Parents pass down a ‘gift that keeps on giving’

Originally published July 21, 2012. Download a pdf of the original story here.

The first official day in my farm estate-planning career was July 1, 1992.

At 22 years of age, I journeyed into business with a limited knowledge of the technical aspects of estate- and farm-continuation planning.

The man responsible for my initial training taught me many lessons. One of the most important was, “If you give a hungry man a fish he will soon be hungry again and asking for more.

"If you teach a hungry man how to fish, he will be able to repeatedly feed himself and his family and will never be hungry again."

Reflecting on the past 20 years, it is apparent successful farm families have been able to promote this type of self-sufficiency at a high level.

Respect, diligence, faith, responsibility and stewardship have been a cornerstone of agricultural life. Passing these traits to the next generation is sort of "a gift that keeps on giving."

Economics, demographics

A common goal for most families is the pursuit of a self-sustaining operation while protecting the most significant asset in the farm estate – the land.

Escalating land values have significantly affected recent estate and farm-continuation planning. What will it take for land values to come back to a "normal" level?

The textbook economic answer for lower land values are increasing interest rates, lower commodity prices, increased demand for alternative investments relative to the demand for farmland or a combination of all of these factors.

In my opinion, these long-established economic indicators ignore the most important factor in land prices in the recent past and the near future – the demographics of the majority of land owners.

Currently, 65 percent of all of the land is owned by people who are 60 years and older. This age group is conservative. They are not spenders.

They have accumulated land at a relatively low acquisition cost, and they will pass on in the next two decades.

This age group has a majority of their land paid for and has immense equity and cash flow to subsidize land purchases at unreasonably high prices.

We refer to this as a “rob from Peter to pay Paul” event.

This model has been and will continue to be the driving force behind land values until this age group transitions their land to multiple heirs.

Eventually, supply will be greater than demand, creating a period of opportunity to acquire land.

Those estates that divide the land will be at a competitive disadvantage by either losing purchasing power or by being over-leveraged in an attempt to keep their land holdings together.

Those families, who have a plan to keep the land together as a unit with a smaller debt load, will maintain purchasing power and have greater opportunity in a market with an increasing number or sellers and a shrinking number of buyers.

Continuation example

We discussed this concept in a review appointment this week with a respected long-time client. They are 80 years old, have three children and have accumulated 1,200 acres. One child farms.

Years ago, we created a plan to divide their land into three heritage trusts at their death.

Each child would receive income from their respective trust after the death of the surviving parent.

The remainder would be divided by the grandchildren equally after the death of the children, effectively skipping a generation of estate tax.

They currently receive nearly $400,000 of income from rent each year and have a taxable estate of about $14 million.

Under current law ($5.12 million federal estate tax exemption with a 35 percent tax), they would owe about $1.3 million of federal estate tax.

Without a tax-law change, in an election year, when tax cuts seem easier said than done, the exemption is scheduled to reduce back to $1 million with a 41-55 percent graduated tax rate on Jan.

1, 2013.

The federal estate tax estimate for this family, if they passed in 2013, would be as much as $6 million.

We assume the exemption equivalent will not revert to $1 million, but this conservative couple is not willing to gamble $6 million in potential tax.

Rather than dividing 1,200 acres into three trusts of 400 acres each and losing purchasing power, this family plans to establish a land company (an LLC or an LLP) that will maintain all 1,200 acres as a common unit.

Mom and Dad are willing to gift each of their lifetime exclusion of $5.12 million to a trust for their children and grandchildren to use the credit before it has a chance to revert to $1 million.

If they transferred 80 percent of the newly created entity, they would have gifted nearly $9.6 million and successfully used a majority of their lifetime gift exclusions.

The entity will have rules for the management of the land (lease and sale) that will live beyond Mom and Dad.

Rent will come into the entity and be divided proportionately to each of the ownership interests of the family.

In this example, the children and grandchildren would receive 80 percent of the annual income ($320,000). Mom and Dad would retain 20 percent of the income ($80,000).

Over 10 years, this would keep $3.2 million of future income from stockpiling back in their estate.

This is the gift (80 percent of the land entity today) that keeps on giving ($320,000 of future annual income).

This strategy accumulates massive income and estate tax savings for the family.

The family will apply for a discount on the gift transaction of 15-25 percent due to lack of marketability and control of a minority interest (less than 50 percent ownership).

A 25 percent discount on 1,200 acres valued at $12 million creates a discount of $3.5 million and could eliminate their current estate tax estimate of $1.3 million.

End result

This family decided to maintain the purchasing power of their greatest asset in an entity that can take advantage of the current lifetime gift exclusion with rules for farm management and the potential to discount land values for estate-tax purposes while allowing each child and grandchild an opportunity to be equal stewards of the land.

Future growth and excess income will be outside of their taxable estate as well.

Whether teaching your children “how to fish” or establishing an estate plan that maintains the purchasing power of your accumulated land, consider continuing the legacy that has been entrusted to us from past generations.

As we approach 2013, consider looking at multiple-planning opportunities to put your estate in a position of competitive advantage.

It may not be this identical strategy but with effort and research you will find a strategy that is right for your family.