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**Basic Estate Planning Fact Sheet Series**

# Miscellaneous Issues

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There are several issues dealing with large estates or dealing with business planning that we would like to address. These may not impact as many people so we have not raised them until the last fact sheet. The miscellaneous issues we want to address are Conservation Easements, Generation-Skipping Trusts, and Limited Liability Companies. Although another fact sheet series could be developed just on business planning and entity selection, we want to make you aware of some basic issues surrounding limited liability companies because they are becoming so popular for business planning.

## Generation-Skipping Trusts

The term "generation-skipping" makes some people think they are disinheriting their children in favor of their grandchildren. While that could be the case, most generation-skipping plans benefit children as well. Generation-skipping features of estate plans are becoming a more important part of an overall estate plan. This section will address some of the issues related to making decisions regarding generation-skipping estate plans.

### Positive Aspects

There are two primary benefits of a generation-skipping estate plan. To begin with, it can create significant estate tax savings. However, it is important to realize that this type of estate plan does not save estate taxes in the parent's estate, but in the estates of children or grandchildren. For example, if a single child has a $1 million estate of his or her own and would inherit $400,000 (this could be in the form of cash, stocks, land or other assets) from the child's parents, a generation-skipping trust for the $400,000 could save almost $200,000 in estate taxes when the child dies in 2011 or after. This savings could be even greater if the assets appreciate in value prior to the child's death or less depending on what the applicable exemption amount for federal estate tax is in the year of the child's death. Also, this

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estate tax savings may occur in the estates of grandchildren, great-grandchildren, and/or more remote generations.

In addition, a trust may be drafted to provide protection against the creditors of your children in the event of financial difficulty. This can include some protection in the event of a divorce. The protection is not unlimited, and creditors for delinquent child support or for necessities such as food, clothing, and shelter have had some success in reaching the assets of a trust. However, in most situations parents want their children to have such necessities. A divorce court should not be able to transfer assets in such a trust to the spouse. However, the court could consider the trust as a resource in determining the appropriate level of alimony.

**Negative Aspects**

The two primary negative aspects of a generation-skipping transfer relate directly to the two primary benefits. First, because the trust will not be taxable for estate tax purposes in the estates of your children, your grandchildren will not receive a "step-up" in basis for income tax purposes after the death of your children. For example, let's say a farm is worth $2,000 per acre at your death and the farm is worth $3,000 per acre at the death of your children. If you gave the farm to your children directly, the entire value of the farm would be in the taxable estate of your children for estate tax purposes. If the children's estate is in excess of the federal exclusion that year, the value of the farm in the child's estate could be subject to federal estate tax ranging between 41% and 55% depending on the year of death. However, if your grandchildren then sold the farm for $3,000 per acre, no income tax would have to be paid on any capital gains because of a "step-up" in basis to $3,000 per acre for income tax purposes at the death of your children. On the other hand, if you gave the farm to a generation-skipping trust for the benefit of your children during their lifetimes and then to grandchildren, the federal estate tax is avoided in the estates of your children, but your grandchildren would have a basis for income tax purposes of only $2,000 per acre. If your grandchildren decided to sell the farm for $3,000 per acre, they would have to pay income tax on the $1,000 of capital gain ($3,000–$2,000). The maximum federal capital gains rate is currently 15%, which is considerably less than the federal estate tax. This is likely to increase in 2009 but still be well below estate tax rates. The maximum Ohio income tax is currently around 6.555%.

Therefore, if your children's estates are, or will be large enough to be subject to federal estate tax, this negative will be less than the benefit of the estate tax savings, so a generation-skipping trust will 1) minimize the tax rate and 2) defer the payment of tax indefinitely until a sale is made and cash is available to pay the tax. If your children's estates will not be subject to federal estate tax, a generation-skipping trust will still help avoid Ohio estate taxes and defer the payment of tax indefinitely until a sale. This is fine if your family plans to hold onto the farm for the foreseeable future. Although, if your children's estates will not be subject to federal estate tax and if a sale is planned in the near future, the generation-skipping trust might cause more tax to be paid in the end than if the trust did not exist.

In some cases it may be hard to know whether your children will be subject to federal estate tax. In fact, if a death were to occur in 2010, the child's entire estate will be exempt from federal estate tax. The facts and desires related to each family need to be examined on a case-by-case basis to see if generation-skipping trusts make sense.

