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ESTATE PLANNING FOR FARM FAMILIES

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ESTATE PLANNING FOR FARM FAMILIES
Loren W. Tauer and Dale A. Grossman*

Introduction

This bulletin was written to assist farm families in their estate planning. Estate planning to many people consists of deciding how property should be distributed at death, but it also includes plans and techniques to build the estate during life. It involves decisions such as the types of property to own, the form of ownership, and, for farm families, the organization and operation of the farm.

This bulletin discusses the basic fundamentals of estate planning to help farm families assess their estate goals and objectives and consider the economic, legal, and tax implications of various plans. The bulletin is by no means an exhaustive source on estate planning and it is not intended to substitute for legal or tax advice which should be obtained from your lawyer or accountant. More detailed publications are available elsewhere and trained professionals should be consulted as an estate plan is formulated.

Estate planning decisions involve complex questions of law, tax and business planning. The only way to find the estate plan that is best for you is to work closely with your lawyer and other specialists who can advise you properly. Tax accountants, appraisers, life insurance agents, bank trust officers and your county extension agent provide other important sources of information which you might consider in the estate planning process. Because you must make the final decision regarding the organization and disposition of your property, it is essential that you be well-informed about the choices available to you so you can make the best decision for you and your family.

Objectives in Estate Planning

Most young farm families start with a modest estate but have major commitments to dependents. It is often said that these families are the ones who are most in need of estate planning. Their meager estate must provide for dependents should either or both parents die. Estate taxes are not yet a concern for this family because their estate has not reached the size where estate taxes would be due. Rather, their concern should be who receives the property in the estate, the administration of the estate, and the care of children. This family is also concerned about increasing their estate to provide for dependents, and that property generates income during their life to supplement the income generated from their labor.

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As the family and the estate grow, the family still has many of these same concerns but they are also concerned about structuring the estate as it increases. They need to be keenly alert and aware of the potential future consequences of business organization and ownership patterns. During this growth phase many families show little concern for estate planning and the estate consequences of many of their business decisions are not completely analyzed. Sometimes irrevocable damage is done.

The third stage of a family life is often referred to as the exit stage. The farm couple is interested in reducing their participation in the farm business, usually as a child is brought into the business. The parents will generally first reduce their labor involvement in the business. They are usually eager to do this and the transition should create few problems as long as the farm can generate sufficient income for the parents and child(ren). Parents next reduce management involvement. This can create conflicts. It is often difficult for a couple to relinquish control of an operation that they built. Finally, and often not until death, they will reduce or eliminate their ownership involvement in the business. The farm couple can be extremely reluctant to transfer farm ownership during their lifetime. Not only are they emotionally attached to the farm, but they may be financially attached as well. Farm couples do not generally have major sources of retirement income other than social security and ownership income from the farm. The financial dependency hinders giving the farm to the child(ren) but it still may be possible to sell farm property to the child(ren). After selling, the parents still own property but rather than farm property it is cash (converted into other investments) or a mortgage or contract. In other instances good estate planning calls for owning the farm property, especially real estate, until death.

Property Ownership

Throughout our discussion of estate and business planning we will often refer to property ownership and control. It is therefore important to understand the forms of property ownership commonly used and some of the legal and tax effects of changing these forms of ownership.

There are two general kinds of property - "real" property and "personal" property. Real property consists of land and the permanent improvements on it as well as rights to use the land like easements. Personal property includes everything else; items like livestock, machinery, insurance policies, stocks and bonds. The law frequently makes a distinction between real and personal property in matters of ownership, taxation, inheritance and the requirements necessary for sale or transfer.

The legal concept of "property" can be divided into one or more interests that can be enjoyed over time. One interest consists of the beneficial ownership interests, including the right to whatever the property generates, for example, income. Another interest is a future interest or "remainder". A property owner can give his or her farm to a church today but retain the right to live on the property and use its income until his or her death. The church immediately receives the right to the future income from the farm but the farmer has a life interest.

Property can be owned solely by one person or organization, or ownership can be shared by more than one party. Sole ownership is obviously the simplest, most straightforward type of possession. The sole owner has the rights to the property within limitations of the laws (such as vehicle registration or zoning) and there is rarely any question raised when these rights are exercised.

Co-ownership occurs when two or more parties hold title to property together. Much property that is co-owned is owned by husbands and wives, but it is also possible for two unrelated people, or members of more than one generation (like a father and son), to co-own property. There are a number of forms of co-ownership defined by law and the rights and tax consequences of each type of co-ownership are different. There is no one form of co-ownership that will always be preferred, but one may be more advantageous than another based on the people and the property involved.

One form of co-ownership is tenancy in common where each party or tenant has separate and distinct property interests. Each co-owner has a fractional interest in the property. The amount of the fractional interest is the percentage of the total value of the property that the individual paid, or received as an inheritance or gift, when the tenancy was created. For example, if property was purchased for \$50,000 and one of two tenants in common paid \$20,000 in cash and mortgage payments, then his or her fractional interest is 40 percent. Each tenant in common is entitled to the income that his or her fraction of the property generates. Each tenant may dispose of his or her interest as he or she wishes. When one tenant dies, his or her interest passes according to the will (or the law of intestate succession if there is no will) - the property does not automatically revert to the survivor(s). Only that tenant's interest is taxable in his or her estate. That portion of the property does fall under the jurisdiction of the Surrogate's Court (Probate). When a partnership owns property it owns it as a form of tenancy in common called "tenancy in partnership."

Another form of co-ownership is a joint tenancy with right of survivorship. This is created by a deed if the property is land. The joint tenants own the same interests arising from the same conveyance of title such that each has an undivided or undesignated interest in the "jointly-owned" property. Each has a right to use the property and a right to any income generated by the property as well. When one of the joint tenants dies, the survivor automatically acquires full ownership in the property. If more than two persons are joint tenants with right of survivorship, the remaining individuals share the property - no third party will take the decedent's share. This ownership arrangement acts like a "will substitute" since the property will automatically belong to the survivor(s), avoiding probate. Federal or state estate taxes are not avoided, however.

A joint tenancy that can be used only by a husband and wife and only with real estate is a tenancy by the entirety with right of survivorship. Like other joint tenancy property, upon death of the first spouse, property in tenancy by the entirety is passed on to the surviving spouse. Tenancy by the entirety property cannot be severed without consent of both the husband and wife. However, the tenancy is severed by a divorce.

For federal estate tax purposes the full value of jointly-held property is completely included in the taxable estate of the first joint tenant to die except to the extent that the surviving joint tenant(s) can prove that he or she contributed to the purchase or acquisition of the property. This rule applies to unrelated as well as related joint tenants. If each joint tenant contributed a portion of the purchase price, then proof of contribution can be made. However, the type of contribution is important. It must be income earned or property owned by each joint tenant. For example, a farmer and his wife may purchase property for their farm, pay for the land with earnings from the farm, and hold the property as joint tenants, but if the farm is operated by the husband as a sole proprietor generally under the law the husband is the only one who is considered to have contributed to the purchase of the land. This is true even if joint tax returns were filed and the wife spent hours working in the barn and in the fields. However, a 1978 change in federal tax law, referred to as "credit for services" (which will be discussed later) may give a spouse some limited credit for his or her service contributions. If the farm is operated as a husband-wife partnership and partnership tax returns are filed, then contributions by the wife can be proved. Other possibilities of proof include earnings of the wife from an outside job which were contributed to the farm business or from a salary paid to her by her sole proprietor husband. If the property had originally been willed or given to both husband and wife together, then equal contributions can be proved and only half of that joint property would be included in the estate of the first to die. Regardless of how property is acquired, it cannot be overemphasized that documentation is essential to prove contribution.

Real estate, bank accounts, and U.S. savings bonds are about the only types of property which can be acquired and held in joint tenancy without any present gift taxes due if unequal contributions are made. Thus, a farm couple can purchase farmland and hold title as joint tenants without paying any gift tax regardless of whether husband and wife contributed equally. However, if a dairy herd is purchased and held in joint tenancy and if the husband and wife did not contribute equally, then a taxable gift from one to the other occurs when the joint tenancy is created and gift tax may be due.

Problems can occur with joint ownership of personal property. One of the most common is with joint bank accounts. When such an account is maintained, each joint tenant "owns" an undivided one-half interest in the account. But if one joint tenant withdraws for his or her own use more than he or she has deposited, a gift has occurred. For example, John opens a joint account with his wife, Mary, by depositing \$1,000. Over a six-month period, John and Mary each deposit \$500 more to the account. To make a down payment on a car being purchased in her name, Mary withdraws \$1,000 or one-half of the current balance in the account. At this point, John has made a gift to Mary of \$500 - the amount she withdrew in excess of her contribution to the account. This illustrates the importance of good financial record-keeping where a couple is commingling earnings and property. There will be occasions where a surviving spouse will benefit greatly from having complete books to substantiate that he or she contributed to the purchase of an asset or a bank account balance.

There are very real differences between tenants in common and joint tenants with right of survivorship. A husband and wife holding a large amount of real property as joint tenants may face higher estate taxes when the first spouse dies even though some of the expenses of probate may be reduced. Aside

from the family residence, it is often recommended that spouses purchase real property as tenants in common or in separate names to reduce the complexities involved in property ownership, and the problem of providing proof of contribution, as well as to create two estates of equal size to minimize the estate tax to be paid (see section on estate tax).

Husbands and wives may convert property held by them as joint tenants with right of survivorship or as tenants by the entirety into a tenancy in common and there are circumstances where this is a good idea. Great care should be exercised, however, since breaking up a joint tenancy may result in a gift of all or part of the property to one of the spouses. The gift tax consequences of this event may outweigh any benefits that otherwise might be realized in estate planning. It is imperative that a couple consult with an attorney and review their entire estate plan before changing the form in which they own already-acquired assets.

Whether severing a joint tenancy creates a gift, and of how much property, depends on (1) when the couple purchased the property jointly, (2) the extent to which each spouse contributed to the purchase, and (3) whether a gift tax return was filed when the property was purchased.

If a husband and wife purchased farm land as joint tenants prior to 1955, for tax purposes, such property is deemed to be owned by each of them equally, regardless of who provided the money. Therefore there is no gift if the tenancy is severed and each party takes half. If the property is placed in the name of the wife, the husband has made a gift of one half the value of the property and a gift tax return should be filed. The same would be true if the property went entirely to the husband.

