Division of Agricultural Sciences

UNIVERSITY OF CALIFORNIA

ESTATE PLANNING FOR FARMERS

ALIFORNIA AGRICULTURAL
xperiment Station
xtension Service

CIRCULAR 461
REVISED

Mr. and Mrs. Farmer — ask yourselves these questions:

HUSBAND:

1. How is my property held? Joint tenancy? Community property? Separate property?
2. Is this the safest, most efficient way to hold that property?
3. Could my farm operation be more efficient from a tax standpoint, and offer greater security for my family, if I used a partnership or corporate business organization?
4. How can I arrange the disposition of my property so that I provide lifetime security for myself and future security for my wife and children?
5. Is my will in proper form?

WIFE:

1. How much property do we have—land, equipment, insurance, cash—and how is it owned?
2. What are the terms of my husband's will, and where is the document kept?
3. Should I make a will, too?
4. Who is our attorney?
5. How much do I know about our farm business, records, debts, bank affiliations, and the like?

If you can answer all these questions to your own satisfaction, you are in good shape at present and you have a sense of security for the future. If you are in doubt about some of the answers, you probably need help.

ESTATE PLANNING is the forming of a plan for economic management of your property so that it will provide present enjoyment for you and future security for your heirs.

Whether the property you own is large or small it must be disposed of in some way in the event of your death, and if it is valued over a certain amount it will be taxed. The state inheritance tax must be met by the person receiving the property; the federal estate tax must be met by the estate of the deceased person. Both taxes tend to reduce the property in the hands of future generations.

Legal arrangements to save taxation are not wrong nor immoral. In fact, both federal and state governments encourage the taxpayer to use the law in his favor, but he must take the first steps in so doing.

But taxes are not the sole concern in planning the estate. Preservation of the property as a continuing, functioning unit following disability or death of its owners, and transfer of that property to the advantage of its future owners must also be considered.

This circular outlines the various ways of owning property, and suggests methods by which you can legally reduce the tax burden on your estate. Actual cases from attorneys' files showing problems which could have been avoided are described, beginning on page 31.

THE CALIFORNIA FARMER spends time and money to increase the value of his estate by good management practices. Unfortunately, what he has built up is sometimes devaluated at his death because he failed to plan for the future.

This circular is intended to make the California farmer and his wife aware of problems involved in ownership and disposition of property, and to suggest some ways by which those problems can be solved. It is not intended as a substitute for competent legal counsel, and should not in any circumstances be so construed. It cannot be emphasized too strongly that estate planning is an ever-changing legal concept which must be viewed not only in the light of the applicable tax and general laws, but also from the standpoint of human relations. Therefore, this circular should be used only as a possible source of ideas for securing advice from legal counsel.

The circular was prepared as a joint effort in which the Agricultural Extension Service is happy to share, together with the University of California's School of Law, the California Farm Bureau Federation, and a group of practicing estate attorneys.

Geo. B. Alcorn

Director, Agricultural Extension Service

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Ways of owning farm property

Before you can plan your estate from an income and death tax point of view, you will need to understand the types of property ownership. In California, there are four usual ways of holding title to property: (1) tenancy in common; (2) joint tenancy; (3) separate property; and (4) community property.

You must know how property is owned

Tenancy in common ownership between a husband and wife is not used to any large extent in estate planning at the present time. Tenancy in common property has been of little importance except possibly in connection with stock certificates of eastern companies, in which case a community property agreement is desirable to identify property as community property. This type of ownership will not be discussed further.

Joint tenancy property is held by more than one person

Joint tenancy applies to property held by more than one person (generally by a husband and wife). On the deed of conveyance or in the agreement between the spouses it is provided that such property is held by the husband and wife as joint tenants. In addition, in some instances there is added the phrase, "with right of survivorship." The main incidence of joint tenancy property is the fact that where there are two such persons, each joint tenant owns an undivided, equal one-half interest, and that on the death of the first joint tenant, all of the property goes to the surviving joint tenant without necessity of probate administration. In some counties, court proceedings are required to terminate joint tenancy ownership of real property; in others, a mere affidavit of the surviving joint tenant is sufficient. The procedure depends upon the practice acceptable to the title insurance companies in a particular area.

Separate property belongs to one person only

Separate property is that which is owned by a spouse prior to marriage or which arises after marriage by gift or inheritance. It includes also all the rents, issues, and profits from such property. In case either spouse dies leaving separate property, it is necessary to administer the same in the probate court of the county of residence.

Community property is all property that arises out of the earnings and efforts of the husband and wife during marriage, and the rents, issues, and profits from such property. Where the spouses own only community property, no probate administration is required in case of the death of the wife if she dies without a will. If she should leave a will, it has been the general practice to probate her half of the community property. If the husband dies, all community property is subject to probate administration. However, by use of proper language in a wife's will, if the wife dies first probate may be avoided as to her half of the community property.

and does not become community property when you marry

One common misunderstanding should be corrected here. Separate property *does not* become community property upon the marriage of two individuals.

Property acquired before moving to California

Quasi-community property is property acquired by either spouse while residing outside California which would have been their community property had they been residents of California at time of acquisition. On moving to California the property would remain the individual property of the acquiring spouse, and the other spouse would have no rights or interests in the property until death of the acquiring spouse. On death of the acquiring spouse, the property is treated in most instances in the same manner as community property. Quasi-community property includes rents, issues and profits of such property, and property acquired in exchange for such property.

An estate can be hit hard by death taxes.

Death tax impact

Two death taxes are imposed upon residents of California: the California inheritance tax, and the federal estate tax.

When you inherit property, you pay a state inheritance tax on part . . .

The state inheritance tax is imposed upon the people who inherit property. It is not imposed on the gross estate except under peculiar circumstances not important here. In other words, it is a graduated tax that is assessed against particular individuals who inherit from the decedent. However, it is possible to shift the tax burden among legatees by an appropriate will provision. The table on page 8 will give you some idea of this tax.

The rules on inheritance taxation of property passing from a decedent to his or her surviving spouse have been subject to several recent legislative changes. Under the present law, when either spouse dies, his or her one-half of their community property can pass outright to the surviving spouse free of inheritance tax. If the decedent's one-half of the property is left to a trust, the value of the surviving spouse's interest in the trust likewise passes free of inheritance tax. A surviving spouse has an exemption of $5,000; a minor child, $12,000; and an adult child, $5,000.

and a federal estate tax on all the property involved

The federal estate tax is an entirely different tax. The federal government is interested primarily in the size of the gross estate. It is not interested in who inherits a particular property, except in the case of charitable bequests and in the case of a marital deduction (to be mentioned later). For purposes of computing the federal estate tax liability, the entire estate of the decedent is thrown into a common pot. Many people believe that insurance is not taxable for federal estate tax purposes. This is not true. In case the decedent has an ownership interest in the policy, the proceeds of the policy are included in his estate for federal death tax purposes. It is true that there are provisions, under the federal Internal Revenue Code, which would exempt life insurance and life insurance portions of accident insurance policies under certain circumstances where the ownership of the policy has been transferred out of the hands of the decedent; it is a common estate planning device for each spouse to own the life insurance of the other spouse.

But you pay the federal tax only if the estate is over $60,000

The federal estate tax is a graduated tax also. In order to be taxable, the decedent's estate must be in excess of $60,000. This estate then moves into higher brackets as follows:

Taxable estate (before $60,000 exemption)	*Tax*
$ 60,000	$ 0
70,000	500
80,000	1,600
100,000	4,800
120,000	9,500
150,000	17,900
200,000	32,700
300,000	62,700
500,000	126,500

As can be seen, this tax is extremely heavy after $100,000 is reached. The tax on the first $100,000 is only $4,800, whereas, on the next $50,000, it jumps to $17,900, an increase of approximately $13,100. On $200,000, it jumps to $32,700. Thus, on the second $100,000, the tax is roughly $27,900, and this situation continues as the taxable estate value rises.