Finally, because the trust is generally not subject to the claims of creditors, the trust assets are not available to secure the personal debts of your

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children. The trustee in its capacity as trustee may buy and sell property and borrow money using trust assets as security. However, this activity occurs within the trust and does not relate to personal obligations. Further, it is much less complicated from an accounting standpoint to avoid debt all together within the trust.

### Limitations on Generation-Skipping Transfers

Because of the large potential tax savings that could result from such a trust, the government has placed some limitations on the amount of generation-skipping transfers that may be made without causing the transfer to be subject to a 45% tax in addition to the gift or estate taxes payable. Each person may transfer up to $2,000,000 in a generation-skipping transfer free of generation-skipping transfer tax in 2008 and up to $3,500,000 in 2009. In addition, gifts each year that do not exceed the $13,000 annual exclusion for gift tax purposes, or that are made directly to a qualifying school for tuition expenses or directly to a medical provider for health care expenses also avoid the generation-skipping transfer tax.

However, if the annual exclusion gifts are made through the use of a trust, additional requirements must be met in order for the gift to qualify for the annual exclusion for generation-skipping transfer tax purposes. Accordingly, it is possible for a gift to qualify for the annual exclusion for gift tax purposes but not for generation-skipping transfer tax purposes.

In most cases, if the estate, after paying estate taxes, exceeds the exemption amount for generation-skipping transfer tax purposes, the excess generally should be distributed directly to children. There are some exceptions where paying the generation-skipping transfer tax on a direct skip to grandchildren will minimize the total tax liability, such as where the entire family is extremely wealthy or where the children have sizeable estates and are not expected to live a long time.

Historically, Ohio law required a trust to terminate at an arbitrary point in time. In general, the trust could continue for twenty-one years after the death of the last to die of the person's lineal descendants living at the date of the person's death. As of March 22, 1999, a trust now can be prepared so that the assets held by the trust, whether cash, stock, land or any other assets, will never be subject to estate tax at the death of the children or younger family members, based on current laws, for as long as it remains in the trust. The trust must in some manner expressly indicate that the rule against perpetuities does not apply and either the trustee must have an unlimited power to sell all trust assets or someone else must have an unlimited ability to terminate the entire trust. It probably makes sense to set the trust up from the outset with the potential to last forever, but give each generation the right to terminate the trust as to future generations. This gives the maximum flexibility in deciding how the trust will be administered.

These factors present a big opportunity for planning for very wealthy families in 2010 even if the estate planning laws do not change. Since there is no federal generation-skipping transfer tax in 2010 and the maximum gift tax rate only for 2010 is 35%, you may be able to transfer large sums to a generation-skipping trust with relatively low transfer tax cost and have it outside of the estate tax system forever, even if the laws do not change. However, you will pay gift tax for gifts exceeding the $1,000,000 gift tax exclusion.

### Conclusion

As you can see, there are many tax issues to consider when deciding whether a generation-skipping trust is appropriate for your family. The tax savings can be significant to your children

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and grandchildren. At the same time, you may be able to accomplish other family objectives, such as protecting the family's resources from creditors or making sure that some assets will be available to help pay for the educational expenses of your grandchildren. It could also be used to protect the family farm for generations. In many cases you will need to communicate with your children to know whether this type of trust is suitable for your family or whether it is even desired. We know that this is not for everyone, but we encourage you to consider whether it makes sense for you.

## Limited Liability Company

A limited liability company (LLC) is an extremely flexible entity of choice for business purposes. It provides the limited liability protection of a corporation with the option of taxation as a sole proprietorship if a one-member company or as a partnership or a corporation (C or S) if more than one member. It has Articles of Organization, similar to Articles of Incorporation for Corporations, which are filed with the Secretary of State. It has an Operating Agreement, similar to a Partnership Agreement and Bylaws. We would also encourage the use of buy-sell provisions. The owners are called members (instead of partners or shareholders) and the ownership interest is called a membership interest (like a partnership interest).

LLCs are relatively new in Ohio; the law became effective July 1, 1994. They have been used in this country since 1977. However, the form has been used for a long time in Europe and South America. It was developed in Germany in 1892. (When you see GmBH behind a German company name, it's a limited liability company.) Part of the United States' slowness in accepting the idea was waiting to see if the IRS would actually permit partnership tax treatment. The IRS has done so, and the rulings coming down have been quite favorable. Social Security and Workers' Compensation treat members as they would partners in a partnership. Members will be treated as self-employed, unless the member is not a manager and would be considered a limited partner if the business had been formed as a limited partnership.

