Sustainability Requires Succession

A Failure to Plan is a Plan to Fail

Who is Steve Collins?

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Focus of Presentation:

Summarize the Process of Succession Planning

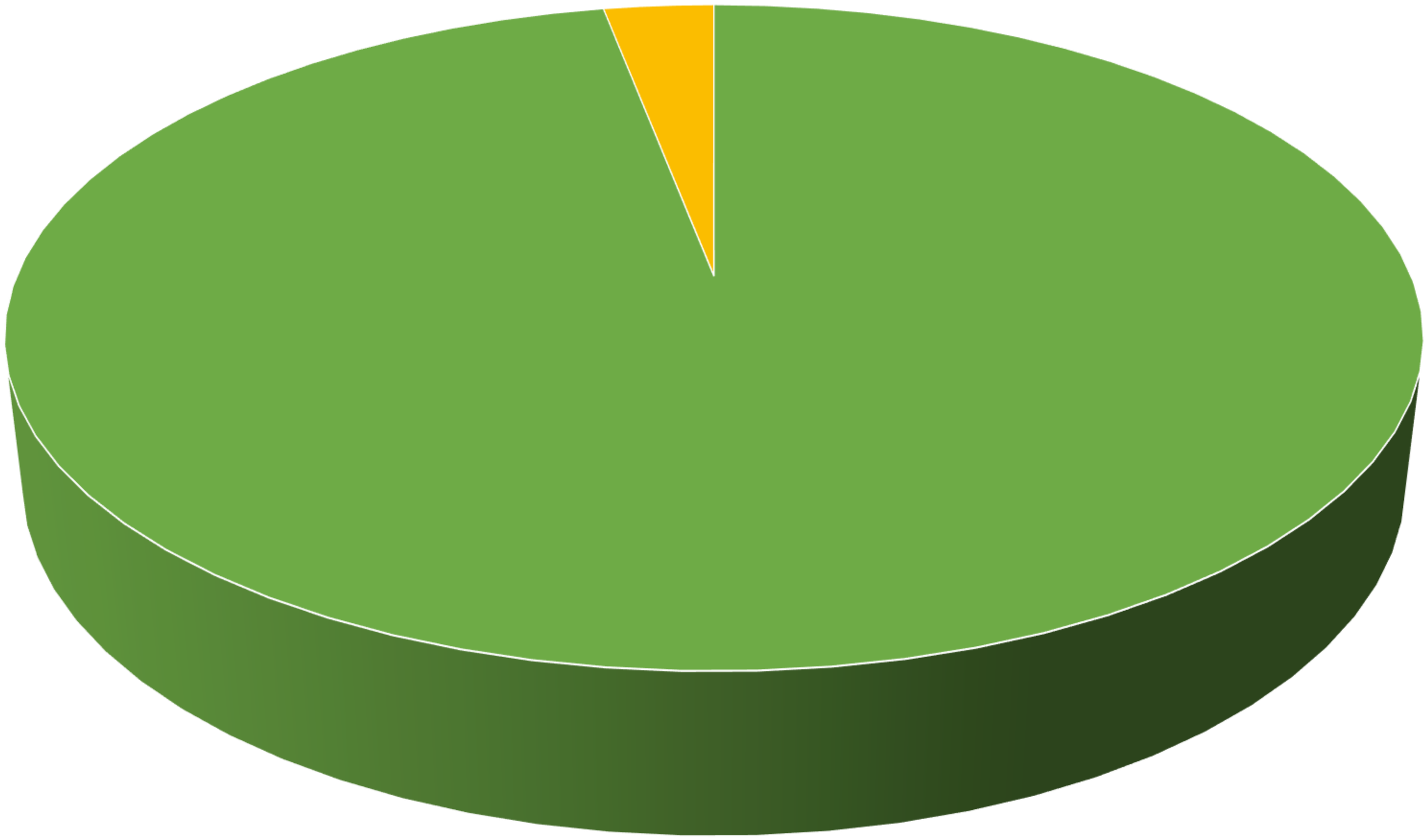
Highlight Key Considerations at Each Step of Succession Planning

