect, starts all over with the necessity of proving his insurability.

Term insurance may also be convertible. If this provision is in the policy, a person may exchange the term insurance for permanent insurance within a specified period of time without taking a medical examination.

Term insurance has the lowest premiums of any life insurance policy and is relatively inexpensive, especially when the insured person is young and the term is short. Because of the increased risk to the insurance company, the longer the period of term insurance contracted, the higher the rates will be. Also, with each new term contracted, the rates for a given amount of insurance will go up with the age of the applicant.

For example, a $10,000 term insurance policy that may cost a 35-year-old farmer $70 for the year it is in force, would cost him about $450 for the same coverage at 60. Most term insurance policies are constructed so that they are not renewable beyond age 65.

There is also a type of term insurance called reducing or declining term. With this, the premium remains the same each year, but the amount of protection reduces. This type is frequently used to protect a debt being paid off in installments.

WHOLE LIFE INSURANCE is a permanent policy that guarantees protection for your entire life. It combines financial protection and investment. Whole life is available in two basic types of policies, depending on how long premiums are paid. These are ordinary life and limited pay life.

With an ordinary life policy, premiums are paid until the insured individual's death. Then the face value of the policy is paid to the stated beneficiaries. Cash surrender and loan values increase during the life of the policy.

Limited pay life is very similar in that the policy is in force during the person's whole life, but premiums are paid for only a limited number of years. Since fewer premiums are paid than on an ordinary life policy, the premiums are larger. By the same token, cash and loan values accumulate at a faster rate.

Policies are generally written for a specific number of years, such as a 20-pay life policy, or to a specific age, such as to age 65.

The cheapest form of whole life

insurance is nonparticipating ordinary insurance. Participating life insurance has an extra cost in the premium. As a result, the surplus and profit come back to the policyholder in the form of a dividend. With nonparticipating life, there is no dividend. If the cost for a participating policy is $50 per thousand dollars of coverage, nonparticipating life would probably cost less than $40 a thousand. If only protection is the goal, with some cash value at maturity, nonparticipating whole life insurance may be the answer. This is especially valuable to farmers in their late 40s and 50s seeking insurance protection for their families.

(Note: Dollar costs of insurance used in this article are approximations and vary by company. They are used here only for comparison.)

**ENDOWMENT POLICIES** place more emphasis on savings than do other types of insurance. They are designed to accumulate a certain amount of money over time, meanwhile providing life insurance protection. The policy is written for a specific period and for a certain face value. Twenty-year endowments are common, but 10-year, 30-year, and endowments at a specific age are also written.

If the insured dies before the policy matures, the face value is paid the beneficiary. If the insured is still living when the maturity date arrives, he collects the full face value or has other options to receive the policy proceeds. However, the life insurance coverage of the policy ceases as of the date of maturity.

## COMPARISONS

In choosing an insurance policy, both the needs to be filled in the estate plan and your ability to pay must be considered. Usually a compromise is needed between the two. Term insurance policies written for a limited period provide maximum protection at the least cost, but only for the period of coverage. They have no surrender value and offer no protection after the term.

Endowment policies written for a limited time are one of the most expensive types of life insurance. They provide the least protection and the most investment.

However, it must be recognized that labels or names given to types of policies are not the deciding factors in cost. A term policy written to age 100 or an endowment policy written to age 95 will have about the same yearly cost as an ordinary life insurance policy. For a given age level, the yearly premium rate will depend on the term or length of the policy, the number of payments, life expectancy of the insured, and disposition of the face value.

Although cost of coverage varies somewhat with the companies, a 30-year-old farmer taking out a $10,000 life insurance policy would pay approximately $40 for a year's coverage of term insurance on a 5-year policy, $200 a year for ordinary whole life, and $265 a year for endowment to mature at age 65.

Life insurance should be considered as another tool for accomplishing estate planning goals. Know the problem areas in which life insurance can be of service and then pick the kind and amount of insurance that will best fulfill your aims at a price you, your family, and your business can afford.

But what are some of the problem areas where the cash provided by life insurance would be helpful?

## FINAL EXPENSES

Few farm families have sufficient savings to pay medical and death expenses if a member of the family should die. Since most farm assets are not easily or quickly converted into cash, some sources of funds should be specifically provided for this purpose. A nominal amount of ordinary life insurance on each member of the family can readily provide available cash for such emergencies.

There are also probate expenses and tax outlays to consider. When an estate becomes large, federal estate taxes can become a major expense at death. A $200,000 estate may require paying about $30,000 in federal estate taxes. Some families purchase ordinary life insurance on the estate owner(s) to cover these taxes. Others use other estate plans discussed in earlier articles to reduce these taxes. Both alternatives or a combination should be considered.

"Always keep in mind that the tax is due and payable nine months from the date of death," said Richard Wade, Three Rivers attorney. "Everyone should maintain some liquidity. The older they get, the more liquid they should become. This is true not only from the standpoint of death taxes, but also because of high hospital and medical expenses that may not be completely covered by Medicare. There are also high funeral and nursing home expenses. Most people have to pay for nursing home care out of their own pockets.

"The most difficult estates are those, always, regardless of size, that have little or no liquidity," said Wade. "Liquidity protects the major assests so you don't have to sell them within a short period of time at a substantial loss."

## FAMILY LIVING COSTS

The death of the breadwinner can be a serious financial loss to a young family. The annual income needed to provide the basic necessities of life for a mother with children are quite high. The bigger the family, the heavier the burden. This becomes even greater as the children move through their teens.

Young farmers generally don't have the amount of owner equity in the farm business that can be used to support the family in case of his death. Income may also be restricted because the young family has put its earnings back into the budding farm business.

Life insurance can be purchased to provide at least some of the lost income if the breadwinner passes away. A 10-or 20-year convertible term insurance policy is an excellent program for a farmer in this situation. The limited dollars available will purchase the maximum amount of protection for the family. Protection, not savings, is the critical need in this situation.

When the children start to become financially independent and owner equity in the business increases, some of this term insurance that was purchased for protection can be dropped or converted into ordinary life insurance.

"One of the problems with so many of these farm estates is that the assets are not liquid," said Berrien County Probate Judge Ronald Lange. "It takes time to turn real estate into cash or to turn bonds in. Certificates of deposit usually have a due date and you lose interest if you turn these in too soon. I would say, depending on your living standard, that you should plan on a three- to six-month emergency fund to carry the surviving members of the family through. Insurance would qualify as part of this emergency fund, depending on how long it takes to get payment.

For people of modest income and little property, the purchase of life insurance may be one of the only ways possible to build and leave an estate.

## FARM TRANSFER

A farmer works hard to build up his farm business and to make it profitable. If he desires to pass the business on to his wife and children, certain steps will have to be taken to make sure this is possible. As was mentioned earlier, taxes, settle-

ment costs, and death expenses can put a large strain on farm businesses that have little or no cash reserve. There may also be a need for cash to hire help to run the farm until the children get old enough to take over. Or there may be a need for enough cash for the wife to have some breathing time free from pressures to look over the alternatives available.

"It is important that a widow and children try to remain 'normal' in their usual surroundings for a time after the death of the husband," said Gary Stone, professor in the MSU College of Business. "Life insurance can provide the funds that will make this time possible. It can also help preserve the assets of the estate by eliminating the necessity to sell under pressure."

Take for example a young or middle-aged farmer who is at that stage of his farming career where all of his money is invested back each year into the farm. His debt load is heavy and his equity is still low. If he owes $70,000, a $100,000 term life insurance policy can help protect his business and transfer it intact to his family if an accident or illness claimed his life.

At another time in the business development, he might have a partner—his father, another relative, someone outside the family, or, later, his own son. Without proper estate planning, death of a partner can put so severe a strain on the operation that the business is destroyed. This can be avoided by use of insurance as part of a buy and sell agreement between the partners.

"Say we have a $100,000 farm partnership between you and me," said Stone. "If we make no provisions and I die, you are required by law to sell the business and give half of the proceeds to my heirs. By my death, you are out of the farm business.

"On the other hand, we can create a buy and sell agreement that calls for each partner to pay the heirs of the deceased partner $50,000 for their half of the business. Then each of us would take out a $50,000 life insurance policy on the life of the other partner. If you die, I collect $50,000, which I in turn present to your heirs for their half of the business. They are required to sell it to me as part of the buy and sell agreement."

Buy and sell agreements assure that the surviving partner(s) can more easily retain control of the farm business.

A special kind of life insurance arrangement, designed originally for business situations, is called joint life.

A joint life plan insures two individuals under one policy. The policy pays off on whichever of the two dies first. The survivor then has the option of continuing the policy without evidence of insurability if he or she is under 65 years old.

The joint life plan is adaptable for partnerships, husband and wife, father and son, mother and daughter, or about any other combination you might consider.

The main advantage is the reduction in premiums over what the two individuals would have to pay separately. If a husband and wife, both 30 years old, took out two separate $10,000 policies, their total premiums would run about $400 a year. Under a joint life plan, the cost would be about $240 a year.

It represents even greater savings if the two individuals being insured are of markedly different ages. If a father 50 years old and a son 30 each took out separate $10,000 policies, their combined annual premiums would be about $620. Their joint life premiums would be about $420.

### CREDIT INSURANCE

Major, outstanding loans are often one of the expenses difficult to pay after the death of the farm operator. Loan payments can be covered by a declining term insurance policy or credit life insurance.

It is common practice for many credit agencies to write credit life insurance on the borrower assuring automatic loan payment in case of death. In some cases it is a required part of the loan. The same protection can be obtained in a term life insurance policy purchased by the borrower. For young farmers, the latter method may be the cheaper alternative.

### RETIREMENT

An investment program through an endowment life insurance policy or retirement income policy to mature at age 60 or 65 can provide retirement income. (More on this subject in a future article dealing with farm retirement plans.) The savings feature of a life insurance policy provides a relatively fixed dollar investment. It does not fluctuate in value like common stocks do during periods of inflation. Most of the farmer's assets — machinery and livestock — are usually considered in the same category as common stock in that they can vary widely in value over time.

Many farmers during their lifetime accumulate a large amount of owner equity in their business and are able to use the returns from this investment for retirement income. In some cases, this income plus social security benefits are adequate for retirement income without purchasing an investment program through life insurance. For others, this is not possible. Only you can make this determination for your family situation.

### SAVINGS

Endowment life insurance can be purchased to provide savings for many purposes. Education for the children is a common use. Regular payments required on these policies force the insured into a systematic savings plan.

The major disadvantage is that the returns may be lower than those from other investments, including those in the farm business. This is particularly true for a young farmer who is almost always short on capital for business investments.

### INSURANCE ON WIFE

Most of the attention on insurance falls on the husband because usually most of the property has been accumulated in his name and he is the main operator of the farm business. There are several reasons, however, to seriously consider some amount of insurance on the wife.

The wife plays an important part in the estate plan, not only as a beneficiary, but also as a tax asset. If the wife dies first, there may be a marked increase in total taxes paid by her estate and later that of her husband. Insurance on her life may be advisable to compensate for the additional estate taxes that will be incurred on her husband's estate as well as the additional income taxes the husband would have to pay.

Also, if the husband isn't insurable, insurance on the wife's life can help to build up a reserve for payment of taxes in the combined estates.

Perhaps as important or more important is the establishment of a fund to help the husband take care of the home and family if his wife should die at a young age, leaving a house and children to be cared for in addition to the family farm. Although the contributions of the wife, which run from tractor driver to nurse to cook and bottlewasher, are often taken for granted, they would be expensive to replace if it was necessary to hire them done.

### THE BENEFICIARY

If a life insurance policy is purchased mainly to offset death costs

and estate settlement expenses, perhaps a trust should be the beneficiary if you are seeking to avoid probate expenses. Above and beyond the amount needed for these purposes, generally an individual beneficiary should be named.

Because a life insurance policy is a legal contract, the face value of the policy must be paid to the listed beneficiary(ies). This is an advantage because designation of the individual who is to receive the benefits generally is not open to negotiation or court efforts to upset the contract. But it is also a heavy responsibility on the insured to make sure the beneficiary listings on his policies are kept up to date. Otherwise the money will not go to the correct individuals to complete the estate plan.

Cash within the estate is a "must." When this need is met, the farmer can transfer money outside of the estate to someone else by giving over control of the policy. This method of reducing your estate and avoiding federal estate tax was discussed in a previous article on gifts.

Basically, the rule is that to escape federal estate taxes, the deceased insured individual must not have retained any incidents of ownership in the policy. This means mainly that he no longer has the power to borrow on the policy or to change beneficiaries. Someone else must own and have complete control over the policy and pay the premiums.

### SETTLEMENT OPTIONS

Life insurance usually provides for payment of benefits in a lump sum. However, if a family wants to put some or all of its life insurance money away for future spending, it can do this through what are called settlement options. When any settlement option is chosen, the company keeps the stipulated sum and pays it out to the beneficiary of the policy in the manner selected.

The insured can specify exactly how he wants the life insurance proceeds paid to his family in case of death, or he can leave the choice for the family to make later on. When it uses one of these options, a family knows exactly what its income from the policy will be and exactly how long this income will last.

Settlement options can be used by living policyholders, too. For a living policyholder, the cash value of his policy forms the basis of the settlement arrangement he may choose. Older people can take advantage of this provision in their policies by converting their cash values into retirement income.

There are four basic settlement options:

INTEREST OPTION — The company holds the money and pays interest on it. The company pays at a current interest rate which is usually considerably higher than the rate guaranteed in the policy. Arrangements can generally be made to withdraw part of the money if desired. The remaining money can be withdrawn later or left to someone named by the beneficiary of the policy.

AMOUNT OPTION — A regular monthly income of a desired amount is paid until the money and the interest it earns are used up.

TIME OPTION—A regular monthly income is paid for the desired period of time. The amount of monthly income is determined by the money and interest available.

LIFETIME INCOME OPTION — This plan is very different from the other options. The amount received depends on (1) how much money you have coming to you, (2) the rate of interest guaranteed by your policy, (3) how old you are, and (4) whether you are a man or a woman.

### PART OF PLAN

The type of insurance, beneficiaries, payment options, settlement options, ownership of the policy — all of these factors and related decisions turn on the goals and needs of your specific estate plan.

Many companies have agents with experience to discuss your needs as they relate to your estate plan. Some of these companies, in fact, have individuals who specialize in relating insurance to estate plans and who will counsel with you free of charge about the various options available to you. It will be well worth your while to arrange a meeting with one of these knowledgable individuals as you are in the process of developing your estate plan.

Only by examining your position with the help of experts will you be able to obtain the protection your family needs or reach your savings goals to the best degree that your financial position will allow.

Some of the factors that should be included in your evaluation are: annual income needs of your family, number of years income is needed, amount of owned equity, availability of family assistance, earning ability of wife, income available to make premium payments, and social security benefits.

Many insurance agents recommend that the amount of insurance should be five times annual earnings. This may be excessive insurance for some families and not enough for others.

It is a general rule that the earlier in their lives a young farm couple creates an estate plan, the more effective it will be in helping them to reach their goals. This is especially true with insurance. The younger the age of the person taking out the policy, the greater the financial advantage in terms of lower premium payments. As farm couples grow older, the insurance alternatives they can afford become more and more limited.

# Managing your life Insurance

ONCE AN insurance contract has been purchased and the policy received, all too often it is seldom thought of again. Life insurance is a sizeable investment and a key factor in your overall estate plan. As such there are certain steps that should be taken to make sure it fulfills the purpose for which you purchased it.

### THE POLICY

The policy itself is your copy of the contract with the insurance company. It is not possible to collect on the contract without a policy.

When the policy arrives you should read it over to make sure it lives up to the understanding you had with the insurance agent. If you have any questions, contact the agent or company at that time. Chances are you will be having the policy for a long time so you might as well make sure you have what you want at the beginning. Most agents and companies will respond quickly to your request for information.

Keep the policy with your important papers. Make sure the beneficiaries know where it is kept. One disadvantage about keeping it in a safety deposit box is that the box is sealed at your death and there may be a delay before it is opened as part of the probate proceedings.

If the policy is lost or destroyed, contact your insurance company. They will require that you fill out a lost policy affidavit. They keep careful records to make sure that the beneficiaries don't try to collect

twice at your death. Replacing a policy is usually a fairly simple matter.

### BENEFICIARIES

The main purpose of having an insurance policy is to transfer a settlement to the person or persons of your choice. You make the choice by designating the beneficiary or beneficiaries of the policy. However, times, situations, and family conditions change. It is important that you in turn periodically review your beneficiary listings and change them when necessary. This is a fairly simple task. Contact your insurance company. Usually they will send you a change of beneficiary form to fill out. When it is received by the company, it is attached to your policy and the change is completed. Sometimes a simple handwritten letter outlining the desired change will be sufficient.

### SETTLEMENT OPTIONS

In addition to naming the beneficiary of the policy, you also have the right to select the manner in which the proceeds of the policy will be paid to the beneficiary.

You can select any of the four options mentioned in the accompanying article on use of insurance in your estate plan. Or you can leave this selection of payment option up to your beneficiaries. In many cases this is the wiser move because the beneficiary will be in a better position to evaluate his or her financial condition and needs at the time of settlement than you would be able to predict years in advance.

### PRESENTING A CLAIM

When you die, your beneficiary can start settlement proceedings. When she contacts the company, they will send her a claimants statement which must be returned with proof of death, usually a copy of the death certificate. The claimants statement includes, among other things, an outline of how she wants the proceeds handled—which of the settlement options should be used and how.

With most claims, it is just a question of normal processing. This will generally only take two to three weeks. However, if problems develop, it can take much longer. For example, sometimes there is a question of whether the insured person died of natural causes like a heart attack or of an accident, which would mean the policy would pay double. Usually the company will take the time to adequately determine the cause of death.

### CHANGING POLICIES

There is a serious rash in Michigan of efforts by some insurance agents to convince people to replace life insurance policies in force with new policies from other companies. There are several possible disadvantages to policy holders making a switch.

First, with every new life policy taken out, there is a two-year contestable period. During that period the company can look into the health background of an individual for chronic health problems and for misstatements on their insurance application form. After the two years pass, the policyholder goes into what is called the "safe" area.

How does this affect you? If you have an existing policy in the safe period, you are guaranteed coverage according to the contract. However, if you cancel or cash out that policy and take out a new one, you are again subject to the two-year contestible period. Also, application for a new life insurance policy means a physical examination. What if you don't pass?

Second, when you take out a new policy you are doing so at a higher stated age. This results in higher premiums.

Third, if you have built up cash benefits in your existing policy, sometimes these may be lost.

### INVESTMENT SWITCH

Another version of efforts to change or "roll-over" policies involves a different investment philosophy. There is a whole segment of the life insurance industry that believes that whole life insurance with its cash accumulation aspects is a poor investment.

Agents who think this way go around trying to convince whole life insurance policyholders to cash out their policies and replace them with term insurance that just provides protection. The cash surrender value of the policy is then invested with a security brokerage firm in mutual funds or the like.

There is nothing illegal about these efforts, but sometimes they do not work to the advantage of the policy holder for the reasons outlined above.

If you have more cash value insurance than you need to complete your estate plan, the switch to term insurance and security investments may benefit you. However, for many farm families the change could have very undesirable side effects. Only you can make the proper decision.

The Bureau of Insurance of the Michigan Commerce Department is so concerned with the number of life insurance policy replacements going on in the state that it passed an administrative rule in June 1971. This requires an agent replacing a policy to fill out a Michigan state form which provides for a point by point comparison between the policy you now have in force and the new, proposed policy. If an agent tries to convince you to change policies, be sure to have him fill out this form. If he refuses, you would probably be better off turning down his suggestion.

If you are interested in changing the type of policy you have to another type, check first with the company with which you are now insured. Many policies have built-in provisions for conversion to other types of policies with little, if any, loss in premiums paid.

An insurance contract is an imporant investment and a key factor in your total estate plan. As such, it should be properly cared for and "managed" to produce the desired benefits.

# TRUSTS PROVIDE TAX SAVINGS AND MANAGEMENT

CHAPTER 10

ONE OF the most flexible of all estate planning tools is the trust. Because of the wide variety of ways it can be designed, it holds potential for helping you reach some of your most desired estate goals.

The three main advantages of trusts are their ability to (1) minimize estate and inheritance taxes, (2) reduce estate administration expenses, and (3) provide professional management services for your property.

The latter services can vary from an investment program to make the most out of profits not needed in the farm business, to management of the farm business itself after your death until your children are old enough to take over.

Because information about trusts is just as broad in scope as the trusts themselves, we will limit our article to the major types of trusts and the advantages of each. Hopefully this will give you enough information to begin an evaluation of your estate plan goals and an idea of whether or not a trust could help you reach those goals. This can be further explored with your local bank trust officer and your lawyer.

## TRUST TERMINOLOGY

But what is a trust? The dictionary defines a trust as "a fiduciary relationship in which one person (the trustee) holds the title to property (the trust estate or trust property) for the benefit of another (the beneficiary)." This is a very simple definition of a very complex legal step.

When creating a trust, the owner of the property, known as the grantor, settlor, or donor, transfers property to a trustee or custodian. The trustee, in turn, manages, controls, and has legal title to the property.

All transactions are governed by the trust agreement. The resulting income and benefits of the trust are transferred to the beneficiaries. Final ownership or rights in the trust property are eventually assigned to the beneficiaries. Time and conditions for this final transfer are outlined in the trust agreement.

A trustee can be an individual (lawyer, CPA, trusted friend, or even the original owner in some cases), an institution, such as a bank's trust department, or both jointly. No personal ownership or rights in the trust property are kept by the trustee. He is required to carry out the exact instructions of the trust agreement with ability and diligence. He is legally liable if he fails to do so.

The law permits a person creating a trust to write into it almost any directions, conditions, and restrictions he may desire. He may leave the trustee little room for personal decision-making, or he may give the trustee sweeping powers, as may be necessary if the trustee will be required to run a farm business.

Any kind of property can be placed in trust, including personal property, land contracts, and real estate. Usually only income-producing property — like a farm — and property that can be invested by the trustees — stocks, bonds, and cash—are placed in trust.

Beneficiaries do not hold title to the property while the trust is in force. They may or may not have possession of the property, depending on the terms of the trust.

A trust can continue for a lifetime, until a child reaches a specific age, until a spouse remarries, or for any period of time set by the owner in the trust agreement. The only limit is the rule against perpetuities. Under this rule a trust cannot last longer than lives "in being" at the time the trust is created, plus 21 years.

With some of the rules and terminology behind us, let's look at the two general types of trusts. These are lifetime trusts and testamentary trusts. Lifetime trusts are, in turn, divided into two major kinds—the living or inter vivos trusts and irrevocable trusts. Each of these has different requirements and fits into different situations.

## LIVING TRUSTS

One of the most commonly used trusts is the living trust. Its correct legal name is an inter vivos trust, meaning "between lives." Other commonly used names are pour-over trust and insurance trust.

"The revocable living trust is created by an individual during his lifetime," said John T. Creden, senior vice-president and senior trust officer of the First National Bank of Southwest Michigan, Niles. "It is completely amendable and revocable. An individual can put property in or take it out whenever it best suits his needs. Or, if he so desires, he can cancel the trust altogether.

"One of the advantages of a liv-

ing trust is that property put in the trust before the grantor's death does not pass through probate," said Creden. "This will reduce the costs of probate and estate settlement.

"Privacy is another advantage," said the Niles trust officer. "Because trust property put in during life doesn't go through probate, the terms of the trust and its assets are not a matter of public record, as a probated will would be.

"Tax advantages are usually one of the major reasons for creating a trust. This revolves around efforts to minimize federal estate taxes and state inheritance taxes as the estate passes from husband to wife to children.

"Also when a person creates a living trust with a trust department, there is usually some security investment done. By its nature, a trust department offers a professional securities investment service. This appeals to people for different reasons. Often there is a person who is very good at making money in his business, like farming, but who doesn't have the time or background to personally maximize the growth of the earnings he is able to put aside."

"A person may turn to a living trust in his later years because of an inability to properly manage the farm or business. He may wish to retire. Or he and his wife may be doing a lot of traveling and want someone on the scene to manage on a daily basis.