LLCs do have some limitations. For crop farmers concerned about government payment limitations, a general partnership will give the business more "persons" than an LLC. Also, the IRS has not ruled on some tax issues, although this is becoming less of a concern because so many of the rulings have been favorable. Because they are new, some professionals are hesitant to work with them. You need to make sure your accountant is comfortable with the idea. An LLC also may become cumbersome to use if the business covers several states.

Compared to limited partnerships, LLCs provide liability protection for everyone, regardless of their involvement in day-to-day management. As with any entity, you may still be liable personally for your personal acts, such as if you were driving a vehicle owned by the LLC and cause an accident. In limited partnerships, only limited partners have liability protection and then only if they do not participate in daily decision making. General partners are treated as partners in general partnerships and have no limited liability protection. In other words, LLCs provide more flexibility in who can be involved in management decisions without worrying about losing limited liability protection. Other than these factors, a limited partnership and LLC are nearly interchangeable. Both would serve you well as a land-holding entity and provide you with a way to transfer ownership interests to the next generations.

We have used limited partnerships and now limited liability companies for a number of years

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in estate planning. Because so many families have a large percentage of equity in real estate, they find it more difficult to make gifts to decrease the size of their taxable estates. An LLC or limited partnership is a tool to make gifting easier by giving membership or partnership interests. Using an LLC or partnership as a separate land-holding entity may also provide a way to involve all the family in the dirt that holds an attachment for them, while keeping off-farm children out of the operating entity. You can structure the operating or partnership agreement so that the managers or general partners are also the persons operating the family business. In the buy-sell, the managers/general partners can have a right to purchase the other members'/partners' interests. This also works well in situations where spouses have contributed to land purchases but are not owners of the operating business. The separate land-holding entity gives them the ownership rights reflecting their contributions. In addition to the management benefits, an entity often allows for valuation discounts for gift and estate tax purposes. The discounts range in value based on the facts and circumstances in each case, but a typical discount for a minority interest in the business entity is thirty-five percent. The IRS recently has had some success in attacking the discount concept, so it is important to pay close attention to how the company documents are prepared and to revisit old documents.

Limited Liability Companies are becoming more and more popular because of their flexibility for income tax purposes and for the additional liability protection provided by the company as compared to a limited partnership or sole proprietorship. With all of its advantages, there are still some situations where the other entities may be a better fit for what you hope to accomplish.

## Conservation/Agricultural Easements

The purchase of development rights, or purchase of an agricultural easement has brought conservation easements into the limelight in the agricultural community. Among conservationists, conservation easements have been used and in existence for years, but agricultural easements have become popular only recently in Ohio. In the case of a conservation easement, land in a natural state is prohibited from development, whereas by an agricultural easement farmland is prohibited from non-agricultural development. Forest, grassland, historic, and open space easements also protect those private lands from development. During the rest of this fact sheet, all of the above easements will be lumped together under the descriptor of conservation easement.

### What is an easement?

The conservation easement is a legally binding covenant that is publicly recorded and runs with the property deed for a specified time or in perpetuity. It gives the holder the responsibility to monitor and enforce the property restrictions imposed by the easement for as long as it is designed to run. An easement does not grant ownership nor does it absolve the property owner from traditional owner responsibilities, i.e., property tax, upkeep, maintenance, or improvements.

An easement is the legal instrument to make binding the retirement of most development rights. The development rights are not transferred, but instead extinguished. Usually when we think of an easement, we think of putting into writing permission for someone other than the owner to use the land in a very specific way. In the case of conservation easement, the landowner is granting to a land trust, conservancy, or government agency the right to enforce the

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extinguishment of the terminated development rights.

Even though property in its entirety can be transferred to an entity to protect the property from development, and often is, with an easement, only the right to protect the property from development is transferred. Keep in mind that there are costs to protect the property, so that some property owners may be asked to fund annual monitoring and maintenance costs of easements when donated to a nonprofit organization.

### What is the landowner giving up with an easement?

Property owners should keep in mind that once the authority to protect the property from development is granted, neither the granting property owner nor future owners can dissolve that power, even if a change of mind occurs. For that reason it is imperative that much thought be given to designate future development thought to be appropriate by the grantor.

A conservation easement is designed to protect a property according to the owner's wishes. The landowner determines what is prohibited and what rights are given to the land trust/conservancy/government agency. Common rights reserved by landowners are for restricted home sites on predetermined sites for children and grandchildren to build houses if they so choose. In the case of farmland, development necessary for continuation of a viable farming operation is allowed, such as building barns. Common rights given the land trust/conservancy/government are access once a year to assure and document that the easement restrictions have been followed. The right for public access is usually not included in a conservation easement.