Provide Resources Available to Assist Succession Planning

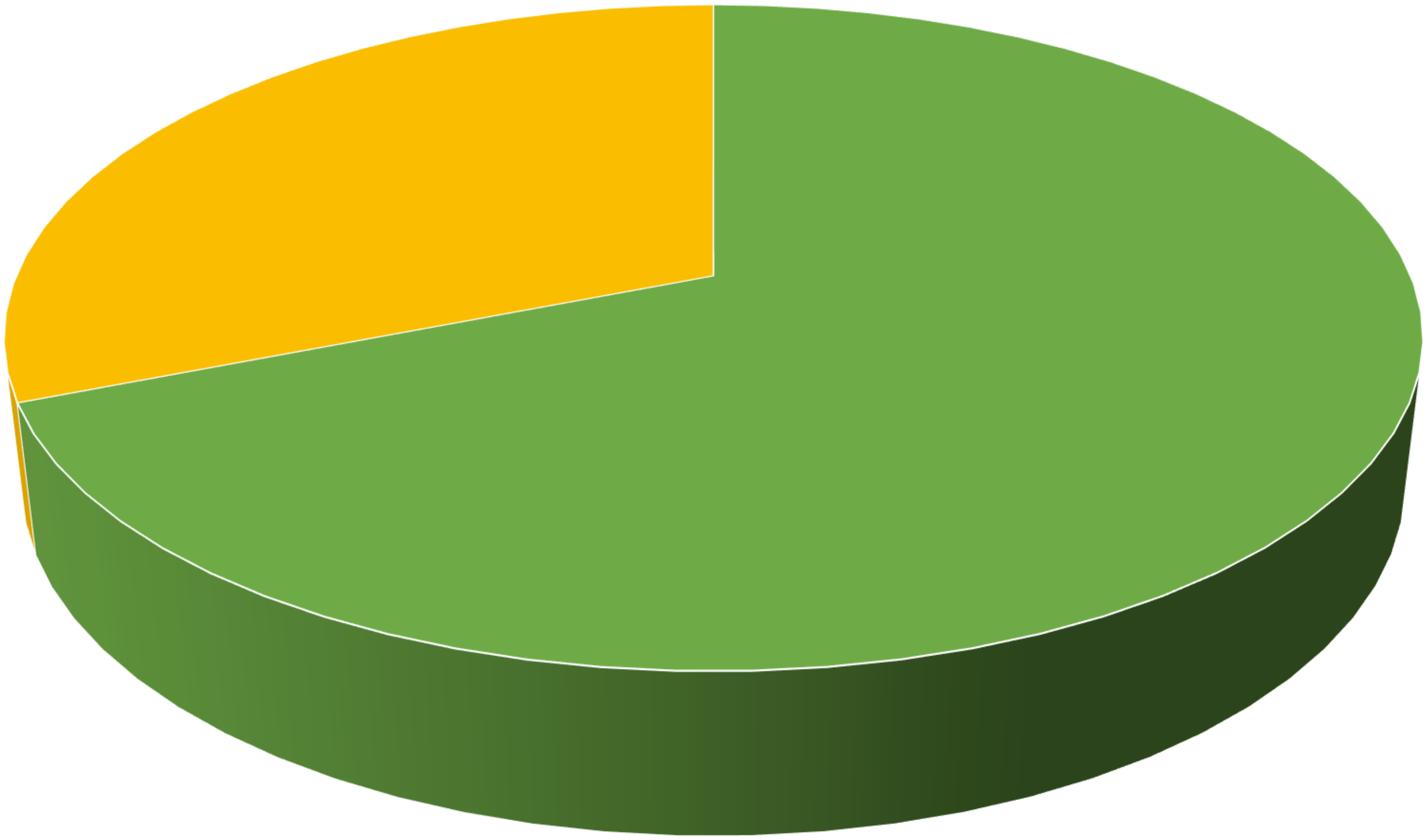
Why is Succession Planning Important?

Succession of Family-Owned Farms & Ranches is an Immediate National Security Issue.

