

Farm Transfer and



Estate Planning

By Annette Higby



FARM TRANSFER AND ESTATE PLANNING

Farm succession — the transfer of the farming enterprise from one generation to the next — is most often a gradual process. The traditional progression begins with a transfer of labor and farm income, then a gradual transfer of management and control, and eventually the transfer of farm assets — first farm chattels such as livestock or farm equipment and then farm land. In practice, the progression is rarely a neat and orderly process. Each family follows its own course, and some never take the next or final step of the transfer of farm assets.

The pace and progression of farm succession is necessarily dictated by the arc of the business, the size of the estate, the mix of farm and non-farm assets, the retirement needs of the senior generation, and the personal goals and objectives of each generation as they mature. Equity for non-farming heirs is also a consideration. Because all of these factors change over time, an estate plan or a farm succession plan is never “done.” At best, it is a current snapshot of a plan to transfer the business given the current circumstances.

In the case of a transfer outside the family, there is no “traditional” progression to follow. Those who bring a non-family member into the business

are blazing a new trail entirely. In these cases, it’s even more important to foster good discussion and define and document the rights of the parties by using legal tools such as leases; milk, livestock, or crop share agreements; and partnership or some other business operating agreements.

Farm succession inside or outside the family can be a difficult topic for families. It raises issues of changing roles, money, and death.¹ These issues are intensely personal — even painful. It’s easy to be overwhelmed.

Ideally, the first conversation about farm succession should occur long before the new partner or partners are brought into the business. Once the parties are ready to explore the legal tools to formalize the relationship, the basic business agreement — the operating agreement in the case of an LLC or a partnership agreement, for example — can provide attorneys and other service providers with a framework for discussion about the division of labor, how management decisions will be made, how control of the business will be allocated, the division of income, and the ownership of business assets.

The business agreement should also address issues of a buyout of the business interests of any partner who might wish to leave the business or withdraw from it. Therefore, the agreement

should provide some means of periodically valuing the business. It should also address how and whether the business will continue in the event of the death or disability of a partner or member.

The value of the business should be reviewed annually, along with a review of each partner’s capital account or other measure of ownership at tax time. An annual discussion regarding how and whether the junior generation’s ownership interest should increase is useful, and non-farm heirs should be informed about anticipated changes in ownership of the farm business. It’s also essential to hold regular family business meetings to discuss cash flow and make decisions regarding capital expenditures and other farm management issues. These practices will set the stage for healthy, ongoing communication and a successful farm business succession.

Along with the personal issues, farm succession can involve a complex set of business, tax, and legal issues. It’s a rare attorney, accountant, or cash flow analyst who can address all these needs. Successful farm succession may require a team of professionals, although the overall process must be family- and farmer-driven. When it comes time to put all the pieces of the puzzle together, the farmer is the only expert.



Lifetime Transfers of Livestock and Farm Equipment by Gift

Making an effective lifetime gift of an asset requires: 1) some act indicating an intent to make a gift immediately and irrevocably, 2) unconditional delivery or divestiture of the asset, and 3) acceptance by the receiver of the gift.² Where there is intent and unconditional delivery, acceptance can be presumed. Absent duress or incapacity, once a lifetime gift is made, you can't "take it back." Lifetime gifts of farm assets must be considered very carefully. Assets needed to fund retirement, including any health care needs that may arise, should not be gifted. The tax consequences of gifts for both the giver and the receiver should also be considered carefully.

On the other hand, making a lifetime gift of farm assets to the next generation can often make good economic sense. Gifts that improve the creditworthiness of the successor, for example, can facilitate the purchase of the balance of the assets by the successor. A gift of breeding stock can help the successor begin building equity in the offspring. A gift of an income share in the farm business gives the heir an opportunity to build equity by reinvesting a portion of that income back into the farm business. This gifted and earned equity can provide the collateral necessary to finance a buyout of the balance of the business. It can also lead to an attitude change – a successor with an equity stake in the business will work and contribute in ways quite different than a mere employee.

Gifts may also make sense from an estate tax perspective. Those with estates in excess or within

“ Making a lifetime gift of farm assets to the next generation can often make good economic sense.

striking range of the estate tax may want to consider making gifts. For these estates, gifts put assets immediately in the hands of heirs; reduce the size of the estate, and ultimately, reduce the estate tax.

Gifts that exceed the so-called “annual exclusion” amount, which for 2006 is \$12,000 or \$24,000 for a husband and wife, require that the giver file a gift tax return. Even if the gift does not exceed the annual exclusion, filing a gift tax return can provide documentation of the gift and establish a valuation for the asset. A gift tax return can also be filed to document sales of farm assets to family members. The value of filing a gift tax return in these instances is that it starts the three year statute of limitations on IRS challenges to valuation where there is “adequate disclosure” on a gift tax return. Adequate disclosure includes at the very least the method used to determine value. Use of any discounts must also be disclosed.

If the value of the gift does exceed the annual exclusion amount, this doesn't mean that there will be a gift tax due. The amount above the annual exclusion amount can be applied against the giver's lifetime unified credit. There is, however, a lifetime limit on gifts of \$1,000,000. There is no gift tax consequence for the receiver of the gift. For more on the Annual Exclusion amount, see “Annual Gifting” on page 54.

Gifts receive a “carry over basis” meaning that the “giver's” basis in the asset carries over to the receiver of the gift. If the giver's basis in the asset



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is zero, the successor will also have a zero basis. When the successor sells the asset, he will have to report as income the difference between the sale price and the giver’s carry over basis. In this respect, a lifetime gift may not be as advantageous to the successor as transferring the same asset by Will or Trust—transforming it into a bequest rather than a gift. A bequest receives a “stepped up” basis equal to the asset’s fair market value at the time of transfer. There are, however, many good non-tax reasons to make lifetime transfers of farm assets.

Gifts should be well documented. For gifts of livestock or equipment, the giver should write a letter making an unconditional gift to the succes-

sor. The letter should note the value of the asset and the giver’s basis in the asset. Gifted livestock and their offspring should be tagged. Titled assets should be re-titled. Gifts can also be documented in a gift tax return. For gifts of \$5,000 or more, a gift tax return is a good idea.

Gifting assets will also have implications for Medicaid eligibility. Certain transfers for less than fair market value made less than 36 months prior to the date of application for Medicaid may result in a period of ineligibility. (See “Permitted and Penalized Transfers” on page 62.)

Tax Basis

	Lifetime Gift	Sale	Bequest
Transferee	Takes a carryover	Basis = Price	Basis = FMV on date of death (stepped up basis)
Transferor	No gift tax if less than annual exclusion/ lifetime exclusion	Recognition of gain	Potential for estate tax

Transfer of Livestock or Equipment by Sale

A sale of farm equipment and livestock to a successor may have unexpected tax consequences to the seller. The seller will have to pay tax on any “gain” realized from the sale of the assets with the gain being equal to the difference between the sale price and the adjusted basis of the asset. Long term capital gains are taxed at 15 percent. The sale of certain kinds of depreciable property used in the

farm business, however, may lead to the recognition of ordinary income. Ordinary income is taxed at the same rates as wage income at a rate that may be higher than the 15 percent capital gains rates.

Sales of farm machinery and livestock can result in significant tax liabilities. The amount of gain that must be reported as capital gain or as ordinary income depends on the type of asset, how long the

farmer has owned the property and the extent of depreciation allowed and allowable on the property. Farmers should not make sales of business assets to successors without first consulting a tax professional. Service providers should encourage farmers to get an estimate of the tax bill before the transfer is made and to factor the results into their retirement income planning.



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Combining a Gift and Sale of Livestock and Equipment

A sale of property on especially advantageous terms is part sale and part gift. The gift part of these transactions is subject to the rules on the annual exclusion amount and the lifetime unified credit described above.

If the interest rate charged on an installment note, for example, is less than the market rate of interest, the difference is considered by the IRS to be a gift. Every month the IRS publishes an “applicable federal rate” schedule for short, medium, and long term notes to provide guidance to taxpayers on market rates of interest. The applicable federal rate can be found on the IRS website at <http://www.irs.gov/taxpros/lists/0,,id=98042,00.html> If the inter-

est rate on the installment note is below the AFR, the transaction is, in part, a gift. These rules apply for both family and non-family transactions.

A sale of the farm asset for less than fair market value is also part gift. It's essential that every basis for valuation of the asset being transferred within the family be well documented. Valuation can be established by using an asset's book value or by an appraisal. A farmer may also use his or her own knowledge of what comparable assets are selling for in the community and include those comparable sales in the letter making the gift. If the value is discounted for any reason, it should also be documented in a gift tax return that includes

an appraisal. A bargain sale can give the successor a better basis in the property than an outright gift and can also reduce the capital gain to be recognized by the seller.

An installment sale may be intentionally structured as part gift and part sale. A seller who cancels payments as they become due is making a gift of the payment. These transactions should be documented by a letter that cancels and gifts each payment. The cancelled payments, whether in excess of the annual exclusion amount or not, may be documented using a gift tax return. Filing a gift tax return would start the three year statute of limitations on any IRS challenge to value.

Leasing Farm Equipment and Livestock

Leasing can avoid some of the tax consequences of an outright sale of farm assets. Because there is no transfer of the underlying asset, there is no capital gain to be recognized. There is, however, an income tax consequence and in some cases, a self-employment tax consequence from rental income. For more on agricultural land leases and the tax treatment of rental income, see “Agricultural Leases” on page 70.

Leasing an income-producing asset such as cows

or equipment can provide a successor with an opportunity to build equity by reinvesting a portion of the income in additional income-producing assets. A livestock lease can be structured as a “share lease” where an owner and lessee split income and expenses along an agreed upon percentage. A livestock share lease is especially advantageous for low-equity successors with limited operating capital because the up-front operating costs are shared along with the resulting income. The livestock lease may

also be a simple, straight-cash rent per head rather than a share lease. A cash lease requires a successor to make an up-front cash payment. A lease arrangement, however, can be structured as a part lease and part gift if the rental payment is less than a fair market rental.

Livestock that has been gifted to the successor may also be leased back by the farm, thus providing income to the successor to re-invest in additional livestock or other farm assets.



Transferring an Interest in a Farm Business

The traditional progression of farm succession is to transfer the farm business long before the farmland changes hands. Where there is a joint farming operation with a successor and where financially feasible, a transfer of shares or an interest in the farm business, rather than a piecemeal transfer of assets, makes the most sense. Restating your partnership agreement, amending your operating agreement, or even choosing a new legal structure all together may be the first step in transferring the farm business.

The legal structures most appropriate to use for the transfer of a farm business will allow you to easily value, track, and transfer an interest in the farm business. Legal structures such as Limited Liability Companies, Corporations, Partnerships, and Limited Liability Partnerships make it easier to track ownership and income and can therefore facilitate a gradual farm transfer. In these structures, farm assets are reduced to “units” or “shares” or a capital account, facilitating a gradual transfer to a successor. These structures can also provide a gradual transfer of management and control of the farm operation. There are other considerations, however, in choosing an appropriate legal structure. For more on the legal structure of the farm business, see Chapter I, “Legal Structure of the Farm Business.”

When transfer of the farm business is a primary objective, certain elements of the partnership or

other operating agreement of the business become essential. **The following elements are of particular concern.**

Rights to Income

Rights to income from the farming operation needn't be divided strictly on the basis of ownership. Where a successor is contributing significant labor, the business agreement may provide for an income share proportionately greater than the successor's ownership interest in recognition of that contribution.

Income paid to the senior generation no longer involved in the management of the business may also be structured to avoid self-employment tax.

Rights to Management

The legal structures suggested above will, in varying degrees, allow the senior generation to retain or gradually transfer management control while transferring a significant ownership share to a successor. A partnership agreement, for example, may lodge control in the partner who owns the majority of the capital interest in the partnership. A limited liability company may initially issue only non-voting units to a successor, retaining voting control in the senior generation until the successor has the necessary management expertise to take over.

Control can shift over time as ownership shifts in favor of the successor. These shifts can be accomplished through periodic review and amendment of the business agreement.