Under federal law, it is well established that only one half of the community property is taxable in case of the

CALIFORNIA INHERITANCE AND GIFT TAX[1]— RATES AND EXEMPTIONS

Effective as to { decedents dying / gifts made } after 7:00 p.m., July 29, 1967

CLASSIFICATION		EXEMPTION	Rate of tax on amount left after deducting exemption from $25,000.00	$25,000 to $50,000	$50,000 to $100,000	$100,000 to $200,000	$200,000 to $300,000	$300,000 to $400,000	Over $400,000
Husband or Wife	Decedent's Separate Property only[2]	One-half of Separate property[3] Plus $5,000.00							
Minor Child (Includes Adopted)		12,000.00	3%	4%	6%	8%	10%	12%	14%
Adult Child Grandchild, Parent, Grandparent (Relationship may be by Blood or Adoption) Mutually Acknowledged Child Descendant of Mutually Acknowledged Child		5,000.00							
Brother, Sister (Excludes Brothers- and Sisters-in-law) Descendant of Brother or Sister (Includes Descendant by Adoption or Acknowledgment) Wife or Widow of Son, Husband or Widower of Daughter		2,000.00	6%	10%	12%	14%	16%	18%	20%
Strangers in Blood and Relationships not Specified Above		300.00	10%	14%	16%	18%	20%	22%	24%

[1] GIFT TAX ANNUAL EXEMPTION. Value of $3,000.00 transferred to each donee in any calendar year is excluded from tax unless transfer is of a future interest.

[2] COMMUNITY PROPERTY passing or given to a spouse is exempt from inheritance and gift tax except that (effective September 17, 1965): (1) decedent's half is subject to inheritance tax to the extent that a power of appointment therein is given to the surviving spouse and (2) decedent's half resulting from separate property conversions is treated as separate property in computing inheritance and gift tax.

[3] MARITAL EXEMPTION. One-half of separate property is exempt only in computing inheritance tax. This exemption is not applicable to gift tax.

HOUSTON I. FLOURNOY, *State Controller*

death of either the husband or the wife. That is to say, if the husband and wife have a $100,000 community property estate, only $50,000 is taxable on the first death. If they have a $200,000 community property estate, only $100,000 is taxable on the first death. The table above shows that, in case of a $100,000 community property estate, there would be no federal tax on the first death because of the $60,000 exemption; in case of a $200,000 community property estate, the federal tax would amount to $4,800 on the first death. The federal estate tax on a $300,000 community property estate would amount to $17,900 on the first death; on a $400,000 community property estate, $32,700 on the first death.

Only one half of community property is taxable at death of one owner

If a decedent owned separate property at death, such property is taxable in his estate except that he is entitled to a deduction for the value of property he leaves to his wife, either by his will or through operation of law. The deduction, however, cannot be more than 50 per cent of the decedent's adjusted gross estate. To obtain this marital deduction, the property which passes to the surviving spouse must pass outright or into a trust with provisions written specifically to take advantage of the marital deduction. Simply stated, if a husband has $100,000 of taxable separate property and leaves at least $50,000 to his surviving wife outright or in one of these special trusts, only the remaining $50,000 would be taxable in the husband's estate. This would be true whether the $50,000 passed to the surviving wife under the husband's will or because of joint tenancy ownership of property between husband and wife. In other words, the surviving widow would get a marital deduction equal to roughly one-half of the taxable separate property. The deduction can be obtained with separate property or community property which passes to the surviving spouse, so long as the decedent's estate includes separate property; the separate property serves only as the measure of the deduction. The marital deduction is a complex legal concept, but in general it may be stated that the decedent's estate will get a marital deduction equal to up to one-half of the value of the decedent's separate property if the amount claimed as a deduction is left to the surviving spouse. If the decedent's property is left to someone else, there would be no deduction. The surviving spouse has to inherit or receive some property from the decedent in order to obtain the benefits of the marital deduction.

But all his separate property may be taxable to his estate

unless there is a marital deduction

The marital deduction of up to one half the estate

may be claimed only if the property is willed to the surviving spouse

A word of caution is necessary here. Merely leaving the surviving spouse a life estate in particular property will not authorize tax saving by the marital deduction. The full fee title or its equivalent must be left to her.

From the analysis above, it can be seen that there is not a great deal of difference between the taxation of community property and separate property for death tax purposes when each spouse, in effect, is the heir of the other—the normal, natural condition. In other words, on the first death, only one half of the property will be taxable. Consequently, on smaller estates, no great problem is presented because the tax impact is relatively light. Until an estate of $120,000 is reached, no federal estate tax is due, and the impact of the state inheritance tax is not very great. It is on this basis that some attorneys have recommended the placing of smaller estates in joint tenancy ownership. On the other hand, if there are other factors, such as a low-cost basis, for income tax purposes, or if the decedent wants to protect children of a prior marriage, the property should not be in joint tenancy.

When the $120,000 figure is reached, however, other problems are presented that require more detailed discussion. These problems arise mainly out of what might be called the "aggregation of the estate" in the hands of the surviving spouse. In most cases, the wife generally outlives the husband. Therefore, she will collect any insurance that the husband may have carried, together with the other estate that both spouses may have accumulated.

However, "aggregation of the estate" in the hands of the surviving spouse

Before any Federal tax is incurred on the death of the first spouse, the property of husband and wife must have a value of at least $120,000 provided that at least one-half thereof belongs to or passes to the surviving spouse.

may result in very heavy estate taxes upon his or her death

Let us assume that such an estate is held in joint tenancy ownership. In the case of the first death, there is no tax. In case of the second death, however, there is a tax of $9,500. If the estate is $200,000 on the first death, the tax is $4,800, and on the second death, $32,700. On a $300,000 estate, the tax is $17,900 on the first death, and $62,700 on the second. These figures indicate that it would not be wise to leave these larger estates to the surviving spouse because of the heavy impact of death taxes on the second death. Note that on a $120,000 estate, the $20,000 over $100,000 produces a tax of about $4,700 upon death of surviving spouse. If that $20,000 could be removed, the tax due would be only $4,800, or if some device could be worked out whereby the second $60,000 (or perhaps $40,000 of it) were held back in some manner, there would be practically no death tax impact. As the brackets become higher, the death tax impact becomes very great. Consequently, attorneys have recommended breaking up these larger estates to prevent an aggregation of estates. This is especially true in view of the many common accidents and disasters that occur today. If a husband and wife are driving along the highway and both are killed, and if one sur-

It is therefore advisable to break up large estates vives the other by a period of an hour, a day, a month, et cetera, it would be necessary to probate the estate of each, and to pay the heavy tax burden set forth above on the second death. (There is some previously taxed property credit, which may make a slight difference in the above figures.)

Accordingly, if the estate is over $100,000, it may be preferable to establish a trust device under the will of the spouse first to die whereby the surviving spouse is trustee, for himself, of the deceased spouse's share of the community property. In that way, there is no aggregation of estates. The trust that is set up is one that enables the surviving spouse to treat the property much as his own except that he cannot use any of the principal, unless the Court determines that a portion is needed for special reasons. (The trust could even provide for use of principal, if ascertainable standards were provided.) He is entitled to all of the income from it so long as he lives. In this way, on a $200,000 estate, there are only two taxes of $4,800 each on the first and second deaths, instead of $4,800 on the first and $32,700 on the second. On a $300,000 estate, the saving is even more marked. If the estate is divided through the trust device, there would be two taxes of $17,900. If the estate went in its entirety to the surviving spouse, however, the tax on the second death would be $62,700. In this case, there is a possible tax saving of approximately $44,800.

This may be done by establishing a trust device

Another, non-tax factor must be considered with regard to these larger estates if children are involved. Each spouse would like to be sure that, in case anything should happen to him, his one half would go to the children. In many instances of a second marriage, the children of the first marriage have been cut off from the will or have lost their father's or mother's share of the property. The trust device mentioned above is a vehicle for preventing such a happening. Under this device, the surviving spouse has a life interest only in the income, and cannot use the corpus, or principal, of the deceased spouse's one half. This means that the corpus, or principal, under the terms of the decedent's will, goes directly to the children upon the death of the surviving spouse, or continues in trust for their benefit until they reach a specified age. This does not imply suspicion between the spouses, but merely takes care of something of which all are cognizant.