## GETTING STARTED

Generally, a living trust is created after discussion with a bank's trust officer, a CPA, and/or a lawyer. The lawyer then draws up the trust instrument. If the grantor does not intend to utilize the trust at that time, usually a $10 deposit is made to make the trust legal. It then exists as an inactive trust. It can be activated at any time by the deposit of property.

The grantor of the living trust still owns the property in trust and will have to report income from the trust as ordinary income.

Sometimes a living trust is created mainly to be the recipient of proceeds from a life insurance policy. Under these conditions it is known as an insurance trust. In earlier articles, the importance of liquidity—often cash—in the settlement of an estate was stressed repeatedly.

If you tried to provide this cash through your will in the form of a testamentary trust, you would make your insurance payable to "my estate." If you have an inter vivos trust, however, the insurance would be made payable to ............... Bank and Trust Company, or whoever the trustee may be. The big difference is that in Michigan, insurance payable to a named beneficiary isn't subject to state inheritance tax, while that paid to "my estate" is. If payable to the trust, it will also avoid probate. Federal estate taxes will come out the same either way.

Another intangible benefit of establishing a living trust is that it gives a man an opportunity to get to know the trustee who will be handling the property in his estate after he is no longer there to watch over it. In this period, the trustee can also learn how the grantor thinks and what his wishes are.

## IRREVOCABLE TRUST

The second kind of lifetime trust is an irrevocable trust. When someone puts property into an irrevocable trust, he or she has given it away for good. It will not come back to the grantor.

"Generally the reason people create an irrevocable trust is to do just that—give the property away to get it out of their estate for tax purposes," said John Creden.

Because it is a gift, the grantor pays gift tax on the property at the time it is put into the trust, if the amount exceeds gift tax exemptions and exclusions. When the grantor dies, because the irrevocable trust is no longer under his control or part of his estate, the contents pass to the beneficiaries with no further tax due.

For an example of how such a trust would work, a property owner could transfer property into trust for his son's use, with the remainder to go to his grandson when the son died. The property would not be included in the estate of either the father or the son and would pass automatically to the grandson at the son's death with no further taxes.

It is important to note that irrevocable trusts cannot be altered, amended, or revoked once they are in force. For that reason they must be carefully drawn up to anticipate and make provisions for all possible situations that may arise.

If you are in a high income bracket and are supporting another person, perhaps your mother, or putting children through college, you may be able to reduce your income taxes through use of an irrevocable trust. In your tax bracket, it may take earnings of $4,000 to provide $2,000 for your mother's support. However, if property were transferred into an irrevocable trust that would generate $4,000 a year in earnings, because of your mother's tax bracket probably the whole amount would be available for her use.

It could work the same way for children in college. Such a trust cannot, however, be used to discharge legal obligations to feed, house, and educate dependent children through high school.

It is possible with a special type of trust known as a Clifford trust to have trust funds revert to the grantor at the end of a 10-year or longer period or at the death of the beneficiary, whichever comes first. This type of trust is irrevocable in nature until it is terminated.

## TESTAMENTARY TRUST

The second general kind of trust is the testamentary trust. It does not exist during the life of the grantor, but rather is created by his or her will. Then the trust is the beneficiary of the estate rather than an individual.

A farmer who creates a testamentary trust keeps direct control over his farm business and property during his lifetime. Upon his death, the trust comes into being. Property in the testamentary trust is managed and distributed in accordance with the directions of the trust agreement.

Because the property goes to the trust after the death of the owner, it first passes through probate. All related costs and taxes are paid at that time. Few tax savings are possible on the estate of the spouse that dies first in this situation. However, a testamentary trust acts much as a living trust does in minimizing taxes on the death of the surviving spouse.

Many of the benefits that exist in a living trust after the death of the property owner also apply in the case of a testamentary trust.

This type of trust can be an important method of providing for management of property for minor children if both parents should die. It is a way to use property for the protection of the wife and family during her lifetime and then pass the unused portion on to the children at her death. It can arrange for management of the property if the wife lacks the experience, ability, or inclination to do so—or until the children are old enough to assume management responsibilities. A trust department usually will not be directly involved in management of an operating farm, but rather will act in a supervisory capacity over

the manager.

The general method used to minimize taxes is similar in both the living trust and the testamentary trust. The main target of management efforts is the estate tax because it takes the biggest bite out of the estate. The secondary target is the Michigan inheritance tax.

Glenn Ferrey, vice-president of the Old Kent Bank trust department, Grand Rapids, outlined in the following two examples how trusts can be used to minimize these two taxes.

Ferrey started with a situation where the husband's estate consists of $125,000 in individually-owned property, $40,000 in property owned jointly with his wife, and $35,000 in life insurance with the wife as beneficiary.

When the husband dies, his wife is entitled to a marital deduction of 50 percent of his $200,000 estate. She also can take advantage of the standard $60,000 exemption. Total federal and estate taxes on the husband's estate would be $8,200.

When the wife dies, however, if she has managed to live on the income from the estate without touching the principal, the whole $191,800 remainder will be subject to tax without the 50 percent marital deduction to ease the tax bite.

State and federal taxes on her estate would be $34,640. This means a total tax load on the estates of both husband and wife of $42,840.

### LIVING TRUST

"Now let's see how a living or pour-over trust would change the total taxes paid before the property reaches the children," said Ferrey.

The Old Kent Bank vice-president started by assuming that the husband in the new example owned exactly the same property as the first man. Then he added an assumption that the husband had created a pour-over trust during his lifetime. Into this he had transferred most of his individually-owned property. He also made the trust the beneficiary of his life insurance policy.

Just before he died, he transferred all his remaining individually-owned property into the trust. He could legally do this even on his death bed. He also had placed a provision in his will that all individually-owned property he might have missed, other than personal property, should go into the trust. This is how the trust got one of its nicknames. Everything is pouring over into it.

After the husband's death, the wife inherited the $40,000 in joint property outright. Utilizing the marital deduction, she is entitled to 50 percent of her husband's estate tax-free — $100,000. Provisions in the pour-over trust will provide her with the remaining $60,000 she needs to make up the 50 percent.

The wife receives this $60,000 tax-free. It is placed into what is called a marital or "A" trust. The husband has to stipulate that a marital trust will be created from his pour-over trust or the full $60,000 would go directly to the wife. If she is a sharp, well-informed money-manager, he may prefer that the money go directly to her. Or he may feel that she needs the extra protection and investment service provided by a trust.

Even though the marital trust is created, the money is still hers. She receives the earnings, has access to the principal, and can pass the property in the trust to anyone she wants at her death by her will.

### FAMILY TRUST

The other $100,000 of the husband's estate is taxable. Total state and federal taxes would be $7,300. This amount is lower than the first example because of a reduction in the state tax. This is due to the fact a trust was created for the wife and her age, which reflects the number of years she has yet to enjoy the trust.

The $92,700 left of this half of the estate after taxes goes into a non-marital or family trust. It is also known as a "B" trust.

The husband can arrange this trust in the trust instrument so that his wife will receive the income from this B trust for her lifetime. He can also make provisions for her to invade the principal of the family trust under certain situations, always at the sole discretion of the trustee.

Three fairly typical reasons for principal invasion that are often built into the family trust are (1) to maintain the standard of living that wife and children enjoyed when the husband was alive, (2) to meet the needs of the wife and children in any emergency that arises, such as replacing the roof on the family home or providing braces for the teeth of one of the children, and (3) education of the children.

The grantor has much latitude in making decisions on how and by whom the family trust property can be used. He can make it impossible to invade the principal at all; he can make it easy to invade; or he can set a special limitation that would keep the wife from invading the family trust principal once she remarries.

The wife cannot influence who will receive the family trust property at her death. This was determined and outlined by the husband in the original pour-over trust. He also probably set forth how he wanted the proceeds paid to the children and at what ages. It is common to break the transfer of funds to the children down into two or three distributions spread over a number of years.

At this point in the estate, the wife is probably receiving the income from both the marital trust and from the B or family trust. When she dies, the family trust passes on to the children or other beneficiaries, as provided for by the husband, with no further taxes due.

If the wife has lived on the earnings of the two trusts and has not invaded the principal of her marital trust, her taxable estate would be $100,000. After the $60,000 standard exemption, state and federal taxes on her estate would be $6,600.

How much did the use of trusts add to the estate received by the children? Total taxes paid by the father and mother in the first example, without the trusts, were $42,840. Total taxes paid by husband and wife in the trust example were $13,900. The difference between the two was $28,940 that went to the second couple's children instead of to the government.

### COSTS AND FEES

The fees charged by bank trust departments for handling a trust vary greatly, depending on the size of the trust and type of services demanded. The size of the trust department and its location in the state will also influence fees.

For simple management of a stock and bond portfolio, trustee fees will generally run between one-half and one percent of the property in the trust, payable annually—for example $500 on a $100,000 trust.

For extra services, such as farm management, extra fees are charged. The more complex the duties of the trustee, the higher the fees will be.

Most trust departments have a schedule of current fees for different services that you can examine. Don't bother to try to pin them down as to the level of these fees at some point in the future. They won't guess.

Often there will also be a closing fee when the trust is terminated to offset the extra work involved.

"Fees charged by a trustee are completely tax deductible for income tax purposes," said Glenn Fer-

rey. "Also an important thing to consider is that if a trustee is worth his salt, he will earn his own fees and then some in superior management of the assets of the trust."

## CHECKS AND BALANCES

"Trustees are required by state law to operate under the prudent man rule," said Glenn Ferrey. "That means we as trustees are not allowed to invest in anything that a prudent man wouldn't invest in. We are also required to keep the money in our trust working and earning. If we fail on either account, the trust department is held responsible."

Other checks and balances exist in the form of regular inspections of trust departments by state and/or federal bank examiners, bonding of employees working with trusts, internal audits by the bank staff, and the fact that trust department funds are always held separate from those of the related bank. Then there is also the reputation of the individual or trust department acting as trustee. This is an important factor in itself and should be closely scrutinized before a trustee is selected. The size and expertise of the staff that will be servicing your trust should also be taken into consideration.

Another important check can be built into the trust itself. The primary income beneficiary, probably your wife, can be given the right to change trustees if she is not satisfied with the income generated or with the trust officers handling the trust. You can continue to protect the trust if a change takes place by outlining in the trust instrument cerain minimum requirements for a new trustee.

## CAREFUL PLANNING

First comes the estate plan with its many people-related goals. Once these have been established, take a long look at trusts to see if they can help you reach those goals.

Carefully created, a trust will enable you to accomplish desired actions both before and after your death for the benefit of your wife, family and other beneficiaries.

# PART II: FARM TRANSFER

# when and how should you PASS ON THE FAMILY FARM?

## CHAPTER 11

Estate planning is much more than a set of rules for minimizing taxes, although it is that too. Basically the goal of estate planning is to create the best possible conditions for all of the people involved; to transfer farm property to the next generation with the least possible emotional and financial problems.

In earlier articles, we wrote about many tools used in estate planning, such as ways of owning property, trusts, gifts, life insurance, and annuities. These are all important, but are only methods used in achieving the goal of transfer of farm property from one generation to another.

With the large amounts of capital required in farming today, the younger generation doesn't have much chance to become farmers unless they can get started with their dad or another relative.

Once the son(s) or daughter gets established in farming, however — prove their interest and ability — the question of transfer of farm ownership comes up. When, how, and under what condtions should the transfer take place?

The question of transfer of the farm is a difficult one for everyone concerned. The parents have owned the farm for years. They worked hard to build and maintain a viable business. It has become a part of their life and, as such, it is difficult to part with. A question of security and independence is also involved. As long as the parents have the farm, they have a means of supporting themselves and of being independent of others for their support.

The children, on the other hand, are trying to build a place for themselves and their families. They are seeking opportunities to build a profitable business with a future and are anxious to try out their wings in farm management decisions.

One of the main responsibilities of a sound estate plan is to take these different wants and goals into consideration and to integrate them into a plan that will meet the needs of all involved.

### GOALS OF TRANSFER

A plan for gradually transferring management control of the business and asset ownership to a son, son-in-law, or daughter is a key part of any arrangement.

The goals that need to be achieved include: (1) financial security for the parents, (2) financial security for the family member buying the farm, (3) general agreement and understanding among all family members, (4) equitable treatment of other children, (5) maintenance of the farm as a profitable business, and (6) minimization of estate transfer costs.

**Financial security for parents.** The farm represents a lifetime of investment, work, and worry for parents. They should be able to enjoy the fruits of their labor in their old age. The assets invested in the farm usually represent their main source of income. Often they aren't in a financial condition to be able to make substantial gifts to the farm-operating son. Any arrangements should recognize, first of all, their needs for adequate income and security.

**Security for the son.** As is true for the parents, a son working into the farm business with the idea of achieving eventual ownership and control needs to have a certain degree of security. After all, he is putting his livelihood and that of his wife and children on the line. He is investing his future.

The son needs some tangible degree of protection for investments that he may make in the farm business, such as new capital improvements and maintenance of the physical assets of the farm, such as buildings and machinery.

Another psychological fact needs to be considered, too. A son and his family have a desire — a need — to own at least some of the real estate involved in the farm operation. With the longer life-span that exists today, if a son has to wait until the death of his parents to achieve ownership of the farm property, the need to own could be thwarted to the extent that it destroys the relationship between generations. The children may all leave parents who hold on too tightly to their property, leaving no one who desires to continue the family farm.

**Family understanding.** It is not necessary to involve nonfarm children in all of the decision-making discussions concerning transfer of the farm business. They should, however, be informed that one or more members of the family is working out an arrangement to eventually have control and ownership of the farm business. They should be in agreement with the general idea or problems could possibly arise at a later date.

Off-farm children hear about the high price of land and other farm property. They generally think the home farm will also bring top prices, even if the farm is not tops. Therefore,

if the farm is going to be sold to a son, professional appraisers should be brought in to arrive at a fair market price or to justify the established price.

It is usually much better for the parents to inform the other children of plans concerning the farm business than to leave this up to the son who is working into the business.

**Equitable treatment of other children.** At the same time provisions are being made for the farming son, the other children need to be recognized and treated equitably. Note that we said equitably and not equally. A child who has stayed home and worked with a parent in building a farm business has made a contribution towards maintaining and improving the value of the parents' assets. In doing this, he may have worked for low wages in the beginning or given up the opportunity for a college education.

In recognition of this, it is frequently best for parents to make allowance in some way while they are living, such as through gifts or other financial help. This prevents controversy which might occur after death if children aren't treated equally in the will. Such a controversy, fueled by lack of understanding of the contributions of the farming son, has been known to create a permanent split between the surviving members of the family.

**Maintenance of the farm business profits.** A key concern for the farm operators of both — and in some cases three — generations is the necessity of keeping the business in a profitable operating condition during the total period in which management and capital control is in the process of being transferred.

From a practical standpoint, maintenance of the farm as a going, efficient concern often means preventing the farm from being divided up among all the children involved. In most cases this can be achieved by a plan that would allow the farm-operating son to purchase the whole farm with proceeds held and used by the parents during life and distributed among their children at their death.

**Minimization of estate transfer costs.** In all transfer processes, one of the concerns that faces most people is the minimization of inheritance and estate taxes and probate fees. These need to be recognized and planned for as part of any farm transfer program. Factors involved in achieving this goal have been covered in depth in earlier articles in this series.

**Other goals.** Estate planning is a personal thing. Your specific family situation may bring forth many other goals or problems. Recognize them and try to develop a transfer plan that satisfies them for the mutual benefit of all concerned.

## TIME TO TRANSFER

The time to make the farm ownership transfer depends on many considerations on both the parents' part and that of the son. Age of both parents and son is usually a key influencing factor.

In general, the farm transfer should be seriously considered and action started when the son meets the following conditions:

1. Attains maturity with respect to farm experience, managerial competence, and business judgement.
2. Is certain he will farm.
3. Has sufficient capital and income to support additional debts and other ownership responsibilities. A cash-flow budget should be prepared to determine whether the son can make a go of it.

Parents' considerations are also important. In general, the farm transfer should be made under the three following considerations: When the father retires, completely or partially, from the day-to-day work and other responsibilities of the farm operation. When the parents can transfer their estate to nonfarm or other farm investments. When the parents have adequate sources of income.

In those cases where the father is not old enough to retire and his income needs are still high, but the son has built a financial reserve for a farm purchase, continuing the father-son partnership with the son purchasing a neighboring farm may be the answer.

A satisfying way can be found for those who seek answers.

## FARM PARTNERSHIP

One of the most common procedures utilized in the transfer of a farm business is a family farm operating agreement. The farm partnership, as it is more frequently called, provides an ideal method of gradually bringing a junior member of a partnership into ownership of assets and the management of the total business.

This is generally achieved by having the original partnership between a father and son composed of only the personal property assets in the farm business. This would include the machinery, feed and crops on hand, livestock, and operating capital.

Since most young incoming partners do not have much capital to contribute they may purchase a share of the parents' capital invested in the business and then contribute this to the partnership. The note which is taken to finance the purchase can then be repaid to the parents from his earnings in the business.

The real estate is generally left in the name of the parents who rent it to the partnership. The rental is an expense of the partnership.

As time progresses and the son acquires greater ownership through both paying off the note and expansion of the farm business, he may start to purchase some of the real estate from the parents or purchase additional real estate to be added to the farm unit.

When the parents reach retirement they may sell out their share of ownership in the personal property, draw their social security retirement benefits, and rent their real estate to the business. Eventually, they may work out some program for selling all or part of the real estate to the farm operator.

This general framework of growing into and out of a partnership has tremendous flexibility for the parties involved. One of the key concerns is to be sure that the plan is financially and legally sound and in written form for the protection of all families involved.

## FARM CORPORATION

Another arrangement for a transfer of ownership might involve a corporation instead of a partnership. In the corporate framework, ownership in the business is represented by shares of stock. The formal procedure involves voting these shares of stock at an annual meeting to elect a board of directors who are responsible for running the business during the ensuing year. Any stockholder who owns less than 50 percent ownership in the corporation effectively has little control over the election of the board of directors and the policies of the corporation.

Stockholders who make up the majority of ownership run the business as they see fit. This can be either advantageous or disadvantageous depending upon the side you are on. If there are nonfarm children who desire to leave their inheritance invested in a farm business, owning shares of stock in a family farm corporation may be a desirable way of achieving this goal since their liability in the business is limited to their stock ownership.

The taxation of a farm corporation can be very similar to that of a partnership or it can be the same as that of any other corporation. Generally, additional taxes and costs are involved in setting up and operating under the corporate framework.

Anyone contemplating the use of a corporation would need to analyze these carefully in comparison with some of the additional benefits that could be achieved.

## HOW TO PROCEED

Good procedures should be followed in making the farm transfer.

- Have a discussion with the entire family as to whether they want to keep the farm in the family. This may already be decided if one or more sons stayed home.

- Consult with the son or sons who wish to own and operate the home farm. Exchange ideas and thoughts often.
- Give early consideration to ideas about when and how to make the transfer.
- Transfer the farm at the negotiated price in line with the purposes of the family.
- Consult your attorney and have him put the plan in legal form.

If the issues are thought out and the farm transfer is carefully planned, transfer will be beneficial and rewarding to both parents and children.

# "HOW" IS A MAJOR FACTOR IN SELLING YOUR FARM

CHAPTER 12

Should we sell the farm business?" This becomes an important question for farmers as they approach retirement.

Income obtained from the farm gradually declines as the operator gets older. This occurs not only because of loss of physical capacity to "keep up," but also because of a loss of interest in the farm business.

Income can usually be increased and its fluctuation from year to year reduced either by converting the farm to principal and interest income or by reinvesting the sale proceeds in higher-yielding investments, such as savings accounts, bonds, and stocks.

A recent MSU study of retired farmers indicated they had a $41,320 average value of farm assets from which they were obtaining only $1,369 a year in cash income. In comparison, 5 percent interest on the same amount would bring $2,066 a year.

The survey also revealed a serious lack of liquidity (cash or property that can easily and quickly be converted into cash) in the total assets of these farmers. As pointed out in earlier articles, this can result in heavy losses to an individual's estate.

An additional problem related to holding on to the family farm is the fact that it's management can create serious problems for a surviving widow.

When a family member is growing into the farm business, sale of the farm becomes even more important in the estate plan. The younger farmer needs to acquire equity and eventual control of the business in order to operate at fullest capacity. Transferring the farm to a son by will, in most cases, comes too late in his life. In many instances, he will have become frustrated and left the family farm. Having built a new life for himself and his family, he will probably not return.

If he stayed on the farm, on the other hand, he may be nearing retirement himself by the time he inherits the farm. Paying off brothers and sisters would be a problem at this age. He may also have made improvements in the farm over the years for which he was not compensated.

---

*A frequent problem in a farm sale is determining the tax impact on the seller.*

---

In considering the sale of the family farm, let's first look at the tax problems and then the various methods of sale.

To determine the tax impact of the farm sale, it is first necessary to establish the **cost basis** of the farm being sold. To calculate this, it is necessary to have a record of the original cost, the costs of all improvements made on the property since it was acquired, and of all depreciation claimed.

Improvements made on farmland may be of three types:

1. Improvements subject to depreciation, such as farm buildings, silos, fences, and tile drains, which are made of wood, concrete, brick, masonry, or metal. This improvement investment is then reduced each year by the amount of depreciation deducted or allowable on annual income tax returns.

2. Improvements that are not depreciable, such as cost of clearing land not previously used for farming, constructing open ditches, and soil and water conservation expenditures.

Costs of such improvements are added to the original cost. If any item has been deducted as a farm-operating expense, such as soil and water conservation expenditures, it cannot be included in the cost basis. Therefore, it is important to have a complete record of all depreciation and capital expenditures during the entire period of ownership.

3. Improvements to the farmer's personal dwelling. Except for a part used for the farm business office or for hired labor, these are not depreciable for tax purposes. The cost of dwelling improvements should be added to the original investment to determine the basis for gain or loss when sold.

A personal residence is considered a capital asset and not property used in the business of farming. In all cases where the farmer's personal dwelling is part of the farm that is sold, any gain realized on the dwelling may be postponed for tax purposes. This may be done if all of the proceeds from the dwelling are reinvested in another dwelling, purchased and occupied by the farmer, within one year prior to or after the date of sale of his original dwelling. This time period is extended to 18 months to build and occupy a new dwelling.

If the farmer is age 65 or older when he sells his home, with or separate from the farm, all gain from the dwelling is exempt from income tax if the home sells for $20,000 or less. If the home sells for more, it may be partially taxable. A farmer must have lived in the home five of the last eight years and can have this exemption on only one dwelling during his lifetime.

Depreciation and other recapture

provisions need to be examined relative to real estate sales. This is a complicated subject and should be checked with an accountant.

*Depreciation and other recapture provisions have been added to the income tax picture in recent years.*

**Briefly, any depreciation taken after 1969 by a method which yields a depreciation deduction in excess of what would be taken by the straight-line method will be recaptured as ordinary income when the property is sold.**

Any such excess depreciation taken after 1963 and before 1970 may be partially recaptured. There is a 100 percent recapture for property held less than 21 months. The percentage decreases one percent for each month the property is held over 20 months.

If the property is held for more than 10 years, there will be no 1963-1970 excess depreciation recapture. If depreciable realty is held for 12 months or less, all depreciation — not just the excess over straight-line — will be recaptured to the extent of the gain on the sale.

The 1969 tax reform law also provides for the recapture as ordinary income of all soil and water conservation and land-clearing expenditures made on farmland. However, there is no recapture if the land has been held for at least 10 years. When land is sold within five years after acquisition, expenditures are recaptured in full. For sales in the sixth through the ninth year, the amount recaptured decreases by 20 percentage points each year.

Once the above information has been determined, the farmer can figure his **cost basis.**

The first factor is the original purchase price if purchased, the established value if inherited, or the cost to the last purchaser if acquired by gift. Let's use a $25,000 original purchase price for an example.

Next we must consider the cost of improvements capitalized during the ownership, such as buildings, orchards, tiling, fencing, well and water systems, and major improvements, as outlined in improvement category two above. This will be $9,000 in our example. From this figure we must subtract the amount of depreciation allowed or allowable during ownership. We will use a figure of $7,000. This gives a net addition of $2,000, which represents the difference between capital improvements and allowable depreciation. This is equivalent to the undepreciated value of improvements left on the current depreciation schedule. Add another $4,000 for the expense of the sale. Totaling these three figures gives a cost basis of $31,000. ($25,000 + 2,000 + 4,000 = $31,000)

Subtracting the cost basis ($31,000) from the gross sale price ($60,000) gives a **capital gain** of $29,000.