Mechanics of Transferring an Interest in the Farm Business

Certain legal structures – the limited liability company and the corporation, for example – reduce farm assets to units or shares, making the transfer of ownership fairly simple. Units or shares can be gifted or sold to a successor. Valuation is accomplished by a periodic appraisal of the farm assets. The assets' aggregate value divided by the number of shares or units issued is the per-share value. If units are gifted and the value of the gift exceeds the annual exclusion amount explained above, a gift tax return must be filed. It's good idea to file a gift tax return even if the gift does not exceed the annual exclusion amount as documentation of the gift and its value.

A farm partnership can also facilitate transfer but instead of tracking shares or units, the partners track capital accounts. A gift of an income interest in a farm partnership can allow the successor to build equity in the business by reinvesting income back into the partnership, thus growing the business.

For example, Grandmother gifts her 25 percent capital share in the family farm partnership to her



granddaughter who begins farming in partnership with her father who has a 75 percent share. The partnership agreement provides that profits and losses will be shared between father and daughter, fifty/fifty. Rather than taking her full income share each year, she reinvests a portion of it in the farm business, gradually building up her capital interest in the business while increasing the farm's profitability and capital.

It is rarely, if ever, a good idea to transfer an ownership interest in the farm business to non-farm heirs. If the shares come with management rights, such a transfer can cause a great deal of friction with respect to distribution of income and reinvestment of capital. If the shares come without management control and no rights to transfer out of the family, there is potential for resentment. There are better ways to provide for non-farm heirs. See for example, the Buy-Sell

Agreement below and "Ways to Provide for Non-Farm Heirs," page 45.

The Buy-Sell Agreement

A buy-sell agreement can be used to protect the heirs of the partners and to ensure a smooth transfer of a deceased or disabled partner's share in the business to the remaining partners. A buy-sell agreement provides for stable continuity of the business without a threat of termination upon the death, disability, or withdrawal of a partner.

In essence, a buy-sell agreement is a provision within the partnership agreement that obligates or provides an opportunity for the surviving partners to buy, and the deceased partner's estate to sell, the deceased partner's equity in the partnership. A buy-sell agreement can also be used to prescribe the terms of a buyout of the business in the event

of disability or withdrawal of a partner.

A buy-sell agreement should provide a means for valuing the deceased partner's share. Valuation can be accomplished by an appraisal or by using the periodic valuation of the partnership assets by the partners. Annual valuations of the business by the partners as part of the annual review of capital accounts are a good idea, in any event.

A buy-sell agreement may also provide repayment terms for the surviving partners including any necessary down payment, a formula for determining the interest rate, and other terms. An installment buyout can provide income to a surviving spouse.

Buy-sell agreements can also be funded through life insurance. A policy on the life of each partner can be purchased for the benefit of the surviving partners and the proceeds can be used to buy out the deceased partner's share.

Transferring Farmland

The farmland is most likely the farm family's most prized and most valuable asset. Its disposition can present one of the most emotional aspects of farm succession and estate planning for both generations. In some families, the farm is divided equally among all the heirs – farm and non-farm alike. In other families, the farm goes to the farming heirs. Some families accomplish this transfer while the heirs are quite young. Others transfer the farm by Will or in Trust only after the deaths

of the senior generation. No matter how the farm is transferred, these choices have emotional, legal, and tax consequences for both the transferee and the transferors.

Mechanics of Transferring Farm Land

Lifetime transfers of farmland by gift or by sale to a successor generation are eased by first transferring

the farm into an entity that allows you to value, track, and gradually transfer interests over time. A Limited Liability Company, for example, will reduce the asset to "units" that may be gifted over time. The gifts can stay within the annual exclusion amount or the transfer can be accelerated by using up some of the senior generation's unified credit. There is, however, a lifetime gifting limit of \$1,000,000. As with the transfer of other farm assets, the gift should be documented by filing a



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gift tax return. It's wise to appraise the farm every two to three years to back up the value used in the gift tax return. Any discounted valuation must also be backed up by a discount appraisal. (See "Discounted Valuation for Minority Interest and Lack of Marketability" on page 56.)

If you place a residence into an entity such as a limited liability company, you may lose your right to claim it as a homestead. You may also lose important tax benefits allowing the exclusion of gain on the sale of a principal residence. For those reasons, it may be best to leave a residence out of the entity and to transfer it separately (See "Re-titling Assets to a New Entity" in Chapter I, Legal Structure of the Farm Business on page 13.

Transfers by Sale

Exclusion of Gain on the Sale of a Principal Residence

A lifetime transfer of the farm by sale can have significant tax consequences. If the farm was purchased many years ago, it is likely to have a low tax basis. If the fair market value of the farm exceeds its tax basis, the transfer will result in taxable capital gain. The tax code offers an exclusion of up to \$250,000, or \$500,000 for qualifying married couples who file jointly, of gain for property that has been owned and used by the taxpayer as the taxpayer's principal residence.³ Taxpayers must have occupied the property for at least two out of the five years prior to the sale. The exclusion can be used every two years. Only the homestead portion of the farm property will qualify. The farm-

land and any other property used for business purposes are not eligible for the exclusion.

Section 1031 – Like-Kind Exchanges

The tax code also allows a deferral of the recognition of gain for certain like-kind exchanges of property. Property held for productive use, such as a farm, or property held for investment if exchanged solely for similar property can defer recognition of gain. Like-kind is interpreted very broadly – just about any other interest in real estate will qualify provided it has a productive purpose. A principal residence, for example, would not qualify.

The farm owner can make an actual swap with another owner of like-kind property under Section 1031. The farm owner can also sell the farm, place the sale proceeds in escrow, identify a like-kind property within 45 days, and purchase the like-kind property within 180 days of the sale. Any proceeds that are not used to purchase the replacement property will be subject to capital gain taxation.

Capital gain is deferred only under a Section 1032 like-kind exchange. In this situation, the farm owner's basis in the original farm is carried over to the replacement property. When the replacement property is sold, the resulting gain must be recognized.

Installment Sales

Farmers who sell their farm land under an installment contract such as a contract for deed may elect to report any gain using an installment method. Each payment received is reported as part in-

come, part gain, and part a return of basis in the property. To calculate the gain portion, take the contract price less the expenses of the sale and less the adjusted basis in the property. This is the gross profit, or the total gain from the sale. Determine the gross profit percentage by dividing the gross profit by the total contract price. For example, if the total contract price is \$500,000 and the gross profit is \$350,000, the gross profit percentage is 70 percent. (\$350,000 divided by \$500,000.) After subtracting the interest portion of each installment payment, 70 percent of the balance of the payment is reported as capital gain.

Easing Farm Land Transfer Using a Conservation Easement

Probably the biggest barrier to an outright sale of farmland to a farming heir is farmland affordability. When sold as part of a farm transfer plan, a conservation easement can reduce the sale price the new operator pays without reducing retirement income for the selling farmer.

A conservation easement is an interest in land. It is recorded in the town land records just like a deed. A conservation easement restricts the development of the property while allowing agricultural and/or forestry uses. While there are some common aspects to a conservation easement, each is unique to the farm it conserves. For example, some easements allow future development on well-defined house sites while restricting the bulk of the property to agricultural uses.



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A conservation organization may purchase a conservation easement or the easement may be donated by the landowner. Funding for easements comes from state and federal funds, private foundations, and local fundraising. Easement holders in Vermont – those who must enforce the easement - include the Vermont Agency of Agriculture, the Vermont Housing and Conservation Board, and private land conservation organizations such as the Vermont Land Trust and the Upper Valley Land Trust.

Funds that come from state and federal sources are administered by the Vermont Housing and Conservation Board (VHCB). VHCB has set dollar limits on a per-acre and per-project basis, however funds from other sources make it possible for projects to be funded in excess of these caps. Farms must also meet certain criteria to be considered eligible for conservation funding. For a good description of these criteria, go to VHCB's website at: <http://www.vhcb.org/conservation.html#Anchor-Farmlan-65515>.

Farms first go through a pre-application process with VHCB. The pre-application must be sponsored by a land conservation organization or the Vermont Agency of Agriculture. Farms with prime agricultural soils, located in a farming area potentially threatened by development pressure, with a good infrastructure, and under sound resource management are given priority.

Other factors can also enhance an application for conservation. Private land conservation organizations, for example, like to see a local financial

contribution from a town conservation fund. A promise by the landowner to provide public recreational access can also enhance an application.

The value of an easement is determined by an appraisal prepared by a certified appraiser. The appraisal sets a value on the farm “before the easement” and a value for the farm “after the easement.” The value of the easement will be the difference between this before and after value. In the farm transfer context, the new operator will pay the farm owner the after-value of the farm and the conservation organization will pay the farm owner the difference between the before and after value. For an example, see the case study by Alex Wylie of the Vermont Land Trust on page 41 of this chapter.

Easements with an Option to Purchase at Agricultural Value

By stripping the development value from the purchase price, a conservation easement brings the sale price a bit closer to the amount a farmer can pay for the farm with farm income. Some conserved properties, however, attract estate buyers who are willing to pay a much higher value. These estate sales can take conserved farmland out of the agricultural market by pushing the “after value” well out of reach of local farmers.

To counter this trend, the VHCB and private land conservation organizations have begun using a new tool for properties with potential estate value and for some “bare land” projects. The new

tool is a special kind of option to purchase the conserved property. The option is included in the conservation easement and it gives the land trust organization the option of stepping in and purchasing the property should it be offered for sale to a non-farmer, who is defined as someone who doesn't derive at least 50 percent of his or her gross income from farming. The option does not apply to sales within the farm owner's family or to another farmer.

If the land was to be sold to a non-farmer and is likely to be taken out of agricultural production, the option holder is able to step in and buy the farm for resale to a farmer.

The option price that the conservation organization will pay is based on a formula aimed at determining the property's value if its highest and best use is agricultural production. The option to purchase at agricultural value, or OPAV, sets an option price as the greater of:

- The agricultural value of the property as determined at the time the easement was purchased, adjusted for inflation, or
- The agricultural value of the property as determined by an appraisal at the time the option is to be exercised.

For whole-farm conserved properties that include farm improvements and a residence, the formula adds a value for these structures to the agricultural value of the land in order to obtain the full agricultural value of the property. For farm improvements, the value is



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determined by a “cost approach” method appraisal. For the farm residence, the contributory value is the cost or replacement value of the residence.

Easing Farm Transfer using an Option to Purchase at Agricultural Value

If an OPAV may be used, the appraisal conducted at the time of conservation includes three different appraised values: the “before the easement” value; the “after the easement” value without an OPAV; and the property’s agricultural value, which is its value assuming that its highest and best use is agricultural production. Adding an OPAV to the easement can further reduce the purchase price a farm successor pays. An OPAV also increases the price the farm owner receives for the easement. The OPAV should open up affordable farm purchase options for farmers.

Tax Implications of Conservation Easements

Sellers of a conservation easement are allowed to defer any gain on the sale. The sale proceeds may be applied against the property’s tax basis. This reduction in basis will result in a larger gain if the property is later sold. If the sale proceeds from the sale of development rights exceed the property’s basis, however, then gain will have to be recognized to the extent of the difference. **For example:**

Example 1:

A owns farmland with a total adjusted basis of \$200,000 and a fair market value of \$600,000. A sells a conservation easement on the property for \$200,000. The full \$200,000 realized from the

sale of a conservation easement is applied against A’s basis leaving A with a zero basis in the farm. If the property is later sold A will have to recognize the difference between his basis (zero) and the sales price as gain.