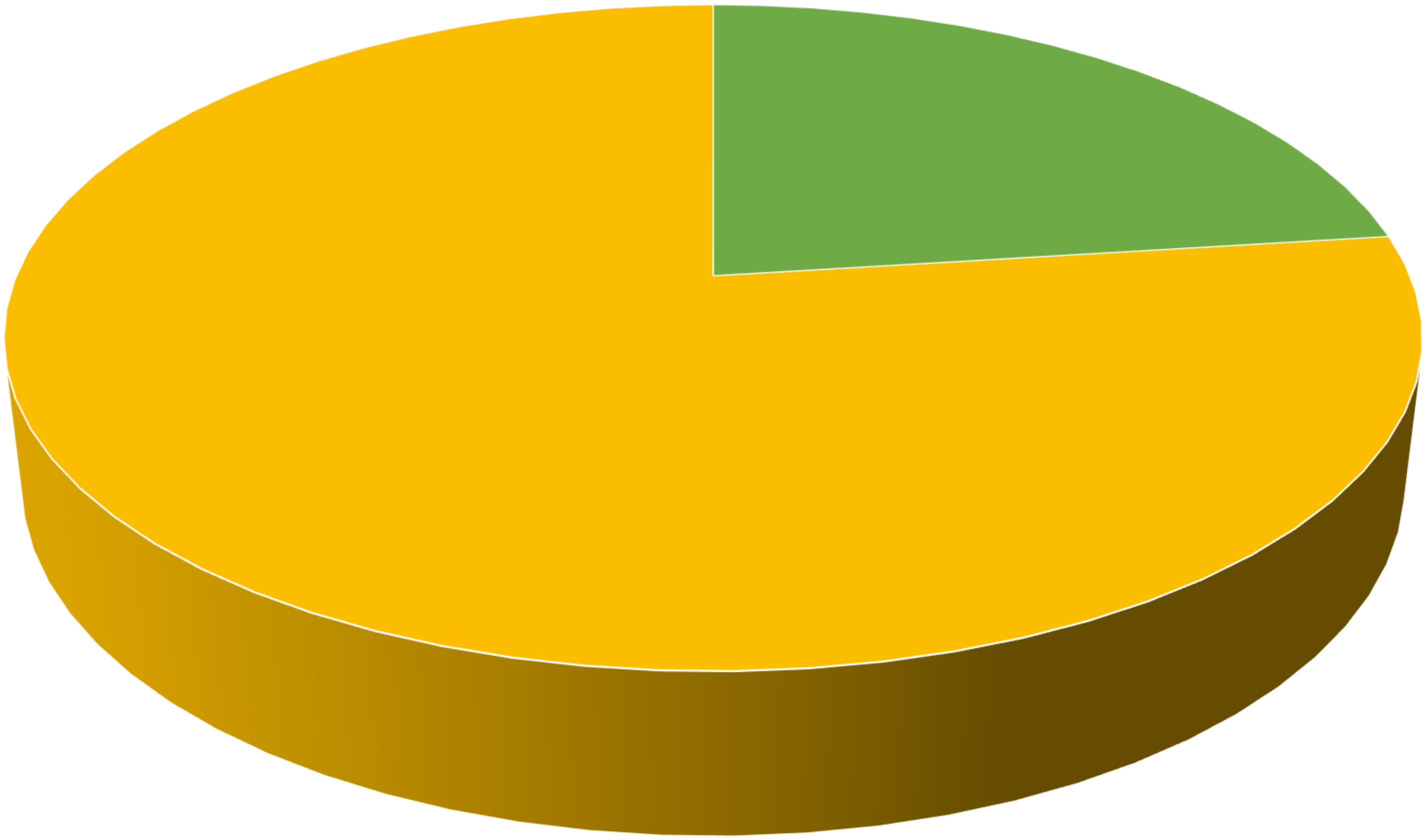
97% of all US farms and ranches are family-owned