If a husband and wife purchased real property as joint tenants after 1954 but before 1977, for tax purposes it is presumed to be owned in the same proportion as the two of them contributed capital towards the purchase. If the husband contributed all of the purchase price in the beginning, if the tenancy is severed and the couple take it as tenants in common, a gift of one half the value of the property is made to the wife.

A husband and wife have two alternatives for treatment of jointly-held property acquired after 1976. If, for example, the husband furnishes all the money to purchase property jointly with his wife, he can elect to have one half the purchase price treated as a gift when the tenancy is created if a gift tax return is filed. Therefore any subsequent appreciation in the value of the property is in her estate as well as his and she will be deemed to own half the property if the tenancy is subsequently severed. If no gift is declared at the time of purchase in the above example, a taxable gift of half of the appreciated value of the property would be made if ownership were subsequently changed to tenants in common.

Ownership of property can be determined by the wording on the deed to the property if the property is real estate. Personal property ownership may be determined by the name on the bill of sale. Property which is registered will have an owner listed on the registration document. Sole ownership of property exists when there is only one name on the document. Co-ownership exists when more than one name appears. The term "with right of survivorship" implies joint tenancy. If the names of two spouses appear followed by the words

"husband and wife", it is a tenancy by the entirety. If only names are listed, then ownership would be as tenants in common. This is often the case where a partnership purchases a piece of equipment and the names of the partners are placed on the bill of sale. When determining ownership, it is advised to collect the necessary papers and documents and consult with an attorney.

Federal Estate and Gift Tax

The 1976 Tax Reform Act changed the method by which federal gift and estate taxes are calculated. The federal gift and estate tax is now a unified tax. Taxable gifts are taxed at the same rate as property in an estate. A federal estate tax return must be filed if the gross estate exceeds \$175,000. Most full-time farmers would have gross estates of at least that amount. A gift tax return must be filed if gifts to any one individual exceed \$3,000 during a calendar year.

Federal Estate Tax

The gross estate includes all property in which the decedent had an ownership interest at the time of death. This includes real estate, machinery, livestock, feed, cash, and other assets. To determine the tax, property is valued at its fair market value as of the date of death, or as an alternative, six months after death. Farmland, if qualifying conditions are met, can be valued at its "use" value for farming, which may be lower than its market value.

Just as with income tax returns where deductions are subtracted from gross income, deductions are allowed against the gross estate. One such deduction is mortgages and other debts against the deceased. Other deductions include funeral expenses, fees of the executor and attorney, and losses from fire, theft, and storm during settlement of the estate not compensated by insurance. All of these deductions are subtracted from the gross estate to obtain the adjusted gross estate.

Another deduction is the marital deduction. This deduction is allowed for the amount of property that is transferred to a living spouse either by will or through joint tenancy. The maximum amount of the marital deduction is one-half of the adjusted gross estate or \$250,000, whichever is greater. For instance, if the adjusted gross estate is \$250,000 the maximum marital deduction is \$250,000. If the adjusted gross estate is \$400,000 the maximum marital deduction is still only \$250,000. But, if the adjusted gross estate is \$750,000 the maximum marital deduction is \$375,000, one-half of \$750,000. The amount of the marital deduction or more must actually pass outright or in a qualified trust to the living spouse.

An orphan deduction is also available. The amount of the deduction depends upon the age of the orphan. The deduction is equal to \$5,000 multiplied by the difference in years between 21 and the child's age. Property equal in value to the deduction must pass to the orphaned child.

The taxable estate is derived by subtracting all deductions from the gross estate. Then, as with income taxes, a rate schedule is used to obtain the tentative tax. There is a credit available which reduces the tax payable. The credit for 1981 and later years is \$47,000. A credit is also available if property in the estate had previously been taxed in another estate during the past ten years. The credit is equal to the estate tax paid on the previously-taxed property if the previous decedent had died within two years. Eighty percent of the previous tax is deducted as a credit if death occurred two to four years before, 60 percent for four to six years, 40 percent for six to eight years, and 20 percent for eight to ten years. Another credit can be applied against the federal estate tax which is based upon any state tax on the estate. This credit is computed from a rate schedule such that the larger the estate, the greater the credit. For example, if the adjusted taxable estate is \$90,000 the maximum credit is \$400. If the adjusted taxable estate is \$440,000 the maximum credit is \$10,000. By subtracting the credits from the tentative tax, the tax payable is computed. Generally this tax is due nine months after death. However, the tax may be paid in installments if the estate qualifies.

To illustrate the computation of the federal estate tax, assume that a farmer has \$1,014,000 in assets, \$150,000 in liabilities, and he dies in 1981, leaving all his property to his wife.

Husband's gross estate (assets)	\$1,014,000
minus liabilities	150,000
minus estimated funeral and estate settlement costs	34,000
Adjusted gross estate	\$ 830,000
Marital deduction	415,000
Taxable estate	\$ 415,000
 Tentative tax	 \$ 126,900
Unified tax credit	47,000
 Federal Tax Payable	 \$ 79,900

The federal credit for any state estate tax paid or other miscellaneous credits were not computed for this example and may be available.

Property Valuation for Estate Tax

Generally, property owned by a decedent is valued for estate tax purposes at its market value the date of the decedent's death. If a decedent owned 100 shares of common stock that was trading at \$50 a share on the date of his or her death, then the value of the stock for the decedent's estate tax return is \$50 times 100, or \$5,000.

There are a number of alternatives to this estate property valuation rule. First, it is possible to select an alternative date other than the date of death to value property for the estate tax return. This alternative date is 6 months after death. If this alternative date is selected then all property must be valued as of that date. It is not possible to use the date of death to value some property and 6 months after death to value other property.

For farm estates where livestock and crops must be sold, feed fed, and other assets liquidated before 6 months after death, then these assets are valued as of the date of disposition, if the alternative valuation date is selected.

Gifts made during the decedent's life that must be included in the gross estate are valued at the date that the gift was made. This is true even if the gifts have appreciated in value for the recipient. The only exception is a taxable gift which is made within three years of death which will be valued at the date of death.

An alternative estate valuation procedure is available for closely-held family businesses, including farms. The procedure allows farm real estate to be valued at its farm use value rather than at its market value. Farm use value may be lower than market value since market value is the value of the property at its highest and best use - including use as shopping centers and housing developments.

Use valuation can only be used on farm real estate and is not available for farm personal property or non-business property. In addition, a number of conditions must be met to apply "use valuation". Some of the important conditions follow: (1) The farm business must comprise a major portion of the decedent's estate. Specifically, the adjusted value of real and personal farm property must be 50 percent or more of the decedent's gross estate. However, only 25 percent of the gross estate needs to be business real property. (2) The decedent or a member of his or her family must have operated and owned the farm property in five of the decedent's last eight years of life. This prevents non-farm investors from quickly buying farmland before death to take advantage of use valuation. (3) The farm must be operated by a designated family member for 15 years after the decedent's death. This rule forces the farm to remain a family farm. To insure this a lien is placed on the property and if a designated family member (or an alternative member) ceases to operate the farm or if the farm is sold, part or all of any tax previously saved by use valuation must be paid. (4) Use valuation cannot reduce a decedent's gross estate by more than \$500,000. (5) All heirs must consent to the utilization of this procedure.

The use value of farm real estate can be calculated by the capitalization formula:

$$\text{Use value} = \frac{\text{Gross annual cash rent} - \text{Annual property tax}}{\text{Effective interest rate for Federal Land Bank Mortgages}}.$$

The gross annual cash rent is the yearly rent value of the farm real estate. Annual property taxes are local as well as any state property tax. The effective interest rate for Federal Land Bank Mortgages includes debt and stock purchase costs, and is calculated yearly by the IRS for each of the twelve Farm Credit Districts. Example: Farmland with a cash rental value of \$35 an acre and real estate taxes of \$10 an acre, with a district Federal Land Bank effective mortgage rate of 10 percent, will have a use value as follows:

$$\frac{\$35 - \$10}{.10} = \$250 \text{ an acre.}$$

In situations where farm real estate had not been rented (at fair market rent) and there is no comparable rent information for similar type real estate, other use valuation techniques can be used.

The "Credit for Services" Rule

Farm real estate is often held in joint tenancy or tenancy in the entirety between husband and wife. That property is then included in the estate of the first to die except to the extent that the surviving spouse can show contribution. This is often not difficult for the husband to do, but if the wife survives, and statistics indicate wives usually survive husbands, she may have difficulty proving contribution unless she held a job off the farm, inherited property, or explicitly received a salary or profits from the farm business. Most farm couples file a sole proprietorship tax return, not a partnership return. A sole proprietorship has one manager and operator, usually the husband, and the net income from the business accrues to that sole proprietor. A joint tax return for married couples does not show or prove equal earning or sharing of income.

If a spouse is an active participant in the farm business as well as the marriage, that participation should be acknowledged by a business arrangement that fairly reimburses that business participant. The reimbursement can be as a wage or salary for labor (wages paid to a spouse are not subject to social security taxes), rent for property, and profit sharing for management. Sometimes a husband-wife partnership is the proper arrangement. (Partnerships do not have to be 50-50.)

Unfortunately, many farm couples have not monetarily recognized the contributions of the spouse in the farm business and so it is difficult to prove contribution. This has been recognized by Congress and so the "Credit for Service" rule became part of the tax laws in 1979. This clause states that a spouse can be given partial credit for the value of the jointly-held property in the estate of the first to die, over the actual money contribution which can be shown, if the surviving spouse can prove "material participation" in the farm business. The credit is at the rate of 2 percent per year of the value of the jointly held property over the original amount both contributed increased by six percent simple interest a year. An example can illustrate the rule.

Sam and Mary purchased a farm in 1965 with title in joint tenancy. Sam provided \$40,000 and Mary \$20,000 and the farm is valued at \$320,000 in 1980. Mary materially participated in the farm business for those 15 years. Sam's original contribution for the purposes of this rule increased at 6 percent simple interest for 15 years from \$40,000 to \$76,000. Mary's original contribution grew at the same rate and time from \$20,000 to \$38,000. Together their original contributions grew to \$114,000. That leaves \$320,000 minus \$114,000 or \$206,000. For 15 years of material participation at 2 percent a year Mary receives credit of 30 percent times \$206,000 or \$61,800. Thus, Mary contributed \$38,000 plus \$61,800 or \$99,800. This amount is excluded from Sam's estate. However, \$220,200 of the jointly-held property is still included in his estate.