Farm Transfer and Farm Conservation Case Study

By Alex Wylie, Vermont Land Trust

Joe and Marilyn Hand have been leasing the Quinn Farm for 10 years. Starting with the calves that Joe was given as part of his pay when he was working for a neighbor during high school, they have been able to build up a nice herd of 75 cows and young stock in this time. They also own a tractor and manure spreader. The farm owner’s health is deteriorating and she has decided that she wants to sell the property and move to Florida to be near her daughter. The Hands would love to own the Quinn Farm, but they can not afford the \$625,000 price tag. While discussing their financial realities, their banker suggests that the Hands look into conservation. The Hands visit Kate Quinn and

ask if she is willing to wait to put the farm on the market while they look into the possibility of conserving the farm. Kate is delighted. She very much wishes to see her family’s farm continue in agriculture. However, she is also concerned that she will be a burden on her family if she does not get full value for her farm. The local land trust comes out to the farm to determine if it is going to be competitive for conservation funding, taking into consideration the soils, other important land features for commercial agriculture, the location, and the farm operation. In addition, the land trust reviews all the aspects of the easement and the process. Kate has to accept that the process might take well over

a year, but the Hands and Kate decide to proceed. After being approved as a pre-application at the VHCB Ag Advisory meeting, the Quinn Farm is appraised. The value of the conservation easement, which includes an Option to Purchase at Agricultural Value, comes in at \$305,000. At the closing, Kate Quinn ends up with her \$625,000 by selling the development rights on the farm to the land trust and selling the conserved farm to the Hands. Both sales are arranged as installment sales to mitigate some of the capital gains Kate will need to pay. Thanks to this arrangement, the Hands will find it much easier to cash flow the \$320,000 purchase price.

**Example 2:**

A owns farmland with a total adjusted basis of \$100,000 and a fair market value of \$600,000. A sells a conservation easement on the property for \$200,000. Because the sale proceeds exceed A's basis in the property by \$100,000, A will apply \$100,000 against his basis leaving A with a zero basis in the property and A will recognize \$100,000 in gain.

Conservation and a Charitable Deduction

In cases where funding constraints do not allow a conservation organization to pay the full price for

an easement, landowners can realize some tax benefits by donating a portion of the value of the easement and claiming a charitable deduction. This is sometimes called a bargain sale.

When conservation is used to make farm transfer more affordable, the transaction can be structured as conservation followed by a sale to the successor or as a sale to the successor followed by conservation of the farm. Whether conservation precedes or follows the sale may well be a function of which party – the buyer or the seller – is in the best position to make use of a charitable deduction from a bargain sale. A taxpayer in a higher tax bracket and with higher income gains

the most from a charitable deduction.

Conservation by Installment Sales and Like-Kind Exchanges

Sellers may also spread out the recognition of gain on the sale of a conservation easement by using an installment sale. Additionally, a landowner may defer gain on the sale of a conservation easement by using a like-kind exchange. For example, a conservation easement may be exchanged for a fee interest in other farmland. For more on like-kind exchanges, see “Section 1031 Like-kind Exchanges” above.

Estate Planning

Estate planning is developing a plan for the disposition of real and personal property in anticipation of death. The goal of an estate plan may be to ensure the continuation of a family business or simply to distribute assets equitably among heirs. A primary objective may be to provide maintenance and support for a surviving spouse or minor or disabled child. An estate plan may also seek to shield as much family wealth as possible from taxation or to provide for charitable gifts to the organizations or causes important to the deceased.

Meeting some of the objectives of an estate plan may require a lifetime transfer of assets. Other

estate planning tools, such as Wills and Trusts, are designed to take effect after the death of the transferor.

Representing the “Family” in Estate and Farm Succession Planning

Attorneys and other service providers who counsel farm families about farm succession and family estate planning matters must clearly identify their client when they begin providing services. Is the client the owner of the property being transferred, the entity being formed, or the “family”? It's per-

missible for attorneys to represent multiple clients — several owners of a closely held business, a husband and wife, multiple trust beneficiaries, for example — only when multiple representation appears to be in the best interests of the clients. Where family members appear to have more common objectives than discordant ones, multiple representations can save them time and expense. However, if serious conflicts arise either at the outset or in the course of the work, it is best for each party to have separate counsel. These issues should be discussed openly with the clients and the outcome of that discussion should be included



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in the engagement letter. A multiple representation agreement will avoid any misunderstandings among the clients.

Attorneys and service providers also need to discuss the scope of information that may be shared among family members as well as with other service providers. Include consent to speak freely with other family members and with other service providers in the engagement letter or the case questionnaire that is signed by all the clients and returned to the attorney.

Intestacy — Dying without a Will

For those who die without a Will or Trust, the State of Vermont has a statute that dictates which kin receives what share of the property.⁴

- For those who die unmarried, their estate passes in equal shares to their children.
- For those who die married and without children, their surviving spouse may either take a third of

the estate or the whole of the estate if it does not exceed \$25,000. If it does exceed \$25,000, the surviving spouse is entitled to one-half of the remainder. The other half will pass as if the spouse had not survived. If there are no other kin, however, the surviving spouse will take the entire estate.

- For those who die without a surviving spouse and no children, the estate is divided in equal shares to the father and mother if they survive, or

What's in an Estate Plan?

An estate plan is a written document. It should be updated periodically and at a minimum, include the following:

- A Multigenerational Family Tree that includes social security numbers and contact information for each family member.
- An inventory of farm and non-farm assets and how each is titled.
- Farm and non-farm liabilities.
- A description of insurance policies that includes: ownership; name of the insured; face value; cash value; date of transfer, if any; and contact information.
- Retirement accounts including: IRAs, Roth IRAs, and any other retirement accounts.
- Location of important records including: will, trust, deeds, powers of attorney, durable power of attorney for health care, stock certificates, insurance policies, and partnership or other business operating agreements.
- Estimate of retirement needs including a retirement budget with housing, health, and living costs.
- Estimate of retirement income including: current estimate of social security benefits, IRA distributions, investment, rental, farm, or other income that will provide cash for retirement needs.
- Plan for succession of operating business including: assets to be transferred to respective heirs and method of transfer, such as buyouts or gifts; proposed schedule of transfer (by will/trust or annual gifting); summary of any buy-sell agreements; annual gifting plan; history of annual gifting.
- The plan for transfer of non-farm assets including non-farm real estate, stocks, bonds, and insurance proceeds.
- The plan for transfer of farm land.
- Wishes with respect to personal property.
- Budget for transition expenses: insurance premiums, professional fees, annual expenditures, periodic appraisals, and any other expenses.
- Names and addresses of personal representative/trustees.
- List of professional farm service providers, including: accountants, attorney, financial analyst, insurance agents, and brokerage firms.
- Charitable giving wishes.
- Attachments to the estate plan should include:
 - Copy of Will, Trust, Durable Power of Attorney, and Durable Power of Attorney for Health Care.
 - Gift tax returns.
 - Copy of business agreements including the operating agreement or partnership agreement.
 - Copies of deeds and other



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if one has predeceased, the whole will go to the surviving parent.

- For those who die without a spouse, children, or parents, the estate passes in equal shares to their brothers and sisters.

If none of the kin named above survive, the estate passes to the next of kin in equal degree.

- For those who die without any kin, their real and personal may “escheat,” or pass into public ownership. In this case, the personal property goes to the town in which the decedent lived. The real property escheats to the town in which the property is situated.⁵

Three Basic Estate Planning Documents

At a minimum, both the senior and junior generation members of the farm business should have the following three basic estate planning documents in place.

A Will

The purpose of a Will is to direct the distribution of assets at death. Without a Will, assets pass under a set of rules of descent devised by the state of Vermont, as described above.

A Will may direct the payment of last expenses, direct the transfer of specific assets to specific beneficiaries, and designate who shall receive the remainder of the estate.

It is especially important for families with young children to have a Will that names a guardian for their minor children should both parents die. A Will can also provide for the creation of a testamentary trust for the benefit of minor children and name a trustee to administer the trust for their benefit.

A Will also designates an executor or a personal representative who will carry out the wishes of the testator under the supervision of the probate court. A Will may also include instructions with respect to burial or funeral arrangements.

A Durable Power of Attorney

A Durable Power of Attorney allows a “principal” to designate an agent to act on their behalf should they become disabled or legally incompetent. A Durable Power of Attorney can ease the continuation of the farm business in the event of disability of one of the business principals. The agent’s power to act on the principal’s behalf may be effective on the day they both sign the power of attorney, or the agent’s powers may “spring” into being only when and if the principal becomes disabled or legally incompetent. This type of DPA is known as a springing power. A lawyer should draft a Durable Power of Attorney. Most DPAs grant the agent some very broad powers in a laundry list format. **For example, the agent is frequently empowered to:**

- Sign legally binding documents on the principal’s behalf;
- Do the principal’s banking;
- Manage real estate, including selling it;

- Collect rents;
- Sue or defend a suit;
- Collect debts owed to the principal;
- Access the principal’s safe deposit box;
- Manage the principal’s business;
- Deal with Social Security and other state and federal agencies on the principal’s behalf;
- Borrow money and pledge the principal’s property as security;
- Deal with the IRS and other taxing authorities;
- Make gifts to the principal’s spouse and children;
- Manage any stocks or bonds, including trading them;
- Hire, fire, and pay medical personnel and professional advisors; and
- Put the principal’s property into a revocable trust.

In the event of disability, a durable power of attorney will spare the principal’s family the trouble of going to court for a legal guardianship in order to manage his or her affairs. Where there is a durable power of attorney in place, the farm business can continue with minimal disruption. While a guardianship is court-supervised, the exercise of a power of attorney is not. **A principal should only choose someone whom they trust absolutely to be their agent.** If the principal doesn’t have someone like this, it may be best to have a court-supervised guardianship. A power of attorney can only be terminated by the principal’s death or by written notice.



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DPA for the Farm Business

In the farm context, a durable power of attorney should include the power to deal with those farm agencies, farm suppliers, and farm programs most likely to interact with the farm business. Your DPA should include, for example, the authority to make decisions regarding Vermont's current use program, farm creditors, the Vermont Agency of Agriculture, NRCS, and any other USDA program. It should also include the authority to conduct an appeal on the principals' behalf in the event of a denial of USDA program benefits.

Advance Directive for Health Care

An advance directive for health care is a document that gives to another the authority to make any and all health care decisions when the principal is not capable of making these decisions. The agent will have the authority to consent to life sustaining treatment, to withhold consent, or to withdraw life sustaining treatment. The Vermont Ethics Network has developed a new advance directive form available at: www.vtethicsnetwork.org.

The new advance directive form combines the purposes of the old Living Wills and Durable Power of Attorney for Health Care forms. The new form is also more comprehensive, covering organ donation and funeral direction issues. An attorney should assist a client in filling out this document whenever a Will or Trust is prepared.

Providing for Non-Farm Heirs

Farm families fortunate enough to have a succes-

sor to take over the operation often struggle to find strategies that are fair to non-farm heirs. Most families want to pass on a successful business while also maintaining close family relationships. Following are some ways that farm families have achieved a measure of comfort with differing bequests:

- They purchase life insurance for each heir. The farming heirs use the proceeds for estate taxes on the farm transfer or reinvestment in the farm while the non-farm heirs can use the proceeds any way they wish.
- They use life insurance to fund a buy-sell agreement that allows the farming heirs to purchase the farm from the parent's estate. Proceeds from the sale of the farm are distributed to all heirs.
- They leave parcels not necessary to the farming operation or those most amenable to development to non-farming heirs.
- They invest proceeds from the sale of development rights for the benefit of all the heirs.
- They leave all or a greater portion of non-farm assets to non-farming heirs.
- They place non-farm assets in a charitable remainder trust and use income from the trust to purchase replacement life insurance for the benefit of the non-farming heirs. (See the sidebar, "Charitable Remainder Trusts," on page 48 for an example.)

- They balance annual gifts of farm assets to farming heirs with gifts of cash to non-farming heirs.
- They give non-farm heirs a right of first refusal to purchase the farm at its agricultural use value. If the farm is ever sold for development, the non-farm heirs have the right to step in and purchase the property for its agricultural use value or otherwise share in the appreciated development value of the farm property.
- They leave the farm in trust for the benefit of those heirs actively farming. Under the terms of the trust, if the property is ever sold, all of the heirs will share in the proceeds.

The comfort level associated with any particular compromise will change as the estate changes. If over time, the farm assets appreciate faster than the assets going to the non-farm heirs, the family may have to revisit the issue.