Such a device also protects the children

The paragraph above has explained the trust device in an oversimplified manner in order that it might be more easily understood. Many tax and non-tax problems arise when the surviving spouse is named both as trustee and as beneficiary, and it is for this reason that the use of banks as trustees is widely accepted. There are also sub-

A bank is a good trustee because

it can effect tax savings

stantial advantages from a tax standpoint. For instance, if the surviving spouse were the trustee, he could not be given any discretion as to how to pay out income without having to pay all of the income tax on all of the income, except where the discretion is tied to an ascertainable standard. A bank, on the other hand, can be vested with this discretion to divide income as it is needed in any particular year, and thus can divide the income tax among the beneficiaries to whom it is allocated. Also, a bank may be given a discretion to invade the principal to pay any unusual expenses, such as doctor bills or hospital bills; but this discretion may not be granted in an unlimited manner to the surviving spouse where he is also a beneficiary without the danger of having the entire principal of the trust taxed in his estate on his death, thus nullifying the benefit of the trust from an estate tax standpoint.

Although there are distinct tax and non-tax advantages in using a bank trustee, there may be offsetting disadvantages. Banks are not usually in a position to undertake active farming operations on property owned by the trust. The bank may wish to dispose of the farm properties and invest the proceeds in securities or similar investments or lease out the farm property for operation by an independent party. One way to guard against possibilities like this is to appoint a bank and the surviving spouse as co-trustees, giving the bank the discretionary powers over income which are needed to achieve the desirable tax results while giving the surviving spouse some ultimate control with the bank over the trust assets.

A "spendthrift trust" protects the survivor's old age security

Another factor of importance in some instances is that the trust set up in the decedent's will for the surviving spouse is known as a "spendthrift trust," both the principal and income of which are exempt from the attachment of creditors. This means that the deceased spouse is really protecting the surviving spouse so that if any untoward event or accident should occur, subjecting the surviving spouse to liability, the creditors of the surviving spouse cannot reach this property. Thus, the surviving spouse is protected and will have enough to live on in old age.

When property of the deceased spouse is separate property, the problem of setting up a trust for the surviving spouse may create some difficulty if it is also desired to secure the marital deduction. The life income trust described above will not entitle the surviving spouse to the marital deduction on separate property. However, this matter can often be worked out by making certain outright bequests to the surviving spouse and then placing the balance of the estate under the lifetime trust, or by using separate trusts—one for the marital reduction money and the other for the balance of the estate.

Joint tenancy ownership is not a good idea for large estates because . . .

Where property is held in joint tenancy, it must be remembered that the will of the first joint tenant to die is of no effect with respect to the joint tenancy property. The characteristic of joint tenancy property is that it automatically goes to the surviving joint tenant regardless of the provisions of the will of the deceased joint tenant. In such instance, the surviving joint tenant is the absolute owner of the entire estate, whether it originally was community or separate property. From this factor, the aggregation of estates problems described above can arise. There is no means of preventing such aggregation of estates when property is held in joint tenancy. This is one of the reasons why tax counsels advise against the placing of large estates in joint tenancy ownership. Another factor against joint tenancy is that there is no protection to the children of the deceased spouse. Automatically, the surviving joint tenant receives the entire estate and it is his to will away, to give away, or to treat in any manner that he so desires. For these two reasons, joint tenancy should not be used in large estates except as a vehicle in the estate planning if there is a particular item of property that should go to the surviving spouse.

it results in the aggregation of estates

it does not protect the children

Special consideration must be given to a farm-holding which during the lives of husband and wife exceeded 160 acres. Such consideration is required whether or not the farm was held in joint tenancy or as community property. For example during their lives the Federal laws permitted them to receive water sufficient to irrigate not to exceed 320 acres. Upon death of either the husband or wife, land in excess of 160 acres cannot be placed in a trust or held by the surviving joint tenant for a period longer than 5 years and still receive water.

160-acre limitation

How you own property affects the income tax you pay.

THE INCOME TAX ASPECT OF PROPERTY OWNERSHIP

Under the income tax law, both state and federal, each item of property has a cost basis for tax purposes. This cost basis, in general, is the cost of acquisition, plus permanent improvements, less depreciation. In case of death of one of the spouses, an appraisal has to be made by

Every item of property has a cost basis for tax purposes

agents of the state and federal governments. This appraisal is based upon the fair market value of the property as of the date of death of the decedent or, in the case of the federal government, if so desired, one year after the date of death. Under the income tax law, it is provided that a new cost basis is acquired on property at the value set forth in the Federal Estate Tax Return or the Inventory and Appraisement that are set up in the estate of the decedent for federal and state tax purposes, respectively. This cost basis is in varying amounts depending on type of ownership existing between the spouses at time of death.

This is usually original cost plus permanent improvements less depreciation

In the case of community property, there is a new cost basis equal to 100 per cent of the value at which such property is appraised in the estate of the decedent. This is true in spite of the fact that only 50 per cent of the community property is taxable in the decedent's estate. In the case of joint tenancy property, the decedent's share only receives a new cost basis. In the case of separate property of decedent, 100 per cent of the separate property would receive a new cost basis.

To clarify this situation, the following is a specific example. Suppose that, many years ago, a husband and wife acquired a 40-acre vineyard at a cost of $10,000, and that the improvements and depreciation about equaled each other, so that net cost basis of the husband and wife as of the date of the husband's death aggregated $10,000. Assume that this 40-acre tract is now worth $50,000 and is so appraised for federal and state death tax purposes. If the property is held as community property, the surviving spouse will get a new cost basis on the 40-acre piece up to $50,000. This means that if she wants to sell the property, she will have no capital gains tax to pay unless she receives in excess of $50,000. If she decides that she does not wish to sell, but wants to retain, develop, and continue to farm the property, she will set up her vines, trees, wells, pumping plants, and other permanent improvements on a reasonable value and start redepreciating the property. This, of course, would have a very decided effect upon her annual income tax.

The cost basis for community property is more advantageous than . . .

There is another income tax factor in favor of community property ownership as opposed to joint tenancy which follows from the new cost basis given community property. The income tax laws now provide for recapture of certain prior depreciation which requires that a portion of the proceeds be reported as ordinary income if the property is sold at a gain. Where the property is held as community property the new cost basis received on the death of one spouse will tend to eliminate gain that might be otherwise subject to ordinary income tax rates.

If the property were held in joint tenancy and had been derived from community funds, so that only one half is taxable in the estate of the decedent, the surviving spouse would receive a new cost basis only on the decedent's one half of the property—in this instance, $25,000—and retain the cost basis on her half of $5,000. This means that she would have a capital gains tax to pay in the event that she sold the property for more than $30,000. Also, the total value upon which the property could be set up for depreciation would be $30,000 as contrasted with $50,000 under a community property arrangement.

that for joint tenancy property . . .

On this new cost basis, another important factor arises in connection with any crop that is on the property. In the instance above, if the decedent spouse should die any time after May 1, when the grape crop is set, an appraisal can be secured of the crop as distinguished from the land and improvements. A new cost basis is thereby secured on the crop, which becomes a cost item just like any other item of expense of the surviving spouse, and she should be able to offset such expense against her gross income. In other words, if the crop on the 40-acre piece held as community property amounted to a net of $10,000, the surviving spouse would pay only a very small death tax liability on $5,000, and by so doing, should secure a new cost basis of $10,000 on the crop. If, however, the property were held in joint tenancy, the surviving spouse would still pay a death tax on $5,000 of the $10,000 crop, but would have a cost basis of only $5,000 against the crop, and would have to pay an income tax on the second $5,000.

especially where a crop is involved

In larger estates, another factor also points up why it is preferable to hold property as community property rather than as joint tenancy. This arises out of the graduated nature of the income tax law. It is well known that the higher the income, the higher the tax bracket; the lower the income, the lower the tax bracket. In other words, the more taxpayers in any particular situation, the lower the tax. A husband and wife are two taxpayers. When property is held in joint tenancy ownership, and the husband dies, the wife is automatically entitled to the entire joint tenancy estate and she is taxed on all of the income arising after the date of the husband's death. A joint return can be filed in behalf of the husband and the wife in the year of his death, splitting the income, in effect, between the two of them. However, in the next year, the wife is a sole taxpayer, and is taxable upon the entire amount.