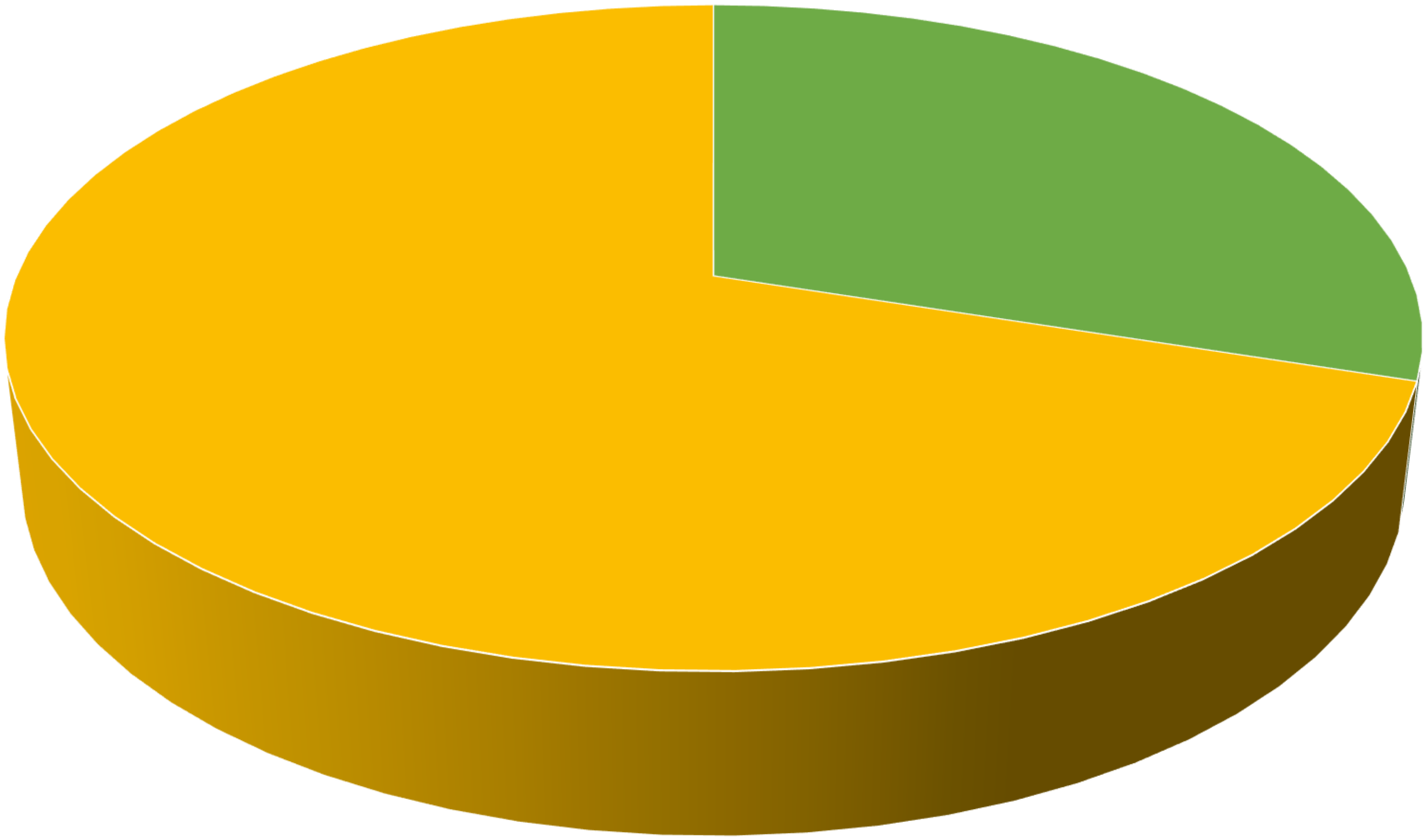
69% of all operators expect to transfer the farm or ranch to the next generation



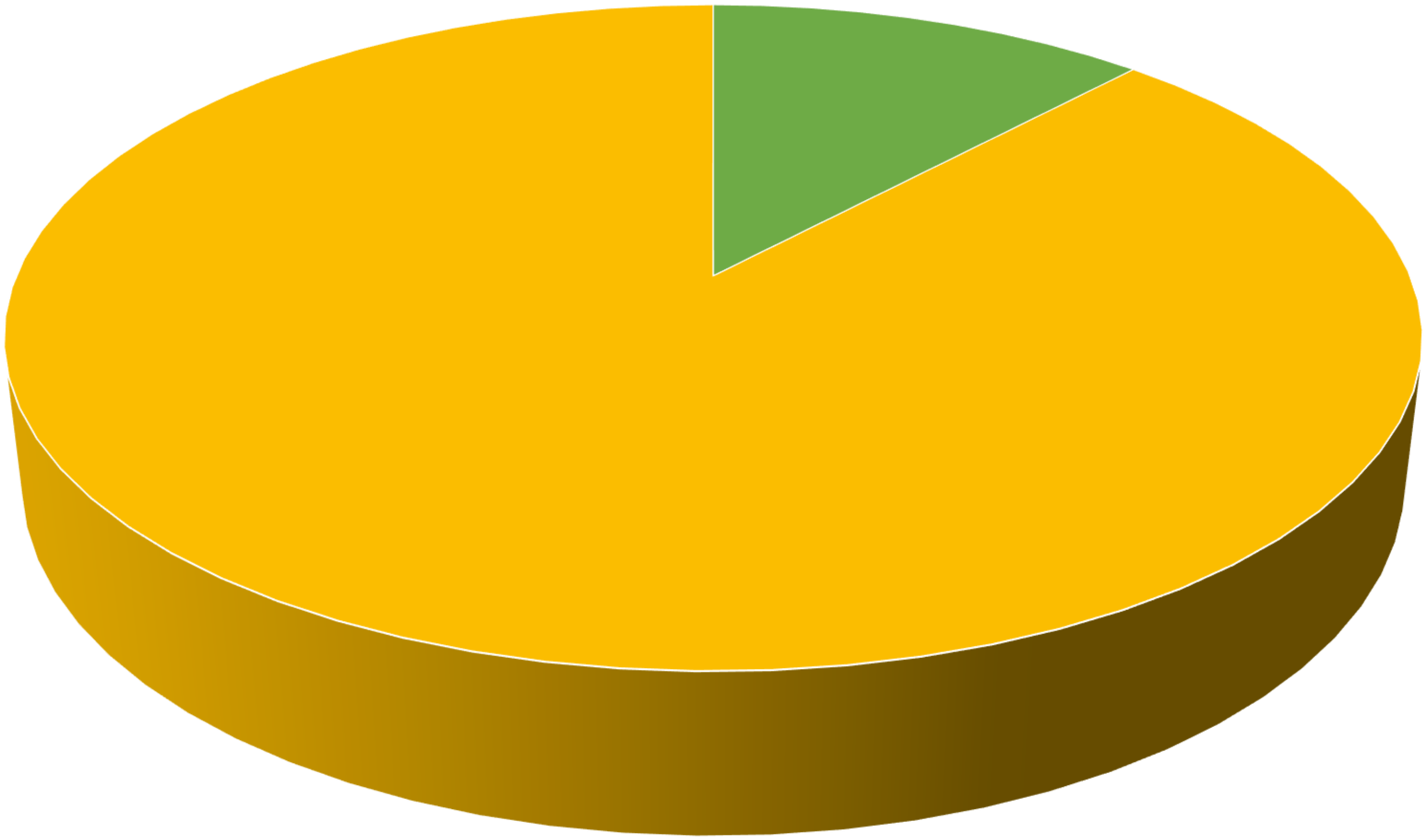
Only 23% of operators have a specific succession plan



