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KENTUCKY FARM BUSINESS MANAGEMENT PROGRAM
STATE NEWSLETTER

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Estate Planning with Trusts

By: Lauren Turley

Most farmers would much rather spend their time on a tractor or in the pasture checking on their livestock, but it is often important to spend time in the office and manage the business aspect of the farm. One of the aspects of the farm that deserves attention as a farmer's asset base increases, is estate planning. Estate planning is advisable for farmers of all ages, not just the older ones. Anyone with a significant asset base could use an estate to manage those assets during life, at death, or after death. Estate planning includes the transferring of land and other assets to heirs and the settlement of estate taxes, but also maximizing the value of the estate. The sooner farm families begin the process, the more satisfying the results will be. The younger farm family should have a longer period to plan and take steps to put the plan in place.

The goal of estate planning should be to determine what you have, how you want your estate to be handled, and how you want the property to be distributed. There are a wide range of tools that should allow for your objectives to be accomplished. One of the tools of estate planning is a trust. The trust is one of the most flexible devices and in many situations, may be very appropriate. With a trust, property is transferred into the trust and a third party, the trustee, manages the property and pays the income to the named beneficiary or beneficiaries according to the instructions given by the person setting up the trust, the trustor. Basically, a person using a trust is trusting the trustee to handle property for the benefit of beneficiaries.

The trustee can be a person or an institution, such as a bank, but usually receives a fee for management of the trust. When property is transferred to a trust that has been created, a gift is made to the beneficiaries of that trust. There is separation between the assets and beneficiaries as the trust document sets out the powers of the trustee in managing the property and gives instructions for the timing of distributions for paying out trust income. Trusts can help avoid expenses and time involved in the probate process after death, as well as, reduce estate taxes. Another advantage in a trust is that assets can be managed and distributed according to a predetermined schedule, especially beneficial in transfers to minors, elderly persons, and others that are not competent to make decisions.

Simple trusts are required to distribute all of their income currently and may deduct the amount of the income which the trustee distributes. The beneficiaries of the simple trust pay the income tax. Complex trusts are not required to distribute all of their income currently, thus both beneficiaries and the trust, may be taxpayers.

It is important to learn about the different types of trusts before taking the steps to set up a trust. Two basic types are living trusts and testamentary trusts. The living trust is established during life with property transferred to the trust, but it may also continue on after death. Living trusts can be revocable or irrevocable. Living trusts offer privacy as they are an agreement between the grantor and the trustee and may not have to be filed and become public after death. A revocable trust can be amended by the grantor once it is established. Assets in a revocable trust are not required to go through probate process, so the transfer may be quicker after death. The property in the revocable trust does remain part of the taxable estate for purposes of calculating the federal estate tax; therefore, the value of the estate is not reduced. However, heirs do receive a step-up in basis on the property. The revocable trust can be used to transfer management of assets as successor trustees can be involved in managing the assets before death. An example of this would be the initial trustee being the property owner, but as the initial trustee approached incompetency or desired to be less burdened with property management, a successor trustee would assume responsibility of the property management. This type of trust will generally cost more than creating a will. Irrevocable trusts cannot be changed once they are set up. An irrevocable trust is commonly used for high value estates as it can reduce the value of the taxable estate. Transferring assets to an irrevocable trust does trigger federal gift tax concerns. If the grantor does not retain decision making power or the right to receive income, the trust will not normally be taxable in the decedent's estate. Irrevocable trusts may also save estate settlement costs as property is transferred during life and thus not subject to probate. With this type of trust, enjoyment by beneficiaries cannot be contingent on death; there must be present interest from the beginning.

Testamentary trusts are established at the time of death and are often part of an individual's will. The property owner retains complete right to the property until death. The property is transferred to the trust after settlement of the estate. The primary purpose of the testamentary trust is to provide for management of property after death. Testamentary trusts can be used to hold and manage the property of minor children. The trust may provide income as needed for the support, care, and education of the children. Income not needed would increase the value of the trust and once the children reach a specified age, they may receive their share of the trust. Two types of testamentary trusts in which a charitable deduction may also be received for the portion of the trust going to charities are the charitable remainder uni-trust (CRUT) and the charitable remainder annuity trust (CRAT). With the establishment of a CRUT, property is transferred into the trust irrevocably and the trust pays beneficiary income for life or term of years. There is no capital gains tax on the transfer of assets to the trust. The payment varies each year and is figured as a percentage of the fair market value of the trust assets. The remainder of the trust goes to charities after the death of the beneficiary or after a set term of years. A CRAT is similar to a CRUT. Property is transferred irrevocably and the trust pays the beneficiary income at least annually for life or term of years. At the death of the income beneficiary, the trust terminates and the assets go to the charitable organization. There is no capital gains tax on transfer to the trust.

Estate planning shouldn't be put on the "back burner" but should be tackled early on and communicated to others in the family. The trust may be worth considering in many estate planning situations. It would be very beneficial to ask for advice from your accountant and attorney in developing a plan.