An equitable estate plan doesn't simply allocate assets; it also allocates the unified credit and the tax burden associated with the transfer of assets. When bequests are not equal, it's important that estate taxes be "apportioned" so that each heir is responsible for the estate tax attributable to the assets he or she receives. Otherwise, liquid non-farm assets meant for non-farm heirs could go to pay the estate taxes due on the farm transfer. Most boiler plate tax allocation clauses have the taxes and expenses for administration coming out of the residue of



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the estate. If there are three heirs, and the farm is left to A with the residue of the estate going to B and C, under the standard tax allocation clause, A gets the farm and B and C will receive the residue less any estate taxes due. In this sense, the tax allocation clause is a dispositive provision. It's also important to ensure that

liabilities associated with farm assets transfer with the encumbrance.

Title to Personal and Real Property

How title is held to personal or real property can be a form of estate “planning” because a title af-

fects the disposition of the property upon death.

Tenants by the Entirety

In Vermont, married couples or couples in a civil union may hold title to real or personal property as “tenants by the entirety.” Each tenant is considered to own the whole; without the consent

Agents Owe Special Duties

Under the laws of the State of Vermont, designated agents have certain duties. First and foremost, they owe a “fiduciary duty” to their principal. A fiduciary duty requires that in the performance of their duties under this power of attorney, they always:

- Act in good faith and in the interest of the principal;
- Refrain from self-dealing or in their own self interest and benefit;
- Avoid conflicts of interest which would impair their ability to act in the best interests of the principal;
- Do not commingle the funds of the principal with their own funds or the funds of third parties;
- Exercise the degree of care that would be observed by a prudent person dealing with the property and affairs of another person;

- Take no action beyond the scope of authority granted by the terms of the power of attorney;
- Keep records of all transactions taken under the power of attorney;
- Provide accountings upon request of the principal or at such times or in such manner as is specified by the terms of the power of attorney;
- Always follow the directions of the principal specifically forbidding an action, notwithstanding any provision of the power of attorney giving the authority to take such action; and
- Comply with any lawful termination of the power of attorney upon notice of the principal.

Vermont law also puts some limits on the powers of an Agent under a power of attorney:

- The agent may not exceed the authority given under the power of attorney.
- The agent may not use it to make health care decisions or to change or revoke the principal's durable power of attorney for health care or his/her living will.
- The agent may not use it to change or revoke the principal's will.
- The agent may not require the principal to take any action against his or her will.
- The agent may not use the power of attorney to act as a personal representative or a trustee on the principal's behalf unless the trust specifically authorizes it.
- The agent may not take any action specifically forbidden by the principal.
- The agent may not convey lands belonging to the principal unless the

power of attorney is properly executed and the power of attorney specifically provides for that authority.

- The agent may not compensate him or herself for duties performed under the power of attorney unless the power of attorney specifically provides for compensation.

The agent may not make a loan or a gift of the principal's property to others or to him or herself unless the power of attorney specifically provides for gifts.

- The agent may not appoint another person to act as an alternate or successor agent unless the power of attorney specifically provides that authority.

A power of attorney may not limit or waive a principal's right to an accounting.



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of the other, neither has the power to convey the property to a third person or pledge it as security for a personal debt. The principal difference between tenancy by the entirety and joint tenancy is the inability to encumber the property without the consent of the other tenant. Creditors of only one spouse are unable to attach the property unless the debt was incurred for the necessary upkeep of the property.⁶ In this way, a tenancy by the entirety provides a kind of liability shield. Unless the deed or other title document indicates otherwise, at the death of one spouse, the surviving tenant by the entirety automatically becomes the full owner of the property. If the couple is divorced, the tenancy by the entirety is terminated and ownership becomes a tenancy in common.

Tenancy in Common

Any transfer of land to two or more people is presumed to create a “tenancy in common.”⁷ In a tenancy in common, each owner owns an undivided interest in the whole. If there are two tenants in common, each is said to own a “one-half undivided interest” in the property. Tenants in common may own equal or unequal “undivided” interests. Upon the death of one tenant in common, his or her interest passes to his heirs under the terms of his will or under the laws of intestacy, if he has no will. He may leave his interest to any heir or heirs he wishes. If the Will provides that his heirs are to take equal shares of the estate, they will take their respective fractional share of the property. For example, if a one-half undivided interest passes to

four heirs in equal share, they will each take a one eighth undivided interest in the whole.

Joint Tenancy

To create a joint tenancy in real or personal property, the deed or other title document must clearly express intent to create a joint tenancy. A joint tenancy is created by using words such as “with rights of survivorship,” or “WROS,” or “as joint tenants and not tenants in common” in the title document. If there is any ambiguity in the deed, courts will resolve the question in favor of a tenancy in common. Whether you own an interest as a joint tenant or a tenant in common makes a big difference. Upon the death of a joint tenant, the property passes to the survivor. If the farm is titled in the name of two farm partners “as joint tenants with rights of survivorship,” the whole title to the farm passes to the other partner upon the death of one partner. Title passes automatically without going through probate or passing under the joint tenant’s will. Upon the death of a tenant in common, on the other hand, that person’s interest is passed to his or her heirs under a Will or under the laws of intestacy.

At common law, joint tenants could only own equal shares of joint tenancy property. A recent change made by the Vermont legislature allows joint tenants to own equal or non-equal interests in joint tenancy property.⁸ If the title document is silent, equal ownership is presumed. Where a fractional share is expressed and a joint tenant dies, his or her share will be allocated among the survivors

in proportion to their respective joint interests at the time of the joint tenant’s death. For example, if there are three joint tenants and A owns 50 percent, B owns 25 percent, and C owns 25 percent, and A dies, B and C will each take a proportional share of A’s 50% interest. Each will now own 50% of the property. If B dies, A’s proportional share will be $\frac{2}{3}$ of B’s interest, and C’s proportional share will be $\frac{1}{3}$ of B’s interest, leaving them with a $\frac{66}{100}$ and $\frac{2}{3}$ rd interest and a $\frac{33}{100}$ and $\frac{1}{3}$ interest respectively.

A Life Estate

A life estate is an interest in land that endures for the life of the life tenant. Where there is a life estate, there must also be a “remainder interest” in the property that will pass to whomever is to take the property at the death of the life tenant.

Leaving a life estate to a spouse and the remainder interest to your children is a traditional estate planning technique designed to provide for one’s spouse after death while ensuring that the property ultimately ends up with children of the marriage rather than with a new spouse or the children of a successive marriage. The same objectives are more appropriately accomplished through the use of revocable living trusts, which will be discussed later in this chapter.

At the death of the life tenant, the property passes automatically to the “remaindermen.” The remainder interest passes automatically. It does not go through probate or pass under the terms of a Will.



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Probate and Non-Probate Assets

Probate is a court-supervised process for proving a Will and carrying out its provisions. An executor prepares an inventory of the decedent's estate, notifies and pays creditors and other claimants, and otherwise carries out the instructions found in the Will. Heirs and others named in the Will are notified and kept informed about the process.

The assets that pass by virtue of a Will and must therefore go through probate are called probate assets. However, some assets, such as

property held in joint tenancy, automatically pass to the surviving joint tenant upon the death of a joint tenant. These assets do not pass as a result of a Will, but by law. This asset needn't go through probate. Other non-probate assets include IRA's, annuities, insurance policies, and any other specialized assets for which the deceased has designated a named "beneficiary." These assets also pass automatically upon the death of the insured. Assets in a revocable living trust, as described later in this chapter, also avoid the probate process. All the assets must be specifically titled to a trust, however.

Basis at Transfer — The "Stepped Up" Basis

Whenever property is transferred, it is important to track what happens to the asset's "basis." Generally, your "basis" in property is what you paid for it. If you later sell the property you may have to pay a capital gain tax on the difference between the selling price and your basis.

When you give property away during your lifetime, the person to whom you give it gets a "carryover basis," meaning that your basis will

The Charitable Remainder Trust

Charitable Remainder Trusts are most useful for estates that will be subject to the estate tax, for high income donors who can benefit from a charitable deduction, and for property that would result in significant capital gain if it were sold and re-invested.

A CRT is an irrevocable trust. The donor places property into the trust, giving up all rights to the trust property but retaining an income interest. At the donor's death, the trust property passes to a charity of the donor's choosing. The donor is allowed to take a charitable deduction when the property is placed in the trust. How

much of a charitable deduction is based on an IRS formula that takes into account the income beneficiary's age, the value of the property donated, the income that will be withdrawn over the life of the Trust and other factors. The amount a donor can deduct in any given year may be limited, however; for gifts of appreciated property, for example, the donor can only deduct 30 percent of his or her adjusted gross income. The donor can deduct the balance in future years.

The donor's income interest can be a fixed percentage – at least 5 percent – or a fixed amount to be

paid each year. The donor may also designate someone else as the income beneficiary. The income can be paid for a term of years or can be paid until the income beneficiary's death. The CRT allows the donor to take the asset out of the taxable estate while retaining the income from the property.

The property in the CRT will be managed by a trustee. The property donated can be securities, cash, or land. The Trustee can be the charity, a bank trust department, or the donor. If the property is highly appreciated or a low income-producing asset, the Trustee can sell the asset and

reinvest it in a high income-producing asset. The donor can thus sell and reinvest assets and increase his or her income without having to recognize the capital gain that would result from selling it as an individual.

Income from the CRT can also be used to fund replacement life insurance. The donor can make annual gifts to heirs from the CRT income that is used to purchase life insurance on the life of the donor. The policy is owned by the heirs or by an irrevocable insurance trust and is not taxed in the donor's estate at the donor's death. The life insurance thus replaces the asset donated to charity.



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carry over to the new owner. If you made a lifetime gift of farmland with a basis of \$10,000 to a successor, the successor's basis in the property is \$10,000.

For property that passes at your death, however, there is another rule for basis. For these transfers, the heir receives a "stepped up" basis. The basis for the heir becomes the fair market value of the asset on the date of death. A remainder interest that passes automatically at the conclusion of a life estate also gets a step up in basis equal to the fair market value of the property on the date of death of the holder of the life estate.

These rules on basis have a tremendous impact on the timing of a transfer of farm assets, particularly land. If the senior generation purchased the farm in the 1950s, its value has probably appreciated significantly. A lifetime transfer will give the heirs a very low basis. A transfer at death will result in a much higher basis. Heirs, especially farming heirs, need to understand the long term tax consequences of a lifetime transfer of low basis farm assets. Both generations need to weigh the capital gain consequences with many other factors such as estate tax liability. If the asset is appreciating rapidly and it appears that the estate will be subject to an estate tax, it may be best to begin moving the farmland out of the estate and into the hands of heirs no matter what the basis. In addition, sometimes business, family, or personal reasons argue for a lifetime transfer of farm assets.

Revocable Living Trusts

More complex estates require more complex estate planning tools. An "inter vivos" or "living trust," so-called because it is created during the lifetime of the creator of the trust, can offer valuable estate planning and asset management tools. It can provide significant estate tax benefits and provide for the continuing management and transfer of an ongoing farm business even after the death of its creator. A trust can also provide income and other support benefits to a surviving spouse while ensuring that at the second spouse's death the asset will go to the heirs of the creator of the trust — not to someone else's heirs. All of these aspects of a revocable living trust will be discussed in turn.

Revocable living trusts, however, are not for everyone. They are a sophisticated estate planning tool that requires a higher level of effort on the part of the creator of the trust to set up as well as from those who administer the trust after his or her death. Using a trust successfully requires a considerable investment of time and effort.

Basic Trust Mechanics

A living trust is created by a trust agreement. At a minimum, the trust agreement will create a trust and provide for its initial funding. The trust agreement will also dictate the powers of the trustee over the trust property and designate a successor trustee. It will provide for revocation or amendment during the creator's lifetime and

for the use of trust assets in the event the creator becomes disabled. The trust agreement will also, much like a Will, specify the trust beneficiaries and the disposition of trust assets at the death of the creator of the trust.