There are, as usual, requirements and restrictions to the use of "Credit for Services". The spouse must materially participate in the farm business. It is not clear yet what constitutes material participation. Driving to town for parts may not be sufficient. In addition, the maximum credit for services is 50 percent - that's 25 years at the 2 percent rate - or half of the

property. Lastly, the "Credit for Services" cannot reduce the deceased spouse's gross estate by more than \$500,000.

The Installment Payment of Federal Estate Taxes

The federal estate tax return for a decedent is due nine months after the decedent's death and the estate tax is due at that time. However, it is possible to obtain a one-year extension to pay the tax if an acceptable reason can be given to the IRS. It may be possible to renew the extension each year for up to 10 years. Interest at 12 percent a year is assessed on the unpaid tax. In addition to this extension it is possible to pay the estate tax in installment payments under either of two options if the estate qualifies.

A 10-year estate tax installment payment option is available if an estate consists of a closely-held family business. To qualify, the business property value of the estate must exceed 35 percent of the value of the gross estate, or exceed 50 percent of the value of the taxable estate. Only that portion of the estate tax attributed to the business can be paid in installments. The portion is determined by the ratio of the farm property value to the value of the adjusted gross estate. The estate tax on non-business property is due when the estate tax return is filed. The payments can be made in 10 equal annual installments. The interest charge is the rate for delinquent taxes - currently 12 percent. A tax lien is placed against the property to ensure tax payment.

The 15-year installment payment option for estates that qualify, is more advantageous than the 10-year installment plan. First of all, the interest rate is 4 percent rather than 12 percent. In addition, not only are payments spread out over 15 years rather than 10 years, but the first payment can be deferred for 5 years (with interest). As with the 10-year plan only that portion of the estate tax attributed to the business may be paid in installments. Because it currently costs more than 4 percent to borrow money, and it is also possible to earn more than 4 percent on investments, it would seem foolish for the executor of an estate not to take advantage of the 15-year option. However, there are a number of qualifying conditions and restrictions which restricts or discourages an executor from using the 15-year payment option. To qualify the closely-held family business must comprise 65 percent or more of the adjusted gross estate. The farm must be operated as a family business and not held as an investment only. The 4 percent interest only applies to the first \$345,800 of estate tax. A tax lien is placed against the property to ensure tax payment. There is also an acceleration of the tax payments if more than one-third of the farm is disposed of before the tax payments are completed.

Federal Gift Tax

Gifts made during life may also be subject to tax. The law provides a \$3,000 annual exclusion which enables a donor to give any person during a calendar year tax-exempt gifts of \$3,000. A husband and wife can give \$6,000 together without tax even if the \$6,000 is the property of only one spouse. However, if the amount of the gift exceeds \$3,000, a tax return must be filed even if no tax is due. The yearly exclusion can be used for any number of

gifts to donees. A husband and wife, for example, may give their four children total gifts of \$24,000 in one year without taxes. In ten years they can give \$240,000.

Gifts larger than the \$3,000 annual exclusion will be subject to tax and a gift tax form must be filed. The amount of the gift greater than the \$3,000 exclusion is subject to the same tax rate as an estate. In addition, the unified credit of \$47,000 may be used to offset any tax liability.

It is possible to make gifts over time without any tax liability by using the annual \$3,000 exclusion, or to make substantial gifts with some potential tax liability but still pay no tax by using the tax credit available. Additionally, gifts to a spouse are covered with a \$100,000 marital deduction before any tax is due. The second \$100,000 in gifts to a spouse is fully taxed and anything over \$200,000 receives a 50 percent deduction. Use of the gift tax marital deduction may result in reduction of the estate tax marital deduction. However, the reduction is never greater than \$50,000.

One exception to these rules applies to gifts made within three years of death. The value of such gifts is included in the gross estate and subject to federal estate tax if the gifts exceeded the \$3000 annual exclusion so that a gift tax return was filed when the gift was made. The basic idea behind this rule is that individuals should not be able to avoid the tax by making gifts of their property to others shortly before death.

Because the gift and estate tax is a unified tax, adjustments in computing the estate tax are made if a deceased individual made taxable gifts during his life. Added to the estate is the value of taxable gifts beyond the \$3,000 annual exclusion. The tax is then computed. Any gift tax that had previously been paid is subtracted from the tax. Finally, the tax credit of \$47,000 is applied against the tax liability, as well as other available estate tax return credits.

New York Estate and Gift Tax

The New York death tax system is patterned like the federal in that it is an estate tax rather than an inheritance tax paid by those who receive property from the decedent. However, unlike New York's income tax provisions which are automatically "amended" to conform to changes in the federal income tax laws, any changes made in either the State estate or gift tax must be done specifically by the State legislature.

Modifications in the State law made in response to the 1976 Tax Reform Act have occurred in several stages since 1977, so the tax problems of estates where the decedents died between 1977 and 1980 could vary widely even on estates of the same size. Fortunately, the State law now conforms quite closely to the federal provisions in just about every area of estate taxation. Generally the assets included in the federal gross estate are included in the New York gross estate and vice versa, as long as the property is located in New York. New York has a gift tax marital deduction, an estate tax marital deduction and an orphan's deduction as under federal law. There are other provisions enacted by New York to conform with the federal tax system.

In New York if one dies leaving a surviving spouse or children under the age of 21, the law provides that certain property is not considered to be part of the estate but rather it goes immediately to the qualified survivor(s). This exempt property includes \$5000 worth of household goods such as furniture, appliances, clothing of the decedent and food. Books and family photographs, including the family Bible, are exempt to an amount of \$150. Ten thousand dollars worth of farm animals, feed and farm machinery may be passed directly to the surviving spouse or children - an important exemption for farm families. In addition, cash or other personal property valued at \$1000 is exempt as long as there will be enough assets left in the estate to pay the funeral expenses.

Special Valuation

Effective as to decedents dying after August 10, 1977, New York adopted in most respects the federal provisions relating to special use valuation of real property used in farms and other closely-held businesses. In addition to the estate tax reduction which could follow from reducing property values for tax purposes, the State law provides for a credit of up to \$15,000 against the State estate tax for the value of qualified farms and qualified personal property used for farm purposes.

New York has also adopted provisions allowing for installment payment of the State tax if an estate consists of a closely-held business. There are some procedural differences between the federal and state provisions, particularly in the area of enforcement.

General Credit

New York provides for a general estate tax credit, the amount of which is determined before the application of any agricultural use credit, gift tax credit or prior transfer credit. The general credit is reduced as more tax is computed. There is usually less credit available for larger estates than for smaller ones, but the determinative factor is the amount of the tax computed rather than the size of the estate. If the tax is \$2,750 or less, the general credit is equal to the tax. Based on New York estate tax rates, that means that no New York estate tax is imposed on taxable estates of \$108,333 or less. If the tax is greater than \$2,750 but less than \$5,000, the general credit is the amount by which \$5,500 exceeds the tax. If the tax is greater than \$5,000, the credit is \$500.

Prior to the legislative amendments in 1978, credits were provided for certain property transferred to close relatives and for certain transfers of life insurance proceeds. Those credits have been eliminated.

Gift Tax

New York has not adopted a unified transfer tax to bring the gift and estate tax structures into the same system as was done for federal taxation. The current State gift tax rate is 75% of the estate tax rate and there is no unified tax credit similar to the \$47,000 federal credit that can be applied to reduce either federal gift or estate taxes interchangeably. There is a

State credit for estate tax purposes for gift taxes paid during life so the gift is not taxed twice.

New York taxes all gifts made by a New York resident unless they are excludable (i.e., less than \$3,000 per person a year) or the real or personal property comprising the gift is actually located outside the state (in which case it would probably be taxable in another state). Land or tangible personal property located within New York will be taxed by the State if it is the subject of a gift by a non-New York resident.

Wills

For an individual who is responsible for the financial well-being of others, or who cares about what happens to his or her property when he or she dies, a will is one of the most important documents he or she will ever sign. Contemplating one's death is not an exhilarating prospect but an unexpected tragedy could strike even a young person and it is a good idea to be prepared. If you do not have a will, the state will designate who gets your property even if it may be contrary to your wishes or those of your heirs.

There are very rigid rules in every state which determine whether a will is valid, so consulting a lawyer to help you prepare a will makes good sense. Unless you have a very complicated estate, the fee charged by most lawyers to write a will will be among the lowest charged for any legal service. It is important to provide your attorney with a complete financial picture of your current assets and liabilities and anticipated future status, as well as your decisions regarding the distribution of your property at your death. Your personal feelings are important to the estate planning process - after all, it is your property and your family that are involved. Drawing a will and formulating an estate plan to save taxes should be compatible with your wishes, but not a higher priority than your personal goals.

In terms of the general requirements of the will itself, there are a few formalities which must be observed. A will must be in writing and must be signed at the end by the testator (the person making the will). There must be at least two witnesses to the signing. They do not have to read the will itself but they must be able to swear that they knew that the testator was signing a will. You must be at least eighteen to make a valid will, and be mentally competent - that is, have sufficient mental capacity to be aware of the property you own and the people who would be the reasonable recipients of it at your death. It also must be obvious that the will was executed (signed) voluntarily and free from undue influence by those who will inherit.

Once a will is drawn and executed, the same rigid legal requirements apply to any attempt to change or amend it. If you change your mind and want to nullify or "revoke" your will, you must physically destroy every copy or indicate in a subsequent will or will amendment (known as a "codicil") that you intend to revoke the former will or part of the former will. Merely crossing out a few lines or destroying a page will not accomplish what you wish. It is equally important, therefore, to consult an attorney when you want to change your will.

Besides designating who receives what property when the testator dies, the will is used to name an executor to administer the estate and to delineate what his or her powers should be. The will can also be used to designate a guardian for minor children and to spell out preferred funeral arrangements. If part of the property is to be placed in trust at death, the provisions of the testamentary trust are included in the will.

When the will is executed it is important that there be only one original and that should be kept in a safe place. The attorney who prepared the document should keep a copy, but he or she usually does not hold the original. It is often recommended that an original of the will be kept in a safe deposit box in the spouse's name if possible so that it will be easily accessible and not sealed in the decedent's box until the IRS can inventory the contents. Wherever the original will is placed, it is wise to have one or two other family members aware of its location.

Trusts

A trust is a legal tool that can be used to transfer and manage property. It is an ingenious device because the person who creates the trust (known as the "settlor") does not have to give up all control over that property, nor must he or she relinquish the income or benefits derived from it. It all depends on the form of trust used and the needs of the people it is created to serve.