Before we can do any more figuring, we must take into consideration the method by which the farm will be sold. There are several possible methods. Some of these are:

*The method by which the farm is sold will affect total taxes.*

**Outright sale, with mortgage back.** Use of a deed and mortgage in combination is a common method of transferring ownership of real estate between unrelated people. The seller deeds the title to the property to the buyer. The buyer makes a down payment and gives the seller a mortgage on the property to insure payment of the balance of the purchase price.

This method should be encouraged in estate planning within a family, provided the son can make sufficient down payment. Often he cannot. Also, from the parents' point of view there are serious disadvantages when little or no down payment is required. Passing the title to a person who might have little incentive to increase his equity involves some risk.

In this type of situation, some authorities believe the son should pay at least one-fourth of the purchase price before the parents pass title to him. This amount could vary reasonably due to a number of factors.

ADVANTAGES: Outright sale permits the buying son to make permanent improvements on the land. It is a business-like way of making the transfer. Equitable treatment of all children can be separated from the problem of transferring the farm. It may prevent the farm from becoming run down, as sometimes happens with older farmers. It makes it possible for the buying son to operate the farm during his most productive years.

DISADVANTAGES: Parents lose control over the property. The capital gains tax may be greater than the estate taxes would be. Parents are often tempted to sell for less than the market price. If their wealth is limited, this may later cause them hardships.

**Land contract.** The land contract or purchase contract is recommended as a method of sale when the son does not have a sufficient down payment. It is an agreement whereby one party agrees to convey land to another party for a certain price. The title to the property will pass to the buyer and the deed will be delivered at some future date as outlined in the contract.

Although legal title stays with the seller during the contract, equitable title passes immediately to the buyer. This is a quite popular method of selling property today.

Some of the various alternatives of payment under the land contract are: (1) fixed money price and fixed annual payments; (2) payments based on fixed amount of commodities each year. The value of the payment would then be determined by the price of crops that year; (3) fixed purchase price with yearly payments based on a percentage of gross receipts; (4) variable purchase price with variable payments. The payments could consist of a certain percentage of the gross income during the parents' lifetime; (5) combinations of the above.

ADVANTAGES: The land contract makes possible the purchase of a farm by a young man with limited funds. It is one of the few ways this can be done. The repayment schedule encourages a young farmer to build up an equity during his most productive years. The payment plan can be worked out to fit the circumstances. An element of control is left in the hands of the seller. Ejection of a defaulting buyer is easier than is true with a mortgage foreclosure.

DISADVANTAGES: The buyer has less secure hold on the property. It is difficult for the buyer to sell his equity if, for health or other reasons, he wants to quit farming. The seller takes more credit risk in early years of the contract than is taken by regular lending agencies which require a larger buyer equity.

Selling the farm under the installment sales method may help reduce the tax liability by spreading the gain over several years, rather than bunching it all in one year.

*With either a land contract or a mortgage sale, using the installment sale procedure may help reduce the tax liability.*

If the down payment, plus all other principal payments during the year of sale, does not exceed 30 percent of the selling price, the gains on the sale may be pro-rated over the installment period on the basis of the proportion that the payment on the principal for the year is of the total sale price of the farm.

**Sale and gift combination.** The sale method can be effectively combined with the gift by selling enough of the property to afford an adequate income and giving the rest. If this is done, all of the property could be mortgaged to secure the payments due on the sale.

In every instance, if property is "sold" to a son at a very low price, the transaction would be regarded as a gift

# EXAMPLE: STATEMENT ON INSTALLMENT SALES FOR INCOME TAX

1. Name and social security number ____________
2. Type of property sold (farm, machinery, livestock) *Farm Real Estate*
3. Date property was acquired ____________
4. Date property was sold ____________

| | | | |
|---|---|---|---|
| 5. Gross Sale Price: | | | |
| Cash, notes and contract value | | $60,000.00 | |
| Prior mortgage assumed by purchaser | | | |
| Other obligations assumed by purchaser | | | |
| Other property received by purchaser | | | 60,000.00 |
| 6. Cost or Other Basis: | | | |
| Acquisition cost | | 25,000.00 | |
| Plus cost of improvements | | 9,000.00 | |
| Less depreciation allowed since acquisition | | 7,000.00 | 27,000.00 |
| 7. Expenses of Sale: | | | |
| Lawyers' fees, seller's commission, etc. | | | 4,000.00 |
| 8. Gain or loss (Item 5 less Item 6 and 7) | | | 29,000.00 |
| 9. Contract Price: | | | |
| Gross sale price | 60,000.00 | | |
| Less mortgage assumed by purchaser | 0 | 60,000.00 | |
| Plus excess of assumed mortgage over basis (Item 6) | | 0 | 60,000.00 |
| 10. Gross Profit Percent: | | | |
| Gain (Item 8) ÷ Contract Price (Item 9) | | | 48.3% |
| 11. Payments in Year of Sale: | | | |
| Cash on sale | | $10,000.00 | |
| Excess of mortgage assumed over basis | | — | |
| Installments received on principal | | — | |
| Other obligations assumed & paid | | — | |
| Other property received by purchaser | | — | 10,000.00 |
| 12. Ratio of payments in year of sale to Gross Sale Price (Item 11 ÷ Item 5) | | | 16.7% |

Must be 30% or less to qualify as an installment sale.

13. Amount reported on Form 4797: $4,830.00

Payments (Item 11) x Gross Profit % (Item 10)

The amount included on Form 4797 may be partially or totally subject to depreciation recapture provisions as ordinary gain as well as the capital gain provisions, depending on the date of acquisition, time held, and depreciation methods used.

by the IRS to the extent of the value of the farm above the sale price.

Sale-plus-gift is a very flexible method of transferring the family farm. However, it is subject to considerations of both sale and gift in determining the best combination for all concerned.

If a sale-plus-gift plan is used, it is extremely important to have all of the agreement in writing in careful detail. Only in this way can the parties avoid misunderstanding over the long period of time the plan will be in operation.

---

*Let's figure further on our example, assuming that the sale was made with installment payment provisions.*

---

If we divide the capital gain of $29,000 by the sale price of $60,000 and multiply by 100 we get the **gross profit percentage** — 48.3 in this instance.

The total payment on principal during the year of sale must not exceed 30 percent of the gross sale price if the transaction is to be considered an installment sale. In actual practice a 29-percent figure is often used. For our example, we will assume a $10,000 total first-year payment, which is 16.7 percent of the sale price.

The next step is to figure the **net long-term capital gain** for the year of sale. This is obtained by multiplying the total first year payment ($10,000) by the gross profit percentage (48.3 percent) for a taxable gain in the year of sale of $4,830.

Since the sale of the farm — held over six months — is a long-term capital gain, our example would add $2,415 to the taxable income of the seller for the year of sale (50% x $4,830).

If the purchaser assumed a mortgage, the value of the mortgage would have to be subtracted from the sale price to obtain an adjusted sale price. This adjusted figure would be used in figuring the gross profit percentage.

Information similar to that presented in this example should be filed with Scheudle D (1040) along with individual income tax form 1040 for the year of sale.

In subsequent years, the taxpayer would only show payments on principal multiplied by the gross profit percentage to obtain the taxable portion.

Needless to say, this is not a simple matter of scribbling down figures. Farmers would be much better off to have computations made for a major transaction like this by a competent accountant. We have only tried to give enough details for farmers to get a rough idea of how sale of the home farm would affect them tax-wise.

**Trading a farm.** There is frequently a tax advantage in trading a farm for another farm or other business real estate, rather than selling one and buying another. In case of a trade, all or part of the tax liability is postponed. No gain is recognized for tax purposes unless a difference is paid in cash or non-business property is received in the transaction.

---

*Two other possible situations affecting ownership of the farm should also be considered — trading and involuntary conversion.*

---

In particular cases, it may be more desirable in the long run to sell and pay taxes on the gains in order to get a higher cost basis for depreciation on the new property. This might apply in case an unimproved farm is exchanged for a well-improved farm or other depreciable business property such as an apartment house.

**Involuntary conversions.** If property is involuntarily converted into cash through sale to a government agency, such as the highway department, or a corporation, such as a utility company, having condemnation authority, or through insurance proceeds from the destruction of property, such as by fire, the owner does not have to recognize the gain on the sale if within two years he reinvests the proceeds in similar property. Frequently, such a transaction results in a real opportunity for good estate planning.

# TAX CONSIDERATIONS ARE "MUSTS" FOR FARM SALE

CHAPTER 13

When a farmer reaches the point where he wants to sell his farm business, he usually runs head-on into taxes. The thought of depreciation recapture, investment credit recapture, allocation of sale price, determination of cost basis, installment sale provisions, and so forth, can make him throw up his hands in despair. However, the worst thing he could do is to just disregard tax considerations completely.

Although there are many facets to selling out a farm business, the tax implications are not as complicated as they first appear. This is particularly true if the farmer takes the time to analyze his particular situation.

If the assets to be sold can be initially broken into the categories of farm personal property, farm land, the residence, and farm improvements, the tax implications start to become a little easier to understand. (A basic reference to begin this understanding is Internal Revenue Service publication 225, "The Farmers' Tax Guide."

## PERSONAL PROPERTY

The primary items of farm personal property are the livestock, machinery and equipment, the feed and crop inventory, and, possible in a real estate sale, growing crops.

**Livestock** — sales conform very closely to the annual income tax treatment that each operator has for his farm business. In other words, market livestock will always be ordinary income. Breeding livestock will be treated as capital sales.

A farmer raising breeding livestock for cash sale will have a cost basis of zero. If they are over two years old, the gain will all be capital gain. If they are less than two years old, their sale will be short-term capital gain.

Young stock over two years old who are not yet in the breeding herd but where the intent was that they be added to the herd, also receive long-term capital gain treatment. For example, when a farmer retires and sells his entire herd, including young animals he would have used for breeding or dairy purposes had he remained in business, these young animals are sold for breeding or dairy purposes. However, unless they are over 2 years old they receive only short-term capital gain treatment.

The purpose for which an animal is held ordinarily is shown by a farmer's actual use of the animal. The important fact here is that from a tax standpoint an animal cannot be held for draft breeding, dairy, or sporting purposes merely because it is suitable for such a purpose or because it is held for sale to other persons for use by them for such a purpose.

Purchased breeding livestock are treated in the same manner except that the cost basis is equal to the purchase cost less any depreciation that has been taken. Any depreciation taken after 1969 is subject to recapture as ordinary income if the sale price is greater than the cost basis.

For example, a farmer purchased a two-year-old dairy heifer in 1968 for $300. He set a salvage value on the animal of $200 and depreciated the remainder ($100) over a three-year period. Thirty-three dollars of depreciation was taken in 1968 and 1969 and $34 in 1970. The cow was culled from the herd in 1973 for $450.

The cost basis of the cow at $200 ($300 purchase price minus $100 depreciation) yielded a $250 gain. However, the depreciation of $34 taken after 1969 is recaptured as ordinary income, leaving $216 to be treated as a long-term capital gain.

A farmer who uses the accrual basis of tax reporting would have to consider his inventory cost basis at the beginning of the year on each animal in

*Editor's note: In an earlier article on estate planning we dealt with many of the problems and considerations involved in sale of the family farm, either to a family member or to a nonrelated person. Emphasis was placed on the psychological factors involved. This article deals with the tax problems involved in the sale of the farm. Many alternatives are open to a farmer who is selling his farm. Some of these will result in heavy taxes; others will reduce the tax bite considerably.*

*Admittedly, this is still fairly heavy reading in spite of our efforts to keep the article as simple as possible. However, anyone considering sale of his farm at some time in the future owes it to himself and his heirs to get some understanding of the principles involved. Don't worry about details or specifics. They can be worked out with your accountant, or tax man.*

the same manner as for a purchased animal owned by a cash-basis taxpayer.

**Machinery and Equipment** — The cost basis for machinery and equipment is equal to the cash purchase cost plus undepreciated value of any trade-in minus any depreciation that has been taken. Any difference between the sale price and this cost basis is a capital gain. However, any depreciation on machinery and equipment taken since 1961 is subject to recapture, the same as we discussed for livestock, if the sale price is greater than the cost basis.

During the years of operating the business, farmers seldom run into these provisions because older equipment is traded in on new equipment and the recapture provisions do not become involved in a trade.

About the only way long-term capital gain beyond depreciation recapture can be obtained on machinery and equipment sales is where the sale price is greater than the original purchase price. This may occur quite frequently, however, when a farmer is disposing of all of his equipment. In such a case, each item should be treated and reported separately for tax purposes so that the full capital gains benefit can be achieved.

For example, if we have a $7,000 tractor purchased in 1964 which has been depreciated down to $1,000 and is sold for $9,000, it appears that we have an $8,000 gain. However, $6,000 of that gain (the actual depreciation taken) is recaptured and treated as ordinary income. Only the $2,000 of gain over and above the purchase price is long-term capital gain. This can occur because items of equipment may have been traded several times to obtain that tractor with a depreciation cost basis of $7,000 at the time of purchase, but which may have had a fair market value of $15,000.

**Feed and Crops** — The cost basis for feed and crops in inventory for a cash basis taxpayer is zero because the growing costs have been deducted in the annual income tax returns. The sale of feed and crops in inventory is always treated as ordinary income. Growing crops which are sold with the farm may be treated as capital gain but the expenses of growing during that year must be added to the cost basis of the farm real estate rather than deducted as a farm business expense on Schedule F.

**Allocation of Sale Price** — When selling farm personal property as a group or with the farm real estate, there is a problem of allocation of the purchase price to the different groups of assets such as livestock, machinery, and crop inventory and within groupings to specific assets such as a dairy cow, heifer, a tractor, or a bushel of wheat. There will be a gain or loss on some items, recapture provisions as ordinary income on other items, and capital gain.

As a general rule, it is wise to evaluate the package sale and allocate as much of the sale price as is reasonable to those items which will yield capital gain and less value to those items which will yield ordinary gain and ordinary income. In other words, as much value as is reasonable should be put on the breeding livestock over two years old and the specific items of machinery which are worth more than their original purchase price in your income tax depreciation schedule.

**Investment Credit Recapture** — When selling machinery and equipment and, since 1971, breeding livestock, investment credit recapture provisions need to be taken into consideration. If the total farm is being sold to an outsider, there may be nothing that one can do to prevent the recapture except to recognize the fact that you have had the use of some money that was owed to Uncle Sam interest free.

Where a sale may be involved to a buyer whom you trust, and substantial investment credit recapture is involved, it may be possible to retain ownership of that property for depreciation and interest and then sell it to him when the appropriate holding period is over so that the investment credit will not have to be recaptured.

## REAL ESTATE

In a real estate sale, an allocation must be made of the sale price between the various real estate assets — the residence, the land, and improvements. The difference between the purchase price allocated to the land and the sale price allocation to the land as long as it has been held for more than six months will always be long-term capital gain.

**Residence** — The residence allocation of the sale price has several alternatives open for tax treatment. First, if the seller has purchased a replacement residence in the period one year prior to the sale or one year after the sale or moves into a new residence within 18 months after the sale, the cost basis of the residence is transferred to the new residential property in a tax-free exchange. This holds as long as the new residence is equal or greater in value than the old.

In addition, if the seller or his spouse is 65 or over and lived in the residence in 5 of the last 8 years they can elect to have the gain on the sale of the residence treated under special provisions which allow an older couple to sell their home with no income taxes paid on the gain. This holds for the first $20,000 valuation of the residence and becomes a fractional nontaxable portion if the value of the residence being sold is greater than $20,000.

This election would be worthwhile using if a new residence is not going to be purchased or if the new residence was purchased outside the time limitations discussed above.

Improvements to the farmer's personal dwelling, except for a part used for the farm business office or for hired labor, are not depreciable for tax purposes. The cost of dwelling improvements should be added to the original investment to determine the basis for gain or loss when sold.

**Improvements** — The treatment of improvements, particularly the depreciation recapture provisions where rapid depreciation methods have been used, appear to be very complicated. However, recapture provisions do not affect most farmers because they have used straight line depreciation and, therefore do not apply. This is true for such items as buildings which have not come under the recent eligibility provisions for investment credit.

However, many farm real estate improvements **have** beem treated for income tax purposed under provisions of the tax law which make them eligible for investment credit and more rapid methods of depreciation. These items include grain storage bins, silos, fences, feed bunks, and, more recently, milking parlors and some specialized structures used in connection with raising livestock. These items are subject to depreciation recapture provisions under IRS code 1245.

In other words, they are treated exactly the same as machinery and equipment and the full amount of depreciation taken since 1961 would be recaptured as ordinary income. In addition, there may be investment credit recapture if the assets have not been held the prescribed amount of time.

On those real estate improvements not subject to code 1245, such as barns, where straight line depreciation has been used, there are no recapture provisions to worry about. However, if either the declining balance or sum of the year's digits depreciation method has been used, the depreciation greater than that which would have been taken under the straight-line method, called additional depreciation, may be subject to depreciation recapture.

Additional depreciation taken dur-

ing the years 1964-69 is not subject to recapture if the property has been held for 10 years or more. If the property has been held for less than 10 years then a fractional portion of that depreciation is subject to recapture equal to 100 percent minus 1 percent for each month after the date on which the property has been held for 20 full months.

After 1969 all of the additional depreciation over the straight-line method is recovered as ordinary income.

**Conservation and Land Clearing** — If the farm property being sold has been held for less than 10 years, deductions which have been taken on Schedule F for soil and water conservation and land clearing expenditures are also subject to recapture as ordinary income.

If the land has been held for less than five years any of these expenditures taken on Schedule F, such as for bulldozing of fence rows, burying stone piles and so forth, are fully recaptured as ordinary income. If the property is disposed of within six through nine years after you acquired it, the 100 percent recapture is reduced by 20 percent per year for each year you have held the land after the fifth year.

Soil and water conservation expenditures during the tax years are limited to 25 percent of your gross income from farming. Any excess expenditures could have been carried to a later year.

Land clearing expenses in any one year cannot exceed $5,000 or 25 percent of your taxable income from farming, whichever is less. Any excess must have been capitalized in the cost basis of the land.

**Installment Sale** — In order to reduce the impact of a sizable chunk of income from a farm sale coming in a single year, many farmers use the installment sale provisions of the income tax code to spread out a taxable gain over later years. For most people, this is a sound tax move. However, with the new income-averaging provisions and the fact that there are long-term investments available which can yield interest rates higher than most people will charge on an installment sale, many people would be as well or better off if they took the cash, paid the tax, and invested the proceeds. In some cases, the cash may also be desired to make gifts and reduce the size of the estate. This is something that needs to be worked out for each individual situation.

Installment sale provisions are relatively easy to qualify for. The major item to recognize is that the ratio of total payments in the year of sale to the gross sale price cannot exceed 30 percent. The gross sale price includes any cash, notes, or contract value obtained by the seller, plus any prior mortgage or other obligations assumed by the purchaser for the seller or any other property received.

Payments in the year of sale include not only the cash received but any installments received during the year on the principal. Any other obligations assumed and paid by the purchaser, and any excess of the mortgage assumed by the purchaser greater than the seller's cost basis.

**How to Get More Than 30 Percent Down** — In many cases, the seller is concerned about getting more than 30 percent of the total sale price and yet still wishes to qualify for the installment sale provisions. When the total farm, including personal property, is being sold, this can be achieved by breaking the sale up into separate transactions.

The sale of feed and crops, for instance, does not qualify for installment sale provisions and, therefore, all of the money should be received for these anyway. Market livestock would also come under the same provisions. Machinery and equipment and breeding livestock also could be broken into separate transactions.

If one category or item has little taxable gain involved, the total amount could be received on that portion, leaving those items with substantial gain under an installment sale.

If even more is desired, there is nothing that says the real estate must be sold as a single parcel. It could be broken into separate transactions and a fairly recent purchase, for instance, which has little gain could be sold for cash and the remaining portion which has been held longer and has a sizable gain involved sold under the installment sale provisions.

This kind of tax management takes a little time to figure but can be very rewarding in terms of providing dollars and minimizing the income tax obligations. Your accountant or tax man can be of valuable service in figuring out the alternatives.

In addition, if a greater down payment is desired, the seller could mortgage the property prior to sale and have the purchaser assume the mortgage. Payments in the year of sale do not include the value of an assumed mortgage except to the degree the mortgage is greater than the seller's cost basis. If this becomes a problem, an alternative is to sell the property on a land contract and let the seller carry any size mortgage he desires. Payments on the contract ought to cover the mortgage payments under this procedure.

**How Installment Sale Helps** — An installment sale allows one to spread the gain into the future and postpone the reporting of the gain and the actual payment of the tax. Under installment sale provisions, the gain can be spread over a considerable number of years.

If the buyer is in a close working relationship with the seller, additional payments on the principle may be paid in low income tax years for the seller and, therefore, a little control made on the taxable income.

If your contract leaves complete control of the payments to the purchaser, the seller may find that he will end up with more paid on the principal than he anticipated in any single year. This is particularly true if the purchaser decides to refinance and to pay the seller off. All of the remaining gain must then be included in that particular year.

**Income Averaging** — The income averaging provisions of the Internal Revenue code can be very beneficial when a farm sale is involved. This is particularly true if the four years prior to the sale have been years of low taxable income.

Income averaging provisions have the effect of spreading the additional taxable income for the current year equally over the four prior years and the current year so that the additional income does not get shoved into such extremely high tax brackets simply because it was received in a single year.

For instance, a couple who had an average of $10,000 of taxable income during the period 1969, 1970, 1971, and 1972 sold their farm. This resulted in $30,000 of taxable income in 1973. Ordinarily their income tax would be $7,880. Income averaging would reduce their tax to $6,760, a savings of $1,120. The lower the income in the base period years, the greater the benefit will be.

An additional factor to be considered when selling the farm where a substantial amount of gain is involved in any one year is the additional tax on minimum tax preference income. This involves that portion of the capital gain income which is not taxed when the gain is split by 50 percent.

If this gain is greater than $30,000 plus the income taxes that are paid in the current year, the additional tax preference income has a 10 percent tax. This is very unlikely to occur unless there is other tax preference income, such as interest on tax-free bonds.

**Selling Farm in Parcels** — Local and state regulations limit the size and in some cases the number of parcels of land that may be sold. The tax law only indicates how the gain will be taxed. It is important to maintain an investment and not a dealer status in making these sales. Parcels of property in the control of a dealer are sales in the ordinary course of a trade or business and as such any gain is treated as ordinary income.

If the nondealer requirements are met, the first five lots or parcels sold can all result in capital gains. However, starting with any sales made in the taxable year in which the sixth parcel is sold, 5 percent of the selling price is treated as ordinary income and only the remainder of the gain is treated as capital gain. Where a farm is being broken into parcels of this type there must be an equitable apportionment of the cost basis of the entire farm to each separate parcel.

If a taxpayer sells or exchanges any lots from a tract, and then does not sell or exchange any **more** lots for a period of five years from the last sale or exchange, the remaining property is considered a new tract. This means that the taxpayer can sell or exchange up to five more lots without any part of the profit being taxed as ordinary income.

## TIMING OF SALE

With planning, the total business may be broken into separate portions and sold in different years to reduce the overall tax impact. This naturally occurs as a farmer gradually reduces his commitment in the farm business by disposing of the livestock enterprise in one year, and continuing to cash crop the farm real estate. A few years later the real estate is rented out and the machinery is sold and subsequently the real estate is sold.

This procedure could be shortened into slightly over a one-year period to get into three tax years by selling the livestock and crops late in the year, the machinery during the winter of the next tax year, grant an option to the buyer to purchase the following January or sell for no down payment in the spring and start taking payments in January of the following year.

**Formation of a Corporation** — A long-term plan for a farm business sale that includes a large personal property inventory, which would create primarily ordinary income, might be the formation of a corporation. Property can be contributed to the corporation at its cost basis which subsequently becomes the cost basis of the stock. This procedure must be utilized carefully and the corporation organized at least three years prior to the sale of the stock to prevent denial of capital gains treatment on the stock sale.

The corporate procedure in itself might provide an avenue for a gradual sale of the business by selling shares of stock over time. Incorporating the family farm — advantages and disadvantages — will be covered in the first September MF.