Only 30% of family-owned operations survive transfer to 2nd generation



Only 12% of family-owned operations survive to 3rd generation



The average age of owner/operators is getting older at an **increasing** rate.

The ownership of 70% of all agricultural operations will change hands over the next 20 years.

Why do so few family ranches have a succession plan?

Why do so few family ranches have a succession plan?

- Perceived Need to Retain Control: Don't believe the ranch could successfully operate without them.

- Uncomfortable Topic: Requires consideration of own mortality.

- Uncertain about losing own identity and life role.

- Unclear How to Deal Fairly with All Family Members.

- Lack of Retirement Income Source.

Succession Planning Steps

Step 1 – Setting Individual Goals & Priorities

Ma & Pa Set Their Goals & Priorities

Consider & Prioritize Your Legacy Goals

These goals may include a desire to:

- Pass on owners' values and knowledge
- Provide financial security for the family
- Provide sufficient retirement income
- Preserve the ranch as an agricultural business
- Preserve the ranching lifestyle for future generations

Family Members Set Their Individual Goals & Priorities

Ma & Pa should ask each family member to independently determine and prioritize their own goals for the future of the ranch and put them in writing.

Step 2 - Discuss Goals & Priorities

Family meetings should be held to explore and reconcile each family member's goals

Who should be included? Only Adult Children? Spouses? Adult Grandchildren?

Discussion must be respectful and each participant should be given a fair opportunity to express their views without fearing criticism.

Discussion should include how each family member's knowledge, skill, experience and personality fits with the ranch succession plan

Step 3 - Evaluate Current Ranch Conditions

Obtain an appraisal of the Real Estate, including fixed improvements, Equipment, & Inventories

Review ranch financial viability: Assets, Liabilities & Profitability

Review ranch operational viability: Scale, Land Available, Resources

Review ranch management and labor needs and resources.

Step 4 – Determine Goals & Priorities of Succession Plan

Assemble the key family members to consider the information obtained in Steps 1 through 3.

Compile a written set of succession goals & priorities

Step 5 – Assemble Team of Professionals

Succession planning is a team sport requiring specialists in key areas of expertise.

Professionals should have experience handling the issues unique to family agricultural operations.

The advisory team should include:

Attorney with estate planning experience.

CPA with succession & estate tax planning experience.

Management consultant with experience in helping family ranches communicate and implement succession plans.

Step 6 - Decide on Implementation Timing

Management and Ownership do NOT have to be transferred at the same time.

By starting the transfer of management while Ma & Pa are still alive, the successor has access to Ma & Pa's guidance and support during while assuming control of ranch operations.

Downside: Creates potential for interpersonal conflict if Ma & Pa don't agree with Jr.'s decisions.