To establish a trust, property is transferred from the settlor to another person (known as the "trustee") with the understanding that the recipient will hold the property or use it in some way as directed by the settlor. Anyone who benefits from the use of that property, for example by receiving any income generated by it, is known as a "beneficiary". A trust does not last forever. When it terminates, either at a given time or upon the occurrence of a given event (like the death of the beneficiary), those who get the property are known as "remaindermen". The settlor, beneficiary and remainderman need not all be different people. An individual can set up a trust naming himself or herself as beneficiary if he or she wishes to have someone else manage the assets in the trust.

There are two types of trusts differentiated by when they are established. A trust set up during the settlor's life is called an "inter vivos trust". A trust set up by someone's will to take effect when that person dies is a "testamentary trust". Both trusts are excellent methods to provide financial security for infants or family members who should not or cannot manage their own affairs, as well as being important devices in any scheme to minimize income and estate taxes.

There are legal requirements to establish an enforceable trust, so it is important to consult an attorney or other professional, like a bank trust department representative, when setting up a trust. Among other things, to transfer real property to an inter vivos trust there must be a conveyance of title in writing. Further, a testamentary trust must be consistent with the other provisions in the will and must be set up in accordance with state law. In all trusts, the beneficiary or beneficiaries must be identifiable, either by name or as a class of people like "my children".

Choosing a trustee is a very important step in setting up a trust. No one is required to accept such a position unwillingly, but once someone agrees to serve he or she cannot relinquish the responsibility without permission of the court. Therefore it is important that a person understand the duties and responsibilities of a trustee generally, as well as under the terms of the particular trust, when they are asked to assume such a role. If there is a large amount of property in the trust (known as the trust "corpus" or "principal") or if managing the trust corpus is a complicated undertaking, it may be wise to appoint a corporate trustee like a bank to serve alone or as co-trustee with an individual. Any trustee is entitled to a fee for services with the maximum amount established by state law which relates to the value of the trust corpus. For example, for managing a testamentary trust in New York, a trustee may receive \$7 per \$1,000 or major fraction thereof on the first \$300,000 of principal, \$3.75 per \$1,000 on the next \$500,000 and \$2.50 per \$1,000 on all additional principal. Therefore to administer such a trust valued at \$800,000 would cost less than \$4,000 or .5% of the principal per year.

The trustee's powers are those given to him or her by the trust document and those specified by state statute. New York recognizes very broad powers which a trustee can exercise unless the trust document specifically directs otherwise. The trustee manages the assets and this generally includes buying and selling property, investing in stocks and bonds, and paying out income to beneficiaries consistent with the trust terms.

While a trustee may have broad powers, he or she also has very clear duties and high standards against which his or her performance is measured. He or she is a fiduciary and as such must avoid any personal gain at the trust's expense and he or she must exercise care in making his or her decisions. He or she may not be rash and speculative in his or her investing and he or she must take special pains to preserve the trust principal from loss. He or she must account for all the assets which pass through his or her hands and respect the wishes of the settlor in distributing income and/or principal.

Typically, the beneficiary receives income, and perhaps a portion of the principal, during his or her lifetime. Once income is distributed a beneficiary can do with it what he or she pleases. However, the trust can include a "spendthrift" provision which would prevent a beneficiary from spending or assigning income to another before he or she has received it, an important limitation where the beneficiary tends to be careless with his or her financial planning.

A trust can provide for a pay out of income sufficient to provide support for the beneficiaries at the discretion of the trustee. This is a common way to provide for loved ones in a testamentary trust, particularly minor children. A trust can also be used to assist in the management of your property when you are older or when you wish to do other things than manage property.

A trust is sometimes used to save estate tax on the estate of the second spouse to die. A husband leaves a life estate in trust to his wife with the property to pass to their children at her death. The wife receives income from the property during her lifetime but cannot sell or will the property. The property is included in his estate but not hers since her interest in the property terminates at her death. A common problem for farm families using

this procedure is that property in joint tenancy between husband and wife cannot be used by the husband to set up these marital trusts. Another problem is that very few corporate trustees are able or willing to manage farm property, particularly farm personal property.

A trust is an extremely helpful tool in estate and financial planning. It provides flexibility and a greater degree of funds management than might be possible with an outright gift - either during life or at death. As discussed in the section on "charitable gifts," a trust is also useful when someone wants to give to a charitable organization during lifetime but does not have easily-liquidated assets or divisible property.

Gifts

A gift is a lifetime transfer of property without receiving payment for the property. There must be an intent to make the gift by the donor, accompanied by acceptance of the gift by the recipient (donee). In addition, the transfer does not occur until the gift is delivered to the donee. Putting a letter in your safe deposit box which says that you intend to give your daughter your heirloom pocket watch is not a gift if the watch stays in your pocket.

The gift tax is a tax on the transfer of property. No tax is incurred until the transfer occurs. A promise to transfer property as a gift in the future may be legally binding, but it would not incur a tax at the time of the promise. A tax is imposed on gifts placed in a trust at the time the transfer is made to the trust, even though the trust beneficiary may not actually receive the income or trust principal until some future date.

Besides a trust, a gift can take many subtle forms. If two people open a joint savings account and one of them makes all the deposits, a gift occurs whenever the noncontributor makes a withdrawal for his or her own use. Similarly, if a married couple purchases real property as joint tenants with one spouse providing more than half of the purchase price, a gift occurs when the tenancy is terminated if the noncontributing spouse receives half or more of the proceeds or property, unless a gift is declared at an earlier point.

It is possible that the IRS will consider a gift is made even where the donor argues that there was no intent to make a gift, so be careful. If you discharge a debt it will be considered a taxable gift. If you make an interest-free loan, particularly to a family member, you may be deemed to have made a gift equal to a reasonable rate of interest, although some tax courts have ruled that this is not a gift. If you make a habit of forgiving loan payments on debt owed you by a family member, the IRS will maintain that the gift occurs when the debt was incurred rather than when forgiven unless you have a demand note as evidence of your intent to collect the entire debt at some reasonable point in time. However, if you forgive payments on debt incurred as the result of an installment sale, that forgiveness is taxable income to the donor.

One of the fastest and easiest ways to reduce the size of an estate - and therefore the amount of estate tax to be paid - is to make a gift of property.

However, many people hesitate to just give away what they have worked hard to acquire, so it is important to weigh the factors involved in gifting.

Making lifetime gifts to family members produces nontax benefits as well as estate (and possibly income) tax savings. Giving young people ownership of farm property provides them with a stake in the farm business and often an incentive to involve themselves fully in its operation. For example, the gift of a calf to a child old enough to take responsibility for the animal's care is an excellent way to teach a child not only how to raise livestock, but also to understand the obligations which go along with ownership of property. Additionally, giving income-producing property to a family member in a lower tax bracket might lessen the overall tax bite for the family.

It is important to consider the economic situation of the donor, and that of the donee, when deciding whether a gift of property would be wise. This is particularly true of farmers who tend to have relatively few non-farm assets. Some estate planners maintain that in these times of inflation the only appropriate time for most people to make gifts is on their deathbeds. You can give up to \$3,000 to anyone you wish and that property will not be included in your taxable estate, or subject to gift tax. However, going over the \$3,000 amount within 3 years of your death will bring the entire amount of the gift back into your taxable estate, even the \$3,000 annual exclusion.

Active farmers engaged in expanding their operation who have all their assets tied up in the business may not be in a position to make substantial gifts. They are still involved in building the business and living with it at least in the near future. Income taxes are of more consequence to them than estate or gift taxes.

When the working farm is the center of a younger couple's life it may not be economically or psychologically wise to give away farm assets. Particularly since farm commodity prices fluctuate so drastically, land represents financial security. Additionally, any gifting plan which might break up the farm operating unit or impair liquidity could have disastrous consequences.

The circumstances are somewhat different, however, when you consider a farmer who has reached the so-called "exit" stage in the cycle of operation. After a full and productive life on the farm many individuals decide they are ready to slow down and they are eager to involve another family member in both management and ownership of the business. When a farmer reaches the point in his or her life where he feels he has acquired enough property to feel he or she has been successful, and to guarantee a degree of financial security in the future with which he or she feels comfortable, it is time to consider how gifts as well as sales of property might be utilized in formulating an estate plan.

When making gifts to your children or grandchildren you should first think about their current and anticipated needs. Obviously their financial requirements should be considered in your decision making. Cash or easily liquidated property might be of great help to a young adult attempting to complete medical school or start a business, while a savings account for your minor grandchild might be a better way to provide for his or her future needs.

It is also important to consider whether your donee can both appreciate the gift and put the property to good use. It would be a mistake to give a farm to your son who has no interest in operating it if his disinterest results in mismanagement, loss of profits or worse, bankruptcy.

It is possible to make gifts of money or valuable property to a minor child without setting up a somewhat cumbersome trust or worrying that the child will have control of property before he or she is old enough to use it wisely. The Uniform Gifts to Minors Act provides a mechanism for making a gift to an adult as custodian for the minor child. In New York, the child will receive outright control of the property at age eighteen, or sooner if the donor so designates. In the meantime, the custodian has "management and investment powers". The donor, an adult relative, parent or guardian of the child, or a bank trust officer may be the custodian. The gift must be to only one child and only one custodian should be designated per gift. In other words, you may not open a savings account in the name of "John and Mary Smith as custodians for their children, Patty and Steve."

Many people benefit from making gifts to their spouse. The tax advantages are clear - lifetime gifts up to \$100,000 can be transferred gift tax free. By transferring ownership of rapidly-appreciating property, you freeze the value of the gift for your estate tax purposes.

The key objective of transferring property to a spouse is to balance the size of each estate. Then, regardless of who dies first, the estate tax is lower than if the property was all held in the estate of that person. For this technique to work the property must be willed to someone other than the surviving spouse. Otherwise all of the property will be taxed when the second spouse dies. And, the tax may be tremendous since the estate tax marital deduction cannot be used if there is no surviving spouse.

Before making gifts to a spouse, take the time to think about the circumstances surrounding the gift, particularly if your primary reason for making the gift is to reduce estate taxes. Obviously the first consideration should be the value of property currently owned by your spouse. Remember, too, that the situation may change and make allowances if, for example, your husband or wife is likely to inherit property or acquire an interest in a business outside the farm.

Although it is an unpleasant concept on which to dwell, a spouse's health and life expectancy are factors which influence a decision to make a gift. While statistics indicate that women generally outlive men, this rule-of-thumb may not hold true in a specific instance where a wife is a number of years older than her husband or is in poor health. If this is the case, a gift from husband to wife may be pointless for, upon her death, her property would go back to her husband to be taxed again in his estate unless specific provisions in her will provide for distribution to other persons.