## ALTERNATIVE TO SALE

In many cases, when selling a farm the proceeds of the sale will be reinvested in "like kind property." (This would not be possible to do when selling farm personal property unless farm personal property of a similar nature is being repurchased.)

Real estate may be traded for other business real estate. Therefore, it may be worthwhile to postpone the gain by working out a three-way transaction where the buyer purchases the real estate you want and trades it for your property. You have a nontaxable exchange in which you carry the cost basis of your former property to the new property, but have not had to pay the income taxes on the gain. This may be advantageous when you want another farm or possibly rental property.

Another alternative to selling the property is to retain ownership and lease the property to another user. This may be particularly useful where investment credit recapture provisions apply. In such a case you might wish to grant an option so that the potential buyer is assured that at a later date he can purchase the property.

A fact to note is that the amount paid for an option to purchase property is not includable in the seller's income until either the option is exercised, forfeited, or allowed to expire unexercised. If the option is forfeited or goes unexercised the option income is treated as ordinary income. If the option is exercised, the amount received on the option is added to the purchase price of the property and treated the same as the rest of the sale price.

## CAPITAL GAIN

Most farmers find that the regular procedure for handling capital gains is most beneficial when selling farm assets. Income tax is computed at ordinary tax rates on their regular taxable income plus 50 percent of the excess net long-term capital gain over net short-term capital loss.

However, where regular taxable income and capital gain are both high, the alternative procedure may show less taxable income. This procedure adds the tax from regular income to 25 percent of the first $50,000 of **gain** and effectively 35 percent of all capital gain over the $50,000. To benefit, therefore, the taxpayer would have to be in the 50 percent tax bracket or be a married taxpayer with over $44,000 of total taxable income.

Another consideration which farmers will seldom face is the minimum tax of 10 percent on tax preference items. Tax preference items are the untaxed 50 percent of capital gains, depletion allowances, accelerated depreciation on real property, and stock options. In any taxable year these are totaled and then reduced by an exemption of $30,000, plus the income tax for the year. Any excess is taxed 10 percent. If all the taxpayer has is capital gains as tax preference income it is very unlikely the minimum tax will apply.

# PART III: ORGANIZING THE FARM BUSINESS

# ORGANIZING THE FARM BUSINESS

## Sole proprietorship, partnership, or corporation?

CHAPTER 14

Traditionally, the family farm has existed with one person owning the farm business and he and his family supplying the capital, labor, and management. Each farm stands alone like an island in the economic sea.

As the farm grows it faces the needs to attract equity capital, obtain more management talent, and secure a dependable labor force. From a more long-term viewpoint, there is the problem of continuity between generations and of transferring the larger business as a going concern to the next generation without taxes taking too big a bite.

The legal structure of the farm — the way it is organized — has many effects on the ownership and success of the business in handling these problems satisfactorily.

Because of the pressures of modern agriculture, more and more farmers are beginning to examine partnerships and corporations as possible ways of organizing their businesses to make it easier to reach both short and long-term goals.

Some individuals and groups have protested vigorously this trend, claiming the end of the family farm would result. The truth is actually quite the opposite. The way the family farm business is organized is just another business tool. The form of a business does not transform the ideas, goals, and aspirations of a family in and of itself. It is simply a tool to be used in estate planning, each form of organization with its own advantages and disadvantages.

Each of the three forms of organizing a farm business are obviously very complex and impossible to cover in all details in one article or even several. However, we will attempt to point out some of the most relevant points concerning different ways of organizing the farm business in this introductory article; one in the September 1 issue will deal more in depth with partnerships and one in the September 15 issue with corporations. These latter two articles will include case histories of successful Michigan farm operations that are utilizing these business forms.

But first, an overview of the three main types of business organization — sole proprietorship, partnerships and corporations.

### SOLE PROPRIETORSHIP

Basically, sole proprietorship is a form of business where the farm is created and operated by one individual for his own benefit.

Money put into the farm comes from the farmer's own pocket or is borrowed in his own name. He makes the management decisions, decides what directions the business will take, buys the necessary supplies and inputs, and markets the resulting production. Labor and other services are either provided by the family or purchased.

In addition to having the opportunity or right to make all the decisions, the liability for business decisions also rests with the farmer. He accepts all the profits and losses from the business and assumes personal liability for all outstanding debts.

If a judgment is awarded against him for any reason, he must pay the damages. In addition to his business property, all of his personal belongings and even his future income may be subject to attachment and sale to meet the obligations.

The transfer of interest in the business brings the proprietorship to an end. Likewise, death of the owner results in liquidation of the business and creation of a new proprietorship if the farm business is continued.

Sole proprietorships pay no income taxes as a business. All taxable income is combined with the individual's personal income and subject to the individual's tax rates. Capital gain income is also transferred to the individual tax return and subject to individual taxation.

Two or more farmers may be co-owners of property and still operate separate businesses. The owner of a farm and his tenant who owns stock and equipment and who divide the proceeds of the farm are not, as a general rule, partners. The joint operation of a business by two or more individuals for profit would constitute a partnership, but owning property together in itself doesn't qualify as such.

### PARTNERSHIP

A partnership is defined as an association of two or more persons — which may include husband and wife — as co-owners of a business for profit.

The general partnership falls somewhere between the corporation and the sole proprietorship in complexity.

However, it probably has more characteristics in common with the proprietorship than the corporation.

When two or more individuals want to own and operate a business together, but not form a corporation, a partnership is probably their answer.

The partnership can own property in the partnership name. However, capital for the business comes from the partners' personal funds or from money borrowed by the partnership.

Management decisions are made by the partners according to their worked out partnership agreement. The agreement may be written out, spelling out the management responsibilities; oral — a verbal agreement; or implied, reflected by how the partners actually run their business on a day to day basis. Guided by this agreement, the partners make all the decisions related to running their farm business. Because of the complexity of modern farm operations, most partnerships should probably resort to a carefully worked out written agreement.

A partnership continues until it is terminated by the agreement, until the business is liquidated, or at the death of one of the partners. Death causes the partnership to dissolve although the agreement or other provisions can result in continuing the farm business with the creation of a new partnership.

Each partner is liable for partnership obligations for the settlement of debts or judgments against the business. If any partner can't pay his personal bills, his partnership interest may be attached to settle his debts.

The partnership business doesn't pay income taxes. All profits or losses and capital gain or loss are allocated to the partners according to the terms of the agreement. The individual, in turn, pays his own tax at individual income tax rates.

The partnership is the basic accounting unit for income tax purposes and must file an information return showing the income and expense from the business, the names of the partners, and how partnership returns will be allocated to the partners.

### LIMITED PARTNERSHIPS

There is another type of partnership called limited, which varies in a few important characteristics from the general partnership.

The limited partnership has two kinds of partners — general and limited. The former are almost identical with the partners in the general partnership, but the limited partners are quite different.

The limited partner has liability limited to the amount of his investment. He functions completely as an investor in the business and may not participate in the business management or operation.

### CORPORATION

A corporation differs from a partnership in that it is considered a separate business entity, apart and distinct from its owners.

The corporation is quite similar in its legal rights to a person, even though it is only a creature of law and can't exist apart from the statute that gave it the authority to exist and function.

The corporation can take, hold, and transfer property in its own name. The owners conduct and control the business through the shares of stock they hold. Owned capital is raised through the sale of this stock, through bonds issued by the corporation, and from money borrowed in the corporation's name.

Owners of the corporation are liable for business debts and obligations of the corporation only to the extent of the value of their shares. This limited liability under the corporation organization has a lot of appeal because investors can purchase ownership of a business without risking other personal investments to pay corporation debts.

Management obligations as well as the rights of the shareholders are controlled by the articles of incorporation and by law. Together, the law and articles are rouhghly equivalent to the partnership agreement. The elected officers of the corporation transact the business and make minor decisions. With most farm corporations in Michigan, the shareholders, directors, officers, and workers will probably all be the same people. They have to wear different hats when they act in their various capacities.

Since the corporation is regarded as a separate entity, a transfer of an ownership interest by sale or gift of stock break up the business. From an estate planning point of view, the nature of the shares of stock makes transfer of an estate very easy, during life or through death transfers.

These transfers do not necessarily disrupt the continuity of the business. If corporation stock is transferred, ownership changes. However, if large blocks of stock are transferred, the management control may change, too. But this transfer doesn't affect in any way the assets within the corporation, only the stock ownership of the corporation.

When a corporation is formed, articles of incorporation must be filed with the state to define the general purposes and powers of the corporation. This is the formal charter under which it operates. In addition, the corporation, through its shareholders or directors, establishes the bylaws that regulate the everyday affairs of the business. These documents determine and define the limits or scope of the business and the length of life of the business.

Being a legal entity, a corporation is recognized as a taxpaying unit for income taxes. The corporation pays its own taxes at income tax rates established for corporations. Shareholders must then pay personal income tax on their income from the corporation. This creates a problem of double taxation but one that can be offset by other benefits.

There is a way of avoiding this problem if the corporation is closely held by a small group of stockholders. Since 1958 shareholders of this type of corporation could choose to have corporate income taxed at their individual rates rather than as corporation income. This situation is referred to as a "tax option corporation" or a "subchapter 'S' corporation."

Added advantages may be secured through various forms of corporate fringe benefits. These include insurance payments for employees, medical and hospital plans, pension and profit sharing plans, and others related to income tax.

Payments by the corporation are generally a business expense, fully deductible on the corporate income tax return. Unlike a sole owner or partner, a stockholder may be treated as an employee of the corporation and eligible for these benefits.

### CHOOSING A FORM

No two farm businesses are exactly alike and have identical requirements. Even where the type of farm and locality are the same, the likes and dislikes, motives, objectives, personalities, and methods of the individuals involved will be different. That means the form of business organization that best suits their needs may very likely be different too.

The decision as to which form of business organization should be chosen for a new operation, or to reflect changes in an established farm, is one of the most important a farmer must make. Certain basic things should be taken into consideration: (1) the amount of credit and capital required, (2) any possible need to limit liability, (3) the structuring of management and control of the farm business, (4) the expense of organization, (5) ease of transfer of ownership interest, (6) whether continuity of the business between generations is an issue, and (7) tax considerations.

# Comparison of Farm Business Organizations.*

| | SOLE PROPRIETOR | PARTNERSHIP | CORPORATION |
|---|---|---|---|
| Nature of entity | Single individual | Aggregate of two or more individuals | Legal person separate from shareholder-owners |
| Life of business | Terminates on death | Agreed term; terminates at death of a partner | Perpetual or fixed term of years |
| Liability | Personally liable | Each partner liable for all partnership obligations | Shareholders not liable for corporate obligations |
| Source of capital | Personal investment; loans | Partners' contributions; loans | Contributions of shareholders for stock; sale of stock; bonds and other loans |
| Management decisions | Proprietor | Agreement of partners | Shareholders elect directors who manage business through officers elected by directors |
| Limits on business activity | Proprietor's discretion | Partnership agreement | Articles of incorporation and state corporation law |
| Transfer of interest | Terminates proprietorship | Dissolves partnership; new partnership may be formed if all agree | Transfer of stock does not affect continuity of business—may be transferred to outsiders if no restrictions |
| Effect of death | Liquidation | Liquidation or sale to surviving partners | No effect on corporation. Stock passes by will or inheritance |
| Income taxes | Income taxed to individual; 50% deduction for long-term capital gains | Partnership files an information return but pays no tax. Each partner reports share of income or loss, capital gains and losses as an individual | Regular Corporation<br>Corporation files a tax return and pays tax on income; salaries to shareholder-employees deductible<br>Capital gains offset by capital losses; no 50% deduction for capital gains<br>Rate: 22% on first $25,000, 48% on excess<br>Shareholders taxed on dividends paid<br>Tax-Option Corporation<br>Corporation files an information return but pays no tax. Each shareholder reports share of income, operating loss, and long-term capital gain. |

* Reprinted from North Central Regional Extension Publication No. 11, The Farm Corporation, revised 1973.

# PARTNERSHIP: MAKE RULES TO FIT YOUR SITUATION

CHAPTER 15

When two or more people want to co-own a farm business, one of the most simple, flexible methods of organizing is the farm partnership.

There are no set rules or limitations inherent in the nature of partnerships. These are created between the partners in their agreement, to meet their own individual goals, abilities, and contributions.

Farm family partnerships offer enough flexibility to achieve most estate planning goals — lifetime income and retirement advantages for the farmer and assurance of smooth transition and equitable distribution of the farm business to the next generation.

It is flexible for different situations. To a young man it may be the opportunity to go into business with dad. A son who might otherwise think he is getting nowhere and consider trying another line of work will be encouraged to stay with the farm and help make it prosper.

To someone with limited capital and a desire to enlarge his business, it may mean a source of financing, plus some much needed management assistance.

## ADVANTAGES

Many advantages of a partnership are simply extensions of the advantages of a sole proprietorship. Both are very easy to organize, operate, and dissolve, with few legal restrictions.

Maximum individual freedom exists. There are no boards of directors, no officers to be elected, and no formal meetings with minutes are necessary.

In certain situations, however, partnerships have advantages over sole proprietorships.

**Management** — As farm businesses become larger and more complicated the type of ownership management that can and will take responsibility becomes a critical factor. A partnership can pool the management abilities of two or more people into one business and probably be more profitable as a result — if the potential is great enough.

Unless the agreement specifies to the contrary, management of a partnership business is usually jointly held by the partners. They must consult with each other before decisions — at least major decisions — are made.

In most cases, for the success of the partnership it is almost imperative that management be joint or one or more partners may be disillusioned by the domination of the stronger partner. This is unfortunately true in many father-son(s) operations where the father is unwilling to relax his grip on the management reins.

**Capital** — Modernization and labor-saving technology usually are associated with businesses operated by more than one man. For many farmers with limited capital and a desire to avoid hiring labor, a partnership with another farmer who has similar goals has the potential of working out well.

If two or more individuals pool their capital resources, economies may be possible that were not available in their separate, smaller businesses. Likewise, it may be possible for the partnership to obtain larger loans and a better credit rating than smaller, less efficient operations.

A large business with continuity of ownership and management is in a more favorable borrowing position than a sole proprietorship. The business success and continuation is less dependent on one individual. However, continuity is more a characteristic of the individual enterprise's financial condition and potential than of the business structure itself.

The necessity of obtaining outside equity capital presents an entirely different problem than that involving commercial lending institutions discussed above.

A sole proprietorship or a general partnership is not attractive to outside investors unless they want to join in the management of the venture. On the other side of the same coin, if a farmer doesn't want outside interference in the operation of his business, this source of financing is ruled out.

Most nonfarm family members who inherit part of the business assets don't look favorably on business ownership in the form of a sole proprietorship or a partnership. Generally, the family member who will operate the business obtains the personal property and the remaining heirs take ownership of the real estate, which is then leased to the business.

The limited partnership is more tempting to the investor who does not want to participate in management and who wants to limit his liability to the amount of his investment. A limited partner, however, is in a weak position to protect his investment because he cannot actually participate in manage-

ment.

**Transfer of interests** — The transfer of partnership interests between partners is easy because they own a share of a partnership rather than individual property. Such a transfer usually requires changes in the partnership contract unless the original agreement has provisions to allow for changes of this type.

Because of the nature of partnership, interest in it is relatively hard to dispose of to outside investors. In most agricultural partnerships, such a transfer would be impossible.

**Taxes** — Taxes paid under a partnership agreement are merely an extension of a sole proprietorship. A partnership pays no income taxes as such. Profit is allocated to the partners and they, in turn, pay the tax.

Whether individuals in a partnership pay less tax than under a corporate structure depends on the business profit level. Joint federal tax return rates for individuals are higher than corporation rates for taxable incomes between $12,000 and $25,000, and above $44,000.

However, Michigan income tax is greater for a corporation than for a partnership. Also, corporate income can be split between salaries and corporate profit and each taxed as separate entities. For these reasons, a farmer or farmers considering the two business forms should have comparisons made using their specific situations.

## DISADVANTAGES

**Unlimited liability** — The partnership is responsible for business debts, actions, and mistakes of each partner. The partners prosper or fail together.

For the partner with considerable capital assets outside the business, a partnership may make those assets vulnerable to risks not associated with a corporate structure. However, for most family operations with adequate insurance for unexpected disasters, this disadvantage may be worth the risk.

**Loss of control** — Parents who have worked all their life to build the family farm to its present condition may be threatened by the proposed change and therefore reluctant to form a partnership. By its nature a partnership means that the father must give over some of the control of the operation into the hands of his son(s). In the case of a partnership involving people outside the family, the misgivings may be even stronger.

**Conflicts** — A partnership involves the necessity of agreement and cooperation on the part of individuals involved. This creates an opportunity for conflict over the rights and duties of each partner in providing labor and management for the farm.

We mentioned earlier that it is almost imperative that management of the partnership be joint to avoid disillusionment resulting from domination by the stronger partner. A danger of the opposite nature also exists in instances where sharing of management responsibilities results in divided authority and ineffective management. Each partner is responsible, but neither acts. Without decisive action, a partnership will soon drift into an unsound financial condition.

**Lack of continuity** — A limited and uncertain business life is a characteristic of either a partnership or a sole proprietorship. The business is organized and operated for the benefit of individuals who make up the business. Once this benefit disappears through changing goals, death, or other circumstances, the business is dissolved.

Multiple ownership in a partnership can extend the business life over many generations to transfer capital and management to the younger families. However, when an agricultural business becomes large enough to operate profitably with hired management, the corporate structure may offer business continuity not possible in a partnership.

**Difficult search** — Established farmers looking for a partner may have difficulty finding someone qualified and agreeable, even within his own family. Because a partnership is the most intimate of all business relations, the partner must be selected far more carefully than an employee.

## ESSENTIALS FOR SUCCESS

**Partnership agreement** — Since the partnership agreement is a blueprint for the organization and operation of the business, it plays a key role in the total success of the partnership. It is through this agreement that each partner relates to the business.

The agreement should be equitable and fair to each party. Each should share in the partnership proceeds according to his contributions of capital, labor, and management. Unless each feels his resources are fairly compensated in the agreement, he will tend to shift his money and labor to other uses, to the detriment of the partnership.

Individuals who own most of the capital resources in a partnership have a stronger bargaining position than those with little or no capital resources. This is especially true of father-son partnerships. Although the agreement should direct more payments to the largest capital contributor, he should not use his stronger bargaining position to dominate the agreement terms at the expense of the other partner(s).

It may be necessary for the partner with the largest capital resources to sell a share of the personal property to the entering partner, and either finance the new partner directly or assist him in finding commercial financing.

This does not require, however, that all capital from each partner be contributed to the partnership. For example, in a father-son operation, the land does not need to be included in the partnership. It can instead be rented by the partnership.

It is important that a partnership usually combine all income-producing enterprises into one operating unit. If each partner receives income from only one particular enterprise, there is a tendency for each to favor his part of the business and neglect the rest.

Further, business personal property owned by each partner should be merged into partnership property at the start of the agreement. This way each partner no longer owns equipment or livestock in his own name but holds shares of the personal property in the partnership. The partnership itself then becomes the prime concern.

**Relationships between partners** — It is essential that partners relate well to each other. They must be able to live with and overlook each other's faults. They need to be tolerant and understanding, have the ability to forgive, and avoid harsh words.

Father and son farming programs are more often divided because of disagreements over trivial things than over major issues.

In no other occupation are the home and business so closely related as in farming. The wives must like the business, respect the other partners, and get along with the other partners' wives. Friction among wives contributes to impossible situations that can destroy the partnership. Usually if a wife has a voice in the partnership agreement and fully understands its conditions, she will more likely be satisfied.

Problems frequently occur in partnerships because the goals and values between the families are different. This makes it doubly important that the partners respect and honor each other's opinions. Suitable compromises then become possible.

Joint management decisions are another "must." If the business is truly a partnership, one partner is not in charge of the business and the other simply a laborer. Both are in charge.

It is important that the partners

and their wives sit down at least once a month at a specified time to study the business progress and openly discuss any problems. Without a planned time, meetings won't be held, communications will break down, and the partnership will develop problems.

The less experienced partner needs to be given an increasingly important role in management. He may not be a competent manager when the agreement is started, but there should be a general understanding and plan for him to grow into management responsibility.

Partners' qualities may complement each other to offer an opportunity for specialization of responsibilities. Certain areas of management can often be assigned to each party in the agreement.

**Business success** — No matter how fair an agreement may be and how well the partners get along, the partnership will not be successful if there aren't enough earnings. Income must be high enough to support the multiple owners and compensate individuals for their capital resources.

Often it may be necessary to rent or buy more land or expand a livestock enterprise.

However, size of business is not the only criterion for operating a profitable business. Favorable price relationships, use of proven technical practices, efficient production and marketing, and skill in handling finances and investments are all essential.

A joint business operation also requires a careful record of all financial transactions. Inventory records are needed at the beginning and end of each year. Good account records are needed, not only for monthly and yearly settlements, but also for business improvements.

Although one partner may keep the records, the other partner(s) should be kept fully informed and have access to the records at all times.

## AGREEMENT

**Why written?** — Although partnerships may be successfully operated without a written agreement, it is strongly advised that the agreement be in writing.

The ownership and terms of operation of a partnership agreement aren't an inherent part of the business structure itself. These are only reached through a consent of the parties involved.

To develop a common course of action that is essential for partnership success, each partner must understand the other's proposal. Through the agreement drafting process, a more complete understanding between the parties can be accomplished. Misinterpretations can be corrected.

Writing out the terms fosters preciseness and clarity. It is the end result of the bargaining process that must take place.

A written document also serves as a source against which to compare intentions and results. It is present as a reminder of the commitment of each partner and should be reviewed for possible changes as conditions change.

Partnerships should be informal and flexible business arrangements. That is part of their strength. However, writing and signing a partnership agreement contributes stability. It shows that a business is being created and that the step is not casual in the commitments and responsibilities involved.

Another value of a written agreement is that there is no assurance that a partner will always be present. The early death of one partner demands the dissolution of a partnership. But how? One way to convey those wishes is through the partnership agreement. It could save problems and costs for the estate, as well as insuring a method for continuing the farm business.

**The agreement** — A partnership agreement is a statement of the terms under which partners bind themselves to organize and operate until the agreement is changed.

The agreement should serve as a blueprint for the organization and operation of the business. It should be specific enough so each partner knows his rights and obligations, but not so detailed that a business decision can't be made without reference to the agreement. It should include guidelines for future decision-making and cover major aspects of the business organization, operation, and dissolution.

As conditions change, the agreement should be rewritten or amended to reflect those changes.

It should be simple, easily understood, possible to put into practice, and legally sound. To insure these points, it is advisable to have an attorney prepare the document.

However, the attorney can only decide on the appropriate wording and the legality of terms. The future partners must decide what the terms of the agreement should be. This calls for an in-depth analysis of many issues, tax considerations, and alternatives. It may be helpful to use MSU Extension bulletin E-731A "Partnership Agreement Worksheet" to detail terms before contacting a lawyer.

Some of the things that must be decided before the agreement is written are: (1) Nature and duration of the business. (2) Contributions of cash, personal property, and real estate by various partners. (3) Future capital contributions and withdrawals of contributions. (4) How partnership income will be shared through salaries and/or drawing accounts. (5) How and by whom records will be kept. (6) Any limitations on the partners' ability to act individually for the partnership or limits on the partners' personal activities. (7) Allocation of any specific management duties. (8) The conditions and situations under which the partnership would cease to exist.

## STARTING A PARTNERSHIP

Special problems may be created if a father-son partnership is started too soon.

In some cases, it may not be wise, for example, to create a partnership as soon as the son graduates from high school. It may take time for the father and son to figure out if they can — and want to — work together in a common business. The younger man may also need time to determine whether he wants to enter business or get additional education.

During this interim period, the son could work on the farm for wages as an employee or under a wage and profit-sharing arrangement. Both are less formal than a partnership and easier to break off, if necessary.

During this period the son may want to acquire some capital items, but hold them in his own name and receive pay for their use until a partnership can be formed. After both father and son decide to form a partnership, each can contribute capital to the business.

Later, the partnership agreement can be of great assistance in carrying out the estate plan. The agreement may provide for periodic gifts of an interest in the farm. This will result in lower estate taxes.

