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SUCCESSION

Planning for the Next Generation

by Dan Childs, senior agricultural economist | mdchilds@noble.org

As the most populous generation in United States history (commonly referred to as the baby boomer generation) ages into retirement and their elder years, the need to plan for the transfer of their wealth to the next generation becomes more important. The baby boomer generation continues to have a disproportionate share of the total population as they age. Because of their relative size, the baby boomer generation will transfer more wealth than any generation preceding them. For many baby boomers, the daunting task of planning how they want their wealth distributed lies before them.

Each U.S. citizen has an opportunity to influence how the various assets composing the wealth of their estate is distributed after their passing from this life. If an individual chooses not to take advantage of this opportunity, the state of domicile has a default plan for each resident. So if one thinks the task is too great, the state will complete the task for a resident. They may not like the outcome, but it is low cost and requires little or no effort.

There are several legal instruments available to help a person make sure their wealth gets distributed the way they desire. Each instrument must be created correctly in order to withstand legal scrutiny if questioned.

ESTATE TAX

Some folks worry about the estate tax owed. On average, only one estate in 700 (or .1 percent of the population) will owe estate tax. Each estate is allowed an exemption of $5.49 million worth of assets before any tax is assessed. This amount is indexed for inflation each year. Completing a net worth statement will provide an estimate of the dollar value of their estate. In the case of a husband and wife, the unused portion of the first spouse to pass is added to the surviving spouse's exemption, which allows the total exemption for both estates to be $10.98 million. The transfer of the unused portion of the first spouse to pass is commonly referred to as portability and ensures the size of each spouse's estate does not have to be equal or more than $5.49 million to be eligible for the combined maximum exemption of $10.98 million. If the net estate of an individual is larger than $5.49 million, the federal estate tax rate is graduated starting at 18 percent and peaks at 40 percent. The highest rate applies to estates that are $6.49 million (taxable amount above $1 million) and higher.

INHERITED VERSUS GIFT

If a person wants to start transferring a portion of their wealth before death, it is possible to make annual tax-free gifts. Each person can give up to $14,000 per year tax free to as many individuals as they choose. The recipients do not have to meet any qualifications such as being blood relatives. Therefore, a husband and wife could each give $14,000 per year to all their children, grandchildren and friends. The gifts are not taxable to the recipients.

However, there is a difference in the tax basis of an asset depending on whether it is inherited versus received as a gift. When an asset is inherited, it typically receives a "step-up" in basis to fair market value as of the date of death through the probate process. In the case of a revocable trust, the assets would also receive a "step-up" in basis as of the date of the grantor's death. The step-up in tax basis is valuable to the heir because if or when an heir decides to sell the asset, the amount of taxable gain (calculated as the difference between the tax basis and the net selling price) is typically much lower. If an asset is sold soon after it is inherited, it is likely there will be no taxable gain since the tax basis and the market value are the same.

In the case of a gift, the recipient of the gift receives the same tax basis in the asset as the donor had. If or when the recipient decides to sell the asset, they may have a very low tax basis in the asset. This is usually the case when the donor owned the asset for a long period of time, triggering an income tax obligation on the taxable gain. Therefore, if a person is contemplating whether to bequeath an asset (transfer by inheritance) or outright give it to someone, they may want to consider the tax basis they have in an asset and the intent of the recipient before deciding which to do.

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ESTATE TRANSFER PLAN

Since few estates will pay any estate taxes, what impediment(s) keep folks from creating a transfer plan? The answer is likely different for everyone. One reason that often comes up is some hard decisions may have to be made pertaining to dividing the assets in an attempt to treat the heirs equally. It should be mentioned that equal is not necessarily equitable. For example, an equal number of acres could differ considerably in value due to location and/or quality. To elude the task of splitting up the land, some will choose to leave it to the heirs in an undivided interest. This may be OK and even preferable in some instances, like minerals. However, bequeathing land in an undivided interest can cause disagreements among heirs that do not get resolved in their lifetime. Not always but usually when Mom and Dad make the hard decisions, children may not like the result but they accept it because they respect their parents' decision.

WEALTH OR A BUSINESS?

Another situation that can place heirs in an awkward position is when parents try to manage from the grave a business they bequeathed to their heirs. This can be especially true in the case where the business is a farm or ranch. The intent of most parents is to provide a blessing to their children through an inheritance. A question parents could ask themselves is, "Are we passing along wealth or a business?" They could be completely different objectives. For instance, some farms have been in the family for multiple generations. People who have spent a lifetime putting a place together or adding to what their parents accumulated normally want their passion for the land continued for generations to come. Therefore, restrictions are placed on what heirs can do with the property. This could place a burden on the heirs rather than them receiving a blessing of the wealth the property represents. Some heirs do not have the passion nor the skills to successfully manage a farming business. Giving heirs the freedom to choose how best to preserve or leverage the wealth is usually preferable. Passing along a business requires much more preparation and effort than passing along wealth.

TRUSTS VERSUS WILLS

Sometimes people get confused on whether to use one of the many types of trusts or to use a will. There are pros and cons to both. Trusts are usually more expensive to create but less expensive after death. When correctly designed, a new successor trustee takes over at death; there is no probate and, therefore, no documents to be recorded for public viewing. Death is almost a nonevent because there is no change in ownership of the assets. The trust owned them before, and the trust will continue to own them after death. A word of caution about trusts. The grantor (the person(s) creating the trust) must be sure to transfer the assets to the trust. Otherwise, the trust has no benefit. Wills are usually less expensive to create but generally more expensive after death due to the probate process. Documents generated throughout the probate process are public documents available for anyone to view. Some people may have feelings about what information they want to be public. If so, a trust may be more attractive. Often, even when trusts instruments are used, a will is still necessary to provide direction for assets not in the trust.

OTHER DOCUMENTS

A couple more documents are helpful to have for family members who may have the responsibility of caring for the elderly in the later years. A healthcare directive and power of attorney can be very beneficial in carrying out the wishes of a person when they may not be able to make decisions on their own.

Making decisions about your estate can be difficult. However, making those decisions and preparing the documents will be one of the greatest blessings one can provide to their spouse and family members.