Chapter 12 Bankruptcy- Debt Reorganization

By: Jonathan Shepherd

Nobody's long term business goals include bankruptcy. It is an action of last resort and one that carries a lot of misconceptions, fears, confusion, stigmas and is rife with emotions. Possibly one of the biggest misconceptions about bankruptcy is that it is the ultimate death blow to your business. This is not always the case. Chapter 12 bankruptcy allows for repayment of debt through reorganization with one of the biggest benefits being that the debtor can continue in the farming business.

Chapter 12 Bankruptcy Code was added to existing bankruptcy chapters in the 1980's and allows "family farmers" and "family fisherman" to propose a plan to the courts to restructure their debt with a repayment plan. The repayment plan is structured over a 3-5 year period, but generally cannot exceed 5 years. It is an action that must be initiated by the debtor by petitioning the court. Chapter 12 Bankruptcy Code dictates that the debtor must submit a repayment schedule to the court within 90 days of filing the petition. During the duration of the bankruptcy and after, the farmer may continue to farm and the farm assets remain in the debtor's possession (in most cases).

The terms "family farmers" and "family fisherman" cover an individual or an individual and their spouse, but do not exclude partnerships and corporations from using this form of bankruptcy. In order for corporations and partnerships to qualify for Chapter 12 bankruptcy, the corporation or partnership must be at least 50% owned by an individual or an individual family. Also, the farming activities within the partnership or corporation must be carried out by the individual, family or the family's relatives. If you are filing chapter 12 as an individual or an individual and spouse you must meet four criteria:

1. Total debt cannot exceed $4,031,575 (farmers) or $1,868,200 (fisherman)
2. Must be engaged in farming or commercial fishing
3. At least 50% (farmer) or 80% (fisherman) of total debt must come as a result of farming/commercial fishing
4. More than 50% of the gross income for the preceding year must have come from farming/commercial fishing (for farmers, if the previous year failed this income test, then the previous two years before the most recent year must have resulted in more than 50% of gross income derived from farming)

In addition to the above four criteria for individuals and spouses and the 50% ownership rule mentioned above, corporations and partnerships must meet additional criteria to qualify. Specifically, assets of the corporation or partnership must be related to farming/fishing by more than 80%. Further, for corporations that issue stock, stocks cannot be publically traded.

When the petition is filed with the court, other documents are also required to be filed. These documents contain information such as a listing of all debts and assets as well as evidence of farming income, farm expenses and living expenses. Further, the court appoints a trustee who receives payments from the debtor and the trustee in return pays the creditors. Within 21 to 35 days of filing the petition the trustee will hold a meeting with the creditors. In this meeting the debtor is placed under oath and the trustee and creditors ask questions about the debtor's financial situation and proposed repayment plan. This is followed up by a confirmation hearing within 45 days of filing the repayment plan. Here the judge determines if the plan is achievable and if it meets the requirements for Chapter 12 bankruptcy. If so, the plan is confirmed.

When fulfilling a confirmed repayment plan, the debtor gives the trustee all of their disposable income. Disposable income is generally defined for these purposes as what remains from gross revenue generated by the farm/fishing business after subtracting business expenses and family living expenses. The trustee retains a fee for handling the funds and then pays the remainder to the creditors. Ultimately, in Chapter 12 bankruptcy, it has to be shown that creditors will receive as much repayment under this chapter as if the farmer/fisherman had filed Chapter 7 bankruptcy (total liquidation). If this requirement is satisfied, and the farmer/fisherman is able to meet the repayment plan schedule, remaining unsecured debt is discharged at the end of the repayment plan. This does not mean that all unsecured debt will be repaid in total. As long as the debtor makes all payments in the confirmed plan, and all disposable income is given to the trustee, unsecured debt is discharged at the end of the bankruptcy. Failure to fulfill the repayment plan can result in the case being dismissed (no debt discharged) or allow for the case to be converted to Chapter 7 bankruptcy.

One advantage of Chapter 12 bankruptcy allows for secured debt to be written down to the actual asset value with the difference being treated as unsecured debt. For example, assume a farmer owes $50,000 on a tractor but the tractor is only worth $35,000. As a result, the secured debt can be written down to $35,000 for the tractor and $15,000 of the previous debt will be treated as unsecured debt.

Generally debt cancellations (discharges of debt) that result from bankruptcy are considered taxable income. However, the amount of debt cancellation can be excluded from taxable income by reducing tax attributes for the tax year in which the debt cancellation was received. The Internal Revenue Service provides an order for which tax attribute reduction must occur and it follows:

- Net operating losses (for any NOL created in the current year and any NOL carried forward to the current tax year)
- General business credit carryovers
- Minimum tax credits
- Capital losses
- Basis (both depreciable and nondepreciable property)
- Passive activity loss and credit carryovers
- Foreign tax credits

Tax attributes are reduced dollar for dollar except for credit carryovers. Credit carryovers are reduced $0.333 for each dollar reduction of debt cancellation excluded from taxable income. Tax attributes are reduced until the reduction equals the debt discharged or all tax attributes are reduced. It is important to note that the debtor may first choose to absorb some or all of the debt discharged as a reduction of asset basis before applying any remainder to the list of other tax attributes.