An installment purchase plan is often incorporated in the partnership agreement or exists in a separate agreement. This has all the advantages of an installment sale. The father receives greater income with a lesser tax burden as he grows less able to take part in the labor of farming. The son acquires more ownership as he grows better able to handle management tasks.

A sound retirement plan and a continually prosperous farm are the objectives. At the father's death, further installments may be used to support the mother and to equalize the shares of other children. The two case studies included with this article give some idea of the opportunities represented in a partnership.

# PARTNERSHIPS:
## Firm base for father-son farming

It takes a son to keep things from drying up and a father to keep them from blowing up," said Frank Crandall.

The Bedford dairyman was talking about the inherent conflict between generations on a family farm. On the one hand there is the father who is established and has built up some comfortable equity. On the other hand there is the son who wants and needs the opportunity to use his ideas and energies to build security for his family.

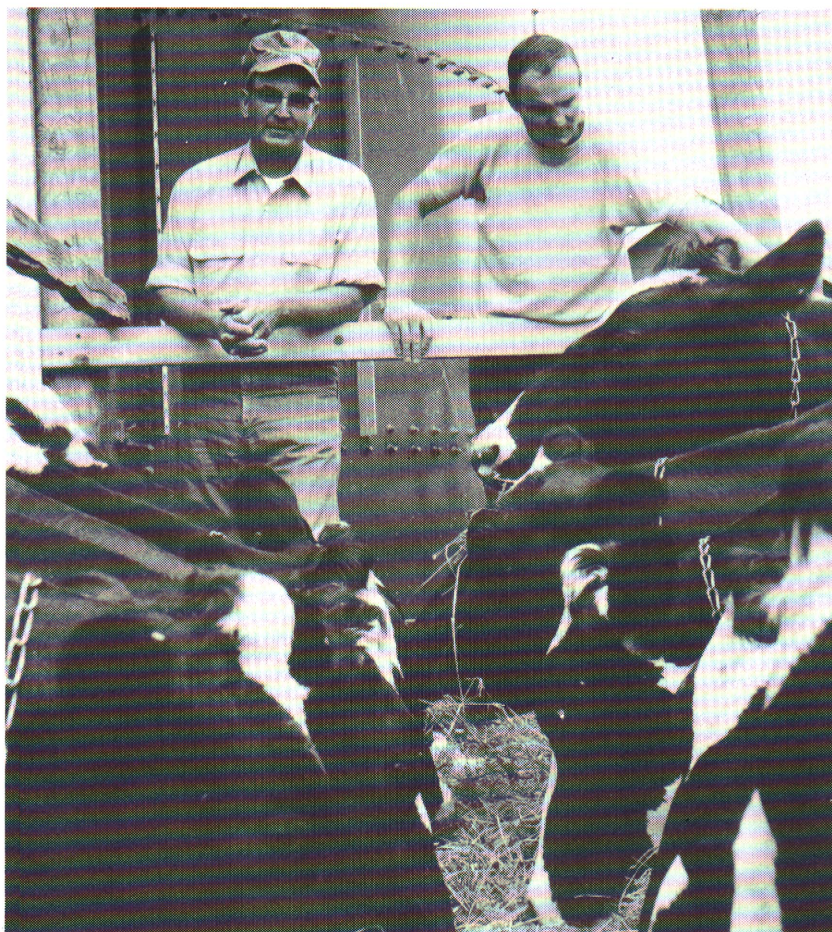
"My father was conservative and I was a little bit radical when we were farming together," said Frank. "Now the same thing is happening with my son Larry, except now I'm the conservative one."

Although on paper this conflict may sound simple and easy to handle, it can be the source of many family problems. Properly channeled, though, this interaction between generations can help build a stronger, more productive farm business. Allowed to fester unresolved, it can result in the father finding himself with no one interested in carrying on the family farm and a son who has found a job in town.

### INFORMAL ARRANGEMENTS

The original 160 acres of the Crandall farm — section 12, Bedford Township, Calhoun County — was purchased by Frank's grandfather nearly 100 years ago.

"The arrangement between my father and grandfather was just a verbal thing — 50-50," said Frank. "They both worked; they both furnished livestock and machinery. The arrangement was about the same between my father and me. I bought in with him in 1941 and he backed me, Just like I back my son Larry."



Frank (left) and Larry Crandall with some of their herd.

When Larry received his degree at MSU in 1966, he and his wife Gloria moved back to the family farm. The current partnership was set up in 1967.

### LEGAL PARTNERSHIP

But between the current generations there is a formal, legal, written partnership agreement. Why?

"I think we went to the formal partnership because of involvement," said Frank. "There are more machinery, livestock, and different aspects of farming than existed a generation ago. When I started with my dad we had just gotten our first tractor. Now everything is power equipment."

"Another important reason is the kids," said Bernadine, Frank's wife. "Without the partnership arrangements, if something happened to Frank, Larry and Gloria wouldn't have the financial backing now to be able to buy the whole operation and keep it going. Actually it is more to protect the kids than anything. After all, what's the sense of having a big operation and a lot of land if it isn't going to be passed on?"

The elder Crandalls also have a daughter who lives nearby, but she and her husband are not involved in the farm. Frank and Bernadine pointed out the advantages of a formal partnership, linked with other written estate planning, in avoiding misunderstandings among children at the time an estate is settled.

"We attended a lot of meetings and heard of cases where if anything happened to one partner or another on a farm, settlements were quite difficult without a formal partnership," said Bernadine. "There are just more legal entanglements now than there used to be."

### INSURANCE

To make the passing of the farm easier on the families in case of death of one of the partners, Frank and

Larry carry insurance policies on each other. The money received from the insurance policy would enable the surviving partner to buy the deceased partner's business holdings from the heirs, keeping the farm operation together. This is especially important in Larry's case since so much of the land is owned by Frank and Bernadine at this time. The partnership agreement also contains the stipulation that the remaining partner will have the first opportunity to buy the deceased partner's share of the business.

### GRADUAL GROWTH

One of the most important reasons for the success of the Crandall partnership is the gradual, progressive way Larry has worked into it.

"When Larry bought into the partnership," said Frank, "he didn't buy into the land, just the personal property — livestock, machinery, and feed.

"Bernadine and I started off with the original 160. In 1948 we bought the 80 where we now live. About seven years ago we bought the 135 acres up the road when it became available. We have always rented a lot of land, but under those conditions you never know when you are going to be turned away.

"Three years ago the farm this side of the 135 — 157 acres — was for sale so the four of us (Frank, Bernadine, Larry, and Gloria) bought it. This got Larry and Gloria started in real estate. We are now in the process of buying 70 acres north of here jointly. This will bring us to just over 600 acres. In addition we rent 265 acres."

### DAIRY HERD

During this same period the dairy herd has grown from the 24 cows Frank and his dad Charles had at the beginning of their partnership to the 113 cows milking now. Today the herd totals 254 head, almost all born and raised on the farm.

The rolling herd average on 113 cows as of June 6 was 17,394 pounds of milk and 638 pounds of fat.

### MORE MAN POWER

One of the main reasons the herd and farm has grown to the size it has in recent years is the addition of Larry to the business as a partner and the extra man and management power he represents.

"I graduated from MSU in 1966," said Larry. "There had been a lot of talk about partnerships in classes there. I heard of many instances where father and son partnerships had worked out well, and some instances where they didn't, and why.

"We had a good operation here. It had the potential of supporting two families. All we needed was to add more labor, and I provided that when I came back to the farm.

"A partnership is about the only way a young man can get into farming today. However, not everybody has an opportunity of coming back into something that is capable of staying above water with the financial needs of an additional family and keep on growing.

"As for the formal part of the partnership — having it down in black and white — that is very important," said Larry. "It provides a security that is about the most important thing about it."

"I think the wives play an important part in whether a partnership is going to work, too," added Gloria. "They have to be able to get along. If they can't, it can be a big problem. This is also true with hired help. You have to suit the wives. If the hours are too long, the wives will pressure the men into leaving."

The Crandalls have one full-time hired man. They also hire three part-time high school-age helpers who rotate working hours.

### PERSONAL INTEGRITY

There are four partners in the Crandall dairy farm, even though the partnership papers are drawn up between only father and son.

Labor within the partnership is divided. Frank is in charge of the field crops while Bernadine is the "haybaler, chopper, and bookkeeper." The younger couple is in charge of the dairy operation with Gloria keeping all the records on the cows — milk production, vaccinations, breedings, calvings, etc. All four "partners" seem to get along well together and respect one another.

"All partners have to maintain their integrity," said Bernadine. "A person can't just always give. You have to hold onto your beliefs a little bit, too. In our case, I think everyone is quite considerate of the others' feelings."

And the cycle goes on. Although Larry may feel a few apprehensions about becoming more conservative at the ripe old age of 31, there is a still younger generation on the scene that will be pushing him some day — Laurie, 5, and Brad, 2.

Brad has a complete set of miniature farm machinery, just like dad and grandpa, and has already plowed, planted, and harvested the living room rug several times this spring.. Another 15 or 20 years may see another partnership, or perhaps a corporation, depending on what fits in best with the total estate plan.

# WORKING TOGETHER FOR THE SAME GOALS

Near Three Rivers, three tall silos stand out above lush fields of corn, marking the location of Gleason Meadows Dairy Farm, one of the stops on the recent state farm management tour.

At least part of the prosperity of this well-run operation is the result of a sound farm partnership between Henry Gleason and his son Jim.

Although the partnership between Henry and Jim is formal, legal, and binding, this was not true when Henry joined his own father on the family farm years ago.

"After I got through college, I came back here and worked with my dad for several years," said Henry. "We didn't have a written or registered partnership. There was just a mutual understanding between us. We divided the profits any way that seemed feasible right at that moment. Neither one of us had very much. Then in 1939 I bought out his interest in the whole farm. It was an even 300 acres then."

### MANY REASONS

Today, however, Henry and his son Jim have a legal partnership. The reasons they give for taking this step are many and varied.

"The partnership protects us both in the case one or the other of us might die," said Jim. "Secondly, income tax laws have changed so that if you file partnership income tax forms, you have to have at least some proof you actually have a partnership."

Henry supported Jim's points and added, "From our standpoint if we always knew that we were going to be here as we are, a verbal agreement between us would be good enough. However, if something should happen to one or both of us and something had to be done to the estate, another person might look at things a lot differently than Jim and I do. That's another main reason for a written agreement."

A buy-and-sell agreement is worked into the partnership papers so that in the case of the death of one partner, the other has the right to buy out the deceased partner's share from his heirs.

### REGULAR REVIEW

"A partnership is something that needs to be redone regularly, too," said Henry. "Ages of the people involved and other conditions change. A partnership might last for a few years on one agreement — I don't think we changed our first one for four or five years. But as time goes on, it needs to be changed and revised."

Henry and Jim have actually drawn up new partnership agreements three times to meet changing conditions. This usually resulted when Jim wanted to obtain more of the equity in the farm and Henry wanted less.

### NECESSARY CHANGE

Jim graduated from MSU in 1958 and worked for the remainder of that year on the farm before joining his father in partnership in 1959. During the 14 years since then the farm has grown from 560 acres to about 700 and the dairy herd from 45 cows milking to about 140 today. The rolling herd average is 16,345 pounds of milk and 616 pounds of fat.

The 158 dairy cows plus young stock add up to over 300 head of cattle on the farm. The Gleasons raise all their own herd replacements and even have a few to sell.

Many changes have taken place in the facilities of the farm over the years, too. A milking parlor was built about the time Jim returned to the farm. New silos have been added . . . a change was made to free stalls.

The Gleasons have two full-time hired men helping them run the expanded operation. The herdsman has been with them eight or nine years and the assistant herdsman, just over a year.

"We haven't had any basic disagreements on the changes we felt were necessary," said Jim. "Most of them were changes that looked economically right and were recommended by experts in the field. We made the changes gradually. It wasn't the kind of thing you could see happening. It was much easier for us to agree on gradual change because if we did something it soon became apparent what the next step should be."

### KEYS TO SUCCESS

"One thing in particular that determines whether a partnership will work or not is the people involved," said Henry. "They have to be congenial — of the same frame of mind and looking toward the same goals so they can work together. And there has to be some give and take. Partners won't always see everything alike. Each has to realize that sometimes he won't get his own way."

Another primary thing to be considered before entering a partnership is whether the business itself has enough volume to support two families. "I suspect that a lot of partnerships founder simply because the business wasn't big enough for a partnership in the first place," said Jim.

An important step in getting a partnership started on the right foot is some division of responsibilities, which the Gleasons have practiced ever since they formed their partnership. Jim has had primary responsibility for the dairy herd, while Henry has tended to work more in the field crop area and with the books.

"It seemed to be the natural thing to do to divide at least some of the responsibilities as far as day-to-day decisions go," said Jim. "Any major decision, of course, is a joint one."

Henry Gleason (left) and son Jim guide semi to loading chute.

# CORPORATIONS: HOW THEY FUNCTION

CHAPTER 16

Selection of the best business organization method for your farm is a crucial part of a sound estate plan. There is no simple formula available to help you make the "best" choice. The beginnings of the decision will have to be worked out through in-depth conversations with your family and with current or potential business associates. Goals, wants, dreams, capabilities will all have to be weighed.

After a thorough look at the possibilities, more concrete steps can be planned with the help of a lawyer and a CPA knowledgeable in farm business organization situations.

There are certain generalizations about the types of business organizations that can be made to assist in the search for the most desirable organization for each individual farm operation, even though no hard and fast rules exist.

The legal structure chosen will influence everything from taxes to ability to attract capital, and from management to transfer of farm ownership.

In the two previous articles we covered a general look at benefits and disadvantages of the three types of business organizations — sole proprietorship, partnership, and corporation — and a more specific look at partnerships. This article, with its companion piece about the Burns Poultry Farm, is devoted to the structure, advantages, and disadvantages of farm corporations.

## SEPARATE ENTITY

The corporation is an artificial being or "person" created under state law. It is a separate legal and business entity, distinct from its owners. Owners are called shareholders because they hold shares or interests in the corporation.

Although the corporation, as a legal entity, acts through human agents, it has many characteristics common to a person. It may take, hold, and transfer property in its own name. Owners of the corporation own stock in the corporation and not the business property of the corporation itself.

For several reasons, including taxes, it is common for shareholders in a farm corporation to rent or lease land, livestock, and machinery to the corporation, retaining ownership in their individual hands. To avoid problems with the IRS, the rental or lease fees must be reasonable and consistent with prevailing rates in the community. The corporation can then deduct the rent or lease fees as a business expense.

The general purposes for which corporations may be formed are set forth by state law. Within these limits, the individual corporation is created through articles of incorporation, which define its general purposes and powers. Experience has taught farmers not to define the goals of their corporation too specifically. This may end up restricting opportunities for the farm corporation at a later date. To avoid this, often the articles of incorporation include a "catch-all" clause to authorize all business necessary or reasonably related to the primary purpose of farming.

## CORPORATION STRUCTURE

A corporation can be publicly owned or closely held. A publicly-owned corporation may have thousands of owners in all parts of the country. A closely-held corporation, on the other hand, is owned by a small group of shareholders. Ordinarily outsiders cannot buy into such corporations.

Ownership of closely-held farm businesses is often confined to this type of small group, usually family members, and the stock is not available for purchase by the public.

Shareholders are required to elect a board of directors who set the overall policy and direction for the business. These directors select officers who, in turn, conduct the everyday business and make minor decisions.

With a small corporation — which includes most farm corporations — in reality the shareholders, directors, officers, and workers may be the same people. When they make certain decisions within the business, they switch hats to fit their different positions.

As a legal entity, the corporation can sue and be sued in its own name and can make contracts with its own members. It is also a separate taxpayer.

Capital is raised by the corporation through sale of stock, from bonds issued by the corporation, and from money borrowed in the corporation name.

A Michigan corporation may have as few as one incorporator and as few as three directors. These directors need not be residents of the state or shareholders in the corporation. There is a minimum paid-in capital requirement of $1,000 under Michigan law.

Perpetual life of the corporation is permitted, if desired.

### INCORPORATING

Steps to incorporating include:

1. Incorporators should work out a preincorporation agreement that sets forth the major rights and duties of all parties after the corporation comes into existence. It is important that all parties go into a corporation knowing exactly what to expect.

2. Obtain an articles of incorporation form from the Corporation and Securities Bureau of the Department of Commerce, Post Office Drawer C, Lansing 48904.

3. Return the completed articles of incorporation to the same address. A filing fee of $35 is required for corporations with up to $50,000 in authorized capital stock. Above that level, an additional one-half mil per dollar is required.

4. The directors meet to elect officers, adopt bylaws, select a depository bank, issue stock in exchange for property or cash or both, and begin business in the name of the corporation.

The articles of incorporation generally include names and addresses of the incorporators; the name of the corporation; the registered office or agent; duration of the corporation; powers and purposes of the corporation; class, number, and value of shares of authorized stock, voting rights, and any preferences or restrictions; and number of directors.

The corporate bylaws are rules governing the internal conduct of the corporation. Included are such items as time and place for shareholders' and directors' meetings, quorum requirements, a listing of officers and their duties, and miscellaneous business provisions, such as insurance carried and timing of the corporation's fiscal year.

Advantages and disadvantages of the corporate form of business organization will vary with each individual situation. However, some meaningful generalizations can be made about these advantages and disadvantages and how they affect a farm from both an immeditate business position, and from a longer range estate planning viewpoint.

### ADVANTAGES — BUSINESS

**Limited liability**—The corporation is a separate, legal entity that exists apart from its shareholder-owners. As a general rule, shareholders are not personally liable for the obligations or responsibilities of the corporation. The shareholder's risk is usually limited to the amount of his investment in the corporation. This is especially important if the stockholder has other, separate interests.

However, in real life, the limited liability aspect of a corporation may not have many advantages in the case of a closely-held, family-operated corporation. In that case, if there is a suit against the corporation, there will often also be a suit against the farmer as the manager-employee of the corporation. Also, it has become common practice for agencies lending money to a corporation to require that the principal stockholder sign a personal note, extending his liability for repayment of the loan.

For these reasons, limited liability has its greatest appeal to shareholders not directly involved in the management and operation of the farm.

**Management obligations**—Shareholders hold annual meetings, transact business, and elect directors. Everyone knows exactly where they stand because decisions are made by counting the number of shares cast for or against a question or issue.

Elected directors are entrusted with the management of the business for the benefit of the shareholders. The major operating decisions of a corporation are made by these several persons acting as the board of directors. Decisions are made by majority vote. Each director has one vote regardless of stock ownership. If, however, one of the directors also owns over 50 percent of the stock, his one vote on the board can be, if he so desires, the deciding factor.

In farm corporations the shareholders, board, and officers are often the same people. Decisions are often made informally. However, it is beneficial to bring questions up before regular monthly or weekly get-togethers to make sure minority ideas and opinions are given proper attention and evaluation.

Officers are elected by the board and are the agents of the corporation, are authorized and directed to perform the regular business duties of the farm operation, to receive and pay out money in the operation of the business, and to maintain adequate records of business transactions.

This more formal structure results in the identification of the management contributions and obligations of all farm family members. Everyone knows what is expected of them, what they can or cannot do, and their relationship to the family farm corporation. As a result, it is possible to minimize much of the intrafamily squabbling and misunderstandings that take their toll in sole proprietorships and partnerships.

**Fringe benefits**—Corporate fringe benefits are deductible as a business expense on the corporate income tax return. Unlike a sole owner or partner, a stockholder may be treated as an employee of the corporation and become eligible for these benefits. They include such things as health and disability insurance, group life insurance, and housing.

**Credit**—A sound, well operated farm corporation has definite advantages from a lender's point of view. When each member of the management team is also a major stockholder, the lender's risk is reduced. Corporations, by their nature, must keep accurate, complete, detailed records that help a lender keep track of the status of his investment. Also, death of a major stockholder does not result in dissolving the business organization.

**Employee participation**—Because the corporation ownership is divided into small blocks called shares, employees can be encouraged in their performance by awards of stock in the corporation. Then the benefit of the corporation also becomes identified with their own personal benefit.

### ESTATE ADVANTAGES

**Farm transfer**—The nature of the stock ownership of the corporation creates an excellent means for transfer of farm ownership between individuals and between generations. A gradual stock sale can enable the parents to build a retirement plan while assuring transfer of the farm to the next generation.

At the death of a major stockholder, because of the corporate structure, the farm can continue to operate as a going concern. This is especially important to the spouse of the deceased major stockholder.

Due to ease of transfer, shares of farm corporation stock make good gifts and can be used to insure equitable treatment of heirs.

**Continuity**—When a sole proprietor or a partner dies, the business organization ceases to exist. A corporation can exist as long as the shareholders desire, if it continues to meet the requirements of the law under which it was created.

This is an important factor that allows farm business to make a smooth transition through a change of ownership. It also permits longer range planning necessary to keep up with the technological changes and the larger size of farms today. Continuity is closely aligned with the ability to obtain capital from outside the immediate farm family.

Another benefit related to corporate continuity is that by providing the

opportunity for an orderly transfer of stock between generations, it helps maintain the farm at a point of peak efficiency, avoiding the low points created by lack of capital in a starting generation, and lack of "go" in a generation nearing retirement.

## DISADVANTAGES

**Initial cost**—The initial cost of incorporating can run from $500 to $1,000 or more for fees, taxes, and professional help, depending on the size and complexity of the corporation.

**Franchise fee**—A corporation organized and doing business under the laws of the state of Michigan is subject to an annual fee of 5 mills on each dollar of its paid up capital and surplus. This is the same as the book value net worth of the corporation. A corporation with a $200,000 net worth is taxed $1,000 annually for the privilege of operating in Michigan. A partnership or sole proprietorship is not subject to this tax. To keep this franchise fee as small as possible, farm corporations generally strive to keep their assets as low as possible. This also provides a greater opportunity for managing taxable income.

Capital gains tax provisions are less favorable for a corporation than for an individual. Individual shareholders can rent assets to the corporation, the corporation can deduct this business expense, and the individual still has the property in his possession for final sale, allowing maximum benefits from capital gain.

**Market for shares**—Because most farm corporations are closely-held, restrictions are usually placed on the sale of shares by shareholders. This is done to insure that nonfamily members are kept out of the family business. Accompanying this limited market of shares is a lack of an established equitable market price for shares. However, these two problems can be eliminated by making provisions for the purchasing of shares by other shareholders or the corporation and the establishing of an equitable price.

**Detailed records**—Additional formality is required in the management of a corporation. Records must be kept of all major meetings of shareholders and directors.

Because the business organization is the creation of state law, an annual report is due the state, and corporate procedures must be followed. The annual report must be submitted to the Corporation and Securities Bureau of the Department of Commerce by May 15 each year.

Corporate procedures must be followed. Examples include transfer of stock ownership, voting procedures at directors' meetings, and amendments to the articles of incorporation.

These additional formalities are not insurmountable, but rather additional procedures that would have been required under a different organizational structure. This disadvantage can actually be an advantage if it encourages a more business-like approach to the farm business and results in smoother relations between shareholders.

**Employment payments**—Social security tax paid under the corporate structure is higher than either a partnership or sole proprietorship for the owner-operator, even for the same income under each business structure.

Owner-operators are considered employees of a corporation, are subject to Michigan workmen's compensation charges on their salary and are entitled to benefits under the act. This is not true of owner-operators in the other two types of business organizations. This can be a disadvantage at times when the addition of the owner-operator to workmen's comp is enough to cause other farm employees to qualify. However, new interpretations of workmen's comp law are sweeping enough that employees of farms large enough to incorporate will be — or should be — covered in any event.

## TAXES

Being a legal entity, a corporation is recognized as a tax-paying unit for income tax paying purposes. The corporation pays its own taxes at income tax rates established for corporations. Whether the different tax rate structure that exists for corporations will be an advantage or a disadvantage will depend on the specific farm situation.

Since 1958, the shareholders of a closely-held corporation have been able to choose to have corporate income taxed to them at their individual rates, rather than at the corporation rate. This election is referred to as a tax option corporation or a subchapter S corporation. Like the partnership, this corporate device enables the farmer to spread business earnings among his children in low tax brackets in the form of salaries and dividends, reducing taxation on the whole of farm earnings.

In the January 5, 1974 MF, an article will be devoted to the advantages and disadvantages of the three forms of business organization as relates to taxes.