To summarize: for large estates, and perhaps even for smaller ones, . . .

When property is held as community property, and a will is left by the decedent spouse, the husband and wife can file a joint return in the first year with respect to her income and to his income down to date of his death. After the date of his death, the estate of the decedent husband

community property ownership

would be taxable on his share of the income from his one half of the community property. The estate is also a taxpayer in the second year, and under the law, one half would be taxed to the wife. The estate can be kept open for a period of two or three years without any great additional cost to the surviving widow, and in this way can assure her of the income tax splitting benefits of the state and federal laws.

is better than

From the above, it can be seen that joint tenancy ownership of property under the present law is something to be avoided except in smaller estates. Even in the latter, joint tenancy should be used only when the estate picture is not complicated by other factors, such as low cost basis, or by non-tax problems, such as family relationships. In these cases, as with the larger estate, a will is mandatory in terms of protection for both tax and non-tax problems.

joint tenancy ownership

You can lessen the impact of taxes on your estate.

Ways to Reduce the Impact of Death Taxes

Sometimes it is better to dispose of property than to hold it

So far the farmer's estate problem has been viewed from the standpoint of the consequences of *holding* the farm property in various ways. In this section some attention will be given to the devices which might be used to reduce the impact of death taxes (estate and inheritance taxes) by *disposing* of property in a certain manner. Admittedly, some ways of "holding" property can be accomplished only by disposing of that property to others, but that is not the central purpose of disposal devices.

As you read this section, remember: The disposal devices suggested are not difficult to understand . . . BUT because of the details of their operation, and their far-reaching effects, it is absolutely necessary that you consult a competent attorney before deciding to use such devices.

But . . . before you act, consult an attorney

Obviously, estate and inheritance taxes can be reduced by reducing the amount of property which will be included in the estate at death. It is equally obvious that one of the easiest ways to reduce the estate is to give away part of one's property during life. This is easier said than done. The individual must figure his financial needs for the remainder of his life and make provision for the many uncertainties of later years. Such predictions are not simple, and the giver takes a calculated risk on the future.

The first concern is that of how much the giver may give without subjecting himself to gift taxes—both federal and state. (The giver usually pays the tax.) While the gift tax is designed to keep a person from escaping estate taxes, he is allowed to make a certain amount of gifts before the gift tax applies. The federal law allows the donor (the giver) to make tax-free gifts of $3,000 per year per donee (the person receiving the gift). This means that a husband and wife together may make gifts of $6,000 per year to as many different donees as they wish without incurring any gift tax liability. In addition, the federal law allows each donor a lifetime gift exemption of $30,000, so that a husband and wife together may make lifetime gifts of $60,000 *plus* annual gifts of $6,000 per donee. The married donor may give $60,000 to his spouse, using his $30,000 exemption, and he may give her $6,000 annually, using his $3,000 exclusion, because the federal gift tax law permits the deduction of one half of any gift to a spouse, under certain circumstances. This is called the gift tax marital deduction. The California gift tax law permits an annual exclusion of $4,000 per donee and a lifetime exemption of varying amounts depending on the relationship of the donor to the donee.

You may give away varying amounts without paying gift taxes

California does not allow a marital exemption for gift tax purposes although a transfer of community property between the spouses is exempt.

Under some circumstances, lifetime gifts may *not* be excluded from the impact of estate taxes. Such an instance is one in which the gift is made "in contemplation of death." While often called the "deathbed gift," "in contemplation of death" is not restricted to deathbed situations. Any gift made less than three years before the death of the giver will be considered to have been made in contemplation of death, and that amount will be included in the giver's estate for tax purposes *unless* it can be proved that the giver actually made the gift for a "life motive." Motives which have been regarded as "life motives" include the following: to save income tax; to help establish relatives or friends in business or to make them financially independent; to induce a son to remain at home; to provide funds for education of the donee; to equalize the financial condition of children. Gifts made in all these instances were held *not* to be in contemplation of death and were excluded from the donor's estate. Any gifts made more than three years before the death of the giver are not regarded as having been made in contemplation of death, and will not be included in the giver's estate for tax purposes.

Gifts made within three years of the giver's death may not necessarily be tax free

Other lifetime transfers may also be included in the decedent's estate if the donor does not completely relinquish control over the transferred property. If, for instance, the donor retains a power to use the income for life, or to revoke the gift, or even the power to designate the eventual recipient of the property, such a transfer will *not* be effective to avoid inclusion of the property in the gross estate.

Some consideration should also be given to the selection of the person to receive the gift. If gifts are made to the giver's spouse, they will be included in the receiving spouse's estate unless he (or she) has disposed of the property before death. This enlarges the receiving spouse's estate, and the saving realized by the giving spouse in making the gift may be offset by the tax on the enlarged estate of the receiving spouse. (Of course, if the receiving spouse lives for some time after the death of the giving spouse, or after the gift, he or she may, during that time, dispose of the property so that it will not be included in his or her estate.) That is why it is generally desirable to make gifts to one's children rather than to the spouse. As stated before, the use of the gift device requires the giver to take a calculated risk unless he is a flawless predictor of the future.

From a tax standpoint, gifts to the children are better than gifts to a spouse

One simple method for making gifts to children of assets other than real estate is under the California Uniform Gifts to Minors Act. The gift can be made by transferring the property to either parent or a third person as "Custodian" under the Act. In order to make certain that the property will not be taxed in the estate of the parent, it is advisable to name a relative or some other third person as Custodian. In any event, the child is entitled to receive the property from the Custodian when he reaches the age of twenty-one.

Certain practical considerations are involved in the use of the lifetime gift. There is seldom any substantial tax advantage gained from making lifetime gifts to the extent of disposing of all property. Nor will the lifetime gift device be especially useful to the person with limited property, who would not be affected by the estate tax. The question of whether a particular person would be wise to begin giving his property away is one which he should decide *only* with the aid of a competent attorney. It should also be remembered that the gift may be in the form of cash, stocks, bonds, land, anything—the value for gift tax purposes being determined by the fair market value of the property at the time of the gift.

For the farmer desiring to retire or enter semi–retirement, the private annuity or "support contract" has been suggested as a solution which, while providing for the transfer of the farm property to the next generation without probate, can result in tax savings. Under this device, he transfers the farm property to the next generation in return for a promise that the son (in the usual case) will support the parents for the rest of their lives. Alternatively, the agreement may call for cash payments.

A "support contract" has some advantages and . . .

Such a plan has, perhaps, some benefits to commend it. There are, however, many dangers. If the agreement calls upon the son to pay the parents' living expenses, it automatically follows the cost of living. Probate expense is saved, that is, if the farm property is the sum total of the parents' property. The son is assured the property and will have more years to enjoy and improve it. The need for liquid assets is reduced. The property will be removed from the parents' estate and freed from estate taxes. To the unwary and unrealistic this support contract plan would appear to be the perfect solution to his estate problems, but he should not be misled.

many disadvantages

There are some very real disadvantages to the plan. It is sad but true, and often tragic, that such support agreements can lead to family friction. Disagreements between the parent and son about the management of the farm commonly arise. Other heirs resent the favoritism. The parents are made to depend completely on the children; the property can be sold or conveyed away by the son, and is subject to the claims of his creditors. In addition to these intangible disadvantages, there are monetary pitfalls in this "perfect solution." If the parents are long-lived, the son may end by paying out much more than the property is worth. The son must pay income taxes on the income from the property, yet he can take no deduction for the payments he makes to the parents. During periods of declining farm income the son may have some difficulty maintaining support or payments. The tax consequences of a sale by the son after the death of the parents are difficult to determine. If the parents die before the son has paid the equivalent value of the property, the "windfall" may be taxable as ordinary income or the son may not have to pay a tax until he sells. In so far as the tax effect on the parents is concerned, they would pay an income tax each year, calculated by using a special formula designed to set aside a portion of the annual income as repayment of their investment. They would pay no tax on the portion set aside. Any consideration of this annuity or support plan should be tempered by the fact that there is a chance the taxing authorities will regard the plan as a sale of the property by the parents to the son, and assert a capital gains tax at the beginning in addition to the yearly tax on the income. Further gift tax problems arise if there is a difference between the value of the annuity

It may cause family squabbles

Parents are made completely dependent upon their children

The tax status is not always clear

and the fair market value of the property.