The option to exclude debt cancellation from taxable income by reduction of tax attributes does not entirely forgive the tax that would be due from the discharged debt if it were added to taxable income. Instead, reduction of tax attributes is a postponement of tax liability. With that concept in mind, it is important to strategically determine what tax attributes to “use up.” For example, if farmland is likely not going to be sold in the debtor’s lifetime, instead being passed on to the debtor’s heirs upon death, reduction of basis in the land may be more beneficial for the debtor by preserving other tax attributes if they exist. In this case, the land basis could be used to absorb some or all of the debt cancellation excluded from taxable income and the heirs will receive a “stepped-up” basis when the land is inherited.

Clearly Chapter 12 bankruptcy is an extremely complex legal action that requires competent legal counsel. This article only provides a brief overview of a chapter of bankruptcy that is available for qualifying farmers and fisherman and is intended only to be educational in nature. If your farming operation is financially stressed, it is advised that you reach out to farm financial experts to weigh your options.

Inheritance Tax

By: Suzy Martin

By Internal Revenue Service (IRS) definition, the Estate Tax is a tax on your right to transfer property at your death. Your gross estate could consist of a multitude of assets including but not limited to cash, securities, real estate, businesses, trusts, etc. In very simplified terms, the value of your estate is based on the fair market value of all your assets on the date of your death less any debts against those assets. For the 2015 calendar year, if the net value of your estate is less than $5,430,000, there will not be any estate tax due nor will an estate tax return need to be filed. In addition, starting January 1, 2011, the IRS has allowed for "portability" of any unused exemption to the surviving spouse of a decedent. In other words, if you pass away in 2015 and your net estate is worth $3,000,000 then your estate can elect to pass on the unused portion of your exemption, $2,430,000 ($5,430,000 - $3,000,000), to your spouse. Portability is an election, which means that even if there is no tax due for the decedent, a timely estate tax return must be filed and the election must be made on that return. An estate tax return is considered timely if filed no more than 9 months after the date of death of the taxpayer.

For residents of the state of Kentucky there are three classes of beneficiaries that determine if there are any inheritance taxes owed by the estate.

- Class A beneficiaries include surviving spouse, parents, children (by blood, stepchildren, children adopted at infancy or adopted children who were reared by decedent during infancy), grandchildren (issue of aforementioned "children") and brothers and sisters (both whole and half). Class A beneficiaries are exempt from paying inheritance tax.
- Class B beneficiaries include nephew, niece, half-nephew, half-niece, daughter-in-law, son-in-law, aunt, uncle, or great-grandchild who is a grandchild of aforementioned "children". For Class B beneficiaries there is a $1,000 exemption of their distributive share of the estate and the tax brackets start at 4% and can go up to 16% if their distributive share is greater than $200,000.
- Class C beneficiaries are all persons not considered Class A or Class B beneficiaries. For Class C beneficiaries there is a $500 exemption of their distributive share of the estate and the brackets start at 4% and go up to 16% if the distributive share is greater than $60,000.

The previous two paragraphs summarize estate tax laws on both the federal and Kentucky level. The reason for that is there are two things you will need to do as you start thinking about estate planning. One, you need to gather all the information you have on your assets. You'll need all of your deeds, insurance policies, stock statements, retirement statements, etc. If you have a balance sheet, you will need to look over it very closely. What is the fair market value of your assets….particularly for machinery, buildings, grain facilities, and land for farming operations? The second thing you will need to do is determine what your goals are for your estate planning. Who is going to inherit your estate? Once you've started to evaluate these two things, (what you have and who is going to get it) you (and your attorney, financial advisor, farm analysis specialist, etc.) can estimate if your estate will owe any taxes.

One myth of estate planning is that if you won't owe any estate taxes there is no need for any estate planning. That is wrong. The way that you go about your estate planning might differ if you expect to pay estate taxes versus if you don't. The best advice I can give for someone that is starting the estate planning journey is 1) surround yourself with a good team of advisors 2) you have to realize that fair and equal aren't the same thing and 3) if it matters to you what happens to your assets, then you must make some tough decisions and, with the help of a good lawyer, put those decisions in writing.

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Upcoming KFBM Events:

Nov. 13th	Owensboro Lenders Conference – 9:00 am CST.
Nov. 19th	2015 Ohio Valley Farm Analysis Group Annual Meeting – Moonlite at 6:30 pm CST.
Nov. 23rd	3026 Purchase Farm Analysis Group Annual Meeting – Graves County Extension Office at 6:00 pm CST.
Nov. 30th	2015 Pennyroyal Farm Analysis Group Annual Meeting – Christian Co. Extension Office at 6:00 pm CST.
Dec. 9th	KFBM State Board Meeting – Woodford County Extension Office, time TBA.
Dec. 11th	Mayfield Lenders Conference – 9:00 am CST.
Dec. 11th	Hopkinsville Lenders Conference – 1:00 pm CST.
Jan 14th	AWMA Meeting – Christian County Extension Office, time TBA.
Jan. 28th	Lexington Lenders Conference – 9:00 am EST.

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