## WHEN TO INCORPORATE?

Deciding on a method of organizing a farm business — whether partnership, sole proprietorship, or corporation — is an important step and deserves serious consideration.

Final decision on one of the methods of organization must be made for each individual farm operation with its particular situations. No general rules can be made. However, as farms become larger, as more credit needs become more acute, and as farm income goes up, incorporation becomes the choice in an increasing number of situations.

In some instances, the advantages to transfer of the estate between generations and continuity of the operation are enough in themselves to justify the corporate route.

## *Burns Poultry Farm*

# A TRUE "FAMILY" FARM CORPORATION

Harry Burns is one of the best known poultrymen in the state. The recipient of numerous awards, Harry has been active in farm and community organizations all of his adult life.

For years, I've been running into Harry's warm greetings and down-to-earth ideas at different meetings around the state. But it wasn't until I visited the Burns Poultry Farm near Millington that I really began to get some idea of the real scope of Harry's character.

Harry and his wife Mildred have achieved what so many other farm parents have tried with often only partial success. They have created an atmosphere that has welded their family into a cohesive farming unit. Their children and grandchildren are intimately involved in making the Burns Poultry Farm productive and profitable.

One of the main business tools that helped Harry and Mildred build a strong multi-generation farm business is the farm family corporation.

### SMALL START

Harry and Mildred Burns started with a few broilers back in 1921. The next year they switched to layers. Their first 20- by 35-foot building seemed quite large to Harry in those days, but it would be dwarfed by their present eight cage houses with a capacity of 70,000 layers.

They worked gradually into the business, increasing production every year. At one time they were up to about 24 brooder houses. Pullets were raised on range, after starting inside.

### INTERESTED CHILDREN

It is hard to know which was the main job and which was the sideline — the developing poultry business or the five sons and a daughter to which Harry and Mildred devoted themselves.

As these children graduated from high school, some went away for short courses at Michigan State University, but soon came back. Son George decided he liked the poultry business well enough to launch out on his own, not far away from the home farm. Their daughter married and now lives on a farm two miles north of the home farm.

The other four sons continued to work for wages on the family farm. When the youngest son reached legal age — 21 in those days — Harry and Mildred knew the time had come for decisive action. The core of that action was the move from a sole proprietorship form of business organization to a family farm corporation.

Harry and Mildred came to an understanding of the needs of their sons to be part of the farm business — to be owners and to share in the profits that resulted from their labors. This understanding and the ability to act wisely on it is perhaps the biggest secret to close bonds between parents and offspring in any farming operation.

### EQUAL SHARES

The corporation was created in 1956 with the assistance of a lawyer. One of the first steps was to take an inventory of all the farm personal property. This was totalled and divided into five equal parts. Each of the sons agreed to buy an equal share in the corporation, with Harry and Mildred owning the fifth share.

"The sons that didn't have the money to pay, why, we just took notes," said Harry. "We charged a small rate of interest and let them pay it off as they worked along and started to make a little better money. Finally, all the notes were paid off."

There are 10 members of the corporation, including Harry and Mildred and the four sons and their wives — Alfred and Albertine, Lloyd and Natalie, Lyle and Beulah, Norman and Dora Elaine.

The corporation has buy and sell agreements with each of the wives to make sure corporation ownership remains within the immediate family. The corporation carries insurance on each of the sons. If a son dies, the corporation uses the insurance payment to buy the shares from the deceased son's wife.

Harry Burns, standing, checks the progress being made by his family in construction of a new 10,000-bird cage laying house.

## INCREASED GROWTH

With the formation of the corporation, the rate of growth of the farm business began to increase. Harry and Mildred rented their original 120 acres to the corporation. As the corporation grew, it purchased land in its own name. It now owns 370 acres and rents another 350 to 400 more.

Its main crop is corn — about 700 acres in total in 1973. All corn raised on the farm is dried, stored, and fed to the layers and pullets.

From the modest beginnings in 1921, the Burns Poultry Farm has grown until it has about 60,000 layers and 30,000 pullets, for a total of 90,000 birds. A new cage house recently constructed will boost the laying flock to 70,000.

Egg production has jumped to over 15.5 million eggs a year, enough to fill the needs of a small city.

## ORGANIZED TALK

The Burns operation has found a way for the five couples involved to work together with a minimum amount of friction. Harry gives some of the credit for this to the corporation structure and the way it brings them all together regularly.

"Naturally we disagree on some things," said Harry, "but I don't think it has ever been serious. One will give in a little bit if the rest are in favor of something.

"We usually try to have a meeting with all the boys at least once a week to decide the week's work, something we are going to buy, or changes that need to be made.

"On more important things, like borrowing money or buying land, we make out a resolution and have it signed by all the members. Smaller things we just talk over and decide by voice vote.

"We usually keep minutes of meetings in a tablet form so we can turn back to them easily," said Harry, "but the resolutions on bigger items, like buying land or making changes in the value of shares, we put in writing and file in the corporation book.

"The paperwork of a corporation isn't much more than would be required anyway."

From a tax standpoint, the Burns family chose the tax option or subchapter S type of corporate structure where profits are allocated directly to each individual at individual tax rates.

## MORE MANAGEMENT TALENT

In any growing farm business, management can easily be a limiting factor. One of the main advantages of either a partnership or a corporation form of business organization is the added ownership management that results.

Although the four Burns sons work back and forth across all jobs, they have naturally tended to specialize in certain areas. Lyle, for example, is more active in the grading work and the feed mill. Alfred is more sales oriented, while Norman does a lot of the trucking.

Through this natural selectivity, corporation members do the things they most enjoy. Specialization also helps to develop greater skills in given areas. However, should the occasion arise, the business has at least two or three individuals capable of acting as experienced managers in any aspect of the business.

## PEOPLE ORIENTATION

One of the greatest strengths of the Burns corporation is its orientation towards people and their needs. A great deal of this appears to be due to the nature and attitudes of Harry and Mildred.

The day I visited the poultry farm, the family and their two full-time, nonfamily workers were busy constructing a large, new poultry house. The trusses had been made in advance by family members. Even the smaller grandchildren had helped.

Construction of the building proceeded at a fast pace. Everywhere people, young and old, were working quickly and efficiently with little guidance necessary. Everyone seemed to have his or her job and to be doing it enthusiastically.

This feeling of unity can perhaps be traced back to the way the grandchildren are given opportunities to be part of the farm operation.

"Most of the grandchildren do chores," said Harry. A schedule of jobs and payments has been figured out and tied to different grades in school. When the grandchildren are in the third grade, for example, they are eligible to do certain jobs for a certain amount of pay. These will change as they move up in school. The grandchildren keep track of their own time. There are always plenty of jobs to be done, as is true on any poultry farm, so there is opportunity for all.

As the young workers approach graduation from high school, their pay increases until they are earning the same rate as would nonfamily workers. The difficulty and responsibility of the jobs increases to match the increased maturity and judgement of the grandchildren.

No guesses were made as to the number of the 30 grandchildren that will want to become involved in the poultry operation after high school or college on a full-time basis. One of the beauties of the corporate structure, however, is that it can be expanded with a minimum amount of effort to include more shareholders.

## RARE INSIGHT

Business tools like incorporation are merely methods of reaching goals, not ends in themselves. The real credit for the success of the Burns Poultry Farm goes initially to Harry and Mildred Burns. It was their wisdom that helped them choose a sound form of business organization. They then exercised rare insight in their efforts to mold their farm business into one responsive to the hopes and dreams of all the individuals involved.

Harry and Mildred put into practice a belief that a business exists only to benefit the people involved. That took a lot of understanding, flexibility, and love.

But much of the success is also due to the sons, their wives, and their children who have learned to overcome the very human emotions that each of us possess and to give and take successfully with their extended family.

# TAXES INFLUENCE CHOICE OF BUSINESS ORGANIZATION

## CHAPTER 17

How should I organize the business side of my farm? Should I remain the sole owner, or should I turn to a partnership or a corporation?

These are simple, direct, yet very difficult to answer questions, even when all the facts about an individual situation are known. In three preceeding articles we have outlined many of the factors involved in the type of business organization under which a farm is operated. This article will deal with tax and fringe benefit differences between operation as a sole proprietor, a partnership, or a corporation.

### THE CORPORATE DIFFERENCE

The most dramatic and most difficult difference to comprehend between the sole owner or partnership and the corporation is the stockholder-employee relationship.

In a sole proprietorship or partnership, the individual or partners are owner-operators of the business. Everything is passed through the business to the individual.

In contrast, in the corporate form, the owners — the stockholders — are treated as distinctly separate entities from the corporation thata becomes a legal, tax-paying "person" itself. Every person — stockholder or not — who works for the corporation becomes an employee and must be treated the same as any other employee.

This distinction creates some vast differences in taxation and the treatment of fringe benefits for owner-employees between the sole proprietorship or partnership form and the corporate form of business organization.

### TAXATION

The corporation has effectively two rates of taxation for federal income tax purposes. The rate begins at 22 percent for the first $25,000 of taxable income (gross income minus corporate expenses) and then jumps to 48 percent on all taxable income over $48,000.

In contrast, individual rates begins at 14 percent and increase to a maximum of 70 percent.

There are four different tax tables for the individual to use in the taxation process, depending on whether he or she is (1) married, filing jointly, (2) married, filing separately, (3) unmarried, or (4) head of a household. Each table, however, follows a fairly similar path. The married-filing-jointly schedule reaches the 22 percent tax level between $8,000 and $12,000 of taxable income. The 48 percent level is reached at $40,000 of taxable income.

### OTHER TAXES

There are some increases in taxes paid under the corporate framework which are borne by the stockholder-employee(s). These include the fact that self-employed social security are 8.0 percent and employer-employee rates are 5.85 percent of each of the individual's two roles (employer and employee) for a total of 11.7 percent. This additional 3.7 percent of wages on income up to $13,200 has the potential of increasing Social Security taxes $488.40 per shareholder-employee per year.

In addition, when income is left in the corporation to be taxed, the state income tax rate on corporations is 7.8 percent versus 3.9 percent for the individual.

When these additional taxes are considered, taxable income split between the corporation and an individual needs to exceed $25,000 in our example before genuine tax savings can be achieved through a corporation. In a two-man partnership, a comparable figure is $50,000. For a three-man partnership, it would be $80,000. See figure one for further comparisons of this same example. It is at these levels that a move to a corporate form of business can possibly provide tax advantages.

The above figures need to be tempered by the fact that each individual's tax situation may be quite different from that assumed.

In addition, other costs, such as bookkeeping and the annual privilege fee, are involved in operating in the corporate framework. Other benefits may also be achieved. All of these need to be evaluated, along with the flexibility in transfer of corporate property through stock transfers.

### FRINGE BENEFITS

The opportunity to have the corporation — the business — provide certain fringe benefits for employees is often cited as an advantage for the corporation form of doing business. This arises because of the stockholder-employee relationship mentioned earlier.

An employer can deduct some personal expenses paid for an employee as long as the employer derives some business benefit. As such, the corporation can provide certain fringe benefits which are tax deductible for the cor-

poration. Under a sole proprietorship or partnership, these same benefits would be personal expenses and not tax deductible.

In a sense, the U.S. Treasury is making a portion of the payment for this type of compensation of labor and salaried management. Fringe items of this nature include:

- Accident and health insurance.
- Disability insurance (Workmen's Compensation).
- Wage continuation plan.
- Group-term life insurance.
- Key-man insurance for the corporation.
- Possible provision of living quarters for convenience of the employer.
- Death benefit to the estate.

Other often cited, but which can be deducted under any business form are:

- Provision of an automobile.
- Retirement programs.
- Travel and entertainment.

The meaning and implications of some of the fringe benefits mentioned above are:

HEALTH INSURANCE — The corporation can deduct the cost of a health insurance plan provided for employees and their families.

DISABILITY INSURANCE — The corporation can deduct the cost of an insurance plan. If the law requires that Workmen's Compensation be carried, it is unlikely that a separate plan would be needed in addition. Cost for coverage comparable to Workmen's Compensation is hard to determine, but for most farmers a plan providing somewhat less income than Workmen's Comp could be obtained for roughly the same rates. Most farm corporations would be required to provide Workmen's Comp coverage because owner-employees are counted towards the number necessary for coverage, whereas in a sole ownership or partnership situation, they are not considered employees.

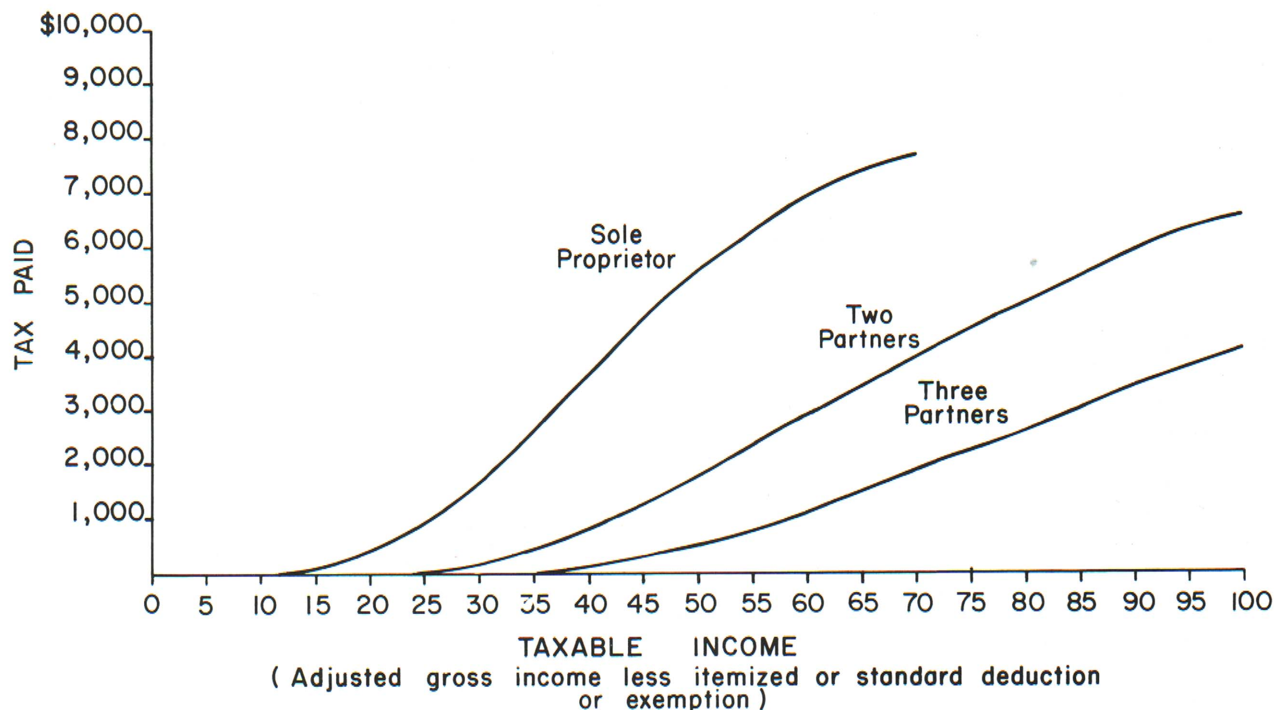
WAGE CONTINUATION — There is some crossover between this plan and Workmen's Comp. Sick pay (with an exclusion of $100 a week) is nontaxable if it is provided through a written group plan.

GROUP TERM INSURANCE — The corporation can provide a term life insurance program for employees under a group term basis. Premiums for up to $50,000 of coverage are tax deductible for the corporation and not taxable income for the employees. Premiums for term insurance coverage over $50,000 or any savings portion of insurance would be taxable to the employee.

KEY-MAN INSURANCE — Premiums are deductible when the corporation has insurance carried on key employees payable to the corporation. The corporation, however, is the beneficiary and not the employees' estates. This insurance might be utilized for debt coverage or to provide cash for a stock redemption plan for key stockholder-employees.

LIVING QUARTERS — In some cases the stockholder-employee's residence could be owned and maintained by the corporation as a tax-deductible expense. This would not be treated as income to the employee if

FIGURE 1. FEDERAL INCOME TAX SAVINGS FROM SPLITTING TAXABLE INCOME BETWEEN THE INDIVIDUAL AND A CORPORATION.




Any direct statement of tax advantages of corporations over sole proprietorships or corporations would be dangerous. This chart is offered only to give a general idea of the comparison between the three corporate forms. The lines on the graph show the tax savings possible through the corporate form over the alternate business form indicated. For the sole owner, there would be about $1,000 in additional expenses related to incorporation. (The example is set up for a married individual with two exemptions.) This means he would not experience a tax advantage from incorporating until his taxable income reached just over $25,000. For two partners, extra corporate expenses would run about $2,000, putting the breaking point at about $52,000 in taxable income. For three partners, the additional corporation expenses would run over $2,500 and the advantage point for the corporate form would be $80,000 in taxable income.

the residence is provided for the convenience of the employer. In a farm business this **can** be established, particularly if the stock is not all held by the owner-employee and his immediate family.

DEATH BENEFIT — If there is a written plan, the corporation can provide to the estate of a deceased employee a $5,000 death benefit which can be tax deductible expense for the corporation and non-taxable income to the estate for income tax puposes. The benefit would be taxable for estate tax purposes.

AUTOMOBILE — Any businessman can deduct the cost of operating an automobile or other transportation for business purposes. Where an employee is provided a car for personal use as well as business, the personal mileage used is considered as taxable income to the employee.

RETIREMENT PROGRAMS — Retirement programs under the corporate framework have been considerably more liberal than that achievable under the first developed Keogh plans for the self employed (sole owners and partnerships). For instance, the basic limitations of the corporation for employer-deductible payments to a profit sharing plan is 15 percent of the total compensation of the participating employees, compared to 7 percent under early Keogh plans. Recent changes have liberalized the tax deductible status of the self-employed retirement plans so the differences are less.

In the corporate form, however, a trust could be created as a retirement program to purchase real estate that could be then leased to the corporation. The lease money, plus the increasing value of the land, would help build the retirement fund.

TRAVEL AND ENTERTAINMENT — Essentially the same rules apply for the individual as for the corporation. If there is a legitimate business purpose for the expense, it is tax deductible.

## FRINGE BENEFIT SAVINGS

Attempting to tally these benefits is very difficult. The following figures give an indication of possible tax savings from some of these fringe benefit programs:

| | |
|---|---|
| Health insurance (Blue cross and Blue Shield) | $ 732 |
| Disability insurance (Workmen's Comp) | 825 |
| Group life insurance | 400 |
| Housing for stock-holder-employee | 2,400 |
| Cost of benefits if provided by the individual | $4,357 |
| Tax savings at 22 percent corporate rate (-) | 959 |
| After tax cost to stockholder-employee | $3,398 |

## OTHER COSTS AND BENEFITS

The franchise fee can be a sizeable annual cost for incorporating businesses in Michigan. It is payable each May 15 and runs five mills on each dollar of paid up capital and surplus in the corporation, plus a $10 filing fee. It is possible to minimize this fee by keeping the assets in the corporation relatively low. This provides a greater opportunity for managing taxable income. Rental can be paid for assets kept in individual names and yet still get the tax benefit of the stockholder-employee status.

It is often desirable to pay out as much in rentals as possible to reduce the effect of high employee payroll expenses, such as social security, and Workmen's Comp. In this way it is possible to minimize taxes paid by balancing individual rates versus corporate rates.

Because of less favorable tax treatment of corporate capital gains in comparison to those of individuals, assets which give rise to recurring capital gains, such as breeding and dairy livestock, should be held in ownership by individuals and leased to the corporate entity. In this way the more favorable individual capital gains rates will apply when the livestock is sold.

Corporate capital gains are taxed at the regular corporation tax rates without any 50 percent exclusions, unless the corporate taxable income is greater than $25,000. At the level and above, a flat 30 percent of the total gain applies.

## SUBCHAPTER "S"

There is an alternative to the typical method of taxation for corporations. Since 1958, shareholders of small, closely-held corporations have been able to choose to have any taxable income left in the corporation allocated to the stockholders on the basis of shares of stock and taxed to them at their individual rates rather than being taxed in the corporation. This election is referred to as a tax option corporation or a subchapter S corporation.

All of the fringe benefits available under the regular corporation are also available with a subchapter S corporation. For a low income corporation, subchapter S provides fringe benefits to employees and capability of transferring shares for estate planning without paying taxes at the higher corporate rate.

For stockholders with outside income, however, the subchapter S corporation may easily increase taxable income to a level clearly disadvantageous over having it taxed through the corporation.

## ACCUMULATED EARNINGS

There is another tax corporations need to be aware of. Accumulated earnings not distributed as dividends and left in the business are further taxed if not retained "for reasonable needs of the business." The accumulated earnings tax has a minimum credit of $100,000 and all earnings over the credit are taxed at 27½ percent for the first $100,000 and 38½ percent on the remainder.

An advantage to the corporate form of organizations is that an accounting year can be selected different from the calendar year. This provides an opportunity to even out income for the best tax advantage between the coporation, employees, and those renting assets to the corporation. In addition, the first year's taxable income can be delayed a year by selecting the fiscal year.

## ALL EMPLOYEES COUNT

The corporate stockholder-employee needs to recognize that **any** employee of the business must have access to most of the fringe benefits supplied to the stockholder-employee. This may increase the costs of business operation beyond the benefits received by the owner. On the other hand, provisions of these types of fringe benefits are becoming more important as farm businesses are forced to compete directly with other industries for talented, capable farm workers.

Many families employ their children in the business and are able to do so without withholding social security taxes until they reach age 21. In the corporate form, however, social security must be withheld and the corporation also contribute if $150 or more cash wages are paid for agricultural labor in a calendar year or if the employee performs agricultural labor on 20 or more days during the calendar year.

## MANAGEMENT IMPORTANT

Organizing a corporation requires a careful analysis of objectives and benefits sought. Through proper business management, many taxes and costs can be minimized. For instance, since capital gains rates are higher under the corporate form, assets such as dairy cows and other breeding livestock, could be held by the individual and leased to the corporation. In the same vein if the annual privilege fee is a problem, real estate can be kept out of the corporation and rented to it.

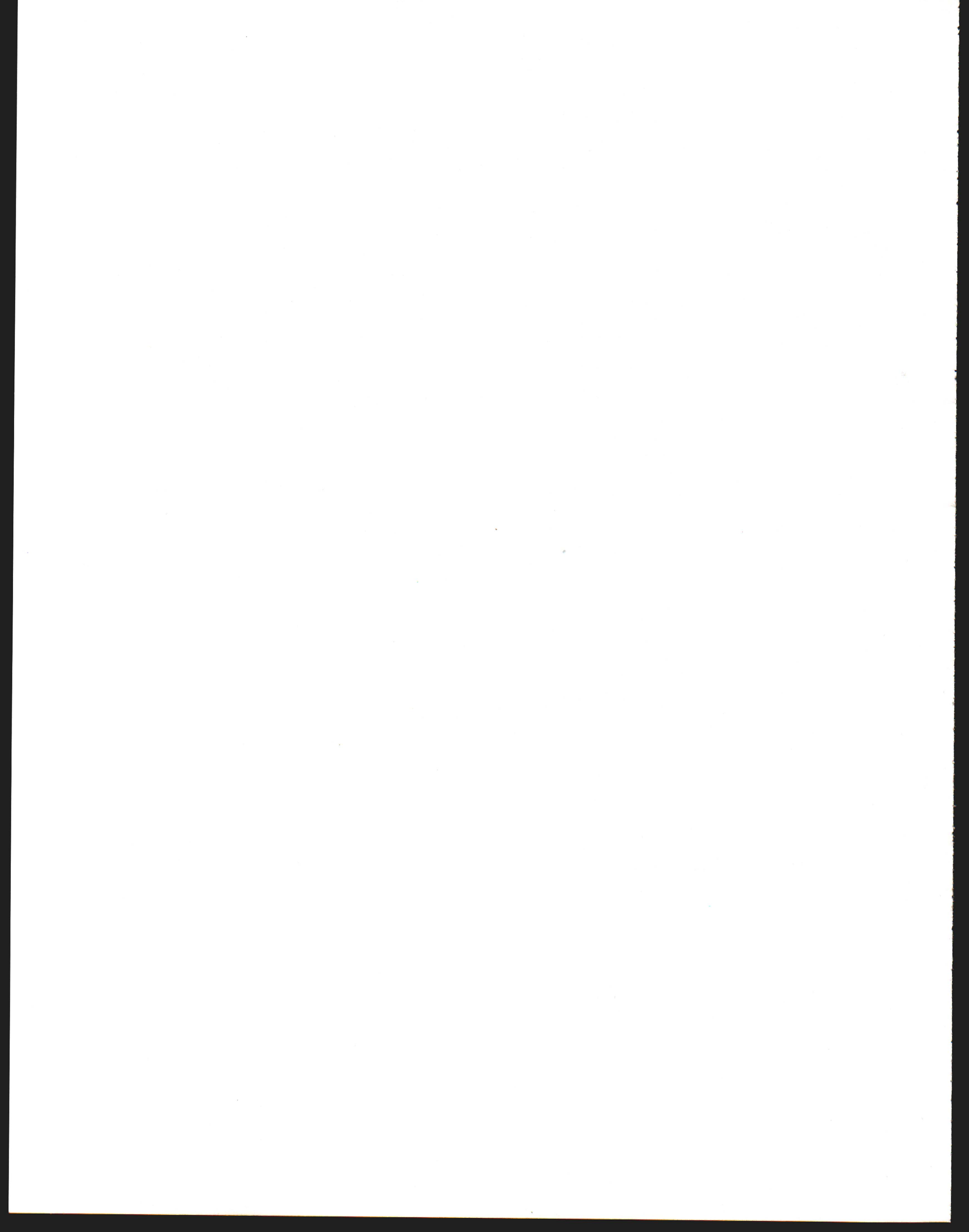
Whether these steps are taken will depend on the basic purpose of organizing the corporation.