The creator of the trust is called the "settlor." The settlor may, and most often does, act as the initial trustee of his or her own trust. As the initial trustee, the settlor continues to manage, control, and take the income from all of the assets placed in the trust. The broad powers of the Trustee in the trust agreement usually allow the mortgage, sale, or other acts of "dominion" over the assets. Assets may also be removed from the trust. In a living trust, the trust is "revocable" until the death of the grantor, meaning that assets can be removed from the trust and the trust may be amended or completely revoked. While the trust is revocable, it is a "grantor trust" and is considered a "disregarded entity" by the IRS, meaning that the settlor continues to claim income from the trust assets on his or her personal tax return. While the trust is revocable, it does not need a tax identification number or to file its own tax return.

The initial transfer of property into a revocable living trust is not considered a taxable transfer and will not result in capital gain or a change in tax basis. A transfer of real estate into the trust is also exempt from the Vermont property transfer tax.⁹

Creating a trust can be expensive. If the trust involves complex estate tax issues, you can expect a fee of \$1,500 to \$2,000. Along with the fee for



drafting the trust agreement, there will also be the expense of re-titling property to the trust. You must re-title all assets including checking and savings accounts, brokerage accounts, and other assets. Re-titling stock certificates can be particularly time consuming. Depending on the goals of the trust, jointly held property may also have to be re-titled. Where both spouses, for example, own property as tenants by the entireties, the property will be re-titled as a one-half undivided interest in each spouse's trust. Interests in a partnership or limited liability company must also be assigned to the trust. IRAs, on the other hand, are not re-titled to the trust.

Special care must be taken in transferring title of farm and non-farm assets to a trust. Creditors with liens on the property will need to be informed, and in the case of real estate, a new application for special use valuation must be submitted. In most instances, a transfer will not trigger a land use change tax under Vermont's Current Use Program (Current Use). For as long as the trust continues to meet the statutory definition of a "farmer," the trust should continue qualify for the program, although a new application will need to be filed to reflect the new owner.¹⁰ To meet the definition of a farmer, one-half of the annual gross income must be derived from the business of farming or the land must be leased to a farmer.

Putting a home in a revocable living trust can also have Medicaid eligibility consequences. Homes in revocable living trusts are not excluded for Medicaid eligibility purposes in Vermont. Homeowners who need to establish eligibility for

“Creating a trust can be expensive. If the trust involves complex estate tax issues, you can expect a fee of \$1,500 to \$2,000.

Medicaid may remove the home from the trust and the home will again be considered an excluded resource. (See “Transfers of Property to a Trust” in the Medicaid Section on page 63.)

There is no case law directly on point in Vermont on whether placing a home into a revocable living trust would result in the loss of the homestead exemption. The Vermont homestead exemption protects up to \$75,000 in equity in a personal residence from the claims of unsecured creditors.¹¹ In most states, placing a home in a revocable living trust will not cost the settlor the value of the homestead exemption.

At the death of the settlor, the trust becomes irrevocable and a successor trustee named by the trust agreement takes over the duties of the trustee. A successor trustee may be a spouse or other family member or an institution such as a bank. The successor trustee may also take over the management of trust assets in the event the settlor becomes disabled. Should the settlor become disabled, the trust agreement will ordinarily provide that income from the trust assets can be used for the settlor's care and support. A trust spares the family the necessity of going to court to establish a guardianship to manage the assets of the disabled family member.

At the death of the grantor, the trust assets will receive a step up in basis. The tax basis will be the fair market value of the assets on the date of the settlor's death. There is also an alternative valuation option under the federal estate tax code. Because valuation can fluctuate widely for some assets, the code allows a decedent to value the estate at its fair market value on the date of death or six



months after the date of death. A significant rise in the value of the assets and choosing the alternative valuation date would provide a higher tax basis in the hands of the heir.

Assuming that all of the Grantor's assets were placed in the trust, at the death of the settlor the estate does not have to go through the probate process. However, probate assets not in the trust will still have to go through probate. Avoiding probate is one of the frequent "selling points" for revocable living trusts. Probate is a court-supervised process for proving and settling a decedent's estate. In states such as Vermont, where the probate process is, relatively speaking, orderly and efficient, this may not be such a big advantage. And some families can benefit from the probate process. Estates that involve family dissension or distrust, for example, can benefit from court supervision.

A trust will at least avoid the expense of probate, which can be considerable for a complex estate. The costs of a trust will be born "up front" at the time the trust agreement is first drafted. There will also be fees if the trust agreement is amended. After the settlor's death, there are costs associated with trust administration. A trust, however, will also keep the trust's administration largely private because the trust agreement will never be a public document. Probate files and the Wills probated within them are open to the public.

After the Settlor's Death

At the settlor's death, the trust becomes irrevocable. The successor trustee steps in to administer the trust

assets and to carry out the settlor's intent with respect to the disposition of the trust assets. The trust agreement will direct the successor trustee to pay any estate taxes, funeral expenses, and other debts of the decedent. The trust agreement may direct the disposition of specific assets outright to particular beneficiary or continue to hold assets in trust until the beneficiary reaches a certain age. The trust agreement may also provide for the funding of one or several "subtrusts" at the death of the settler – a marital trust or family trust, for example.

These subtrusts are separate entities that require their own tax identification numbers and their own tax returns. They must be managed as separate entities, without co-mingling of other funds, and there are fiduciary duties owed by the trustee to the beneficiaries of the trusts.

Avoiding Estate Taxation at the First Death

Assets which pass outright to a surviving spouse will qualify for the unlimited "marital deduction" for estate tax purposes. The marital deduction allows couples to avoid estate taxation upon the first spouse's death. Property that passes into the estate of the surviving spouse will be taxed in the surviving spouse's estate, thus deferring estate tax liability until the second death. For example, H leaves his entire estate of 4 million dollars to W. No tax will be due upon H's death, but when W passes away, W's estate will be liable for the estate tax due that may be due on the 4 million left by W plus any other assets in W's estate.

The tax code also allows a marital deduction for property placed in certain qualifying marital trusts which allow the grantor to direct the disposition of the property after the death of the surviving spouse. These trusts, which provide income and support to the surviving spouse, are sometimes called QTIP trusts. To qualify as a QTIP, the surviving spouse must have rights to all the income from the trust property and also be the sole beneficiary of the trust during the spouse's lifetime. At the surviving spouse's death, however, the trust may direct that the remainder of trust assets be distributed to heirs of the settlor's choosing rather than the choice of the surviving spouse. For example, H leaves 2 million dollars in a QTIP Marital Trust for the benefit of W. During W's lifetime, the trustee distributes all the income earned from the trust property to W. At W's death, as H directed, the remainder of the estate passes to their daughter, D. The property that passes at W's death is taxed in W's estate.

Other types of marital trusts also qualify for the unlimited marital deduction, and some allow distributions from the Marital Trust to other family members during the surviving spouse's lifetime. The QTIP trust is just one example of a trust that will qualify for the marital deduction.

Minimizing Estate Taxes at the Second Death

In the examples above, the marital deduction was effective in deferring the estate tax until the second



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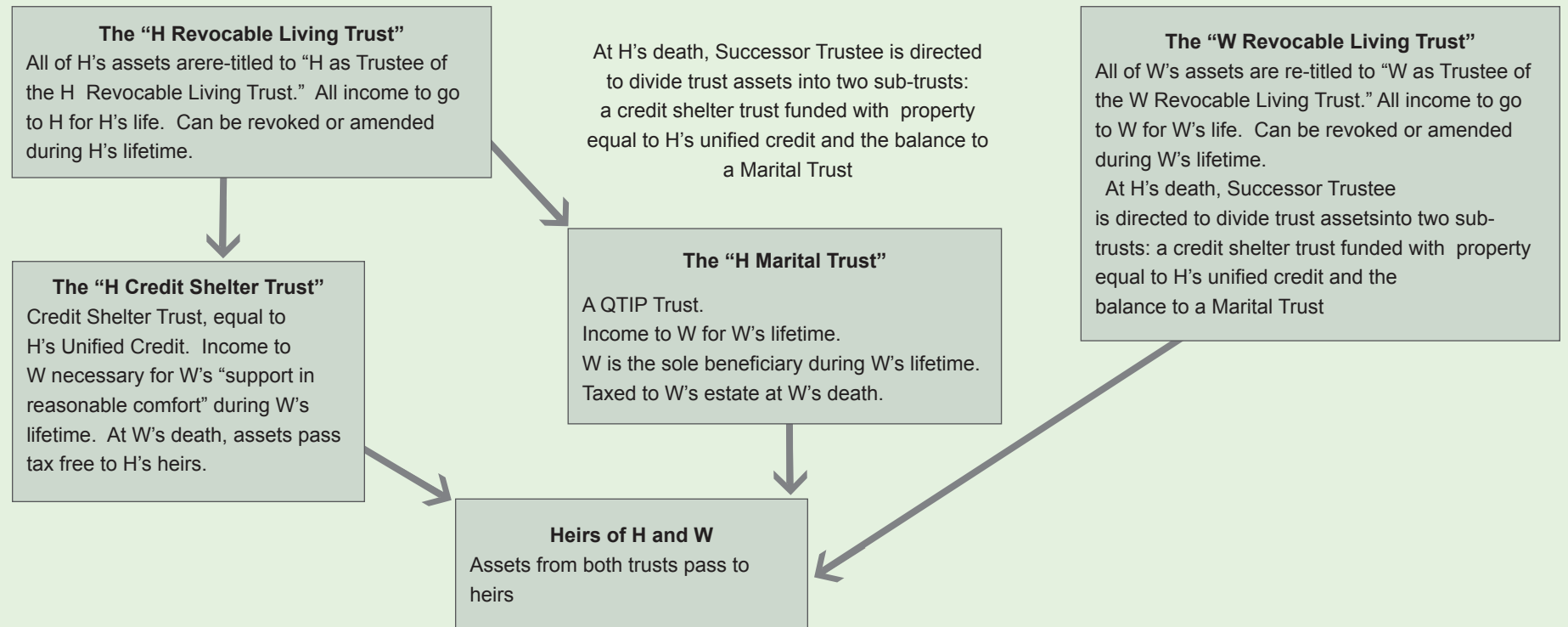
death. Additional estate tax savings are available through the use of a credit shelter trust, sometimes called a By-pass Trust, Non-marital Trust or a Family Trust. Credit shelter trust property does not pass to the surviving spouse but instead, “by-passes” the surviving spouse’s estate. It can be funded in an amount equal to the federal estate tax exclusion amount that is applicable on the date of the first

spouse’s death or on the basis of some other formula that divides the estate between a Marital Trust and a Credit Shelter Trust. The income and principal from the Credit Shelter Trust may be used to support the surviving spouse to an “ascertainable standard.” The Trust may direct the trustee to make distributions for the surviving spouse’s “health, education, maintenance and support”, for example.

The Credit Shelter Trust may also provide for the needs of other family members.

The surviving spouse may not direct the disposition of any of the assets in the Credit Shelter Trust or risk having the property included in his or her estate. At the surviving spouse’s death, the assets and any appreciation in the value of the assets may be distributed to their heirs free of the estate tax.

Revocable Living Trust – Example





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For example, H dies with an estate of 4 million dollars. His trust directs that an amount equal to the exclusion amount applicable on the date of his death, in this case \$2 million, be placed in a Credit Shelter Trust and the balance to be placed in a Marital Trust. The Marital Trust directs the distribution of income solely to the surviving spouse during her lifetime. The Credit Shelter Trust directs the trustee to provide income and principal necessary for W's "health, education, maintenance and support." At W's death, the trustee is directed to distribute the property in both the Marital and the Credit Shelter Trusts to D. The Credit Shelter Trust, including

any appreciated value since the death of H, passes to D, free of the estate tax, at W's death. The assets in the Marital Trust will be sheltered from the estate tax by using W's unified credit.