Clearly, the use of the private annuity or support plan should not be made hastily. As with any estate plan, a decision should be made only after careful examination of *all* the factors, not just those concerned with dollars and cents.

The trust is a good solution for some estates

The trust represents another means of disposing of property in such a way that substantial tax savings can be realized, but this is not its only purpose. The trust will also provide a way to protect property and assure continued income to the family of the settlor (the person placing property in the trust). In the typical trust, the settlor transfers property to the trustee (holder of the trust property) who is under a duty to preserve the trust property and use it for the benefit of the trust beneficiaries (persons for whose benefit the settlor sets aside the trust property). For example, Brown may transfer 100 shares of stock to Jones with instructions for Jones to pay the income from the stocks to Brown's son for 10 years and, after 10 years, to give the shares to the son. This is an express private trust, Brown being the settlor, Jones the trustee, and Brown's son the beneficiary. If this arrangement is made to take effect during Brown's life the trust is called a *living trust.* Brown may set up the trust in such a manner that he cannot change it, or he may retain the power to change it or to destroy it. By making the trust unchangeable, Brown creates what is termed an *irrevocable trust.* Reserving the power to make changes in the trust results in a *revocable trust.* In California, all trusts are revocable unless the terms state otherwise. Trust law, and the tax laws connected with trusts, make up some of the more complicated sets of rules in the law—too complex to be discussed here in detail. But some general observations may be made.

The trust is flexible and complex

It is best applied only to certain types of property

Aside from the tax aspects, while the trust is flexible, it is best limited to certain types and quantities of property. Placing farms in trust gives rise to managerial difficulties because land management is a job calling for full attention. Personal property, such as cash, stocks, bonds, and the like, is more easily managed. Some types of personal property, such as jewelry, clothing, family silverware, heirlooms, family automobile, and the like, are obviously unsuited as trust property. These things are best disposed of by will. Certain types of trusts would not be in the best interest of the person with only moderate means. Where the trust is used, however, it can be formed to provide for the needs of several persons (beneficiaries) with a minimum amount of effort, or none at all, on the part of the settlor.

A number of tax savings are available through the use of the trust. In the case of the irrevocable living trust, for example, the property placed in the trust will not be included in the settlor's estate—if the trust is well planned. The settlor must pay a gift tax on the property given to the trust, subject, of course, to the exemptions or exclusions discussed in the section on the gift device. It should be remembered that even if the gifts to the trust exceed the exemptions and exclusions, gift tax rates are usually lower than estate tax rates. The settlor also obtains income tax savings with the irrevocable trust. The income from the trust property is not taxed to him, but is taxed to the beneficiaries and is made available to them. In this way the income of the property is split into more parts, resulting in a lower total income tax paid by all the beneficiaries than would be paid if the income from the property were taxed all in one piece. Estate tax savings are possible since the settlor of a living trust can remove property from his estate, thus avoiding death taxes and keeping the trust property out of the beneficiary's estate while still giving the benefits of the trust to him during his life.

When properly planned it can result in numerous tax savings

A special type of trust is the so-called "Clifford" trust. This type of trust normally must be for a period of ten years or more, or for the life of the beneficiary. During the term of the trust, all of the income is distributed to the beneficiary or accumulated for his benefit. Upon expiration of the trust, the principal reverts to the settlor. The major advantage of a Clifford trust is the ability to transfer income from a higher bracket taxpayer to a low bracket taxpayer for a number of years without permanently giving away the underlying trust property. Although there are also savings in estate taxes, they are smaller than can be realized from outright gifts or gifts to irrevocable trusts.

Obviously the trust is not a simple device but, when carefully planned, it can be a real benefit to all concerned. Setting up the plans for a trust calls for great skill and imagination as well as recognition of the practical factors of family needs, personalities of the parties concerned, and so on, without undue emphasis on the tax saving aspects. Like other estate planning devices, the trust plan must be reviewed from time to time to take into account changes in the family circumstances and changes in the law.

Planning a trust requires skill and imagination

It has been common practice in farming communities for husbands and wives to make cross deeds to each other and then, in the case of the death of either, for the survivor to record the deed which he or she holds. It should be mentioned that these cross deeds are *really not legal,* and have been disregarded by the California Supreme Court. Title companies have taken the position that such deeds are of no use and effect, and consequently the prop-

Cross deeds between spouses are not legal

erty still would have to be probated. Because of the trouble they cause, cross deeds should *not* be used between the spouses.

Deeding property to a spouse for a life estate is impractical

It should also be mentioned that, under either the deed method or the will method, some people believe that they should use an ordinary life estate for the disposition of real property. In other words, the decedent spouse would make a deed outright to the other spouse, wherein he or she would have a life estate, or, under the terms of the will, would directly provide that the surviving spouse have a life estate in the property. This is impractical in a farming community because of the difficulty of securing any financing where an individual has only a life estate. The bank or other financing institution would require the signatures of both the life tenant and the remainderman, that is, the ultimate owner, to be sure of protection under all circumstances, and this, in some instances, has proved to be impossible for various reasons. Furthermore, the surviving spouse should never be placed in this position.

Insurance is good but it's not the only answer

Various types of insurance form the basis for almost every family's plan for security. Often insurance is the *only* planning. What too few people realize is that insurance is *not* a cure-all for their estate problems. Insurance purchased without proper attention to the total family needs and the total estate plan can do more harm than good.

Insurance can provide cash for death expenses

It can result in tax savings if the policy has been chosen carefully

The intricate workings of insurance contracts and the variety of insurance plans prevent a complete discussion here, but some general observations can be made. To a great extent, insurance can protect against forced sale of property by providing "liquidity"—cash to pay tax, administrative, and other expenses at death—and so preserve the estate. To a lesser extent, proper use of insurance can result in tax savings. Payments made to the beneficiary under the usual life insurance policy are not subject to income tax, although the proceeds of the policy may be included in the taxable estate of the deceased insured. This inclusion can be avoided, however, if the insured takes special precautions by making an irrevocable assignment of all the incidents of ownership in the policy. Thus, by careful planning, funds may be set aside for family security without payment of income tax by the beneficiary or estate tax by the insured. In the case of the endowment policy, the insured faces some special problems, but he can meet these by careful selection of his policy provisions.

Review the insurance you now hold . . .

Examine the policies you have or the policies you plan to buy. If you cannot *fully* understand their provisions, ask the advice of a competent attorney. Check the settlement provisions, the cash surrender provisions, the savings features, the renewal clauses, the reliability of the company and its agents. Find out how the insurance program you are considering fits in with any other security plans you have—social security and others.

A good insurance program forms an important part of the estate plan, but the limitations of insurance should be recognized. The few tax saving features of insurance are *secondary* in most instances, the principal function of insurance being to accomplish some degree of security as well as to provide cash reserves for expenses arising as a result of death.

Get competent advice on any you may be planning to buy

To make a will is to do something about the future.

How to make a will

As stated earlier, the purpose of estate planning is more than the reduction of tax liability. The property owner—farmer or otherwise—is also concerned with providing for the welfare of his family while at the same time avoiding as much conflict and confusion as possible. This can be achieved only if the property owner does something about the disposition of his property himself. There are laws which provide for the distribution of property when no action has been taken by the property owner before his death. While these laws generally protect the surviving spouse and children, they may operate contrary to the owner's desires.

By making a will, you decide how your estate is to be distributed . . .