The succession plan can be designed become effective only upon Ma & Pa’s death.

<u>Advantage</u>:

Provides maximum flexibility

<u>Disadvantages</u>:

May result in increased estate taxes.

Causes the succession plan to be “sink or swim”.

Step-Up Tax Basis

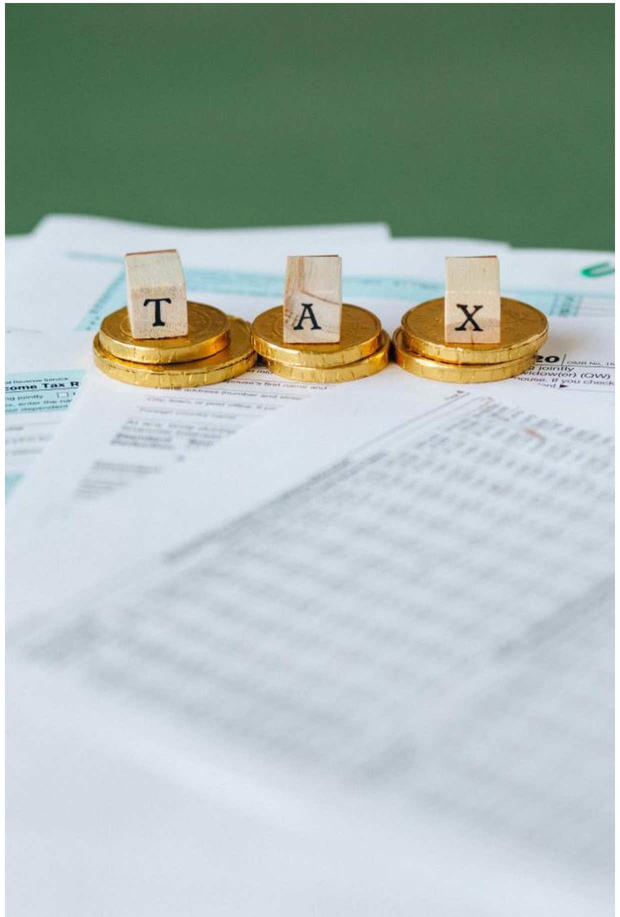
Transferee’s tax basis is the FMV at time of death.

Testamentary transferred assets receive a step-up in basis. IRC Sec. 1014.

Inter-vivos gifted assets do NOT receive a step-up in basis.

Retirement accounts (IRA, 401k) do not receive a step-up

Step 7 – Consider Legal Structure & Tax Implications of Succession Plan



Entities & Financial Vehicles Used in Estate Planning

Lady Bird Deed: Revocable Enhanced Transfer on Death (TOD)

- A deed whereby Grantor retains a life estate but also retains right to sell or mortgage the property.
- Advantages:
- Avoids probate in some cases.
- Provides some protection against Grantee's creditors.
- Disadvantages:
- Does not remove the asset from Grantor's estate.
- Is revocable and thus creates uncertainty.

Entities & Financial Vehicles Used in Estate Planning

Partition in Kind

- Advantage:
- Allows heirs to own independent operations.
- Disadvantages:
- Hard to do equitably.
- Requires retaining an appraiser.
- May cause the ranch operation to be less sustainable.
- If done in the will, requires expensive and uncertain probate action; court may determine to be unfeasible and order sale.

Entities & Financial Vehicles Used in Estate Planning

Tenants in Common

- Advantages:
- Avoids having to divide among heirs.
- Allows heirs to gift or sell their undivided interest. (Right of First Refusal)
- Disadvantages:
- Each co-tenant has a right to request a court to order partition.
- Texas Uniform Partition of Heirs Property Act (UPHPA). TX Prop. Code Ch. 23A. Executor power to sell trumps UPHPA.
- Co-tenant's undivided interest subject to creditors' claims.

Entities & Financial Vehicles Used in Estate Planning

Irrevocable Trust

- Advantages:
- Removes assets from Grantor's estate.
- Avoids probate.
- Creates vehicle for multi-generational transfer.
- Provides protection from creditors.
- Disadvantages:
- Creates a taxable entity (37% on income over $15,650).
- Requires a trustee to act on behalf of beneficiaries.

Entities & Financial Vehicles Used in Estate Planning

Revocable Trust

- Advantages:
- Provides flexibility to revise plan in future.
- May avoid probate.
- Disadvantages:
- Does not remove the asset from Grantor's estate.
- Upon Grantor's death, creates a taxable entity (37% on income over $15,650).
- Requires a trustee to act on behalf of beneficiaries.