Should you incorporate or form a partnership? It depends on your specific, individual farm business, how it could function in each of the three types of business organizations, and what your goals and aspirations are. It is possible to work through all of these factors with the help of a good CPA and lawyer who are familiar with farm business organization and the problems you hope to solve through it.

## TABLE 1: COMPARISON OF TAXATION OF TYPES OF FARM BUSINESS ORGANIZATION

| ITEM | SOLE PROPRIETOR | PARTNERSHIP | REGULAR CORPORATION | TAX-OPTION CORPORATION |
|---|---|---|---|---|
| State Income Taxes | 3.9% of federal adjusted gross income after state adjustments. | Net profit or loss and capital gains allocated to partners who are taxed at individual rates. | 7.8% of federal taxable income with adjustments. | Net income or loss and capital gains allocated to shareholder to be taxed at individual rates. |
| Social Security | Self-employment tax of 8.0% of net profit up to $10,800 (13,200 For 1974 and '75) | Net profit allocated to partners who pay self-employment tax. | Corporation pays 5.85% on employee and officer wages up to $10,800 ($12,600 for 1974 and '75). Employee pays an additional 5.85% in withholding. | Same as regular corporation on employee and officer wages. |
| Workmens Compensation | Carried on employees, not available for the sole proprietor. (Insurance is the same tor all employees regardless of business organization. The rate varies by farm classification from $3.54 to $8.47 per $100 payroll.) | Carried on employees, not available for the sole proprietor. | Carried on all employees including officers. | Same as regular corporation. |
| Real Estate Taxes | No differences | | | |
| Organizational Expenses | | | | |
| Legal fees | —— | $30-400 for written agreement depending on complexity | $200-1000 depending on complexity | Same as Regular Corporation |
| Registration of Name | $3.00 | $3.00 | —— | —— |
| Articles of Incorporation | —— | —— | $10 plus ½ mill on each dollar of authorized stock. Minimum of $25.00 | Same as Regular Corporation |
| Annual Privilege Fees | —— | —— | 5 mills upon each dollar of paid-up capital and surplus. Paid with annual report filed each May 15. | Same as Regular Corporation |

| | | | | |
|---|---|---|---|---|
| Federal Income Tax | | | | |
| Ordinary Income | Individual rates @14-70% | Income or loss allocated to partners and taxes at individual rates. | Net income, not including salaries to employees (defined as all persons drawing salaries or wages). Taxed at 22% on first $25,000; 48% on excess. Losses are locked in the corporation. Individuals taxed on salaries. Shareholders taxed on dividends paid. A $100 dividend exclusion per stockholder applies. | Net income or loss not including salaries to employees allocated to shareholders who are taxed at individual rates. Individuals taxed on salaries and share of income. |
| Ordinary Losses | Offset other income. If not fully utilized, are adjusted and carried back 3 years to offset previously reported income. Any excess is carried forward 5 years following the loss year. | Loss is allocated to partners who treat their share the same as a sole proprietor. Partners loss is limited to the adjusted basis of his partnership interest. Losses in excess of his interest can be recovered by additional contributions to the partnership or through future earnings. | Losses are locked in the corporation. Can be carried back 3 years to offset previously reported corporate taxable income. Any excess carried forward 5 years. | Loss is allocated to shareholders on the basis of stock ownership. A shareholder's loss is limited to the adjusted basis of his stock plus the adjusted basis of any debt of the corporation to him. |
| Capital Gains | Capital gain taxed to individual by including 50% of the gain in ordinary income. | Capital gains allocated to shareholders for taxation at individual rates. | 30% of the gain without the 50% exclusion. If ordinary income is less than $25,000 the gain is taxed at 22% up to the $25,000. | Capital gain allocated to individuals to be taxed at individual rates. |
| State Intangibles Tax | — | — | 3½% of the dividends received by a stockholder but in no event less than 1/10 of 1% of the par value of stock. No par stock assumed to be $1 per share. An exemption of $100 is deducted from the total tax. ($200 for husbands and wives filing joint returns) | Same as regular corporation |
| Federal Stamp Tax | — | — | $.11 per $100 of actual value of stock at incorporation. Transfer tax of $.04/$100 of actual value on transfer of stock. | Same as regular corporation |



# PART IV: RETIREMENT AND BEGINNING YOUR ESTATE PLAN

# Planning ahead can make later years more golden

# RETIREMENT

## CHAPTER 18

If you are like most Michigan farmers, you have spent most of your life building up your farm. You and your wife have worked hard to get where you are. You have plans for your immediate future, but what about those years a little farther off? What about retirement?

There is something about that word — retirement — that scares farmers. Because of that fear they don't give the subject much creative thought and attention. That can be dangerous and expensive.

It takes years of thought and planning to make a sound retirement program part of your estate plan. At least 10 years are needed to bring some aspects to completion, although some progress can be made in less time. Even young families just starting into farming should give some consideration to that time in the future when they will pass into a different phase of their lives.

There are many different methods of reducing or eliminating the financial and emotional worries of your retirement years. With thoughtful planning and effort you can make some of these methods work for you and your wife. On the other hand, a lack of consideration of retirement needs can result in reducing your enjoyment of your "golden years" and needlessly shortening your lifespan.

### RETIREMENT PHILOSOPHY

One of the most important factors in a good estate plan is the development early in your life of a retirement philosophy.

When you moved from youth into being owners of your farm business, you considered it another natural step in the order of life. It was certainly not a withdrawal from youth. Retirement, too, should be thought of as a natural change, but not a withdrawal from life.

Rather than being an end, retirement offers you the chance to do some or many of the things you didn't or couldn't do because of necessary attentions to your farm or family. However, it shouldn't become an excuse for inaction. Live now to your fullest capacity. All of you know of long-awaited, but postponed plans that never came about because of serious illness or financial problems.

Another important philosophical issue is the purpose of your estate. Are you building it for your heirs or for your own old age security? Perhaps it will serve both purposes, but the emphasis should be on your own security.

The best gift you can make to your children is to invest in their ability and capacity so they can earn their own way. You make these investments in time and money in their youth and your middle age.

The next best gift is to provide them with little need to be concerned about your retirement years, either economically or psychologically. If a retired farm couple is busy, contented, and reasonably self-sufficient, then family ties are strengthened, tensions are relaxed, and love and affection are nurtured.

### ECONOMIC ISSUES

In addition to the difficult job of being philosophically ready for retirement, there are the fundamental dollars-and-cents problems.

All of your business life, you have lived with the idea of saving for a rainy day or building up equity in the farm. As you near retirement, you are faced with the necessity of doing an about face in this regard. You will probably have to think about living off the principal you have zealously guarded for so long. If you have had a *very* profitable farm business, perhaps you will be able to get by mainly on interest on your investments with only occasional dips into the principal.

In planning for economic security during retirement, certain basic questions need to be answered: How long will we need income? How much income will be needed? What resources do we have to provide this income? How should we best manage our estate and decisions to provide the greatest amount of financial security?

### HOW LONG?

Part of the answer to the first question is simple. You need retirement income as long as either of you shall live. Financial planning for retirement must start with that knowledge.

It is helpful to speculate about how long that may be. Standard mortality tables used by life insurance companies show that a 55-year-old man has an average life expectancy of 20 more years, or until he is 75. A woman of the same age would have an average life expectancy of 24 years, or until she is 79. The average life expectancy of a man who has reached 65 years of age is 13 more years, or until he is 78; that of a woman 65 is 16 years, or until she is 81.

However, these average figures can be misleading. Each individual must

take into consideration his or her own physical condition and the health of his or her family line — heredity — to either add to or subtract from these averages.

These same tables show that a 65-year-old man has a 20 percent chance of living another 20 years and a 7 percent chance of reaching age 90. For his wife, the expectancy probabilties are even higher.

A 65-year-old couple in reasonably good health should adjust their rate of spending so their assets will last them 25 to 30 years. The probability that either of them would outlive this time horizon is less than 13 percent.

## HOW MUCH INCOME NEEDED?

There is no single answer to the question about the amount of retirement income needed. This will vary with each couple and the standard of living you have maintained over the years. You will have to determine this yourselves. A study of 50 Michigan families in 1968 showed that the average total living costs of these older couples, ranging in age from 64 to 85, was approximately $3,400 a year.

Things have changed since then. A real problem in planning for retirement income is the changes which occur in the value of the dollar. Inflation alone since 1968 would boost that average figure to at least $4,200. Gradual inflation can be expected to continue at about a 4 to 6 percent rate.

For families across the nation, living expenses usually go down upon retirement. This might not be true, however, for farm families who plan to leave the farm. Many farm families fail to recognize the value of noncash farm income. The farm business provides a house to live in and usually some farm produce to cut food costs. If a farm family retires from the farm and sets up housekeeping in a village or urban center, not only will a dwelling have to be provided, but other expenses may increase significantly, too.

On the other hand, many Michigan farm homes are isolated, and difficult and costly to maintain. Older citizens cannot care for big, old houses adequately and their incomes are too low to hire the work done.

The question of housing — and a related one of transportation — are extremely important problems that need careful attention.

The amount of income needed will also be affected by a change in the pattern of spending. The children are grown and have left home; food and clothing expenses will be only for two. However there will be much more spent on such items as medical expenses and travel.

## STRETCHING THE DOLLAR

Once you have done your best to estimate the amount of monthly retirement income you will need, you are faced with the question of how much principal will be needed to provide that level of income.

Money invested at 5 percent interest can be used up — both principal and interest — over a period of years to provide a fixed income as follows: $5,200 will provide an income of $100 a month for five years; $9,970 will provide $100 a month for 11 years; $14,960 will provide $100 a month for 20 years; $16,810 will provide $100 a month for 25 years. Other figures are available from your banker or CPA involving other amounts of principal or interest rates.

If you don't want to use the principal, here are some figures on interest income from each $1,000 invested: At 4 percent interest, the monthly interest income from each $1,000 invested would be $3.33. At 5 percent, $4.17. At 6 percent, $5.00. To determine the desired figure, select the appropriate percentage point and multiply times the number of $1,000 units invested. For example, $50,000 invested at 5 percent interest would produce a monthly income of $208.50.

## SOURCES OF INCOME

Now that we have some kind of idea of how much monthly income is needed and what amount of principal is necessary at different interest rates, let's turn to sources of income for retirement.

**Income from the farm** — It's hard to sell the farm you have poured your life into when time for retirement comes. However, development of a fast-moving, highly-commercialized, and highly-mechanized agriculture is making it next to impossible to retire on the farm in the old traditional method of "phasing out" unless a son or relative is in the process of buying you out. Even then it can be difficult.

Because of the cost-price squeeze, a commercial farm today soon becomes a financial liability if it isn't operated at full capacity. Farmers at retirement age can't afford to shut down or slow down their farming operations. Depreciation and overhead, such as taxes, would eat up the farm investments they have spent their lifetime accumulating.

However, if there is a son or other reliable young man who can take over management and responsibility while buying the farm, the owner can often retire and still maintain a profitable investment in farm property.

**Retiring on the farm** — Many families are convinced they can be happy only if they stay on the farm after retirement. Sometimes this is the most economical solution, too.

If a farm is small, it would likely take most of the selling price to buy a place in town. In a good farming community, the cropland can be rented to a neighbor. Sometimes the farm buildings can also be rented. Cash living expenses would be less for the family that retired on the farm than for one in town.

For a family with a good commercial farm business, however, retirement on the farm is seldom the most economical solution. The only exceptions would be if it were possible to sell the farm without the house or to retain a life estate in the home.

**Sale of the farm** — Most farmers reach retirement age with most of their lifes' savings invested in farm property. Deciding the best disposition of this personal property and real estate is one of the biggest challenges in retirement planning. Will it be sold to a son or relative? Will it be sold to a stranger? What will be the conditions of the sale?

As outlined in three earlier articles on selling the family farm, steps can and should be taken to reduce the potential tax burden, provide for an orderly transition of the property, and provide needed security for the retiring couple.

**Social security**—Social security is not a complete retirement plan and will not in itself provide a satisfactory retirement income for many farmers. It acts more as a base upon which a complete retirement plan can be built.

The amount of social security retirement income to which you are entitled is based on the amount of social security payments you have made between 1955 and your date of retirement. These benefits can range from nothing to over $400 a month per couple.

Because benefit levels have only recently been raised — again — no farm couple can qualify for the maximum amount at present.

To estimate the level of benefits for which you would be eligible, you first need to know your level of payments over the years. If you don't have these payments recorded accurately, you can request a statement of your social security payments at any time. A request form can be obtained from any social security office.

Payments were made on earnings levels that varied with the year, from $4,200 in 1955 to $10,800 in 1973. To estimate your benefits, you must add up your total earnings, determine the number of years you are required to have contributed, and then calculate

your average earnings. This is simplified by use of a pamphlet called "Estimating your social security retirement check" which is available from your local social security office. Once you have determined your average yearly earnings upon which payments were made, you can consult a table in that same pamphlet to translate that into potential benefits.

A farmer who had paid the maximum allowable amounts every year for the last 18 years and who is retiring in early 1974 at age 65 would have paid social security on a base income of $110,400 for average monthly earnings of $511.00. His monthly retirement benefits from social security would be $274.60. If his wife is also 65 years old, she would be drawing $137.30, for a total social security monthly income of $411.90.

This is the maximum amount available to this couple. If their earnings were low enough in some years that they did not make the maximum payments or if there were any years in this period when they did not make a social security payment, they would not receive maximum benefits.

The amount of annual earnings upon which payments are made has gone up drastically in recent years, from $7,800 earnings in 1968-71 to $10,800 in 1973. It will be $13,200 in 1974. Because of the relationship of earnings to retirement benefits, a farmer must have high average earnings in recent years in order to make the maximum payments and, in turn receive maximum benefits.

The amount of retirement benefits is also affected by the age at which you retire. Farmers retiring at age 62 will receive less benefits per month than if they had retired at 65. However, in most cases they will be money ahead as far as social security payments are concerned if they start drawing benefits at 62. A farmer would have to draw social security about 12 years at the higher 65-year-old rate to break even with the extra three years of payments he would have gotten if he had retired at age 62.

Social security benefit levels and tax rates are changed by law from time to time. Just recently Congress changed the maximum earnings from personal services (work) a person receiving social security may have from $2,100 to $2,400. Half of the amount of earnings from personal services above this amount will be subtracted from social security payments.

For example, if a retired farmer did farm work for a neighbor and earned $2,800 during 1974, he would have received $400 over the limit. Half of that amount — $200 — would be subtracted from his social security payments.

As a result of federal legislation in 1972, social security benefits will increase automatically as the cost of living goes up. In the past five years, monthly social security benefits have increased by more than 70 percent.

You can receive social security payments from the government, but it won't happen automatically. You must file your Federal tax return and pay your self-employment tax each year. You must also apply for benefits when you reach retirement age.

Medicare is also available through social security for people 65 or over. It helps to pay the cost of medical care.

Social security is an important part of most retirement plans. As you get closer to retirement it will be important to have an accurate estimate of the benefits you are eligible to receive. In the meantime, the closer your social security payments are to the maximum, the greater your benefits will be upon retirement.

## TAX PLANNING

Tax considerations deserve special attention in planning for retirement. Most people earn less after retirement. For this reason income that can be postponed until after retirement will result in less total taxes.

Farmers can also utilize self-employed, tax-delay set-asides to build up retirement income. Tax laws allow self-employed individuals to set up retirement funds for themselves, setting aside part of their current earnings in a supervised investment fund. This is known as a Keogh Act plan and was covered in-depth in the May 17, 1969 issue of Michigan Farmer. Under this plan you can deduct up to 10 percent of your net earnings or a maximum of $2,500 a year from current taxable income. In effect the tax is delayed from the time the income is earned until the funds are withdrawn after retirement — when income and taxes are usually much lower.

Congress is currently considering liberalizing this plan. The new bill under consideration would raise the maximum contributions from 10 percent of net income to 15 percent and the maximum payments from $2,500 up to $7,500. This liberalization would make Keogh Act plans even more attractive to farmers.

Any farmer with a profitable farm business should consider the possibility of establishing such a retirement fund for himself and his wife.

Owners of some large farms may find it advisable to incorporate their businesses. Retirement plans under a corporation business structure are governed by more flexible rules than other business organization forms.

Tax planning for retirement should also take into consideration some of the many other estate planning tools mentioned in previous articles — such as gifts, annuities, trusts, insurance, and installment sale of land — and their relationships to the various taxes that must be paid. An understanding of the federal gift tax and the federal estate tax can save many dollars in the process of retiring and transferring the farm business to the next generation.

## POINTERS FOR PLANNING

When you begin to develop a retirement plan, or when you reevaluate the one you have, here are some factors to keep in mind:

1. You can never start too early in considering retirement. The earlier some basic decisions are made, the easier it will be to insure the security and joy of your later years.
2. Do your best to keep farm earnings up to the maximum social security base to insure higher retirement benefits. Learn how to estimate what your retirement income will be.
3. Keep an annual farm inventory and a net worth statement. Keep track of your equity in the farm business. At what rate are you saving in farm property?
4. Plan ahead for the future of the farm business. If a son or other young man is interested, make a workable plan for shifting ownership and responsibility gradually. If the farm is to be sold at your retirement, plan ahead for that sale, including a study of the ins and outs of an installment sale. Tax planning can save thousands of dollars.
5. Don't let retirement come at you all at once. Prepare yourself gradually. Figure out when and if you'll want to retire; what you want to do with your time; how you'll want to live; how much it will cost; and how you can best put aside that amount of money.

It's time to start

# AN ESTATE PLAN BEGINS WITH YOU

CHAPTER 19

You have an estate, no matter how small your farm. Your estate is made up of all your assets, minus all of your liabilities. The more years you have farmed, and the more acres you have, the larger your estate. In fact, your estate is probably larger than you realize.

How can you make the most of your estate? That's where planning fits. *In simplest terms, estate planning is the acquisition, enjoyment, and eventual distribution of your property to best provide for and protect you and your family.*

An estate plan starts now and extends its benefits even after your death. There is no one age when an estate plan "should" be made. Every farm family should have one, and every plan should vary with the wants, needs, and property of each individual family.

Young families need to make sure their investments in labor and money are protected in case of an accident; that their children will always be cared for. Middle age families are providing for educations for their children and considering bringing a son or son-in-law into the farm business. Older families are worried about having an adequate income to enjoy their retirement years. All these and many other "needs" should be part of estate planning.

### OBJECTIVES

As you begin forming an estate plan, some valuable objectives to keep in mind are:

(1) Establish goals for your estate. What do you want to accomplish? In what order should you tackle them? Goals should be based around people and their wants and needs. Things have value only in their relationship to people.

(2) Organize the family business in a manner that is most rewarding, both financially and personally, to the individuals involved. This will require a thoughtful look at the benefits and disadvantages of sole ownership, partnership, and a corporation as they relate to your farm business.

(3) Begin considering and planning toward eventual retirement early in life. The longer you have to order your estate and achieve specific retirement goals, the more successful you will be.

(4) Reduce income and gift taxes.

(5) Minimize state and federal taxes and estate settlement costs.

(6) Protect minor children, in case both you and your wife die in a common accident, by naming a guardian.

(7) Plan the timing and circumstances of the sale or transfer of your farm well in advance. Pay special attention to taxes and the type of installment payments that would be best.

(8) Keep the farm in the family, if so desired, by helping one or more of the children get started in farming.

(9) Transfer some property during your lifetime if you can still provide a sufficient, dependable retirement income for you and your wife.

(10) Distribute property according to your wishes, providing equitable treatment of your surviving spouse and heirs. This requires a will.

(11) Attempt to prevent ill feelings and bitterness among heirs resulting from a lack of knowledge and misunderstandings of your estate plan.

(12) Prevent economic hardship for spouse and heirs from lack of money available for living expenses while waiting settlement of your estate.

(13) Provide for enough readily available cash (liquidity) to insure that the property will pass through estate transfer without becoming too heavily laden with debts.

(14) Avoid loss of income and depreciation of your estate from the uncertainty over who will become the eventual owner(s) upon your death.

(15) Accomplish charitable acts, if desired.

(16) Select a qualified, competent executor.

In this series of articles we have covered a variety of estate planning tools that can assist you in attaining your estate objectives. These range from wills and gifts to trusts and insurance. A review of these articles, plus whatever other estate planning material you may have available, will help prepare you to either begin development of an estate plan or overhaul one you already have.

### HOW TO START

• Make a concrete beginning by itemizing all of the property in your estate — both real and personal — and assigning a fair market value. Don't forget the value of life insurance policies, savings accounts, and cooperative stock.

Retirement programs with a death benefit value are also part of your estate. Social Security has a small death benefit value. What about some of the other retirement programs, such as tax-sheltered or Keogh plans? Maybe you signed up for a program like this through the Michigan Milk Producers

Association or other organizations, or possibly you purchased one from a life insurance company. Be sure to include your stocks, bonds, and investment properties.

Then add up all your debts and subtract them from your total assets to arrive at a net value for your estate.

When doing so, be sure to consider the credit life insurance on debts. Don't include debts covered by this type of insurance in your debt list.

You may find the net value of your estate surprisingly large, especially if you have much acreage. Land values have been skyrocketing in recent years.

- Determine how your property would be distributed if you died under your present estate plan. Who would receive your property? If you have no will, distribution will be determined by an arbitrary formula set down by law. It is important for your spouse to make the same evaluation.

How much of the estate would be transferred through the probate process? How much would go directly to beneficiaries as a result of contractual arrangements? What share of your property would go directly to joint tenants? What effects would these arrangements have on the taxes you and your estate will have to pay?

- Determine the objectives you want in your estate plan. Do this as a couple, not individually. You both either have, or will have, spent many years building up this estate together and you should decide together how it should grow and eventually be distributed.

When considering the eventual distribution of your estate, consider the question of equitable — not equal — treatment of your children. What property, if any, do you want particular children to have? Should the transfer be made before death or after death? If a living transfer is desired, what is the best time to do it? What are the transfer tax implications of your plan?

- After comparing your answers to the two previous points decide what changes are needed in your present plan to meet the objectives you have outlined. What needs to be changed if your objectives aren't accomplished? What documents need to be changed? Do you need a new will? Is a trust an important part in your total estate plan? Should you be using more or less life insurance at this stage of your life? Are there some investments you should change? Should you change the type of farm business organization to another of the three basic forms?

- When you have evaluated your present estate plan, or lack thereof, your goals, and the changes that would need to be made to attain them, the next step is to seek skilled, experienced assistance. There are many professionals working in the estate planning field. They are all important if you need their assistance. Most families will not require the services of all five of the main types of professionals, but some may.

LAWYERS—All will need the services of an attorney in the drafting of legal documents to implement estate plans, such as wills and partnership agreements.

