CURRENT FARM ESTATE PLANNING ISSUES

FOR A TRANSITIONAL ECONOMY

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I. INTRODUCTION

The purpose of this paper is to review some current farm estate planning features in a way that will be particularly useful to the active farmer and his or her advisers and professional associates.

Every man and woman engaged in the agricultural industry is more than aware of the contractions within these traditional fields of endeavor, and the corresponding -- if brutally ironic -- increases in collar county real estate values as urban development replaces crop production as the new highest and best use.

In turn, this economic and cultural turmoil is prompting a number of traditional estate planning notions to be reconsidered around the kitchen table, a process exacerbated by a new and dreadfully uncertain set of federal and state gift and estate tax rules that are making the informal transfer tax calculus almost unpredictable. As a result, each farm professional *cum* landlord now requires an even greater grasp of the rudiments of the estate and gift tax laws, the lawful techniques available to reduce the burden of transfer tax and other risks of loss, the non-tax issues relating to the disposition of assets and the protection of intended beneficiaries, and the legal structures best suited for current and future asset administration.

This is not a simple assignment. Estate planning is among the most complex fields of law -- combining, as it does, so many different legal, tax, family, and other practical considerations. Popular misconceptions are rife, and technical errors seem almost unavoidable. The best any farm professional should expect is to stay currently informed of the general principles and trends in order to spot issues that may be of interest or impact. By staying generally informed, and having a sense of when to call in more specialized assistance where appropriate, the intellectually agile agrarian might stand a chance at balancing these new planning challenges to his or her cumulative advantage.

The following materials have been prepared with this purpose in mind: to assist generally with general issues. This paper is not intended to be a comprehensive treatment of any of the selected topics that follow, and many important features have necessarily been capsulized or avoided altogether. Moreover, the "Economic Growth and Tax Relief Reconciliation Act of 2001" (the "2001 Act), the "Jobs Creation and Workers Assistance Act of 2002" (the "2002 Act), and the "Jobs and Growth Tax Relief Reconciliation Act of 2003" (the "2003 Act) have combined to bring important but mind-numbing changes to the gift, estate, generation skipping, and fiduciary income tax rules that must be mentioned in context with the pre-existing tax regime.

Thus, while every effort has been made to assure the reasonable accuracy of the analysis and suggestions included in these materials, your author cannot assume responsibility for the contents beyond their use as a general teaching and reference guide. Any farm professional who is engaged in the estate planning process must independently verify the accuracy and applicability of the law to each particular circumstance, and satisfy himself or herself as to the federal and state tax consequences that may occur.

II. THE ESTATE PLANNING PROCESS

Estate planning begins with the certainty that our tenure in this world is limited, and that our loved ones, and our possessions, will still be here when we are gone. It is in the face of that certainty that we plan for the intelligent disposition of our property for the benefit of those we care most about, and to assure that our desires will be accomplished with a structural minimum of fuss, expense, and taxes.

The process begins by thinking, and gathering information. The usual considerations will include:

* Identifying assets (with special attention to how title to each asset is held), and estimating current and potential value
* Establishing beneficial objectives, by considering the needs and expectations of:
    * Spouses
    * Children (including children with special circumstances, such as disability, or who may or may not be interested in continuing to farm the family farm land)
    * Charities
    * Other valued persons, including dependent relatives, or perhaps an existing farm tenant
* Planning to minimize taxes, including:
    * estate and gift taxes ("transfer taxes);
    * generation-skipping taxes; and,
    * income taxes,

(and sometimes the transfer tax planning and income tax planning are in direct conflict!)

* Planning to protect assets from current or potential claims of the beneficiaries' creditors, tax authorities, public aid, or estranged spouses in the event of the divorce

* Balancing the advantages or disadvantages of inter vivos (lifetime) gifts against testamentary (at death) dispositions

* Choosing appropriate business and estate planning vehicles for holding, transferring, and administering assets, including:

    * Partnerships, including general partnerships, where all partners have equivalent control and responsibility, and limited partnerships, where different roles, responsibilities and liabilities are applied to the general and limited partners

    * Corporations, including regular "C" corporations, which have a separate tax destiny, and "SubChapter S" corporations, which provide for the flow-through of significant tax events to their shareholders

    * Limited Liability Companies, a hybrid business form that shares many features of both corporate and partnership forms

    * Land trusts, an Illinois common-law creation that provides for the centralized ownership of land while facilitating convenient fractional transfers of interests

    * Traditional trusts, including trusts created under a will (a "testamentary trust"); revocable trusts created during the owner's lifetime and becoming irrevocable at death (so-called "living trusts"); and, occasionally, <u>ir</u>revocable lifetime trusts that provide for the permanent transfer of property during the owner's lifetime

* Choosing a representative to carry out the owner's wishes when he or she is gone, or disabled, including all the criteria to be considered in choosing a family member, a corporate fiduciary, and/or an outside adviser like the Farm Manager

* Choosing a responsible adult to serve as guardian for minor children, or for a disabled adult

On the basis of this detailed analysis the estate plan itself is then composed to provide for:

* Lifetime gifts, if any

* Post-death administration, including appointment of the Executor, Trustee, and/or Guardian, and careful recitals of their respective duties, authorities and restrictions

* Payment and apportionment of debts, expenses and taxes
* Implementation of personal and tax objectives
* Distribution of the property and/or
* The continued administration of the property through the trusts or other entities previously formed buy or for the benefit of the decedent.