Entities & Financial Vehicles Used in Estate Planning

Marital Trust – Disclaimer Trust (Testamentary Only)

- Advantages:
- Provides assets for support of survivor spouse.
- Removes deceased spouse's assets from survivor's estate.
- Creates vehicle for multi-generational transfer.
- Disadvantages:
- Requires substantial liquidity in the estate.
- Creates multiple taxable entities

Entities & Financial Vehicles Used in Estate Planning

Intentionally Defective Grantor Trust (IDGT)

- Assets transferred to an IDGT are removed from the grantor's estate for estate tax purposes.
- However, the grantor is still considered the owner for income tax purposes.
- <u>Advantages</u>:
- Removes assets from grantor's estate.
- Allows grantor to transfer value to grantee without constituting a gift by paying the tax accrued on the trust assets.
- <u>Disadvantage</u>:
- Creates a taxable entity

Entities & Financial Vehicles Used in Estate Planning

Partnership

- <u>Advantages</u>:
- It's a pass-through entity for tax purposes.
- Easy to create; no formal paperwork or filing required.
- <u>Disadvantages</u>:
- Every partner can bind the other partners.
- Unlimited personal liability
- No step-up of "inside" basis.

Entities & Financial Vehicles Used in Estate Planning

Limited Partnership

- <u>Advantages</u>:
- Provides a valuation discount on assets at the time of transfer.
- Provides liability shield for limited partners.
- It’s a pass-through entity for tax purposes.
- Allows for disproportionate sharing of gain & losses for tax purposes.
- Restrictions can be placed on the transfer of limited partnership interests.
- <u>Disadvantages</u>:
- Requires formal agreements and filing with the Secretary of State.
- May be subject to franchise tax.
- Limited partners cannot exercise material control of LP management.

Entities & Financial Vehicles Used in Estate Planning

Limited Liability Company

- Advantages:
- Provides a valuation discount on assets.
- Provides liability shield for members.
- It’s a pass-through entity for tax purposes.
- Allows flexibility in management structure and transferability.
- Disadvantages:
- Requires formal agreements and filing with the Secretary of State.
- May be subject to franchise tax.

Entities & Financial Vehicles Used in Estate Planning

S Corporation

- <u>Advantages</u>:
- Pass-through entity for federal tax purposes.
- Provides a valuation discount on assets.
- Provides liability shield for shareholders.
- <u>Disadvantages</u>:
- Requires formal agreements and filing with the Secretary of State.
- Requires corporate formalities to be adhered to.
- May be subject to franchise tax.
- Maximum 100 shareholders.
- Only individuals, certain trusts or estates can be shareholders.
- Only one class of stock, but can have non-voting shares.

Entities & Financial Vehicles Used in Estate Planning

Land Trust or Conservation Easement

- Advantages:
- Reduces the value of the estate.
- May provide income to grantor.
- May provide tax deduction to grantor.
- May protect the ranch from urban development.
- Disadvantage:
- Every Land Trust & Conservation Easement is different, depending on provisions. Competent professional legal advice is essential.

Entities & Financial Vehicles Used in Estate Planning

Annuities & Life Insurance

- <u>Advantage</u>:
- Provides income for retirement or buyout between heirs.
- <u>Disadvantage</u>:
- Requires capital investment or regular premiums.
- Ownership should be held outside of Ma & Pa's estate.

Federal Estate Tax

- Assessed on the fair market value (FMV) of all assets owned by the decedent above the exemption amount.

- Tax Rate: Progressive rate 18% to 40%. Highest rate applies to that portion of the taxable estate exceeding $1,000,000.

- Unified Lifetime Exemption Amount Per Person: 2025: $13,990,000; 2026: $15,000,000. Subsequent years are indexed for inflation.

Federal Estate Tax

- Spousal Exclusion (Marital Deduction): An unlimited amount of assets can be gifted or bequeathed between spouses without gift or estate tax and without filing Form 704.

- Deceased Spouse Unused Exclusion (DSUE). Allows the second to die spouse to use the unused portion of the first to die spouse. ("Portability").
- Timing is Critical: File Form 704 within 9 months of decedent's death.
- An automatic 6 month extension available by filing Form 4768.
- Estates not otherwise required to file Form 704 have 5 years after first spouse's death to file Form 704 for purposes of electing portability of the DSUE. Rev Proc 2022-32.