Utilizing both the marital deduction and a Credit Shelter Trust allows couples to make full use of the exclusion amount available to each of them. In the last example, both H and W would be able to exclude \$2 million from their respective estates. If H died leaving all of his estate in a Marital Trust or outright to his spouse to be taxed at the surviving spouse's death, his estate tax exclusion would be lost.

Planning for the use of both the marital deduction

and the Credit Shelter Trust can be accomplished through a Revocable Living Trust or through a testamentary transfer at death. A testamentary transfer of assets of the estate into the respective trusts would be directed in both H and W's Wills. Unlike a Revocable Living Trust, a testamentary transfer would require that the estate be probated. But it would not require a lifetime transfer of all of H and W's assets into a Revocable Living Trust. In states like Vermont, where probate is comparatively speaking, less onerous, a testamentary transfer may offer the simplest approach to planning for the use of both the marital deduction and the Credit Shelter Trust.



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Estate Taxes

The purpose of our federal estate tax is to discourage the concentration of wealth in the hands of a few.¹² A secondary purpose has been to encourage the productive contribution to society of all our citizens by making it difficult for some to rely principally on inherited wealth for their livelihood. The estate tax has also been justified as a reasonable imposition for the privilege of conducting business in a capitalist society.

The estate tax affects a truly small number of tax payers. In 2003, of the roughly 2.3 million deaths, only 30,627 incurred any estate tax liability.¹³ In Vermont, just 87 estates paid some estate tax in 2003. In 2003, only those estates in excess of \$1 million were at all likely to face an estate tax.

The number of farm estates subject to the estate tax is even smaller. Of the 30,627 taxable estates nationwide in 2003, it is estimated that just 1,967 reported some farm property, most of it held by estates worth in excess of \$10 million.¹⁴

There are a number of reasons why farm estates are unlikely to pay an estate tax. For one thing, the farm economy did not participate in the boom of the 1990s at levels proportionate with the non-farm sector. In addition, Congress has provided numerous mechanisms for farm and other small business estates to minimize the estate tax burden. Good planning and the use of the revocable living trust can ensure that both spouses take full advantage of the estate tax exclusion. Special use valuation and

other tax benefits available only for farms have allowed many farm families to pass on farm assets to farming heirs without incurring an estate tax.

Tax reform efforts that gradually increase the size of estates subject to taxation and an outright repeal of the estate tax will also mean that fewer farm estates will face tax liability. It is estimated that the primary beneficiaries of estate tax reform will be the heirs of the wealthiest 2 percent of decedents with taxable estates above \$5 million.¹⁵

Under our federal estate tax system, each individual is allowed a cumulative credit for transfers of wealth during their lifetime and at their death variously called the “exclusion amount” or the “unified credit.” Because each individual has a unified credit, couples can pass estates with a value of twice their unified credit – estate tax free – to their heirs. The unified credit is currently at \$2,000,000. There is, however, a lifetime limit on gifts of \$1,000,000.

As a result of an estate tax relief measure passed in 2001, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), estate taxes are being gradually phased out. The Act gradually raises the unified credit, reduces tax rates, and repeals the estate tax entirely in 2009. The chart below details the increases in the unified credit and the year of repeal.

Because the legislation repealing the estate tax will expire in 2010, the law will revert to the es-

tate tax laws in place in 2001, if there is no further legislation. In 2001, the unified credit was \$1,000,000.

As a means of paying for the one-year repeal of the estate tax in 2010, Congress eliminated the step up in basis for heirs. Instead of a step up in basis, heirs will take a carry over basis. Congress did include some very complicated rules allowing some heirs to increase their basis by as much as \$1,300,000. In the case of a qualifying spouse, an additional \$3,000,000 may be added to basis. These rules apply only to deaths in the year 2010.

There is much concern that a permanent repeal of the estate tax will result in a permanent repeal of the step up in basis. A repeal of the step up in basis rule could have a disproportionately onerous impact on farmers.

The gradual nature of the estate tax repeal coupled with the uncertainty with respect to the basis rules and further legislation to extend or repeal the estate tax can make estate planning very difficult. It's essential to periodically review your estate plan to keep pace with changes in the law.

Annual Gifting

The “unified” nature of the unified credit used to mean that gifts made during a person's lifetime counted against the individual's overall unified credit. Under EGTRRA, however, the gift tax was



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decoupled from the estate tax. There is now a lifetime limit on gifts of \$1,000,000 even though the unified credit is \$2,000,000.

There is also an “annual exclusion” from the estate tax for lifetime gifts that do not exceed an annual exclusion amount. In the year 2006, gifts of up to \$12,000 are excluded for the purposes of determining the gift tax. The annual exclusion amount is pegged to the rate of inflation, so it is likely to increase periodically. Over time, annual gifting can reduce an estate to levels below the threshold of estate taxation, effectively passing wealth to heirs on a tax-free basis.

Married couples may make so-called “split gifts,”

meaning that one spouse can make a gift of property with a value of \$24,000 if the other spouse consents. This has the effect of doubling the annual exclusion amount.

Mechanisms for Reducing the Estate Tax

Special Use Valuation¹⁶

Special use valuation can substantially reduce estate tax liability, especially where development pressures are driving farmland values upwards. Section 2032A allows certain farm estates to value farmland at its agricultural use value rather than its

fair market value.

For decedents dying in 2006, the aggregate decrease allowed under Section 2032A may not exceed \$900,000. This limitation is indexed for inflation, so it’s likely to increase regularly.

Qualified Real Property

To qualify, the property must be located in the U.S. and it must be acquired by or passed down to a “qualified heir” for use as a farm. A qualified heir includes an ancestor, a lineal descendent, a spouse, or a spouse of a lineal descendent.

The farm business assets – both real estate and personal assets such as equipment and livestock – that are passing to a qualified heir must make up at least 50 percent of the adjusted gross estate. The farmland must account for at least 25 percent of the adjusted gross estate owned by the family.¹⁷ The adjusted value is the property’s fair market value rather than its special use valuation, less any debt against the property.

For five out of the last eight years, the property must have been owned by the decedent, have been used for farming, and the decedent or a member of his or her family must have “materially participated” in the farming operation. Generally speaking, material participation means being actively involved in the day-to-day labor and management of the farm. There are, however, some special rules for surviving spouses that treat active management as material participation.

Within ten years of the decedent’s death, the estate tax savings from special use valuation are sub-

Unified Credit

Year of Death	Unified Credit	Maximum Tax Rate
2005	\$1,500,000	47%
2006 - 2008	\$2,000,000	46% in 2006 45% in 2007-08
2009	\$3,500,000	45%
2010	Estate tax is repealed	
2011	Without further legislation, the unified credit will revert back to its level in 2001, which was \$1,000,000	55%



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ject to recapture if: any interest in the property is disposed of outside the family, the property ceases to be used for farming, or the qualified heir fails to materially participate for three out of eight years in any eight-year period. However, selling or donating a conservation easement is **not** considered a disposition that triggers the recapture of estate taxes.¹⁸

The following formula is used to determine the property's agricultural use value:

(Capitalization of comparable rent – capitalization of income stream) / interest rate.

To calculate this, take the average annual gross cash rental for comparable farm land in the area less the average annual real estate taxes and divide by the average annual effective interest rates for all new Federal Land Bank Loans.

As an example, assume 200 acres of farmland with a fair market value of \$500,000 and real estate taxes of \$8,000. The average annual effective interest rate for federal land bank loans applicable for Vermont for 2004 was 6.64 percent.¹⁹ Assuming a comparable rent of \$75 an acre, or \$15,000, figure \$15,000 (annual cash rent) less \$8,000 (real estate taxes) = \$7,000 divided by 6.64% (FLB interest rate) = \$105,422. That is the agricultural use value. In this example, using the agricultural use value would reduce the gross estate by \$394,578.

Aside from the risk of recapture in the event of farm failure or other circumstances beyond the qualified heir's control, special use valuation will also affect the property's basis. Rather than a stepped up basis, the heir will take a basis equal

to the special use valuation.

Discounted Valuation for a Minority Interest and Lack of Marketability.

Some taxpayers have realized significant estate tax savings by claiming a discounted valuation on business interests gifted during their lifetime or left to heirs by Will or Trust. The value of a fractional interest in a farm operation or farmland in an LLC or family partnership isn't the same as the value of a proportionate share of the underlying farm asset. For assets held in an entity, an LLC, for example, rights in the assets are governed by an operating agreement. The operating agreement may allocate control of the asset to the majority share holders, or an economic interest in the business may have not voting rights at all. The operating agreement may also restrict a shareholder's rights to transfer the property outside the family or impose other restrictions on marketability. When the LLC shares owned by the transferor represent a minority and non-controlling interest and when there is little market for the shares outside the family, the IRS has recognized a discounted value of 20 to 40 percent. If all the assets of the business taken together have a value of \$100,000, for example, a 10% interest discounted by 40 percent would be worth \$6,000 rather than \$10,000. Whenever a discount is used to value gifted property, it must be reported on the gift tax return and documented further with a discount appraisal.

The IRS has begun to successfully challenge minority interest and lack of marketability discounts in certain cases.²⁰ Transfers made within 3 years

before the taxpayer's death are vulnerable to IRS challenge. Where the IRS has been successful, the discount has been lost and the gifted property has been included back in the donor's estate. Successful challenges have involved taxpayers who placed assets in an entity but continued to enjoy the primary benefit of the assets. Factors that made the transfer vulnerable to IRS scrutiny included: a failure to observe the formalities required by the business agreement, distributions tied to meeting the donor's personal living expenses, and putting virtually all of the donor's assets into the entity without reserving adequate assets for his or her personal support. The IRS looks for factors suggesting an implied agreement that the donor will continue to enjoy all the benefits of the property during his or her lifetime in the same manner as before the entity was created. Commingling of funds or continuing to use entity property without payment of rent, for example, all suggest an implied agreement.

Courts have allowed a discount and recognized a transfer as legitimate where there was a substantial and legitimate business purpose for placing the assets into an entity.²¹ Gifts of an interest in an ongoing farming operation should fare well under this type of analysis where there is an ongoing family enterprise for profit and the gifts are made only to heirs actively involved in the farm business. Gifts of farmland to the farming heirs in the form of LLC units, however, may be vulnerable unless there are regular distributions under the terms of a business agreement and a fair market value rental is paid by the farm operation.



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The IRS has also challenged transfers of business interests where at the time of death the donor retained the right to determine distributions of income or controlled the timing of dissolution and liquidation of the company.²² In these cases, the IRS has argued that all the transferred shares should be pulled back into the donor's estate. The IRS position has been much criticized and the case law on this issue is complex and still evolving. Until resolved, business agreements should be structured to avoid IRS scrutiny. Agreements that hold a donor's decisions regarding distributions to a clear standard enforceable by a court of law or that otherwise restrict the donor's rights to designate who will receive distributions or liquidation rights should avoid IRS scrutiny. Transferring all controlling interests out of the donor's estate will most certainly avoid this problem.

Conservation Easements

Selling or donating a conservation easement can provide significant estate tax benefits. Farmland subject to a conservation easement is valued for estate tax purposes at its conserved value, which in most cases will be considerably less than its fair market value with full development rights. A farmland conservation easement that includes an option to purchase at agricultural value can provide a further reduction in value for estate tax purposes. (See "Easements with an Option to Purchase at Agricultural Value," page 40.)

Donating a qualified conservation easement can yield a further exclusion from the estate and a sig-

nificant reduction in the estate tax. The donation can occur even after death if the donor makes an election on the estate tax return. For donations of easements that reduce the property's value by at least 30 percent, the donor and his descendants may exclude 40 percent of the remaining value of the property from the gross estate. For example, if the property has a fair market value of \$500,000 and the easement reduces the value of the property to \$300,000, the estate could exclude \$120,000 (40% of \$300,000) of the property's value from the gross estate. The overall exclusion, however, is limited to \$500,000.²³ For a more detailed description of this provision prepared by the Vermont Land Trust, see: http://www.vlt.org/Tax_Benefits_Donating_Easements.pdf.