The owner of the property is the only one who can decide to place an easement on his or her property. When a property is owned by several individuals, all owners must agree to place the easement. If the property is mortgaged, the mortgage holder must also be in agreement for the easement to be placed. A conservation easement is a voluntary land-protection tool that is privately initiated.

### What are the responsibilities of the easement holder?

Whether the easement holder is a public or nonprofit organization, the holder has the responsibility to enforce the requirements stipulated in the easement. This responsibility generally includes:

a. Establishing baseline documentation through ensuring that the language of the easement is clear and enforceable, developing maps, property descriptions and baseline documentation of the property's characteristics.

b. Monitoring the use of the land on a regular basis. This may require personal visits to the property to ensure that easement restrictions are being upheld.

c. Providing information and background data regarding the easement to new or prospective property owners.

d. Establishing a review and approval process for land activities stipulated in easement.

e. Enforcing the restrictions of the easement through the legal system if necessary.

f. Maintaining property/easement related records.

### Tax Benefits

There can be income tax and estate tax benefits to donation of an easement, but the operative words here are charitable donation, not sale. The Agricultural Easement Purchase Program (AAEP) offered by the Ohio Department of Agriculture (ODA) is at most a 75% purchase

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and at least a 25% charitable donation. Because the AAEP is available only to a select few chosen by ODA each year, sale or partial sale of development rights is generally not available to most farmers in Ohio. Also, the tax benefit even with AAEP is from the donation portion. Therefore, the tax benefit portion of this fact sheet will concern donation, not sale of development rights.

## Requirements for Tax Benefits

For tax benefits to accrue, either income or estate tax benefits, the following must apply:

a. The easement must be perpetual, that means the agreement is forever! The easement is not considered enforceable in perpetuity until recorded, so must also be recorded.

b. There must be a qualified real property interest, such as an easement.

c. The easement must be donated to a qualified conservation organization, such as a nonprofit in the conservation or historic preservation field or a government unit. General private foundations without a track record in conservation or historic conservation are not considered to be a qualified conservation organization.

d. Easement has to provide significant public benefit, which can be justified by preserving open space, farmland, habitat, and/or ecosystem. Extra documentation is generally necessary for historic preservation, such as the property being listed on the Federal Register, or archeological or other documentation of the unique historical importance.

e. "Qualified Appraisal" must be done no more than 60 days prior to the gift, supporting the claimed charitable donation (assuming gift claimed will exceed $5,000) and no later than the due date of the return including extensions.

f. Title search must be done to investigate mortgages and mineral rights:

1. If a mortgage exists on the property the lender must subordinate rights in the property to the easement holder, so that the lender can not force sale to a developer. A lender can still force sale, but cannot force sale without the development restriction.

2. If mineral rights are not owned, it is necessary to show surface extraction is not and likely won't be economically feasible. Otherwise, the easement is not enforceable if the holder of the mineral rights decides to surface mine.

## Amount of Tax Benefits

### Income Tax

First, let it be said that most easements are not driven by income tax benefits. One has to have sufficient income to "use up" the charitable deduction, so often landowners don't realize all the charitable deduction theoretically allowed. Second, the charitable deduction is determined by the appraisal, and is only a portion of the property value. Simplistically, the easement value is the difference between the full market value (development value) and value after restrictions implemented by the easement.

There is a limitation on deductions that can be taken from a charitable gift of property or property rights to charity. Such deductions are generally limited to 30% of adjusted gross income (AGI) the year of the donation. That portion of the deduction not used the first year can then be carried forward for as many as five additional years. However, after six years, any portion not used is lost. Large deductions require significant taxable income (AGI) to take advantage of the deduction.

It is possible to elect to deduct 50% of AGI the year of the donation, but this is to the advantage of only those donating an easement for property with little appreciation and who have much higher income the year of donation than expected the next five years. With this election the total

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deduction allowed is calculated using the original value of the property, or basis (purchase price or value when inherited). Since most property appreciates, the original basis is usually lower than present value, thus this election usually lowers the total deduction allowed.

However, Congress raised the limit to 50% of AGI for certain contributions and 100% for eligible farmers, and increased the carryforward to 15 years for gifts made through the 2009 tax year.

A rule of thumb is that each $1,000 of donated easement value creates an income tax savings of $80 to $330, depending mostly upon one's income, as the higher your tax rate the more your tax savings. Numerous factors influence where you will fall in this range, including alternative minimum tax. To estimate specifically the income tax benefit of a qualified conservation easement, contact your tax advisor.