Charitable Gifts

Charitable gifts and charitable bequests take three basic forms. A property owner may make an immediate, outright gift of property which would be a charitable contribution, resulting in an itemized deduction on the

taxpayer's personal income tax return. Secondly, an individual may make provision in his or her will that a portion of his or her property pass to a charitable organization at death, resulting in a charitable deduction on the estate tax return. Thirdly, a deferred gift is possible if the property owner makes an immediate and irrevocable gift of an interest in property but retains an interest as well. This results in both an income tax and an estate tax deduction but neither deduction equals the full market value of the gift.

A gift to a charitable organization is not subject to any gift tax so the \$3,000 annual exclusion or unified credit are not involved. The donor is eligible to take a deduction on his or her personal income tax return ranging as high as the full value of the property, depending on the organization receiving the gift, the type of property and the subsequent use of the property. If the gift occurs at death, the full value of the property can be deducted on the federal estate tax return.

A charitable gift of property other than cash can have various consequences for tax purposes. If a gift of tangible personal property can be put to a related use by the charitable organization, the donor may take an income tax deduction equal to the fair market value of the property. Donating a saddle to Cornell which is used by the University is an example of such a qualifying gift. Deductions will vary, too, depending on whether the gift is of ordinary-income property (i.e., inventory) or capital-gain property (would result in long-term capital gain if sold). Ordinary-income property leads to a deduction of the lesser of the fair market value of the property or its tax basis when the gift is made. The rule applied to capital-gain property depends on the kind of organization receiving the gift. In any case, a charitable contribution cannot exceed a specified amount, usually 30% of the taxpayer's adjusted gross income for the tax year. Provision is made, in most cases, to carry over the unused portion of a deduction for subsequent years.

The tax consequences of charitable gifts, while always beneficial to the donor, may not always result in a tax saving equal to the value of the property. It is usually true that other factors should be weighed equally when determining when such a gift is made, and to what charitable organization. Deferred gifts or gifts in trust, while more complicated, may prove more satisfactory in this regard. For example, a farm couple could establish a charitable remainder trust. By law, such a trust is required to pay annually at least 5% of either the initial value of the trust corpus or its market value calculated annually to a noncharitable beneficiary, in this case the farm couple, either for life or for a term of 20 years or less. When the trust is terminated at the expiration of that term, the charitable beneficiary receives the principal. This gives the couple a guaranteed income for life while both relieving them of the responsibility of property management and carrying out their wishes that their property go to charity at their death. They pay income tax only on the annuity they receive. All or just part of their assets could be placed in the trust corpus, depending on their needs.

Not every property owner has sufficient property that he or she wants to give away to realistically create a charitable remainder trust by himself or herself. As a result, many charitable organizations have created "pooled income funds" which hold a donor's property in trust but commingled with that of other donors, all of whom retain a life or income interest in the property they contributed.

Income Tax Considerations in Estate Planning

Because they face the grim situation of paying income taxes every March 1, farmers are generally more knowledgeable about income taxes than estate taxes. Much estate planning involves income tax consequences that are unfamiliar to farmers, including techniques which may require the payment of substantial income taxes. Additional income taxes can discourage a farm family from using these techniques but they must be considered in spite of the income tax consequences because such mechanisms allow the family to fulfill many of their estate planning objectives.

Income Tax Basis

The (adjusted) income tax basis of property is what you have invested in that property and have not recovered through income tax deductions such as depreciation or losses. Knowing the tax basis of property is extremely important since the tax basis is used in computing any gain or loss on the sale or other disposition of property.

The rules concerning tax basis are complicated and involved for many types of transactions. Your professional tax preparer is familiar with these rules and is able to determine the tax basis of property that you own. However, it is necessary that you supply him or her with satisfactory records in order for him or her to compute any changes in the tax basis of property. Keeping all of your income tax returns is helpful but not completely adequate. Many actions that affect the tax basis of property never show up on an income tax return. For example, if you add a fireplace to your home, that expenditure increases the tax basis of your home but it would not be recorded on any of your income tax returns. If you sell your home, however, you need to know the cost of the fireplace because that cost is part of the tax basis of the house.

The income tax basis of purchased property is its purchase price or cost. If you pay \$40,000 for a tractor the tax basis of that tractor is \$40,000. If a trade-in is involved then the tax basis of the new property is the adjusted tax basis of the property traded plus the cash boot. If you trade your old tractor that has a market value of \$10,000, adjusted tax basis of \$8,000, and \$30,000 cash for a new tractor with a market value of \$40,000, the tax basis of the new tractor is \$38,000.

Adjusted tax basis occurs whenever an adjustment to the original tax basis is made. As you depreciate your new tractor, its tax basis will be adjusted downwards each year by the amount of depreciation claimed on your tax return. Adding a cab to the tractor (which you wish you had done when you originally bought the tractor) will increase the adjusted tax basis of the tractor. Other tax basis adjustments can occur.

If property is built or constructed by you, such as a barn addition, then the tax basis of the addition, which will be added to the adjusted tax basis of the barn, is the total cost of construction. This includes not only the cost of materials but also any hired labor.

Raised property such as cows or feed has a zero tax basis except for farmers who report income on the accrual basis, and very few farmers do.

If property is inherited then the tax basis of the inherited property is its value in the decedent's estate tax return. This rule allows for "stepped up basis" since the tax basis of property is often stepped up at death. For example, if your father had purchased farmland previously for \$50,000 and it is now worth \$300,000 and he dies leaving the property to you, the tax basis of the property to you is stepped up to \$300,000. (If use valuation reduces the value to say \$250,000 your tax basis is only \$250,000.) You can immediately sell the property for \$300,000 and would not pay any income tax on the sale because \$300,000 sales price minus \$300,000 tax basis is \$0 taxable gain. However, if your father had sold the property for \$300,000 shortly before his death his taxable gain would be \$250,000 which is the \$300,000 sales price minus \$50,000 tax basis.

The tax basis of property received as a gift is generally the same as the tax basis that the property had in the donor's hands. A major exception occurs when the market value of the property is less than its adjusted tax basis, a rare occurrence with farm property. If your father gives you a cow that he had purchased and its adjusted tax basis to your father is \$800, you not only get the cow but also the \$800 tax basis. You can immediately proceed to depreciate \$800 worth of cow on your tax return, and you can use a different depreciation method than what your father was using. If any gift tax is paid because of the gift, then some of the gift tax amount can be added to the tax basis of the property if the donor had originally acquired the property before 1976.

Property Sales

Income taxes must be considered when estate and business planning decisions involve the sale of property. If property is sold for more than its depreciated value (adjusted tax basis), the difference is subject to taxation the year the item is sold. How the item is taxed depends upon the type of property sold. For real estate (land and buildings), the difference between the sales price and the adjusted tax basis is usually capital gain. Currently only 40 percent of the amount of the capital gain is added to taxable income. There are circumstances, however, when some or all of the gain from the sale of real estate must be reported as ordinary income rather than capital gain. The most common instance is when a depreciation method other than the straight line method had been used to depreciate depreciable real estate. Another instance when the gain from the sale of real estate may not be all capital gain is when soil and water conservation or land clearing expenditures were made on the property and written off as expenses rather than added to the tax basis of the land.

If the property sold is personal property, such as livestock or machinery, any gain will be ordinary income rather than capital gain income, unless the item is sold for more than its original cost (tax basis). Only the amount of the sales price over the original cost will be capital gain. Different rules apply to machinery purchased before 1961 and livestock purchased before 1969. Since raised breeding livestock do not have any original purchase cost, all of the gain on sale will be capital gain.

For property to qualify for capital gain treatment it must be owned for a minimum period of time. Dairy and beef stock and horses must be owned for at least 24 months. Other breeding livestock, machinery and real estate must be owned for at least 12 months.

The gain from property sales can be reported over more than one year if payment is received over more than one year. This relieves a taxpayer of paying tax on income that has not yet been collected, and allows spreading income over more than one year to reduce taxes. These installment sales can be made to children, other relatives, or unrelated individuals. Since payments are delayed, it is necessary to charge a buyer, whether that buyer is related or not, at least 6 percent simple interest or the IRS will impute a 7 percent interest rate compounded semi-annually. (This may change soon to 9 and 10 percent, respectively.) Installment sales also have non-tax benefits to both buyer and seller. The buyer receives income payments over time which can be ideal during retirement. The seller benefits by not having to seek debt financing to purchase the property.

Investment Credit Recapture

Recapture of investment credit is a concern for farm families who are considering the sale of property to a child. Parents have to repay some or all investment credit previously claimed on property sold if that property had not been held for the required number of years. This recapture occurs regardless of to whom the property is sold. However, a child (grandchild) cannot take investment credit on property purchased from a parent (grandparent) although that same property might qualify for investment credit if purchased from a non-related (non-lineal) individual.

The transfer of property into a partnership or corporation may or may not require the recapture of investment credit. The key is whether the partnership or corporate business that results is a mere change in the form of doing business. If there is only a change in form, there is no recapture. If a father and son throw all of their farm property into a partnership and receive a partnership interest in proportion to their contribution, then there is merely a change in the form of doing business. If, however, the father retains substantial farm property outside of the new partnership - such as all of the real estate - there may be more than a mere change in the form of doing business and any investment credit on property transferred into the partnership may have to be recaptured. The partnership cannot claim investment credit on property acquired from partners.

Income Tax Effects of Partnership Formation

It is possible to form a partnership without any income tax having to be paid because of the formation. However, some partnership formations can create substantial income tax liabilities.

There are two major income tax concerns in forming partnerships which will be briefly mentioned here. First, almost all farmers have debt as well as property. If you transfer property to a partnership for a partnership interest you may also transfer the property debt to the partnership. This is perfectly legal. However, if the amount of debt that you transfer is greater

than the adjusted tax basis of the property that you transfer, the difference is taxable income when the transfer occurs. A lot of farm property has a high market value but little or no tax basis (raised livestock for example) and has debt against it.

A second partnership formation transaction that can trigger income tax is when a potential partner has little or no property to transfer to the partnership but will provide labor to the partnership and so is given a partnership interest. The value of the partnership interest (minus any contribution) is taxable income to that partner. A remedy is to sell the labor-contributing partner an interest in the partnership. Because that partner probably has little money to make the purchase, the purchase can be financed with 100 percent debt by another partner(s). Beware, however, of the possible tax on capital gain realized by the selling partner(s) in such a transaction.