Estate Taxes on the Installment Plan

Farmers and other owners of closely held family businesses may be able to pay their federal estate taxes in installments of at least two, but not more than ten, annual payments.²⁴ They may also defer the initial payment of principal for up to five years, providing for a fifteen-year repayment period. To be eligible, the value of the farm business assets must exceed 35 percent of the adjusted gross estate. For example, if the farm is worth \$1,000,000, the gross estate may not exceed \$2,857,143. You may defer a portion of the tax liability that bears the same ratio to the tax due as the value of the farm bears to the value of the adjusted gross estate. For example, if the farm assets make up 40 percent of the estate,

you may defer 40 percent of the estate tax liability.

The value of a farm home and related improvements and homes occupied by farm employees may be counted toward the 35 percent requirement.²⁵

Principal payments may be deferred for up to five years, although interest on the unpaid tax must be made annually during the deferral period. After the deferral period, interest payments are made along with annual principal payments. If there is a sale or other disposition of more than 50 percent of the business, the time extension will be withdrawn and the tax will be immediately due and payable.²⁶

For deaths in 2004, the interest rate on the first \$532,000 of estate tax due was subject to a 2 percent interest rate. Interest on the portion in excess of \$532,000 was subject to an interest rate set at 45 percent of the IRS rate for underpayment of taxes, which is announced quarterly by the IRS and is currently set at 6 percent. (The amount subject to a 2 percent interest rate is indexed for inflation, so deaths in later years may enjoy a higher threshold.)

The Vermont Estate and Gift Tax

Vermont does not have a gift tax. Vermont does, however, have an estate tax. For many years Vermont imposed an estate tax equal to the maximum state death tax credit allowed under the federal income tax. The appropriate state credit for federal estate tax purposes was determined using a graduated rate table for the size of the estate. Tying the Vermont estate tax to the allowable federal credit had the effect of bringing in revenue to the state without adding to an individual's estate tax liability because the state just picked up an



amount equal to the state credit. Many states were using this “pick up” tax prior to the federal tax reform legislation in 2001.

In 2001, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) amended the federal tax code to gradually repeal the state death tax credit between years 2002 and 2005. The credit was gradually phased out and replaced with a deduction for state death taxes. To address the potential loss in revenue, Vermont amended its tax code. Under the new law, for decedent’s dying after January 1, 2002, the Vermont estate tax is equal to the amount of the estate tax death tax credit allowed under federal law in effect on January 1, 2001, before the passage of EGTRRA. By tying the state’s estate tax to the former credit amount, Vermont was able to make up at least some of the lost revenue resulting from tax reform. More changes may be in store if there are further changes to the federal estate tax.

Vermont provides an Estate Tax Worksheet with the E-1 Vermont Estate Tax Return. The worksheet provides a table for calculating the Vermont estate tax liability as pegged to the pre EGTRRA law. The table uses the taxpayer’s federal taxable estate – roughly the gross estate less any applicable federal exclusions or credits – less an adjustment of \$60,000. For decedent’s dying after December 31, 2004, with a federal adjusted taxable estate of \$1,540,000, for example, the Vermont estate tax was \$70,800. The worksheet is available at: <http://www.state.vt.us/tax/pdf.word.excel/forms/2005/e-1.pdf>.

In 2001, the Vermont legislature also passed an estate tax reduction for some farm estates.²⁷ Farms that are eligible to pay their federal estate taxes in installments under 26 U.S.C. §6166 described above may reduce their Vermont estate taxes significantly. The reduction is equal to the percentage that the value of the closely held farm business, as determined for federal estate tax purposes, bears to the value of the federal adjusted gross estate. If the farm business makes up 50 percent of the federal adjusted gross estate, the Vermont estate tax will be reduced by 50 percent.

The Generation Skipping Tax

Farm families passing significant assets to grandchildren should take the Generation Skipping Tax, or GST, into account when they plan. The GST is paid in addition to the estate tax. The law limits the amount any one individual can pass to his or her grandchildren free of taxation. The GST exemption for 2006 is \$2,000,000. The exemption will gradually increase through tax year 2009 to \$3,500,000 and, like the estate tax, will have a one-year repeal in 2010. In 2011 it will snap back to \$1,060,000. The purpose of the GST is to discourage wealthy families from transferring large sums of money directly to the third generation – in effect skipping a generation and avoiding one step of taxation. If significant assets are going to grandchildren, a Generation Skipping Trust limited to the available GST exclusion will ensure the full use of the GST exemption.

“Farm families passing significant assets to grandchildren should take the Generation Skipping Tax or GST, into account when they plan.”



Farm Transfer and Medicaid Planning

Medicaid is a joint federal and state poverty program that covers the costs of long-term nursing home level care for individuals who meet certain income and resource limits and who fit certain categorical eligibility requirements. The Medicaid rules governing allowable and available assets, income, and property transfers are complex. The rules are intended to reduce the costs to the public of providing long-term care by ensuring that resources available to the institutionalized family member are used before public support is utilized.²⁸

Many families plan ahead to preserve estate assets in the event that long-term care is necessary. They may convert assets considered available under the Medicaid rules to assets considered not available. In some cases, assets may be transferred to other family members outside the “responsibility group,” i.e., to those not financially responsible for the institutionalized family member. Post-death planning is also possible because in some cases, the Medicaid program seeks to recover its expenditures for long-term care after the death of both the institutionalized spouse and the community, or non-institutionalized, spouse.

Many attorneys in Vermont are skilled at helping families plan for or respond to a need for long-term nursing home care for a family member. This

section addresses only Medicaid planning in the context of farm transfer planning. How do typical farm transfer tools and strategies affect Medicaid Long-Term Care eligibility? What farm assets are considered available? This section focuses primarily on the implications of typical farm transfer strategies for Medicaid eligibility. It also addresses

the potential for the recovery of farm assets as reimbursement for long-term care costs.

Medicaid rules in effect prior to February 8, 2006 balanced budgetary concerns with measures designed to avoid the liquidation of a family business, particularly where the family business is the sole source of support for heirs. Federally man-

The Deficit Reduction Act of 2005

On February 8, 2006 Congress passed the Deficit Reduction Act. DRA made several significant changes to the Medicaid program. The Congressional Budget office estimates a savings of \$6.4 billion over the 2006-2015 periods by increasing the penalties for transferring assets for less than fair market value and other changes. In summary, the DRA made the following changes to the Medicaid program:

All transfers will have a five year look back period rather than

three.

The penalty period for transfers made during the look back period will begin at the time of program eligibility rather than at the time of the transfer.

Individuals with home equity in excess of \$500,000 will not be eligible for Medicaid.

Applicants with annuities must name the state as a remainder beneficiary to the extent of program expenditures for their care.

Vermont's Department for Children and Families that

administers the Medicaid program will have to promulgate new program rules to come into compliance with the federally mandated changes under the DRA. The DRA provides that the transfer rules are to be effective as of February 8, 2006 although the state continues to process applications under the old rules. As of this writing (April 2006) it is unclear whether applications granted under the old rules will be reviewed once the new rules are promulgated.



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dated changes to the Medicaid rules passed in the Deficit Reduction Act of 2005 will make it much more difficult to integrate Medicaid eligibility with farm transfer planning, however. The changes to Medicaid significantly increase the program penalties on individuals who transfer assets for less than fair market value in order to qualify for Medicaid.

The Vermont Agency of Human Services will be promulgating new administrative rules to bring Vermont into compliance with the federally mandated changes. The federal law, however, mandates an effective date for some of the changes of February 8, 2006. As of this writing, the Agency hasn't made it clear whether cases granted in the interim will be reviewed once the new Vermont rules are in place, making planning that much more difficult.

Resource Limits

Medicaid will consider the assets of everyone in a "responsibility group" in determining eligibility. Generally, a responsibility group is composed of spouses, parents, and their dependent children, parties to a civil union, or others who may be financially responsible for the institutionalized family member.

For 2005, the maximum resource limit for the community spouse – the non-institutionalized spouse – was set at \$95,100²⁹ in cash or other property. The institutionalized spouse may have \$2,000 in resources. The institutionalized spouse

may transfer property to the community spouse in order to meet the eligibility requirements.

Excluded Property

Certain kinds of real property are excluded, meaning they are not counted towards the resource limit in determining eligibility for Medicaid long-term care coverage. But remember that even though these assets may not be considered available to cover the costs of care, they may still be subject to a claim by Medicaid for recovery of the costs of care after the death of both the institutionalized and the community spouse. In addition, pre-application transfers of certain property for less than fair market value may lead to a period of ineligibility. (See "Asset Recovery" on page 64 and "Permitted and Penalized Transfers" on page 62.)

A Home and Contiguous Land

Under the current Vermont Medicaid rules, a person's principal place of residence, regardless of its value, is excluded.³⁰ The exclusion extends to the home itself as well as to any contiguous land and other buildings on the land. Thus, an entire farm and anything growing upon it can be excluded, provided the land is "contiguous." A road running through the property does not affect the exemption, but an intervening parcel owned by another does affect it.

The exclusion applies even if the owner must

be away from the home while receiving long-term care, provided the person intends to return to the home or a spouse or dependent is living there. Even if returning to the home isn't a likely prospect, the exclusion can still apply if there is some indication that the homeowner intends to return. It's a good idea for the homeowner to express the intent to return home in a power of attorney or another estate planning document should they require institutionalization.

Under a rule that appears to defy all logic, homes that have been placed in a revocable living trust are not excluded by Medicaid.³¹ If the home is in a revocable living trust, Medicaid will treat it as available. The home, however, may be transferred out of the trust prior to application for Medicaid and will then be considered excludable. The reasoning for this rule may be the fact that property placed in a revocable living trust will avoid probate. Medicaid's primary method of recovering costs from beneficiaries is through the probate process. By forcing homes out of trust, they improve their recovery prospects.

The Deficit Reduction Act of 2005 will require Vermont to change its rules to exclude individuals from eligibility who have an equity interest in their home in excess of \$500,000. The dollar amount allowed will be increased beginning in the year 2011 in \$1,000 increments to keep pace with inflation. The rule won't apply if there is a spouse or minor or disabled child living in the home. The law also allows for a hardship waiver.³²



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Jointly Held Real Property

The current Vermont Medicaid rules will exclude jointly owned real estate in some cases. Real estate held jointly as tenants in common or as joint tenants may be excluded if:

1. The other joint owner refuses to sell, **and**
2. The joint interest was created before July 1, 2002, **or**
3. The joint interest was created more than 36 months before the date of application for long-term care coverage.³³

The Deficit Reduction Act of 2005 will require Vermont to amend their Medicaid rules to impose a 60 month look back period rather than a 36 month look back for transfers made after February 8, 2006.³⁴

Thus, real estate owned jointly by both the senior and junior generation may be excluded depending on when it was transferred. If the transfer was made within the applicable look back period the entire value of the jointly held resource is usually considered available. Whether the property is held as joint tenants, tenants in common, or tenants by the entirety, Medicaid will count the entire asset unless you can establish that the other co-owners purchased their shares of the property.³⁵ If a purchase can be established, Medicaid will count only the applicant's proportional share.

When the farm real estate is owned jointly but in the form of units in an LLC or shares in a corporation, the rules with respect to exclusion and valuation of an institutionalized spouse's interest are not at all clear. Medicaid does have general rules on jointly held resources.³⁶ These rules are very specific with respect to property held as joint tenants, tenants in common, or tenants by the entirety but provide little specific guidance on valuation of jointly held business assets such as LLC units or shares in a farm corporation.

"Generally, resources are counted based upon their availability and the ease with which they can be converted into cash. Availability is often affected when more than one person has an ownership interest in the same resource."³⁷ Presumably, availability, as well as the value of an LLC unit, would be a function of the LLC operating agreement. For example, operating agreements that limit re-sale of units to other family members or require all members to agree to a sale outside the family and other factors that also suggest a lack of marketability might arguably lead to either a discounted – less than fair market value of the underlying assets – valuation or a determination that the asset is not available and should be excluded. On the other hand, operating agreements with well-defined valuation procedures and buy-sell rights among members might be valued closer to the proportionate share of the fair market value of the underlying asset.