**Estate Tax**

There are two main reasons estate taxes can be reduced with a qualified donation of a conservation easement. First, land value is reduced by the amount of the easement. Since the land can no longer be developed, the land is worth less than before. That lower value is used in calculations, resulting in a smaller estate and lower estate settlement costs.

The second benefit is the Qualified Conservation Easement Exclusion (QCEE), or section 2031(c) exclusion for easements that are contributed to the charitable organization. Not only has the value of the land already been reduced, but that lower value may then be reduced an additional 40%. The QCEE is capped at $500,000, which will cap the additional QCEE for those donating a conservation easement on only very high value property.

The other nice thing about the benefits of lowered value and QCEE due to a conservation easement is that the enabling conservation easement can be created before death or post-mortem. The conservation easement can be created by a will, or even if not in the will, the heirs can create one during the estate settlement process and benefit from the resulting lower valuation and QCEE. You may want to consider including express authority in your Will or Trust so that the Executor or Trustee has express authority to do so.

**Example for Federal Estate Tax**

Assume Mom and Dad have a farm worth $4.5 million and $500,000 in cash. If Dad wills all to Mom and Mom's spending equals the appreciation, Mom will die with an estate worth $5 million. Following is approximately the estate tax calculation for Mom's estate if she dies in 2009:

| Item | $ |
|---|---|
| Adjusted Gross Estate | 5 million |
| Taxable Estate | 4,710,300 |
| Federal Estate | 4,710,300 |
| Federal Tax Per Schedule | 2,000,435 |
| Unified Credit | 1,455,800 |
| Federal Tax—After Unified Credit | 544,635 |
| Federal Tax | 544,635 |
| Ohio Tax | 289,700 |
| Total Tax | 834,335 |

However, if Mom and Dad did the following, the calculation could look more like below. Assume Mom and Dad divided up the cash and property equally and when Dad died his estate went to the children, either through a trust or directly. Also assume before Dad died they put a qualified conservation easement on the farm, reducing the value of the farm from $4.5 million to $2.5 million and the Qualified Conservation Easement Exclusion (QCEE) was utilized.

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| Item | $ |
| --- | --- |
| Adjusted Gross Estate | 1 million (Mom's farm value is half of $2.5 M = $1.25M minus 40% QCEE = $750,000 + $250,000 [Mom's half of cash] = $1 million) |
| Taxable Estate | 1 million |
| Federal Estate | 1 million |
| Federal Tax Per Schedule | 345,800 |
| Unified Credit | 1,455,800 |
| Federal Tax—Unified Credit | - 0 - |
| Federal Tax | - 0 - |
| Ohio Tax | 44,700 |
| Total Tax | 44,700 |
| Total Tax—2 Estates | 89,400 |

## Summary

Even though the above analysis for Mom and Dad pointed out that there can be income tax and estate tax benefits, a conservation easement is really only for those who share a strong conservation ethic with their family, especially with the younger members of the family. No matter if a conservation easement is designed to preserve farm, natural, forest, grass and/or open land, or historic land or structures, easements that qualify for income and estate tax benefits are permanent. Since most easements are forever, not only the aspirations and ethics of the current generations need to be considered, but also the aspirations, ethics, and well being of especially one's children.

Keep in mind that those who agree to a conservation easement are dictating to future property owners the restrictions agreed to in the easement. Assuming the property will stay in the family, grandchildren, their children, and then their children on through future generations will be saddled with the easement restrictions. For that reason, some consider the most appropriate easement grantor to be a property owner with a strong preservation ethic, but without heirs.

Finally, keep in mind that the development of a conservation easement is a long, drawn-out process. The process may take years to work through. For that reason it is imperative that the parties that start through the process feel comfortable working with each other and that each party is confident that the other party has their best interest in mind. The easement grantor has to make sure that rights he or she may wish to keep for himself and/or herself and for his and/or her heirs are protected. The easement acceptor needs to work hard to make sure an easement is created that will further the conservation aims of that organization and that it is feasible to enforce the easement. Given that the easement is forever, it is appropriate that it take time to work out the details. That has two implications: first, if you are sure you wish to grant an easement, get started because it will take a while, and second, if you have reservations with the conservancy, land trust or government entity with whom you are working, find another or terminate the process.

These fact sheets should in no manner be considered as a replacement for consulting with estate planning professionals, nor should the general principles in these fact sheets be applied to specific situations without consulting with an attorney.

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