The Final Income Tax Returns

A common statement that is credited to Benjamin Franklin is that the only two things certain in life are death and taxes. A corollary statement to Franklin's statement is that taxes are even certain after death. And this is not just estate taxes! A deceased taxpayer must have an income tax return filed on his or her behalf to pay income tax on any income that he or she earned before his or her death that had not been reported on his or her previous tax return. For a farmer who reports income on the cash basis, and most do, the last tax return would include only cash receipts and expenses that he or she actually received or paid. Other receipts or expenses that a farmer may have earned or incurred, but as of his or her death had not yet received or paid, are not included. Examples include a milk check not received or feed purchases not paid. Rather, these receipts and expenses result in income or expenses that are referred to as "income (expenses) in respect of the decedent". Do not think for one moment that this net income is not taxed. It is. Either the estate must file a "fiduciary" income tax return and pay income tax on the income, or the income can be passed on to an heir who must report the income on his or her individual tax return.

Farm income that results from crops or livestock growing at the time of a farmer's death is not income in respect of the decedent and is not subject to income taxes, except to the extent that the final sales price of the growing crops or livestock is greater than their value at the farmer's death. Finally, property that generates income in respect of the decedent is included in the gross estate. However, the taxpayer reporting this income on his or her tax return receives an income tax credit for the estate tax paid that is attributed to that property.

Other Income Tax Items

A taxpayer over age 55 is allowed a once-in-a-lifetime exclusion of taxes on the gain from the sale of his residence up to \$100,000 gain. This permits a couple to sell their residence, move into a smaller home or an apartment, and benefit from the gain from the sale of their former residence without tax.

Life Insurance for Farm Families

Life insurance for a farmer serves three basic purposes. The first, and typically primary purpose, is to provide funds for a farmer's dependents should the farmer die. A secondary use of life insurance is to provide funds to meet the cash needs to settle an estate. A tertiary use, and in most instances a poor use, is as a form of savings for retirement. Other uses of life insurance are often cited but those uses fall under the above three categories.

Types of Life Insurance

Life insurance policies come in all forms, shapes, and sizes. However, the two most common types of policies are term insurance and whole life (or ordinary insurance). There are variations in these two basic types. Other types of policies are also available to meet the special needs of some farmers.

Term insurance insures for the death of the insured for a limited time period or term. It has no cash value or savings account feature. Thus, it cannot be borrowed against, cashed in, or provide income during retirement. Because term insurance only provides death benefits for a stated period of time, a new term policy can be purchased at a lower cost than a new whole life insurance policy and provide the same amount of death benefits. Because of this, term insurance is often recommended to young farmers who need a large amount of income protection for their dependents and who do not have a large amount of money to purchase life insurance.

There are various types of term insurance. The basic type, at generally the lowest cost, is yearly term insurance. It is purchased for one year. At the end of the year another policy is written to cover another year. As the insured gets older each new policy will cost more for the same amount of death benefits. In addition, the insured runs the risk of becoming uninsurable and unable to obtain the yearly insurance. Because of this possibility, it is often recommended that a farmer purchase a renewable term policy. The renewable policy guarantees the ability to renew a term policy regardless of a change in health, although the premium can be increased at the start of a new term. This option also increases the cost of the term policy.

Instead of a renewable policy many farmers purchase a five-year, ten-year, or twenty-year term policy. This eliminates the problem of renewability. The longer term insurance policies are often written as decreasing term. With a decreasing term policy the premium remains the same each year but the death benefits of the insurance decreases each year. Therefore, a larger amount of protection is available in the earlier years at a lower cost than regular term insurance. There is also convertible term insurance. This is a term insurance policy that can be converted at your option, without evidence of insurability, for another insurance type, often whole life. This option increases the cost of term insurance.

The other common type of life insurance purchased by farmers is whole life. Whole life is term insurance for the whole life of the insured. The premiums paid in the early period of a whole life policy are greater than what

is necessary to provide for the stated death benefits. The excess amount accumulates and is known as the cash value of the policy. In the later periods of the insured's life, when the premiums paid are less than what is necessary to provide for the stated death benefits, the accumulated cash is used to help pay the premiums. Whole life can be purchased with various payment plans. Many are paid up by age 65.

The cash value of a whole life policy can be borrowed against. The interest rate is stated in the policy. Policies that have been in existence for a long time may have interest rates that are extremely low. New policies currently being written have higher interest rates. If you borrow against your policy the death benefit is reduced while you have the loan. The cash value may also be received as cash if you terminate your policy. This, of course, is why some lenders are willing to accept the cash value as collateral.

Life Insurance and Income Tax

Life insurance premium payments are generally not deductible as a business or personal expense for income taxes except when a farm corporation provides life insurance for its employees. Death benefits of life insurance are also not normally subject to income tax.

In a whole life policy the annual increase in the cash value is not subject to taxes as these increases occur. In contrast, if the life insurance premiums were invested in a savings account, each year the interest would be included in your taxable income. This potentially allows the cash value to build much faster than a savings account. If the policy is cancelled and the cash value withdrawn, then the previously nontaxed portion of the cash value is taxed. "Dividends" received from an endowment policy are not taxed as they constitute a return of premiums paid by participants in years where the company's payment to beneficiaries was lower than expected.

Death benefits paid to a beneficiary are generally exempt from income tax. If the benefits are paid in a lump sum at the time of death the amount of the payment to the beneficiary is free from income tax. If the benefits are paid in installments, only the additional interest earned on the death benefits is subject to income tax. The spouse of the insured, however, has a \$1,000 annual exclusion for interest earned from installment payments. If only interest is paid from the proceeds, then the \$1,000 annual exclusion is not available.

Life Insurance and Estate and Gift Tax

Life insurance proceeds are subject to estate tax if the deceased had owned the policy. If someone other than the person insured owns the policy and the benefits are not paid to the estate, then the proceeds are not subject to estate tax. A wife may own a policy on her husband, with the proceeds to be paid to herself, and the insurance proceeds would not be included in the husband's taxable estate when he dies. To be excluded from the taxable estate the insured must have no incident of ownership of the policy. The insured cannot name the beneficiary, borrow on the policy, or change the

policy. The owner of the policy, not the insured, must also pay the insurance premiums.

If a farm family is contemplating life insurance they might consider having the wife own the policy. She should have a source of income with which to pay the premiums. The policy should be willed to her children and not her husband in case the wife dies before her husband, in order to keep the policy out of his estate if that was their original objective. However, for many families it is best to have the ownership in the husband's name so that the insurance proceeds can be included in his estate to fund trusts, pay debts and taxes, and provide for the liquidity needs of the estate.

If the husband currently owns the policy he may transfer ownership to his wife. This is a gift to her and may be subject to gift tax. The value of the gift is approximately equal to the cash value of the policy. Complete ownership must be transferred if he wants to keep the insurance proceeds out of his estate. However, a gift of life insurance within three years of death is included in the taxable estate even if the gift does not exceed the \$3,000 annual exclusion, an exception to the usual rule.

Selecting Beneficiaries

The owner of the policy selects the beneficiary who is to receive the proceeds of the policy. The beneficiary is generally either an individual, the estate of the deceased, or a trust. The beneficiary may also be a charitable organization.

Regardless of whether the insured or someone else with an insurable interest owns the policy, it is usually not wise to name the estate as the beneficiary. If the proceeds go to the estate they are included in the probate estate. Charges such as the attorney's fees and executor's are based on the size of the probate estate. Some argue that naming the estate as the beneficiary will provide cash to the estate to help pay expenses of the estate and thus eliminate the need to sell estate farm property to meet these expenses. However, the same liquidity can be provided by leaving the proceeds to a responsible individual who will make the proceeds available to meet the liquidity needs of the estate by lending money or buying estate property. Do not make this a requirement for the beneficiary or the proceeds will still be included in the taxable estate.

Generally, the best procedure is to name the spouse the beneficiary with children born and unborn as contingent beneficiaries. If the spouse owns the policy the proceeds will be excluded from the deceased spouse's estate. However, if the spouse owns the policy and the children are the beneficiaries, then when the insured dies, the living spouse instantly makes a gift to the children and gift tax may be due.

Life Insurance in a Partnership or Corporation

Life insurance can be used in a partnership to help transfer a partner's interest to the other partner(s) if a partner dies. Various arrangements can be used. In a "cross-purchase" agreement each partner owns a policy on

each of the other partners, pays the premiums, and names himself or herself as beneficiary. When a partner dies the remaining partners will have sufficient funds to purchase the deceased partner's share of the business. With a "buy-out" agreement, the partnership itself owns the policy, pays the premium, and names itself as the beneficiary. In either case the premiums are not tax deductible and the proceeds are free from income tax. If the partnership owns the policy part of the proceeds will be included in the taxable estate of the deceased.

The "cross-purchase" and "buy-out" approach discussed for a partnership can also be used with a corporation with the same results. The difference with a corporation is that the proceeds are used to purchase stock of the deceased rather than his or her partnership interest. Regardless of whether the shareholders or the corporation pays the premiums, the premiums are not tax deductible. The proceeds are not included as taxable income to a stockholder as beneficiary or to the corporation as beneficiary.

Corporations can also provide life insurance for its employees. The premiums paid by the corporation may be a corporate business expense. There are limitations to the amount of coverage when the premiums are deductible expenses.

Life Insurance for the Wife-Mother

Life insurance cannot replace a lost husband or wife. It can, however, help replace the income or other economic value that is lost with the death of a spouse. It is usually much easier to measure the expected economic loss which will occur when the wage-earner or "head of household" dies than if the death is that of a non-salaried participant in a farm family business. In most cases it is the wife who occupies that position.

Determining how much life insurance is enough for a farm wife depends on her survivors' needs and the degree to which she participates in operating the farm. If she is active in the business, buying enough life insurance to guarantee that there will be no expense incurred when it is necessary to hire someone to perform her duties might be wise. If she is employed off the farm, her life might be insured to reflect the loss of income to the family at her death.

Insuring a wife-mother who is not employed outside the home is a more subjective process as there are fewer standard measures of the economic value of a woman in this role. There should be enough life insurance to pay for the care of young children and for the housekeeping services provided by a homemaker if there is no one else in the family who will step in to take over these very important functions.

The loss of a spouse will eventually require that a single rather than a joint tax return is filed by the surviving spouse. This can result in an increase in the income tax of the survivor.