According to the Vermont Medicaid office,

they have not yet been faced with the question of whether to exclude or how to value LLC units.

Livestock and other Farm Chattels

Many farm states exclude the value of livestock and equipment if it is used to produce income. Vermont exempts home furnishings and household goods, including tools, equipment, and other property required or essential to self support.³⁸ While the Vermont rules don't specifically mention livestock, for many farm families, they are essential to self support.

Life Estates

A life estate is an interest in land that endures for the life of the life tenant. Where there is a life estate, there must also be a "remainder interest" in the property that will pass to whomever is to take the property at the death of the life tenant. If the owner of the life estate does not retain the power to sell or mortgage the "remainder interest," Medicaid will exclude its value. If, on the other hand, the life estate owner retains the right to sell the entire property, which is also called a "life estate with powers," the life estate is considered an available resource unless it can be excluded on some other basis. For example, even a life estate "with powers" is excluded if it is the individual's home.³⁹

The Deficit Reduction Act of 2005 requires Vermont to amend their Medicaid rules to provide that a purchased life estate will be included as an asset unless the purchaser has lived in the home for



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at least one year after the date of purchase.⁴⁰

Transferring a home to heirs while retaining a life estate is a common strategy for preserving estate assets from the costs of long-term care. The elder retains the right to occupy the home during his or her lifetime. Its value is considered unavailable for the purposes of Medicaid. At the death of the elder, title to the whole property passes automatically to the heirs without having to go through probate and with a stepped up basis. Avoiding probate also avoids any asset recovery claims that Medicaid may file. This strategy is further discussed in “Asset Recovery” on page 64.

Income Producing Real Property

Farmland that is producing significant income is also excluded. The property must, however, be returning at least 6 percent of its fair market value in net annual income after deducting allowable expenses related to producing the income. Most farmers would have a difficult time meeting this threshold. Thus, farmland that is not contiguous to the home farm would only be excluded if it were returning an adequate net income.⁴¹

Life Insurance

Whole life insurance owned by either spouse with a cash value of up to \$1,500 is excluded. If it has a value of more than \$1,500, it is included. Whole life insurance that is purchased for use in a business buyout or for estate taxes or other liquidity needs related to farm transfer planning purposes should be titled appropriately to the business or

to the junior generation. Term life insurance is excluded by Medicaid.⁴²

Cash Necessary to Operate the Farm

Medicaid also excludes cash needed to run the farm business. Up to three times the monthly average cash operating expenses for the past twelve months can be excluded. Tax returns, business receipts, and expenses may all be used to determine the monthly average.⁴³

Savings Bonds

Savings bonds purchased before June 15, 2004, on which the minimum retention period expires thereafter, are excluded by Medicaid unless they are redeemed, exchanged, surrendered, reissued, or otherwise become available. However, savings bonds purchased after June 15, 2004, will not be excluded unless the owner requests and is denied a hardship waiver based on medical need from the U.S. Department of Treasury.⁴⁴ If the waiver is denied, the savings bond will be excluded until its minimum retention period expires.

Other Exclusions

An automobile, regardless of its value, is excluded. A farm truck may also be excluded if it is used to provide transportation. A burial fund of up to \$10,000 is also excluded.

This is by no means an exhaustive list. See the Vermont Department for Children and Families (DCF) rules for a complete list available on line here: <http://www.dsw.state.vt.us>.

Permitted and Penalized Transfers

Certain transfers of income or resources by anyone in the financial responsibility group to someone outside the responsibility group may be penalized by Medicaid. These disfavored transfers may result in a period of ineligibility for coverage. How long the period of ineligibility lasts is a function of the date of the transfer and the value of the resource transferred.

Any transfer for fair market value is allowable. Thus, where the junior generation is purchasing a share of the farm or farming operation, no penalty period results as a result of the transfer of farm assets. However, these transactions should be well documented, especially where a junior member is contributing sweat equity for a share of the farm.

In addition, transfers of income or resources other than a home that would have been excluded are also allowable.⁴⁵ The transfer of an automobile, for example, would not result in a penalty period because an automobile of any value is an excluded resource.

Certain transfers for less than fair market value are also allowable. With the exception of certain kinds of property transferred to a trust, as discussed in “Transfers of Property to a Trust” on page 63, the current Medicaid rules in Vermont provide that any transfer made more than 36 months prior to the date of application will not result in a penalty period. As a consequence, if a gifting of farm assets is made 36 months prior to the date of application, it should not result in a period of ineligibility.



FARM TRANSFER AND ESTATE PLANNING

The Deficit Reduction Act of 2005 will require Vermont to amend their rules to provide a 60 month look back period for transfers occurring after February 8, 2006.⁴⁶

Under the current rules a transfer by gift of farm assets made within the look back period may be allowable if the applicant can demonstrate that the transfer was made exclusively for a purpose other than qualifying for Medicaid.⁴⁷ For any transfer, there is a rebuttable presumption that the transfer was for the purpose of establishing eligibility for Medicaid. To overcome this presumption, the applicant must present convincing evidence that the resources were transferred exclusively for another purpose. The Medicaid rules include a number of examples of convincing evidence, as listed below.

Examples of evidence from the Medicaid rules include:

- The transfer was not within the individual's control, e.g., was ordered by a court;
- The individual could not have anticipated long-term care eligibility on the date of transfer, e.g., the individual became disabled due to a traumatic accident after the date of transfer; or
- A diagnosis of previously undetected disabling condition leading to long-term care eligibility was made after the date of transfer.⁴⁸

Regular gifting of farm assets, as part of a farm

succession plan, should arguably fit within this rule. Convincing evidence in this context might include:

- An operating agreement or partnership agreement indicating that a primary purpose of the entity is to facilitate an orderly transfer of the farming business from one generation to the next.
- A written business or farm succession plan outlining an orderly annual gifting plan to transfer the farm to the next generation.
- A consistent pattern of gifting initiated during a period in which a need for long-term care could not have been anticipated.

The Vermont Medicaid office has said that this exception has never been used in the context of a farm or small business succession. Establishing this rule's applicability to avoid a penalty period might require using the administrative appeals process or litigation. It is also unclear how and whether the amendments which must be made as a result of the Deficit Reduction Act might affect this rule. Some commentators suggest that the purpose of the transfer is no longer relevant and that even if the transfer is made for a purpose other than qualifying for Medicaid it will be penalized.⁴⁹

Transfers of Property to a Trust

A transfer of assets other than a home to a revocable living trust can result in a penalty period unless the transfer occurred 60 months prior to the ap-

plication for long-term care coverage or in the case of an irrevocable trust, 36 months before applying for long term care.⁵⁰

As discussed above, under a rule that appears to defy all logic, a home placed in a revocable trust is always considered available regardless of when it was placed in trust.⁵¹ The home, however, can be removed from the Trust and will then be considered an unavailable resource. The reasoning for this rule may be the fact that property placed in a revocable living trust will avoid probate. Medicaid's primary method of recovering costs from beneficiaries is through the probate process. By forcing homes out of trust they improve their recovery prospects. (See "Asset Recovery" on page 64.)

Revocable trusts are good planning tools for transferring a family business. A successor trustee can oversee assets until the heirs are capable of taking over the business, for example. There are good reasons to put family business assets into a revocable living trust irrespective of how Medicaid might treat the transaction. Given the 60 month rule, however, it would appear that the sooner families utilize this planning tool, the better.

For some trusts — those which are irrevocable and where no disbursements for the benefit of the applicant are allowed — the look-back period is just 36 months.⁵²

The Penalty Period

If a transfer is disallowed — as is a transfer made during the look-back period — Medicaid will impose a penalty period during which no payments



will be made for long-term care services.⁵³

The penalty period is equal to the total value of all disallowed transfers made during a given calendar month divided by the average daily cost to a private patient of nursing facility services as of the date of application.⁵⁴

Under the current rules the penalty period begins on the date of the transfer and as result quite often the penalty period has expired long before the individual requires care. For example, assume a grandmother makes a one-time transfer of her farm partnership interest to her grandson. Her capital account indicates that her partnership interest is worth \$100,000.⁵⁵ Assume further that 24 months later she applies and is eligible for Medicaid long-term care coverage. Assuming an average daily cost for nursing facility care in Vermont of \$150, the penalty period would be 667 days (\$100,000 divided by \$150) or nearly 23 months. The penalty period would expire before she needed coverage.

The Deficit Reduction Act of 2005, however, will require Vermont to amend their rules to begin the penalty period on the date the individual otherwise becomes eligible for Medicaid. In the above example, the Grandmother would be denied coverage for 23 months after her application and qualification for Medicaid.

Under the current rules and under the Deficit Reduction Act, Medicaid will not establish a penalty period where it would result in an undue hard-

ship. The Medicaid rules include several examples of undue hardship including the following: Where “funds can be made available for medical care only if assets such as a family farm or other family business are sold, and the assets are the sole source of income for the individual’s spouse, parents, children or siblings.”⁵⁶ The Deficit Reduction Act directs each state to provide an application for an undue hardship waiver where the penalty period would deprive the individual of medical care such that the individual’s health or life would be endangered or the individual would be deprived of food, clothing, shelter or the necessities of life.⁵⁷

Asset Recovery

Federal law requires states to recover assets from the estate of any institutionalized family member over age 55 to offset the costs of the long-term care paid for by Medicaid. The Vermont Department for Children and Families will file a claim with the probate court as a creditor of the estate for these expenditures only after the death of the surviving spouse.⁵⁸

Because the Department’s only means of recovery to date is through probate, non-probate assets are not subject to recovery. Non-probate assets include property that passes automatically at death, such as property held in joint tenancy, the remainder interest in a life estate, or assets that were trans-

ferred to a living trust. The Department will file a claim with the probate court as a creditor of the estate to recover its expenditures for long term care – but only after the death of an individual’s surviving spouse.

The following exemptions apply to property that goes through probate:

- Homestead property with a value of less than \$250,000 is exempt from estate recovery where a sibling, a child, or a grandchild will inherit the property and the heir either meets certain income guidelines – 300 percent of poverty – or they provided significant services or financial support that enabled the person to avoid or delay long-term care.⁵⁹
- There is also an undue hardship exemption from estate recovery. Heirs may seek an exemption when recovery of an income-producing asset – such as a farm or other business asset – would create an undue hardship to the decedent’s family members.⁶⁰ When the assets alone or in combination with other assets are the sole source of income for the decedent’s spouse, parents, children, or siblings, or where recovery would render these family members eligible for public assistance, the Department for Children and Families will not seek recovery.⁶¹



Medicaid Eligibility and Permitted Transfers in Vermont

Allowable Assets:

- \$95,100 in cash or other property (non-institutionalized spouse)
- \$2,000 in cash or other property (institutionalized spouse)
- For applications made after January 1, 2006, individuals with more than \$500,000 equity in a home are not eligible.

Excluded Property:

- A home and contiguous farmland regardless of value (unless in a revocable living trust).
- Some jointly held real property if joint interest created 36 months prior to application or 60 months for transfers after February 8, 2006.
- Income producing livestock and equipment if essential for self support.
- A life estate in real estate (if owner of life estate does not retain power to sell or mortgage the remainder interest).
- Farmland (not contiguous to a home)

earning a net annual income of at least 6 percent of its fair market value.

- Cash necessary to operate the farm.
- Auto/farm truck used for transportation.
- Other exclusions: see DCF rules.

Permitted Transfers:

- Transfers for fair market value.
- Transfers of excluded property, other than a home.
- Transfers, other than to a trust, of property made at least 36 months prior to the date of application, or 60 months for transfers after February 8, 2006.
- Transfers of property, other than a home, to a revocable living trust if made at least 60 months prior to application.
- Transfers to irrevocable trusts for the benefit of another if made at least 36 months prior to application, 60 months for transfers after February 8, 2006.
- Transfers made exclusively for a purpose other than qualifying for Medicaid. Client must establish with evidence such as a farm transfer plan, pattern of transfer, etc.