The appropriate legal documents will then be prepared to give effect to these carefully considered conclusions. Generally, these will include:

* A Will, necessary even when a living trust is selected as the primary estate planning vehicle
* Frequently, one or more different trust arrangements
* Entity management plans, as required by the various entities, with supporting buy/sell agreements to facilitate economic continuity in the event that one or another key player is lost
* Title transfers for lifetime gifts, such as deeds, assignments or bills of sale
* Beneficiary designations for the owner's life insurance and retirement plans (as a matter of contract law, those benefits are not normally governed by the Will or living trust unless special provision is made for that purpose)
* One or more powers of attorney, for health care and for property, whereby the individual may appoint another to act in his or her name in the event of catastrophe, absence, or disability

In addition, there may be a separate marital agreement, to define certain interests in the event, say, of second marriages with children from a prior marriage, and maybe one or more contract arrangements for immediate transfers on death, such as joint tenancy, transfer-on-death ("T.O.D.") or payable-on-death ("P.O.D.") accounts.

There is, of course, no set combination of documents that will apply to all individuals. Instead, the legal instruments will be a function of what the individual chooses to do, and the correct application of the governing legal and tax principles. That is the essence of the estate planner's art.

Estate plans should be considered or reviewed whenever a major milestone of life is reached, including:

* Adulthood

* Marriage, or divorce

* Birth of a child or grandchild

* Significant changes in wealth accumulation, or types of assets

* Changes in employment, or business ventures

* Advancing age, or retirement

* Significant changes in tax laws and laws regulating the administration of estates and trusts

In no other area of the law does sound, intelligent planning serve better to prevent unfortunate consequences -- and to reduce costs -- than in the area of estate planning. Absent a carefully considered estate plan the surviving family members will have to cope with the statutory scheme for the distribution of property, and almost certainly additional expense will be incurred to sort things out after the fact.

III. SELECT GIFT, ESTATE, AND GENERATION SKIPPING TRANSFER TAX CONSIDERATIONS

Although family circumstances will always influence estate planning for individuals, most estate planning documents -- wills and living trusts -- include targeted provisions for reducing gift, estate, and generation skipping taxes to their lawful minimum.

Where transfer taxes are not an issue -- where total family wealth is well below the applicable exclusion amount -- tax planning properly yields to convenience, and often only the simplest plans are required. For example, joint ownership of property, or T.O.D. or P.O.D. ('transfer on death" or "payable on death") accounts are in fact the quickest and easiest way to assure successive rights with a minimum of formalities.

But for larger estates -- for families with combined values approaching $1,000,000 or more -- fundamental transfer tax avoidance planning can be vital.

A. The Unified Transfer Tax System. Beginning in 1977, the federal gift and estate tax systems[1] have been combined in order to reduce the differences between transferring property during life and transferring property at death. All taxable post-1976 lifetime gifts (meaning gifts other than to spouses, or gifts in excess of the available annual gift tax exclusions, described below) and any assets remaining in the individual's estate at death are now aggregated and subjected to the unified tax rate schedule. The predecessor separate lifetime gift exemptions and estate tax exemptions have been replaced with a single unified lifetime tax credit, all or part of which must be applied to offset gift tax on lifetime transfers and estate tax due on transfers at death. This credit applies to gifts or devises to any individual other than to the surviving spouse, or to charities. It is important to remember that the unified credit is a credit against the calculated tax due, and is not simply a deduction used in computing the amount subject to tax.[2]

The effect of the unified system is to pile the value of each current set of gifts, or bequests, onto the value of all prior taxable transfers made at any time during the taxpayer's lifetime. Credit is then allowed against the total tax due in accordance with the amount of unified tax credit available during the most recent year of transfer in order to calculate the amount of tax that actually must be paid on that most recent transfer. The estate tax computation at death is thus fully derivative from all prior gift tax computations.

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[1] Internal Revenue Code Chapters 12 (Sections 2501 to 2524) and 11 (Sections 2001 to 2210), respectively.

[2] Note that the 2001 Act has dramatically altered this unified transfer tax philosophy, by decoupling the estate tax and the gift tax effective January 1, 2004. As discussed in greater particularity below, the gift tax applicable exclusion/tax exempt amount will be frozen at $1,000,000, while the estate tax applicable exclusion/ tax exempt amount will continute to increase until the estate tax is abolished in 2010.

Once property has been subjected to this gift and estate tax equation it will not be subject to transfer tax again <u>until</u>:

* It has vested (or deemed to have vested, as with a general power of appointment[3]) in another owner; and,

* That new owner transfers the property to or for the benefit of someone else.

Until both of these events occur the property is "sheltered" by the tax payments -- including the tax credits -- of the last- taxed transferror of the property. This ability to "shelter" property, by making it available in trust for the tax free use by others, is a critical ingredient for crafting tax advantaged estate plans.