How Much Life Insurance

Rules of thumb are often used to recommend the amount of life insurance a family should carry. A common rule is that the death benefits should be at least six times the yearly income of the family. This rule is primarily designed for wage earners and not for farmers where property ownership contributes to income. Rather than use rules of thumb, a more systematic approach is recommended for all families, but especially for farmers. An income requirement and income source budget should be prepared. The income requirements of the family without the breadwinner should be estimated. These requirements depend upon the number of dependents, their ages, as well as the age of the surviving spouse. Various factors need to be considered. If a post high school education is desired for the children, then some allowance must be included into the income needs to complete that goal.

Sources of income without the breadwinner must also be determined and estimated. For a farm family a major source of income is the rental income of the family farm. If sufficient insurance is used to retire all farm debts and pay estate settlement costs and taxes, sufficient income can often be obtained from sale proceeds of livestock and equipment and rental income of the farm. Some additional income may be necessary to maintain the same level of living. Other income sources include social security, retirement plans, and other property ownership. In some cases the surviving spouse might be able and desire to return or continue working. When estimating income be sure to consider income tax.

Social Security

Social security benefits should be included in your estate and retirement plans. Although social security may not provide all of your retirement needs, or provide sufficient support for your dependents if you die, it will meet some of those needs. Your payments into social security are mandatory and may be substantial over your life so you should be aware of all potential benefits available to you. Your local social security office has numerous publications that explain the various programs of the system. Staff members at these offices can also answer questions not discussed in those publications. The following discussion is a brief explanation of the major programs.

An individual who has contributed to social security is entitled to retirement benefits. These benefits normally begin at age 65 but can begin as early as age 62 with reduced monthly payments for life. You make the age selection. The size of the monthly retirement check(s) depends upon the amount that you have previously contributed to social security and your number of dependents. Besides a spouse and any dependent relatives, unmarried children under age 18 (22 if full-time students) are dependents. Retirement benefits are reduced \$1 for every \$2 over \$5,500 you earn during a year from self employment or wages (\$6,000 starting 1982). There is no reduction if you earn rent or interest income. Therefore, if you continue to operate your farm after age 65 your retirement benefits may be reduced, but benefits will not be reduced if you rent out the farm or sell it under an installment sale and collect interest and sales income. After age 72 (70 starting in 1982) you can earn any amount of self-employment or wage income and not have your retirement benefits reduced.

Your dependents can receive benefits if you die at any age. These benefits amount to three-quarters of the monthly benefit you would have received at retirement (age 65). If you have no dependents, your spouse will not be eligible for survivor benefits until he or she reaches the age of 60. Your surviving spouse will lose his or her benefits under your record if he or she remarries, but your children will not until they marry or reach age 18 (22 if a full-time student). There is also a lump-sum death payment of \$255.

If you become disabled you and your dependents can draw the same benefits as if you had retired. There is a 5-month waiting period after the disability. You may be required to participate in a vocational rehabilitation program and return to work if you are able. Disability benefits may continue even if you manage to work.

Medicare is also part of social security. There are two parts to medicare; hospital insurance and medical insurance. The hospital insurance helps pay for hospital care and certain followup care. If you qualify for retirement benefits you automatically have hospital insurance when you reach age 65 - you do not need to retire. If you do not qualify for retirement benefits you can still receive hospital insurance if you are over age 65 and pay a premium. The medical insurance portion helps pay the cost of doctor services and related expenses. There is a monthly fee required from everyone for the medical insurance.

To qualify for retirement, death, or disability benefits, you must pay into social security for a minimum amount of time. The minimum requirement varies by the type of benefit and your age. However, regardless of your age, you will qualify for all benefits if you have paid in for at least 10 years (40 quarters). The size of some benefits will depend upon how much you paid in over a period of time.

Spouses that have not paid social security taxes on income they earned are only covered under social security as a dependent under their working spouse's account. Dependents do not have the same coverage. Many married farm wives have paid little, if any, social security tax. If a farm wife becomes disabled she will not receive disability payments unless she has met the payment requirements of social security, regardless of the amount her husband may have paid in. If it is desirable to have a wife covered, she can share in the self-employment income of the farm (a partnership), or earn wages which are subject to social security.

All taxpayers should check periodically to see that their social security payments are being credited to their account. Local social security offices have a postcard that you can mail in to receive a record of your contributions.

Tax-Deferred Retirement Plans

Farmers have two tax-deferred retirement plans available to them. They are the self-employed retirement plan, commonly referred to as the Keogh or HR-10 plan, and the individual retirement account plan or IRA. As the title indicates, a self-employed retirement plan applies to self-employed individuals such as farmers. In contrast, an individual retirement account plan is

available to any individual who is not an active participant in any other qualified retirement plan (Social Security is not considered a qualified plan). A farmer would generally be eligible for an individual retirement plan or a self-employed retirement plan. Both tax-deferred retirement plans permit a farmer to place a portion of his current earnings into a retirement fund for retirement. The amount deposited is not subject to income taxes that year. However, when the retirement fund is liquidated the entire amount of the fund would be subject to taxation, both the original principal and any accumulated earnings from the principal.

A self-employed retirement or Keogh plan is for self-employed individuals and their full-time employees. The maximum annual contribution in a defined contribution plan is the lesser of \$7,500 or 15 percent of earned income. However, an annual contribution of at least \$750 can always be made, if earned income is at least that amount. No minimum annual contribution is required. A partnership may also set up a plan. Individual partners elect whether or not they want to participate in the plan. Partners deduct their individual contributions on their own tax returns. Any full-time farm employee with three or more years of service must be included and covered by the plan. All employees must be covered at the same percentage rate as the employer-owner. The amount set aside for employees is theirs or their beneficiaries (fully vested) even if they terminate employment, die, or the plan is terminated.

A farmer may establish an IRA for himself or an IRA for himself and his nonworking spouse without having to cover employees. This is often the reason an IRA is selected rather than the Keogh Plan. The maximum annual contribution for an individual is the lesser of \$1,500 or 15 percent of earned income. This is a lower limitation than with a Keogh plan.

Although differences do exist between self-employed and IRA retirement investment plans, in general money placed in either plan can be invested in one of three basic ways: (1) individual account usually with a bank, savings and loan, or credit union as trustee but with increasing frequency, brokerage firms and other financial institutions, (2) individual retirement income policy or annuity with a life insurance company, (3) investment in U.S. retirement plan bonds.

Retirement benefit payments can begin after age 59 1/2 and must begin by age 70 1/2. Retirement payment can be made as a lump sum payment or as an annuity. The full amount of the payment is included in taxable income the year the payment is received. Any premature distribution before age 59 1/2 is subject to a 10 percent penalty tax in addition to the normal income tax. However, this restriction does not apply in the event of death or disability. The funds in the plan may not be used to secure a loan without the 10 percent premature distribution tax applying.

The tax characteristics of a tax-deferred retirement plan can make it extremely attractive to some farmers. If a farmer expects to be in a lower tax bracket when he or she retires, a retirement plan will allow him or her to defer taxable income from high to low tax years. Even if a lower tax bracket during the retirement years is not expected, just the ability to defer taxes may be beneficial. This will allow the money that would have been used to pay taxes to earn a return before taxes are paid. However, if funds can be invested in the farm business and earn a greater return than a retirement

shelter, even after taxes are paid on those farm earnings, then a retirement plan may not be beneficial.

A retirement plan can also provide a source of income to pay for estate settlement costs or for the support of dependents should a taxpayer die. Although a retirement shelter cannot provide the same degree of protection as life insurance when a farmer is young, it may be able to replace some life insurance as a farmer becomes older and at an age when term insurance rates become very large. An advantage of a retirement plan over a farm investment in an estate is that the value of the retirement plan is not included in the taxable estate if the plan is paid out as a qualifying annuity to a decedent's beneficiaries, although they pay income tax on the annuity payments. The farm investment would be included in the taxable estate.

Business Organization

A farm family's estate consists primarily of farm property. Thus estate and business planning are closely tied together. A decision whether to purchase additional farmland, for instance, has tremendous estate planning implications. Not only will the farmland increase the value of an estate, but the type of ownership will dictate how the property can be transferred at death. The manner in which a farm is organized - sole proprietorship, partnership, or corporation - affects estate planning. For example, if a farm is incorporated, at death ownership is passed to heirs as corporate stock rather than farm property. Transferring stock permits the use of estate planning techniques different from those used in transferring farm property.

The vast majority of farm operations in New York are organized as sole proprietorships. That does not mean that these operations are not family businesses. In most instances the spouse and children are involved in the operation. The business may be organized so that the family receives wages for their labor contributions to the business. Wage incentive plans can be used in addition to a base salary. In some instances the sole proprietor may rent property from other family members, often a spouse. Farm business arrangements might also be used. For example, a child can operate a livestock or crop operation, pay his or her parents rent for the use of their property, and file his or her own farm tax return. All of these arrangements require careful business planning. In addition, good communication between all the parties involved is essential.

Beyond these business arrangements are partnership and corporate organization structures. These are often used when more than one generation, or more than one family of the same generation is involved in the same business. A multiple family situation is not a requirement, however; a single man or woman may incorporate his or her farm business for management, tax, or estate planning purposes. A detailed discussion of the pros and cons of partnerships and corporations is beyond the scope of this publication, but we do have a few comments.

A partnership, and especially a corporation, are more complex - legally, operationally, and for tax purposes - than a sole proprietorship. Therefore, before you leap into a partnership or corporation be sure you adequately understand the requirements, limitations and possible results of a change in

business form. Often the same business or estate objectives can be fulfilled within the framework of a sole proprietorship.

A corporation may save income taxes or allow more flexibility in transferring estate property, but it probably will not substantially change the way a business is operated. If you presently have a partnership and one son is responsible for crop production, another son is responsible for livestock production, a daughter is responsible for purchasing and marketing, and you coordinate all activities, incorporating will permit you to assume the position of chairman of the board and president of the company, and your children can be vice presidents in charge of crop production, etc., but the day-to-day operating and management decisions will probably not be altered. If the business is not already operating efficiently, or family members are not working together, do not expect a corporation to change that.

Divorce and Property Settlement

As well as having devastating personal consequences, divorce can have far-reaching financial and economic effects on a family. Statistics indicate that between 20% and 35% of marriages today end in divorce so it is not unreasonable to briefly mention the impact of a divorce on estate planning, particularly where a farm family is involved. In a farm family much of a couple's net worth is tied up in the farm real estate and the farm business. In addition, family members other than a husband and wife contemplating divorce may have an interest in all or part of the assets which might be affected by a property settlement.