LIFE INSURANCE—Changes in life insurance beneficiaries can be made through the representative of the life insurance company with which you now hold your policy. Perhaps you will also need to purchase more insurance For a specific purpose. He can also give you ideas on how life insurance can be used in your total estate plan.

ACCOUNTANT—An accountant can help to organize your business arrangement, such as a corporation or partnership. He or she can assist in preparing tax records and in determining tax implications to the estate of given lines of action.

TRUST OFFICER—If, in analyzing your situation and formalizing your objectives, you find a trust would be useful as a part of your total estate plan, contact your local bank. A trust officer can assist you in determining how a trust can achieve objectives for your estate transfer.

INVESTMENT COUNSELOR—Changes in investments are an important part of estate planning. Contact your financial advisor, stock broker, life insurance representative, or others in the investment field to assist you in evaluating alternative investments and to provide assistance in making new investments.

- Once your estate plan has been carefully worked out and legally formalized, review your plan every year or every other year at the most for possible changes that may be needed because of changes in family situations or objectives.

Plans should be written for a three- to five-year period and reviewed and changed to meet changing conditions. Don't attempt to develop an estate plan that will last the rest of your life.

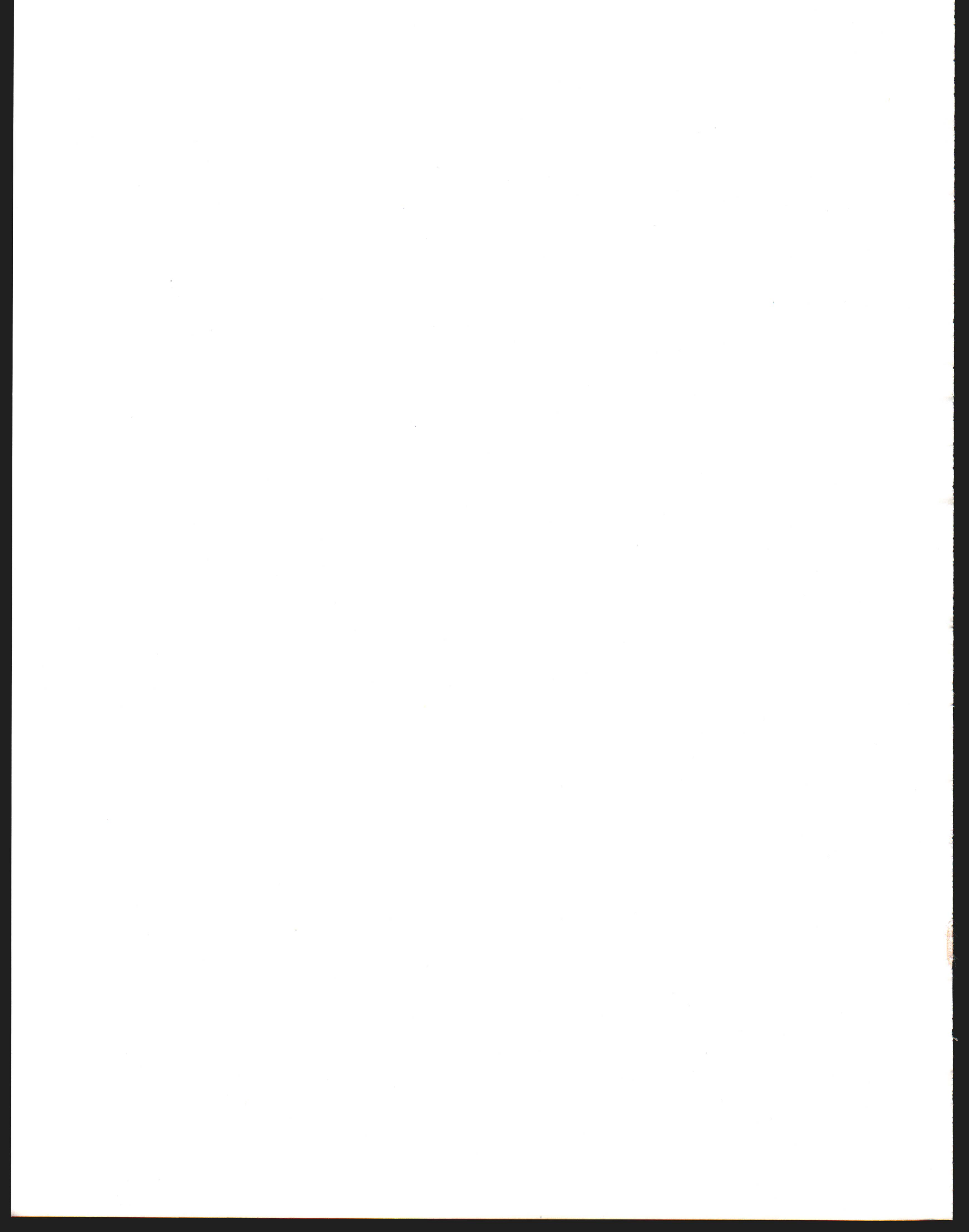
### YOUR CHOICE

Just as you have an estate, you also have an estate plan. Your plan can be well-thought-out, complete, and people-oriented. As such, it will help your estate to grow and flourish to the maximum of its potential. It will also bring you peace of mind, security, and contentment.

However, if your estate plan consists of many unrelated pieces with no guiding goals, progress may be difficult. Hard earned money may seep away through unnecessary taxes. It may be hard to encourage the next generation to carry on the family farm. Retirement may find you unprepared and ill-financed.

You have an estate plan. Now it's up to you to make sure it is the best possible plan for you, your spouse, and your family.

# APPENDICES



# APPENDIX A: FAMILY PAPERS

## FAMILY RECORD

| Name | Date of Birth | Birth—Where Recorded | Membership in Church, Fraternal Organizations, etc. |
|---|---|---|---|
| Husband | | | |
| Wife | | | |
| Children | | | |
| | | | |
| | | | |
| Parents | | | |
| | | | |
| | | | |

## FAMILY ADVISERS

| Name | Address—Phone Number |
|---|---|
| Lawyer | |
| Accountant | |
| Executor of Will | |
| Banker | |
| Insurance Agents | |
| Stockbroker | |
| | |
| Other Advisers | |

| RECORDS | WHERE KEPT |
|---|---|
| **PERSONAL RECORDS** | |
| Wills | |
| Marriage Records | |
| Birth Certificates | |
| Baptismal Records | |
| Citizenship Papers | |
| Adoption Papers | |
| Divorce Papers | |
| Death Certificates | |
| Armed Forces Papers | |
| Social Security | |
| Name and No. | |
| Cards | |
| File Copy | |
| **PROPERTY RECORDS** | |
| Deeds to Property | |
| Where is deed recorded? | |
| Deed to Cemetery Lot | |
| Abstracts to Title of Property | |
| Mortgage Papers | |
| **BUSINESS RECORDS** | |
| Contract Papers | |
| Guarantees | |
| Insurance Policies | |
| Important Receipts | |
| Income Tax Records | |
| Bank Books | |
| Cancelled Checks | |
| Safe Deposit Box | |
| Safe Deposit Box Keys | |
| Other Important Keys | |
| Stock and Bond Certificates | |
| Vehicle Titles | |
| Household Inventory | |
| Personal Debts | |
| Loans to Others | |

## HEALTH, ACCIDENT AND HOSPITALIZATION INSURANCE RECORD

| COMPANY— LOCAL AGENT AND ADDRESS | NAME OF INSURED | POLICY NUMBER | BENE-FICIARY | KIND OF INSURANCE | PREMIUM | | BENEFITS AND OTHER INFORMATION |
|---|---|---|---|---|---|---|---|
| | | | | | DATE PAYABLE | AMOUNT | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |

## REAL ESTATE AND PERSONAL PROPERTY INSURANCE RECORD

| COMPANT— LOCAL AGENT AND ADDRESS | PROPERTY INSURED (HOME, AUTO, FURNISHINGS) | KIND OF INSURANCE | COVERAGE | PREMIUM | |
|---|---|---|---|---|---|
| | | | | DATE PAYABLE | AMOUNT |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |

# APPENDIX B:

FINANCIAL STATEMENT FOR ESTATE PLANNING

Date ______________________

Section I (Summary)

| | | | Market Value | |
|---|---|---|---|---|
| | | Owned Jointly | Husband | Wife |
| 1. Cash and checking accounts | | $______ | $______ | $______ |
| 2. Savings accounts | (Schedule A) | ______ | ______ | ______ |
| 3. Investments | | | | |
| (a) Bonds | (Schedule B) | ______ | ______ | ______ |
| (b) Stocks | (Schedule C) | ______ | ______ | ______ |
| (c) Other intangible investments | (Schedule D) | ______ | ______ | ______ |
| 4. Farm Personal Property | | | | |
| (a) Crop Inventory | (Schedule E) | ______ | ______ | ______ |
| (b) Livestock Held for Sale | (Schedule F) | ______ | ______ | ______ |
| (c) Breeding and Dairy Livestock | (Schedule G) | ______ | ______ | ______ |
| (d) Machinery and Equipment | (Schedule H) | ______ | ______ | ______ |
| 5. Other Tangible Personal Property | (Schedule I) | ______ | ______ | ______ |
| 6. Life Insurance (face value) | (Schedule J) | ______ | ______ | ______ |
| 7. Farm Real Estate | (Schedule K) | ______ | ______ | ______ |
| 8. Residence (if separate from farm) | | ______ | ______ | ______ |
| 9. Other Real Estate | (Schedule L) | ______ | ______ | ______ |
| 10. Government Benefits | (Schedule M) | ______ | ______ | ______ |
| 11. Anticipated Inheritance | (Schedule N) | ______ | ______ | ______ |
| 12. Employment Benefits | (Schedule O) | ______ | ______ | ______ |
| Assets - Total Value | | $______ | $______ | $______ |
| Indebtedness: | | | | |
| 13. Real Estate | | | ______ | ______ |
| Balance due | (Schedule P) | ______ | ______ | ______ |
| 14. Personal Property Indebtedness | (Schedule Q) | ______ | ______ | ______ |
| Indebtedness Total | | $______ | $______ | $______ |
| Net Worth, Assets Less Indebtedness | | $______ | $______ | $______ |

## SECTION II. SUPPORTING SCHEDULES

### BANKS--SAVINGS AND LOAN--CREDIT UNION

(SCHEDULE A) SAVINGS ACCOUNTS

| TYPE OF ACCOUNT | NAME AND ADDRESS OF DEPOSITORY | BOOK NUMBER | IN WHOSE NAME (S) |
|---|---|---|---|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

### INVESTMENTS

(SCHEDULE B) BOND RECORD

| KIND | SERIAL NUMBER | DATE PURCHASED | PURCHASE PRICE | MATURITY DATE | VALUE | IN WHOSE NAME(S) |
|---|---|---|---|---|---|---|
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |

(SCHEDULE C) STOCKS

| COMPANY | SERIAL NUMBER | DATE OF PURCHASE | NO. OF SHARES | COST PER SHARE | IN WHOSE NAME(S) |
|---|---|---|---|---|---|
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |

(SCHEDULE D) INTANGIBLE INVESTMENTS -- Such as Mortgages, Contracts, Notes and Retirement Programs

| KIND | SERIAL NUMBER | DATE PURCHASED | PURCHASE PRICE | MATURITY DATE | VALUE | IN WHOSE NAME(S) |
|---|---|---|---|---|---|---|
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |

## FARM PERSONAL PROPERTY

(SCHEDULE E) CROP INVENTORY

| CROPS | VALUE PER UNIT | UNIT & QUANTITY | TOTAL VALUE |
|---|---|---|---|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

(SCHEDULE F) LIVESTOCK HELD FOR SALE

| DESCRIPTION | VALUE PER UNIT | UNIT & QUANTITY | TOTAL VALUE |
|---|---|---|---|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

(SCHEDULE G) BREEDING AND DAIRY LIVESTOCK

| DESCRIPTION | VALUE PER UNIT | UNIT & QUANTITY | TOTAL VALUE |
|---|---|---|---|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

(SCHEDULE H) MACHINERY AND EQUIPMENT

| DESCRIPTION | COST | ACCUMULATED DEPRECIATION | REMAINING DEPRECIABLE VALUE | MARKET VALUE |
|---|---|---|---|---|
| Livestock equipment | | | | |
| Dry, store and processing equipment | | | | |
| Power | | | | |
| Transportation | | | | |
| Tillage, planting and growing | | | | |
| Irrigation | | | | |
| Harvesting | | | | |
| Labor equipment | | | | |
| Forestry | | | | |
| Miscellaneous | | | | |
| Total | | | | |

(SCHEDULE I) OTHER TANGIBLE PERSONAL PROPERTY

| DESCRIPTION | IN WHOSE NAME(S) | DATE ACQUIRED | COST | MARKET VALUE |
|---|---|---|---|---|
| | | | | |
| | | | | |
| | | | | |
| | | | | |
| | | | | |
| | | | | |

(SCHEDULE J) LIFE INSURANCE

| COMPANY LOCAL ADDRESS | NAME OF INSURED | POLICY NUMBER | BENE-FICIARY | AMOUNT OF COVERAGE | PREMIUM | | METHOD OF SETTLEMENT |
|---|---|---|---|---|---|---|---|
| | | | | | DATE PAY-ABLE | AMOUNT | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |

(SCHEDULE K) FARM REAL ESTATE

| DESCRIPTION | TITLE HELD BY | ASSESSED VALUATION | MARKET VALUE |
|---|---|---|---|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

(SCHEDULE L) OTHER REAL ESTATE

| DESCRIPTION | TITLE HELD BY | ASSESSED VALUATION | MARKET VALUE |
|---|---|---|---|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

(SCHEDULE M) GOVERNMENT BENEFITS

| SOURCE | DESCRIPTION | RETIREMENT BENEFIT | DEATH BENEFIT |
|---|---|---|---|
| Social Security | | | |
| | | | |
| Veteran's Pension | | | |
| Veteran's Death Benefit | | | |
| Disability Benefits | | | |
| Other | | | |
| | | | |

(SCHEDULE N) ANTICIPATED INHERITANCE

| SOURCE | ESTIMATED PRINCIPAL | IF IN TRUST | | | |
|---|---|---|---|---|---|
| | | TERMINATION DATE | ANNUAL INCOME | PRIMARY BENEFICIARIES | REMAINDER BENEFICIARIES |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |

(SCHEDULE O) EMPLOYMENT BENEFITS

| SOURCE | COMPANY | AMOUNT VESTED OR CONTRIBUTED | ESTIMATED RETIREMENT INCOME | DEATH BENEFIT | CURRENT VALUE |
|---|---|---|---|---|---|
| Pension Plan | | | | | |
| Profit-Share Plan | | | | | |
| Salary Continuation | | | | | |
| Health & Accident Plan | | | | | |
| Retirement Funds | | | | | |
| Other | | | | | |
| | | | | | |

(SCHEDULE P) REAL ESTATE INDEBTEDNESS

| CREDITOR ADDRESS | SECURITY | WHEN ACQUIRED | ORIGINAL BALANCE | PAYMENTS | | BALANCE DUE |
|---|---|---|---|---|---|---|
| | | | | WHEN DUE | AMOUNT | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |

(SCHEDULE Q) PERSONAL PROPERTY INDEBTEDNESS

| CREDITOR ADDRESS | SECURITY | WHEN ACQUIRED | ORIGINAL BALANCE | PAYMENTS | | BALANCE DUE |
|---|---|---|---|---|---|---|
| | | | | WHEN DUE | AMOUNT | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |

# APPENDIX C:

WILL PLANNING WORKSHEET

For ______________________________

1. Heirs — Name — Birthdate — Address

   Spouse ______________________________

   Children ______________________________

   ______________________________

   ______________________________

   ______________________________

   ______________________________

   ______________________________

   Parents ______________________________

   ______________________________

   Special Heirs ______________________________

   ______________________________

2. Recognizing those assets in your "Financial Statement for Estate Planning" over which you have ownership which can be distributed under a will, indicate any specific property you wish left to an individual? ______________________________

   ______________________________

   ______________________________

3. To what individuals or charities would you like to leave cash gifts? __________

   ______________________________

4. If a trust arrangement is a part of your estate plans, who is the trustee, the beneficiaries and what property is to go to the trust? ______________________________

   ______________________________

   ______________________________

5. How do you wish to dispose of your personal effects? List any items of clothing, jewelry, furniture, special collections, automobiles or other article of personal use.

| Articles | Beneficiary |
|---|---|
| | |
| | |
| | |
| | |
| | |

6. How do you wish to have any business interests handled?

7. How should the rest of your property be distributed?

8. Whom would you like to be the executor of your estate?

9. If there are minor children, who is to be the personal guardian of the children? Who will be the financial guardian? At what age should the children receive their property from the financial guardian? ______________________________
_____________________________________________________________
_____________________________________________________________
_____________________________________________________________
_____________________________________________________________

10. What about property you may inherit, such as from parents or your spouse,which should receive special consideration for distribution? ____________________
_____________________________________________________________
_____________________________________________________________
_____________________________________________________________
_____________________________________________________________

# APPENDIX D:
# PARTNERSHIP AGREEMENT WORKSHEET

## I. PRELIMINARY STATEMENTS

A. Introduction

1. Names and addresses of the partners: ______________________________

______________________________

______________________________

______________________________

Have the partners been in business together previously? __________ Where and When? __________

______________________________

2. Will the partnership replace an existing business? __________ Who owned the business? __________

______________________________

3. Will a new partner acquire property from the existing business? __________ What property? ______

______________________________

(a) What property will be purchased? ______________________________

______________________________

______________________________ At what price? __________

What are the repayment terms? ______________________________

______________________________

(b) What property will be a gift? ______________________________

______________________________

______________________________

______________________________

Gift value? ______________ Cost basis of gift property: ______________

B. Name and Address of Business

1. What name has been selected for the partnership? ______________________________

2. What is the address of the principal place of business? ______________________________

______________________________

C. Nature of Business

1. What is to be the principal business activity? ______________________________

______________________________

______________________________

2. What future expansion, especially into other activities, is contemplated? ______________

______________________________

______________________________

______________________________

3. Are there any limits on business activities? ______________________________

______________________________

D. Duration

1. On what date will the partnership begin? ______________________________

2. The term of the agreement shall be from ______________ to ______________, and from year to year thereafter unless written notice of termination or change is given by a partner to the others at least __________ months before the end of the agreement year.

II. CONTRIBUTIONS

A. Personal Property Contributions

1. What are the personal property contributions by each partner to the partnership?

| | Name | | Name | | Name | | Name | |
|---|---|---|---|---|---|---|---|---|
| | Market Value | Income Tax Cost Basis | Market Value | Income Tax Cost Basis | Market Value | Income Tax Cost Basis | Market Value | Income Tax Cost Basis |
| Feed and Crops | | | | | | | | |
| Livestock | | | | | | | | |
| Machinery & Equipment | | | | | | | | |
| Other: | | | | | | | | |
| Total | | | | | | | | |

2. If any personal property is to be leased to the partnership by a partner, what is the market value of the property, the lease payment, when due, lease period, responsibility for maintenance, who will purchase replacement property and other lease terms? ______________________________

______________________________

______________________________

______________________________

B. Real Property Contributions

1. If any "use only" real property is being contributed to the partnership, what is its description and market value? ______________________________

______________________________

(a) Fixed real estate expenses are to be paid by whom? ______________________________

______________________________

(b) How will compensation for use of the real estate be calculated? (Interest return and depreciation allocation or share of ordinary income?) ______________________________

______________________________

(c) When will compensation for use of the real estate be paid? ______________________

______________________________________________

(d) Who will purchase new capital improvements? ______________________

(e) If the improvements are purchased by a non-real estate owner, how will he be reimbursed for his equity when the property is no longer used? ______________________

______________________________________________

______________________________________________

2. If any real property is contributed outright to the partnership, what is its description, market value and income tax cost basis? ______________________

______________________________________________

______________________________________________

3. If any real property is leased to the partnership, by a partner, what is its description, the lease payment, when due, lease period, responsibility for real estate expenses, and who will purchase new capital improvements? ______________________

______________________________________________

______________________________________________

______________________________________________

C. Cash Contributions

1. What outright cash contributions will be made to the partnership, and by whom? __________

______________________________________________

______________________________________________

______________________________________________

2. What cash loans will be made to the partnership by a partner? What is the interest rate and repayment terms? ______________________

______________________________________________

D. Future Capital Contributions

1. Can a partner make additional capital contributions? ______________________
Under what conditions? ______________________

______________________________________________

3. Is it planned that partners will reinvest profits in the same proportion as capital contribution? __________ If not, capital accounts should reflect annually the change in capital contributions.

E. Withdrawals of Capital Contributions

1. Can a partner withdraw capital contributions? ______________________

Under what conditions? ______________________

F. Labor Contributions

| Name | Proportion of Working Time Devoted To Partnership | If Less Than Full Time in the Partnership, Give Details of Labor Contribution |
|---|---|---|
| | | |
| | | |
| | | |
| | | |

## III. DISTRIBUTION

A. Salaries

1.

| Name | Salary | When Payable |
|---|---|---|
| | | |
| | | |
| | | |
| | | |

2. Will salary be paid a disabled partner, and for how long? ______________________

______________________________________________________________________

3. Are salaries considered a payment to partners and, therefore, an expense to the partnership to be deducted from total partnership income when arriving at partnership ordinary income? ________

B. Under what conditions may additional funds be withdrawn during the year as a drawing account or advance on ordinary income? ______________________________________________

C. How will the ordinary income of the business be shared? ______________________

______________________________________________________________________

## IV. ACCOUNTS & RECORDS

1. What accounting system will be utilized? ______________________

   Will records be kept on a cash or accrual basis? ______________________

   Calendar or fiscal year? ______________________

2. Who will be responsible for keeping accounts? ______________________

   When will they be open to inspection? ______________________

3. Will there be a difference between individual partner and firm accounting - fiscal or calendar years, cash or accrual basis? ______________________

______________________________________________________________________

4. Where will partnership funds be deposited? ______________________

5. Who will be empowered to sign checks on the partnership account? ______________________

______________________________________________________________________

## V. LIMITING PARTNERS' POWER

1. What limitations will be placed on a partner's authority to bind the partnership? __________

______________________________________________________________________

______________________________________________________________________

2. What limitations will be placed on a partner's personal activities? ______________________

______________________________________________________________________

______________________________________________________________________

## VI. MANAGEMENT

1. If partners are not to have an equal voice in management, what is the arrangement? ______________
______________________________________________
______________________________________________

2. How are management duties to be divided? ______________
______________________________________________

3. How will decisions be settled? By mutual agreement? By majority vote? By arbitration? By one designated partner? ______________
______________________________________________

4. How often and when will partners set time aside for a "business conference" to discuss business progress or problems? ______________
______________________________________________

## VII. DISSOLUTION

A. Buy and Sell Agreements
1. Will a buyout arrangement in case of death or voluntary withdrawal of a partner be part of the agreement? ______________

2. Will the buyout be mandatory or voluntary upon the remaining partners? ______________
______________________________________________

3. How will value be established? ______________
______________________________________________

4. How will the departing partner be paid for his interest? ______________
______________________________________________
______________________________________________

5. Will partnership life insurance be part of the agreement? ______________
______________________________________________

6. If life insurance will be used, what are the provisions? ______________
______________________________________________
______________________________________________

B. Causes of Dissolution
1. What causes of dissolution other than those included in the Buy and Sell Provisions will be covered in the agreement, such as voluntary dissolution or retirement of a partner? ______________
______________________________________________
______________________________________________
______________________________________________

2. If the business is liquidated, how should it be handled? (By sale? By distribution of assets?)
______________________________________________
______________________________________________
______________________________________________

3. What special provisions will guide each cause? ______________________________

________________________________________________________________

________________________________________________________________

________________________________________________________________

________________________________________________________________

## VIII. MISCELLANEOUS

1. How will partner's vacations be handled? ______________________________

________________________________________________________________

________________________________________________________________

2. Is provision for admitting a new member desired? ______________________________

________________________________________________________________

________________________________________________________________

3. Any special provisions for partners' housing? ______________________________

________________________________________________________________

________________________________________________________________

4. Provisions for the continued participation of an incapacitated partner? ______________

________________________________________________________________

________________________________________________________________