Every property owner has the right to control the distribution of his property after death, with some limitation. He exercises this right by the preparation and execution of a will. If one child needs more help than another, if the wife would rather have a cash income than the farm property, if the grandchildren hold an important place in the family plans for farm operation, if any of a number of special situations is present in your family, then *you* must take the steps to meet it. Otherwise the law provides for distribution according to a set plan, a plan which, in the light of special circumstances, may not be fair to those concerned. This distribution often splits property holdings to such an extent that the over-all efficiency is reduced and any single heir may have difficulty uniting the parts.

otherwise, the law will do so, perhaps to your heirs' disadvantage

Too many people think that the preparation of a will is an omen of impending death. This is foolish. The will, like life, health, or accident insurance, is merely an expression of present intention *to do something about the future.* Many people also think that the making of a will is complicated. This is not true. With the assistance of an attorney, making a will can be a relatively simple affair. The preparation of a will is not something which should be left until later years. In fact, the family of the young farmer needs protection and security to a greater degree than any other. The costs of probate when there is a will can be less than when there is no will, and the possibilities for substantial tax savings are much greater under a carefully drawn will. The cost of drawing a will is, in all instances, minor, compared with the advantages to be gained.

With competent legal advice, making a will is fairly simple

You can help your lawyer to draw an adequate will by taking certain preliminary steps. First, arrange to have a conference with your attorney. Ask your attorney about the costs of drawing your will and of probating an estate. Bring to that conference the deeds to all real property, insurance policies, and a general statement of assets and liabilities. Also, be prepared to give the attorney a statement of the income from such property. The attorney will then draw a preliminary version of the will, which you should take home and read carefully. When you are satisfied that the will expresses your intention, return it to the attorney. He will have the final version prepared, and make sure that the proper steps are taken in the signing of the document. *Do not attempt this last step yourself.* Certain legal requirements must be met to make the will effective. Keep the will in a safe place where it is not likely to be destroyed or tampered with. Your attorney will probably retain a copy in his files. *Never make changes in the will without consulting an attorney.* It is possible to change the will, but the changes must be made in a certain manner—*not* by erasing or crossing out portions or by writing between the lines or in the margins. Whenever there is an important change in the family situation, such as a birth, death, or marriage, or a change in the general economic situation, re-examine the will in the light of such happenings. You are always free to change your will or to draw a new one, but *you must do it correctly.*

Keep your will in a safe place

Never change it without legal advice

Preserve your estate by taking the family into the business.

Pointers for estate planners

It cannot be emphasized too strongly that an estate plan is a very individualized plan. What fits one family situation will not necessarily fit another. The preceding discussion has been in general terms. Consequently, the plan to fit a particular person or family *cannot* be devised solely on the basis of that information. **Always consult a competent attorney.** Good legal advice is not cheap, but the advantages—both in money and in feeling of security—will more than outweigh the expense involved.

The estate plan and the family economic situation should be known to the wife as well as the husband. It is tragic but true that most widows know nothing of the financial and business affairs of their husbands. Husbands should give their wives the following information:

1. The location of valuable documents, such as deeds, leases, contracts, insurance policies, wills, military service papers, social security records, and the like.
2. The business records for the farm and any outside employment or business.
3. Any outstanding debts, notes, and mortgages, and who holds them.
4. The banks in which savings and checking accounts are kept, and the location of the bank books.
5. The names of persons who act as business, personal, or legal advisors.
6. The nature of any retirement plans, including social security.

The wife's knowledge of the farm and family business will ease her burdens and give her some assurance of being able to cope with the many problems of widowhood. The handling of the estate will be considerably simpler if she knows something of the problems involved.

FAMILY BUSINESS ORGANIZATIONS

The partnership and the corporate form are most widely used

In contrast to the individual ways of owning property discussed above, there may be a joint or group operation of the farm. Such an arrangement allows the pooling of capital and of labor and management abilities, and gives more assurance of continuity in the operation of the enterprise in the event of the death or disability of one member. There may also be tax savings. Several kinds of joint business operations are possible, but the partnership form and the corporate form are the most widely used. Since many factors must be considered, it is wise to seek competent legal advice before you make a choice.

Bear in mind, also, that although a business may be in

The property involved may be owned in several ways

the form of a partnership or a corporation, the *partnership interest* itself, or the *corporation stocks,* may be held in joint tenancy, or community property, or by some other form of ownership. For example, if a father, mother, and son are equal partners in the farming business, the one third partnership interest held by the son may be the community property of the son and his wife. If the father, mother, and son are corporate stockholders of the incorporated farm, the stock certificates might be held in joint tenancy as between the father and mother or between the son and his wife. Thus, the preceding discussion relating to community property, joint tenancy, or tenancy in common also applies to family business organizations.

THE FAMILY PARTNERSHIP

Joint operation of a farm

The family partnership is probably the most popular device for the joint operation of a farm. A partnership is a legal relationship; it is an association of two or more persons who will carry on, as co-owners, a business for a profit. This does not necessarily mean that the property used in business must be owned by the partnership; it may be leased. Usually profits and losses are shared, and all parties participate in the management. Often there is a firm name and a single set of business records.

helps prepare younger family members for later responsibilities

The farming partnership is often helpful in preparing younger members of the family to assume management responsibilities when the father retires. It also tends to promote interfamily harmony. However, if there are disputes within the family, the success of the farming enterprise may suffer. If the partnership must be dissolved because of such disputes, some of the assets may have to be sold, and may bring prices that are far less than the actual value of those assets in the operating business.

When the sole proprietor decides to form a partnership, he may be required to give up some control over the farm assets. For example, if a father decides to take his son into the farming business, he may make a gift of capital to the son, to be contributed to the proposed partnership. Income and management of the enterprise may also be shared. Because of doubts about his own financial independence and security under a joint enterprise in later years, a father may hesitate to enter into any such arrangement.

Both income and estate tax savings are often effected

From a tax standpoint, the family partnership is often a good device for saving both income and estate taxes. Although a husband and wife may file a joint return to split their income, and the community property system may divide (and thus reduce) the assets owned by one spouse at his death, the family partnership allows further tax savings beyond those to the husband and wife alone.

If sons, daughters, and other members of the family join in the partnership, by splitting the farm income among them, the partners as individual taxpayers will pay lower total taxes than if *all* the income were taxed to the parents *alone*. The estates of the parents will also be reduced as a result of giving property to their children as partners, possibly to the extent of having to pay no estate or inheritance taxes at all.

To obtain a reduction in income taxes, the formation of the partnership must be handled with considerable care. The partnership may not be a mere sham for the purpose of evading taxes, but must be a genuine business transaction with contributions of capital and labor by each of the partners. Often children to be included in the partnership do not have capital to contribute. The tax laws, however, allow a person to make gifts of money or property to his children to contribute to the partnership, provided the formation of the partnership is for a valid business purpose. Gifts of rather substantial amounts may be made, by the parents, free of any federal or state taxes by reason of the gift tax exemptions and exclusions. Even if a gift tax were payable, the cost would not be so great as to outweigh the potential savings in estate and inheritance taxes which would result from the reduction of the parents' estates. (See the discussion on page 17.)

Children may receive tax-free gifts to contribute to the partnership

The children may be given either an undivided interest in a partnership or they may receive directly gifts of money and property which they then contribute to the partnership as capital. Although the family partnership might be formed *without* a capital contribution by the children and still comply with the federal tax laws—merely by having the children contribute their labors—this would not serve to reduce the estates of the parents. The trust device can be combined with a family partnership by having the parents contribute money and property to a trust for the children which would then act as a partnership. This is particularly useful when children are minors.

Of course, the parents could retain management and control of the partnership property by the terms of the partnership agreement. To provide for the parents upon their retirement, the partnership agreement could state that, after allowance for services rendered by the active (nonretired) partners, the balance of the partnership profits is to be distributed according to the share of the total value of the partnership held by each partner. For example, suppose that in a partnership consisting of the parents and two sons, the parents contribute 60 per cent of the total partnership assets and the sons each contribute 20 per cent. When the parents retire, reasonable salaries

Provision can be made for the parents' retirement

may first be paid to the sons active in the partnership; 60 per cent of the remaining profits may be distributed to the parents, and 40 per cent to the sons. In addition to providing for retirement, this provision would prevent the loss of income which ordinarily accompanies the giving away of property. The portion of the income distributed to the retired partners (the parents) must be fairly close to the amount of their capital left in the business. It cannot be disproportionate to the capital interest and thereby an evasion of income taxes.