A married couple embarking on the sometimes involved and time-consuming process of estate planning should not assume that they will divorce before the plan becomes effective - unless their marriage is already unstable. However, it may be the case that a farm couple planning their future and the distribution of their property to family members may be concerned about the future break-up of the marriage of children scheduled to receive property as a result of incorporation of the family farm or at the death of one of their parents. A farm couple might wish to provide for their children and grandchildren but they unfortunately do not like or respect one of their sons- or daughters-in-law. Can that person's participation in the business or distribution of property be limited or eliminated? The answer, generally, is yes.

It should be stated at the outset that a direct transfer of property to another individual, whether by gift, lease, sale or other mechanism, will mean that the transferor will relinquish any right to dictate how the property is used unless such rights are specifically retained at the time of the conveyance. If you wish to limit the use of property you are conveying to another, you should consult a lawyer to ascertain whether such a restriction is consistent with the law and, if so, how it is best managed.

There are some situations where ownership and beneficial use of property are different and this could be a factor when a marriage dissolves. The most common example is ownership of life insurance. A person may own a policy insuring the life of his or her spouse and name someone else, for example the children, as beneficiary. For purposes of a property settlement, ownership of the asset is determined by ownership of the policy since, among other things,

that person is presumed to pay the premiums and have the right to designate a new beneficiary. If this is not the desired result, the arrangement should be re-examined.

By far the most complex problem confronted in drawing up a property settlement of a farm couple is reaching an equitable solution when most of the family's assets are jointly-owned farm real estate, livestock, machinery and other business assets. Breaking up the operating unit will usually greatly impair efficiency - no one benefits from such a result. However, the alternative of continuing a business relationship where a personal relationship failed is normally untenable. Therefore it is imperative that a farm family contemplating a new form of doing business or a comprehensive estate plan, face the harsh reality of the aftermath of divorce if there are marital problems present within the family. There may be alternatives usually passed over by an estate planner that would better suit such a situation.

For example, a farm couple planning for distribution of their property at death could establish a trust for the benefit of their grandchildren with their trusted son or daughter as trustee. Should the younger couple's marriage dissolve, the son- or daughter-in-law would have no direct rights to the trust corpus or income, but the grandchildren would continue to receive benefits under the trust.

More complex forms of business organization can also serve to "protect" the family farm from an estranged spouse. For example, where the farm is owned by a corporation in which family members own shares, provision can be made for the other family members to buy out that spouse under terms that are mutually agreed upon at the time of incorporation should a divorce or death of a family member occur.

Under New York State law, divorce can have an effect on the wills of once-married individuals. If you get divorced, and then die, your spouse will receive nothing under your will even though he or she is identified by name. If you wish a bequest to your spouse to "survive" a divorce, you must be clear that your intent is to give property to that person - "to John Doe, whether or not he is my husband at the time of my death, I bequeath my condominium in Monte Carlo." However, if you are legally separated, but not yet divorced, your spouse will take under your will. If you leave no will the result will be somewhat different. An ex-spouse will get nothing whether you are divorced or merely legally separated.

None of the above is true with life insurance. The named beneficiary will collect the proceeds at death regardless of his or her relationship with the decedent. Divorce or separation, then, should trigger a review of life insurance arrangements.

Probate and Estate Administration

While someone's death automatically triggers a number of events, usually burial for instance, settling the estate and distributing property are not among them. There are laws and procedures which govern administration, but the effective operation of this process depends on the initiative of the individuals who have an interest in the outcome. That interest is twofold -

to complete the necessary legal steps to transfer ownership of property from the name of the decedent to those who inherit from him or her under a valid will, or by state law, and to pay any income or estate taxes due so that ownership of property from the estate is not encumbered by tax liens and judgments.

If the decedent left no will, his or her heirs or next of kin, or perhaps a creditor, should petition the Surrogate's Court to grant "letters of administration" to an administrator. If a will is located, the named executor or other interested person should petition the court to probate, or "prove", the will and grant "letters of testamentary" to the executor. These documents are evidence that the representative of the estate is acting with court approval and gives that person the authority to buy and sell property, and conduct other business on behalf of the estate.

The function of the personal representative generally is to collect the assets and "preserve" them by wise investment and good money management. He or she pays the debts of the decedent and the expenses incurred in administration, as well as income taxes for the decedent in the year of death, income taxes for the estate each year it remains open and the final estate tax bill. He or she also has responsibility for distributing any assets remaining after these obligations have been satisfied to the devisees and legatees named in the will or the distributees designated by law when one dies intestate (without a will).

Generally speaking, admitting a will to probate is a routine matter, as is estate administration. Notice must be given to individuals who would inherit if the decedent died intestate and others somehow adversely affected to give them an opportunity to object to probate. It is possible that this might result in a lawsuit to contest the will. Those named in the will are informed that the will is being offered for probate. If probate is not contested the court will issue a decree and grant letters testamentary so the process of settling the estate can get under way. If the will is contested, a hearing is held to determine if all or part of the will is valid. Those contesting the will have the burden of proving that there are grounds for believing that the testator was incompetent or under duress when the will was executed, or that there is some other reason to disregard its provisions. Only in the most extreme cases does a will contest succeed.

Postmortem Estate Planning

Management of a deceased's estate, or postmortem estate management, receives much less public attention than pre-death estate planning but it is an extremely important process. It is essential that the size of the decedent's estate be preserved, and enlarged if possible, and attorneys and corporate executors skilled in estate tax planning should be consulted to accomplish this result. Tax savings is the other primary goal of postmortem planning.

There are three tax returns involved in estate settlement, an estate tax return, a personal income tax return for the decedent's income earned during the portion of the year preceding death, and estate income tax returns filed each year the estate remains open, often called the fiduciary's or executor's

return. Many of the techniques used in postmortem planning are fairly straightforward - for example, deciding on which tax return to take deductions so as to pay the minimum tax. An example of a deduction that can be taken on either income tax form or on the estate tax form (but not on all three) is the medical expenses incurred in the last illness.

Estate taxes are paid on the value of the estate - but the executor has more than one valuation date that he or she may choose for purposes of determining what the estate is worth. Obviously you would usually like to have the value be as low as possible so as to minimize the taxes due. The option of using an alternate valuation date is a good planning tool since the estate tax return need not be filed until nine months after death.

The income tax considerations of the beneficiaries who are to receive property is also a factor in postmortem estate planning. While the bequest itself is not taxed to the recipient, it may be that the sudden appearance of income-producing property in a given year will push the beneficiary into a higher tax bracket. If it is possible to postpone actual distribution of estate assets, or spread it out over time so that the recipient gets income in more than one tax year, it will allow the beneficiary to do some income tax planning to minimize his or her tax payments in the future.

There are special provisions in the Internal Revenue Code which allow deferral of estate tax payments for up to fifteen years for qualified taxpayers as discussed earlier. This is an important factor in estate and post-mortem planning, particularly where the principal asset in the estate is a farm or closely-held business.

Appendix: Federal and New York Estate and Gift Tax Rates

UNIFIED FEDERAL ESTATE AND GIFT TAX SCHEDULE

Amount to be taxed:		The tentative tax is:	
\$	0 to \$ 10,000	18% of such amount	
	10,000 to 20,000	\$ 1,800, plus 20% of excess over \$	10,000
	20,000 to 40,000	3,800, plus 22% of excess over	20,000
	40,000 to 60,000	8,200, plus 24% of excess over	40,000
	60,000 to 80,000	13,000, plus 26% of excess over	60,000
	80,000 to 100,000	18,200, plus 28% of excess over	80,000
	100,000 to 150,000	23,800, plus 30% of excess over	100,000
	150,000 to 250,000	38,800, plus 32% of excess over	150,000
	250,000 to 500,000	70,800, plus 34% of excess over	250,000
	500,000 to 750,000	155,800, plus 37% of excess over	500,000
	750,000 to 1,000,000	248,300, plus 39% of excess over	750,000
	1,000,000 to 1,250,000	345,800, plus 41% of excess over	1,000,000
	1,250,000 to 1,500,000	448,300, plus 43% of excess over	1,250,000
	1,500,000 to 2,000,000	555,800, plus 45% of excess over	1,500,000
	2,000,000 to 2,500,000	780,800, plus 49% of excess over	2,000,000
	2,500,000 to 3,000,000	1,025,800, plus 53% of excess over	2,500,000
	3,000,000 to 3,500,000	1,290,800, plus 57% of excess over	3,000,000
	3,500,000 to 4,000,000	1,575,800, plus 61% of excess over	3,500,000
	4,000,000 to 4,500,000	1,880,800, plus 65% of excess over	4,000,000
	4,500,000 to 5,000,000	2,205,800, plus 69% of excess over	4,500,000
	Over \$5,000,000	\$2,550,800, plus 70% of excess over	1,000,000

NEW YORK ESTATE TAX SCHEDULE

New York Taxable Estate:		Tax:	
\$	0 to \$ 50,000	2% of such amount	
	50,000 to 150,000	\$ 1,000, plus 3% of excess over \$	50,000
	150,000 to 300,000	4,000, plus 4% of excess over	150,000
	300,000 to 500,000	10,000, plus 5% of excess over	300,000
	500,000 to 700,000	20,000, plus 6% of excess over	500,000
	700,000 to 900,000	32,000, plus 7% of excess over	700,000
	900,000 to 1,100,000	46,000, plus 8% of excess over	900,000
	1,100,000 to 1,600,000	62,000, plus 9% of excess over	1,100,000
	1,600,000 to 2,100,000	107,000, plus 10% of excess over	1,600,000
	2,100,000 to 2,600,000	157,000, plus 11% of excess over	2,100,000
	2,600,000 to 3,100,000	212,000, plus 12% of excess over	2,600,000
	3,100,000 to 3,600,000	272,000, plus 13% of excess over	3,100,000
	3,600,000 to 4,100,000	337,000, plus 14% of excess over	3,600,000
	4,100,000 to 5,100,000	407,000, plus 15% of excess over	4,100,000
	5,100,000 to 6,100,000	557,000, plus 16% of excess over	5,100,000
	6,100,000 to 7,100,000	717,000, plus 17% of excess over	6,100,000
	7,100,000 to 8,100,000	887,000, plus 18% of excess over	7,100,000
	8,100,000 to 9,100,000	1,067,000, plus 19% of excess over	8,100,000
	9,100,000 to 10,100,000	1,257,000, plus 20% of excess over	9,100,000
	Over \$10,100,000	1,457,000, plus 21% of excess over	10,100,000

NEW YORK GIFT TAX

The gift tax is 75% of the estate tax rates.