DSUE Example:

- Ma & Pa own a ranch near DFW. The combined estate is worth $10 million at the time of Pa's death.
- Pa leaves the entire estate to Ma.
- Urban development rapidly surrounds the ranch and at the time of Ma's death, her estate is valued at $20 million.

DSUE Example:

- **Scenario A:**
- No estate tax is due on Pa's death so Ma's advisors do NOT file an estate tax return, Form 704.
- Upon Ma's death, an estate tax return is filed showing a taxable estate of $5 million ($20 million less Ma's $15 million exclusion) and estate tax due of $2 million ($5 million x 40%).

DSUE Example:

Scenario B:

- Even though no estate tax is due upon Pa's death, Ma's advisors timely file Form 704 making a portability election of Pa's unused exclusion.
- Upon Ma's death, an estate tax return is filed showing a taxable estate of \$0 (\$20 million – (Ma's \$15 million exclusion + Pa's \$5 million DSUE)). Savings: \$2,000,000.00

Federal Gift Tax

Annual gift exclusion: Each person can gift $19,000 to any one person per year. A married couple can jointly give $38,000 to any one person per year.

- Gifts can be tangible property or intangible property and are valued as of the date of the gift.

- Any gifts totaling more than the annual exclusion ("Taxable Gift") reduce the Unified Lifetime Exemption.

Federal Gift Tax

Annual Exclusion Example:

- Ma & Pa give the Two Kids each $113,000 every year for 10 years. This results in total Taxable Gifts of $150,000 per year. The Unified Lifetime Exemption would be depleted after the 10th year.

Total Annual Gifts:	$226,000
Annual Exclusion:	-$76,000 ($38,000 x 2 Kids)
Annual Taxable Gifts:	$150,000

- No gift tax or gift tax return Form 704, is due until the donor has made Taxable Gifts in excess of the Unified Lifetime Exemption.

- Annual gifts are a useful method to transfer assets over time.

Strategic Gifting Example:

Ma & Pa have two Kids.

Ma & Pa own Whiteacre Ranch valued at $40 million.

Current Taxable Estate: $10 million

Potential Estate Tax: $4 million

Ma & Pa transfer Whiteacre to Whiteacre LLC, owned jointly by Ma & Pa.

Each year Ma & Pa each gift a 0.25% interest in Whiteacre LLC to each Kid.

Value of 0.5% of LLC: $160,000 ($40 million – 20% entity discount) x 0.005

Annual Taxable Gift: $84,000 ($160,000 – $76,000 (2 Kids x $38,000)

After 15 Years:

Ma & Pa's 92.5% Whiteacre LLC - FMV:	$37 million
Ma & Pa's 92.5% Whiteacre LLC – Discounted:	$29.6 million
Ma & Pa's remaining Lifetime Exemption:	$28.74 million
Taxable Estate:	$860,000
Potential Estate Tax:	$344,000 Saving $3,656,000

Step 8 – Decide How to Compensate Non-Participating Family Members

Many options are available to compensate family members who do not wish to participate in the ranch operations after Ma & Pa pass on.

Life Insurance Scenario

If the transfer is by will, life insurance may be an option.

- The participating heir(s) buy a second-to-die life insurance policy on Ma & Pa.
- The premiums can be subsidized by gifts from Ma & Pa.
- Upon the death of the surviving spouse, the will leaves the ranch to all heirs with an option by the participating heirs to buy out the other heirs for FMV.
- Any excess of FMV over available funds is paid by promissory note and deed of trust.

Lease - Option Scenario

Upon transfer, the participating heirs lease to the non-participating heirs. The non-participating heirs have a deferred put option to sell their interest to the participating heirs for FMV. Participating heirs have option and right of first refusal.

Make Room for All Family Members

It may be possible to create additional business lines or operations for all family members to be involved in. These might include: wildlife or agritourism, direct marketing of beef or other products, or additional livestock breeds such as horses, etc.

Step 9 – Draft & Implement Written Succession Plan

All members of the professional team should be involved in the final drafting of the Succession Plan.

There are specific legal formalities which must be followed in the execution of a will.

All deeds, trust agreements or entity organizational documents should be prepared by an attorney with input from the tax advisor.

The original will is often held by the estate planning attorney.

Step 10 – Periodically Evaluate Succession Plan & Revise if Necessary

Let’s get started. Your family is depending on you.

Succession Planning Professionals

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Essential Documents Everyone Needs

Statutory Durable Power of Attorney

Medical Power of Attorney

Guardianship Declaration

Directive to Physicians

HIPAA Authorization