A partnership should be carefully planned to insure its continuation

The carefully drawn partnership agreement will provide for the contingencies of death or disability of a partner and continuation of the business by others without dissolution or liquidation of the partnership. Unless some such provision is made, partnership will end, by law, at the death of one of the partners. Continued operation of the farm can prevent a forced sale of the farm assets.

The surviving partners may be protected by a buy and sell agreement

Through a "buy and sell agreement," an arrangement can be made, before death, whereby the surviving partners may acquire the interest of the deceased partner. Under this arrangement, each partner agrees to sell his interest to the surviving partners at a given price. A purchase price can be determined by the original agreement or by a later appraisal of the assets.

If a buy and sell agreement is made, some additional thought must be given to financing the purchase of a deceased partner's interest. To provide the necessary funds, insurance is often purchased on the lives of the partners, with the insurance proceeds payable to the surviving partners. Instead of buying insurance, either the partnership or the partners can set aside cash for this contingency. The buy and sell agreement might also allow payment of the purchase price in installments out of profits from the business.

Or, a partner might appoint an executor or a trustee

As a second possibility, the deceased partner's estate could continue to participate in the operation of the farm business, with the deceased partner's executor, trustee, or some relative, as the new partner. Difficulties in maintaining such an agreement can arise, especially if the executor or trustee is not on good terms with the surviving partners. It may be better merely to keep all the deceased partner's interest in the business and to pay a share of the profits to his beneficiary.

Written partnership agreements prevent questions among the partners relating to allocation of gain or loss, retirement, and other matters of special importance. They may also provide easier proof, to the taxing authorities, of the genuineness of the family partnership.

THE CORPORATE FARM

Before incorporating your farm, get competent legal advice

The incorporated farm is another possible method of joint operation. This device makes possible the amassing of capital under centralized management for more effective production and marketing of farm products. A corporation is a legal unit for carrying on a business. It is an entity or legal "person" separate from the legal capacity of the corporation shareholders. Thus, for example, the Jones Corporation is an entirely different legal unit from Mr. Jones even though he organized the corporation to conduct his farm, manages it, and owns all or practically all of its shares. The desirability of incorporating a farm is largely a matter for the individual farmer to decide after seeking the help of a competent lawyer.

The advantages of the corporate device may be compared with those of the partnership. For example, liability of the shareholders of the corporation is limited to the extent of their capital invested, as compared with unlimited personal liability of partners. Continuity of existence is generally unaffected by the death, disability, or bankruptcy of a member, as compared with the normal dissolution of a partnership when the partner is no longer able to carry on the business. Management by the officers and directors of the corporation is centralized, as compared with the power of any partner to act for the partnership within the scope of the business. The corporation has capacity to act as a legal unit separate from the individual shareholders, whereas no such separation exists between the partnership and the partners. These, however, are only a few of the factors to be considered.

In general, a corporation can be more costly than a partnership

The costs of forming a corporation include those for preparing articles of incorporation, filing, recording, stock issuance, and others. They are, in general, greater than those for a partnership. Furthermore, proper maintenance of the corporate form involves an amount of paper work which a small family enterprise may find burdensome.

Incorporation is usually advisable only for large-income farms—$30,000 or over

The corporate form of ownership, from the tax standpoint, is not recommended for the farm with less than an *annual net income* of about $30,000. This is because of the *double tax*. Corporations are taxed on their net earning whether distributed or not. If the earnings *are* distributed, the shareholders will generally be taxed on the distributions (dividends). If the earnings of the corporation are unreasonably withheld from distribution, penalty taxes may be imposed. Compare the taxation of the corporation with that of the partnership. Partnerships do not, as such, pay federal income taxes. Partners are *individually* taxed on the earnings distributed or distributable by the partnership; thus, there is no double tax.

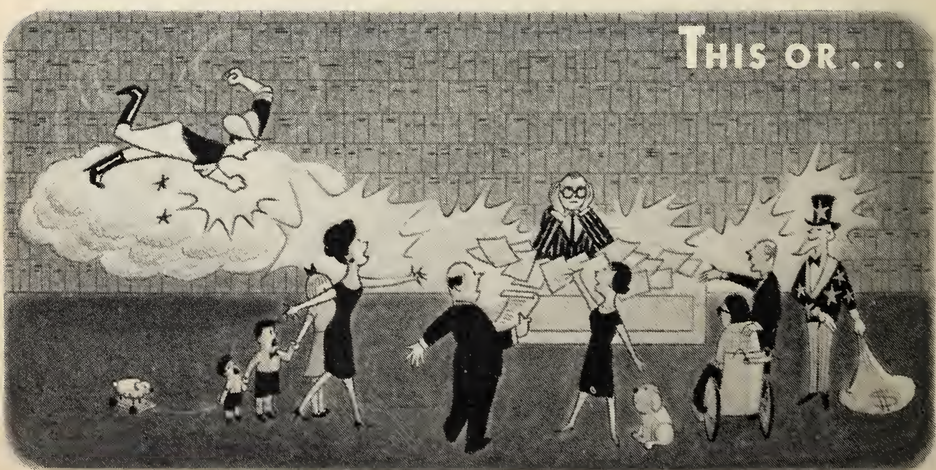
It also is possible to obtain the legal and practical advantages of a corporation for a farming operation while continuing to be taxed in much the same manner as a partnership. An election may be made under subchapter S of the Internal Revenue Code to have the income, with certain technical limitations, taxed directly to the shareholders, which would avoid the double tax that otherwise arises when dividends are declared. There are no provisions in the California tax law comparable to those of subchapter S on the Federal side and a corporation formed and taxed under subchapter S will be taxed as a normal corporation for state tax purposes under California's Bank and Corporation Tax Law.

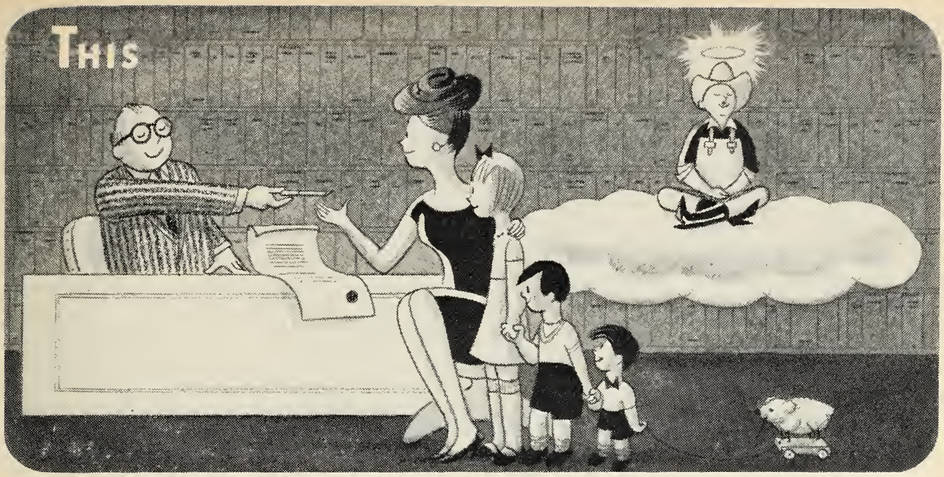
Some tax savings may result from incorporation

Where the farm income is high and a large part is used for reinvesting in the farm, a corporation is advisable. A corporation may pay reasonable salaries to its shareholders for services rendered, and all surplus earnings need not be distributed to the shareholders and taxed to them in dividends. A reasonable amount of earnings may be accumulated for business needs. Because of the legal separation of the corporation and the shareholder, there may be a splitting of income which can result in tax savings. For example, a corporation may rent land from a shareholder and deduct the rent as an ordinary business expense, thus shifting a part of the corporation income to the shareholder owning the land while, at the same time, reducing the taxable income of the corporation.

Corporate ownership of land limits irrigation water to 160 acres

Care should be taken that ownership of the farm land is not placed in the corporation if the land is irrigated with Federal water. Otherwise land owned by a husband and wife not exceeding 320 acres and entitled to receive Federal water will, if placed in corporate ownership, be only entitled to receive water for 160 acres.





THE CHOICE IS YOURS

Unfortunate estate problems and delays in probate which might have been avoided had the decedent consulted an attorney are set forth in the actual case stories which follow. The fortunate situations which followed from careful estate planning with the aid of a competent attorney are also described.

I. THE MUTILATED WILL

Otto had come to this country from Switzerland as a young man. He married, but never had children. After his wife's death, he consulted an attorney about making a will. In the will he expressly disinherited his brothers and sisters who were still in Switzerland whom he had not seen for several years, and with whom he had not been friendly since he suspected them of being Nazi sympathizers in World War II. Under his will he left his entire estate to a number of his friends and neighbors and some favorite charities.

As Otto grew older he became senile and apparently spent long evenings thinking about what would happen to his estate upon his death, and imagining hostilities between himself and the beneficiaries named in his will. The result was that he made many handwritten changes on his will with scratched-out names, comments concerning the scratched-out names, illegible names written in, and other interlineations until the entire will was mutilated beyond legibility.

The result, of course, was that upon his death his will could not be admitted to probate and his estate went to his brothers and sisters in Switzerland—the very people to whom he wanted to leave nothing.

The will should have been left with his attorney for safekeeping, so that Otto's desired changes could have been made in a proper manner.

II. THE OUT-OF-DATE WILL

Robert and Elizabeth owned a fair-sized ranch upon which they conducted a successful farming and livestock operation. They had two teenage daughters at the time they consulted their attorney for the making of a will. They each executed trust wills with the other as beneficiary for life and the remainder over to the daughters until they attained age twenty-five.

A number of years later after the daughters had finished college and married, John and Elizabeth sold the ranch, made extensive investments in securities, and spent a great deal of time in traveling. They also built a beautiful new home in town. On several occasions the attorney urged Robert and Elizabeth to call at his office and discuss possible changes in the wills, because of the changes in their property holdings and in the family situation. No changes were made, and Robert died eighteen years after the making of the original wills.

As the residence was now subject to the trust under the old will, and because Elizabeth felt that for sentimental reasons she would like to have sole ownership of it, she had to use some of her cash to purchase the bank trustee's interest in the residence. Since the securities had greatly increased in value, some of them could easily have gone to the daughters directly under Robert's will, rather than through the trustee. This could have reduced future trustee's and attorney's fees, which will now continue for the remainder of Elizabeth's life. The daughters could have used their father's inheritance at this time while their families are growing, and particularly, could use it in a few years when their children will be ready for college. While the daughters are forced to defer enjoyment of their inheritance until Elizabeth's death, Elizabeth has been provided with more income and property than she needs and thus is forced to pay more Federal and State income taxes than should be necessary.

Many of the difficulties could have been obviated and Elizabeth's future, as well as the future of the daughters and their families, could have been simplified if Richard and Elizabeth had made changes in their old wills, which were most proper for them at the time they were made, but which should have been changed because of altered circumstances.

III. THE THREE-WAY JOINT TENANCY

Ralph and Margaret, brother and sister, inherited farm land from their parents many years ago. Thereafter, Ralph married Esther and they raised a family. Margaret continued to live with them, she being employed as a school teacher. Ralph and Margaret, with some of the money they inherited from their parents, some of Margaret's earnings, and some of the income from the farm, purchased additional land, taking title in Ralph and Margaret's names as joint tenants. Ralph also purchased some adjacent land with farm income and took title in himself and Esther as joint tenants. Some rental properties in town were purchased with farm income and title vested in Ralph's name.

Believing that matters would be simplified in the event of the death of any one of them, they put all of their real property, bank accounts and securities in joint tenancy between Ralph, Margaret and Esther. They correctly understood that each of them held an equal one-third interest in all of the property, but mistakenly believed that if anything happened to Ralph or Esther, his or her share would go to the survivor of them and that Margaret would continue to have a one-third interest in the property.

Ralph died and to the consternation of Margaret and Esther, they learned that they each now owned a one-half interest in the property, that inheritance taxes had to be paid by Margaret and Esther, and that delinquent gift taxes were also due and payable, including penalties and interest. Further expense was incurred since Margaret and Esther are now in advanced years and desire to bring Ralph Jr. into the ranch operations through gifts and partnership arrangements.

Much of the trouble and expense could have been avoided if these people had availed themselves of competent legal advice rather than setting up the unfortunate joint tenancy between the three of them.

IV. THE BACHELOR BROTHERS WHO DID NOT BELIEVE IN WILLS

Arthur and Richard were bachelors. They were the survivors of a family of seven children. One sister had died in childhood. Three other sisters and a brother had died leaving ten adult nephews and nieces surviving. Arthur and Richard continued to farm the old family-ranch property after their parents and brothers and sisters had all died, but they paid a proportionate share of the income each year to their nephews and nieces.

Unfortunately, neither Richard nor Arthur believed in wills. Richard died and then when Arthur died a few months later, the difficulties began. Some of the nephews and nieces purchased the whole or partial interests of other nephews and nieces in the ranch property, and in one or the other or both of Richard's and Arthur's estates.

Distribution in the two estates was most difficult. The nephews and nieces had various undivided interests (sometimes a $\frac{1}{24}$th interest) in certain lands and other fractional interests in other parcels, and there was the additional problem of attempting to manage the property after distribution with the different nephews and nieces having varying ideas as to how the property should be managed.

If Richard and Arthur had consulted an attorney during their lifetimes, they could undoubtedly have worked out an operational plan with their nephews and nieces and could have controlled the disposition of the property through their wills. This would have simplified matters and immeasurably reduced the costs incurred in the administration of their estates.

V. THE PHILANTHROPIC BACHELOR

Leslie, who had no relatives other than distant cousins, was a bachelor who lived for many years with his elderly mother. A few years after her death he learned that he had a fatal illness. Having no other relatives, he consulted an attorney friend with the idea of devoting his considerable estate to the establishment of a laboratory through which soil problems he had encountered in his farming operations could be investigated and remedied. The attorney explained that the preparation of a will involving a gift to charity requires special technical knowledge and careful handling. A will and other documents were drafted to carry out Leslie's wishes.

Through a bank as trustee, and with the cooperation of the University of California at Davis, a soils laboratory was established upon Leslie's death and many worthwhile research activities resulted. This valuable work has led to improvement of soil conditions and farming practices in the county where Leslie lived and—through farm advisors and the extension services—in other areas of the state as well.

Without such a will, Leslie's estate would have gone to some distant relatives whom he hardly knew.

VI. THE INTEGRATED ESTATE AND FARM-OPERATION PLAN

John and Dorothy R. increased their farm holdings and ranch operations over the years. When their three sons returned home after World War II the sons purchased additional farm lands with some of their own savings, and with contributions from their parents. Title to the lands thus purchased was vested sometimes in John's name alone, sometimes jointly with one or more of the boys, and sometimes in the names of one or more of the boys. The farming operations were all conducted under an informal oral partnership arrangement using the name "John R. and Sons."

The operations became more extensive, and realizing that there should be more organization to the larger enterprise they consulted their attorney, who in turn conferred with their life-insurance representative and accountant.

This resulted in the formulation of trust wills for John and his wife which made adequate provision for the survivor of them for the remainder of his or her life, protected the business interests of the boys, and also provided for a married daughter. Wills were also made for each of the boys to accommodate their particular family situations. Two close-held corporations and a family partnership were created whereby farming operations were conducted under one corporation, the livestock operations under another, and the ownership of certain machinery and equipment was held under a partnership.

The result has been efficient farm operation, with income tax benefits to John and the three boys. Upon John's recent death there was a smooth transition for the benefit of the entire family without any forced sale of assets in order to pay taxes or expenses of administration.

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