1. <u>The Applicable Exclusion Amount</u>. The current applicable exclusion amount, for all lifetime transfers and deaths occurring in 2003, is $1,000,000; or, put another way, there is a unified tax *credit* of $345,800, which is equal to the scheduled tax on the first $1,000,000 of transferable gifts.

The 2001 Act threw the unified gift and estate tax system -- and corresponding credits -- into an awkward scheme of transition. Awkward because:

* Beginning January 1, 2004, the estate tax and the gift tax unity were decoupled.

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A power of appointment is the power to direct the disposition or use of property that belongs to someone else. After the U.S. Supreme Court ruled that even the broadest of general powers of appointment is not a "property interest" subject to tax under Internal Revenue Code Section 2033, Congress responded by adopting current Code Sections 2514 and 2041. These tax power of appointment rules, complex in their own right, create a legislative fiction that certain general powers of appointment shall be construed as if the power holder actually owned the subject property. Possession, exercise, release or the mere lapse of a general power can thereby trigger the gift and estate tax. Of course, both Code Sections contain broad exemptions from tax for more narrow powers, most importantly those known as "limited" or "special" powers that are limited by an **ascertainable standard** relating to the health, education, support, or maintenance of the interest holder.

* The gift tax was not abolished, and its applicable exclusion amount was frozen at $1,000,000.

* In contrast, the estate tax (together with the generation skipping transfer tax) is being phased out-- at least temporarily in 2010 -- and until then its applicable exclusion/ tax exempt amount will continue to increase to the point where the tax disappears in 2010; but,

* Beginning January 1, 2011, the estate tax (and the generation skipping transfer tax) is scheduled to be reinstated, and the estate tax applicable exclusion will revert to its 2003 value of $1,000,000.

* Simultaneously, the applicable estate tax rates are geared to fall from a maximum of 55% in 2001 to a maximum of 45% in 2009, with a return to the 55% rate in 2011 upon reinstatement of the tax scheme as it existed in 2001. *Gift* tax rates will be tied to the then-highest income tax rate then in effect.

Note the following sequence:

Applicable Federal Gift and Estate Tax Credit and Exclusion Amounts

Year of Death	**Transfer Tax Credit Amount**	**Applicable Exclusion Amount**
2001	220,550	675,000
2002 & 2003	345,800	1,000,000
2004 & 2005	555,800	1,500,000
2006	785,800	2,000,000
2007 & 2008	780,800	2,000,000
2009	1,455,800	3,500,000
2010	Not applicable	entire estate
2011	345,800	1,000,000

Note that the State of Illinois has amended its Estate and Generation-Skipping Transfer Tax Act to *freeze* its tax calculus to applicable exclusion amount *and* corresponding tax rate as it applies through December 31, 2004; meaning, that an Illinois resident who dies in 2009 could face no federal transfer tax but still owe an Illinois estate tax! (See, the Illinois notice included herewith as Exhibit A.)

2. <u>The Unlimited Marital Deduction</u>. Beginning in 1981 Congress adopted the principle that, for gift and estate tax purposes, husbands and wives are to

be treated as a single economic entity, and that no tax should be imposed upon gifts or bequests between spouses. The first spouse to die may leave an unlimited amount of money to or for the benefit of his or her surviving spouse and, so long as certain technical requirements for the marital deduction are observed, there will be no tax on that property assessed at the first spouse's death. However, to the degree that the property is not consumed during the surviving spouse's lifetime, it will be fully subject to tax upon the second spouse's death.

Thus, while generally referred to as a "deduction", this marital tax treatment is best considered as a tax "deferral"; the tax burden is not so much reduced as it is deferred until both members of the marital team are gone. This contrasts with the unified credit/applicable exclusion amount that is available to each individual without regard to marital status, and which represents a pure reduction of the combined tax burden. Needless to say, a net reduction in the overall tax burden is always preferable to a mere postponement of the total.

Put another way, current transfer tax planning is almost always geared to taking maximum advantage of each person's unified credit/applicable exclusion <u>first</u>. Only after a suitable structure for this tax reduction has be emplaced should planning then proceed to taking advantage of the deferral available through use of the unlimited marital deduction.

This one-two priority requires strict attention to planning -- and drafting -- to assure the proper balance between the unlimited marital deduction and the applicable exclusion amount. For families where the total wealth exceeds the applicable exclusion amount ($1,000,000 in 2003, and increasing in subsequent years), it is possible to unwittingly sacrifice the exclusion available to the first to die by simply passing all of the property to the surviving spouse at death. This is called the "over funded" marital transfer because, when the second spouse dies, he or she will have only one exclusion amount available. The total value of the second spouse's estate that exceeds this one exclusion amount (including specifically the property that passed at the first spouse's death) will then be subject to tax at rates beginning at 41%:

> **EXAMPLE NO 1: Consider a married couple with total assets valued at $2,000,000, all of which are held in joint tenancy. Upon the death of the first, all the property will vest in the survivor, outright, and no tax will be assessed because of the unlimited marital deduction. However, should the second spouse die shortly thereafter, his or her estate would be allowed credit equal only to one current applicable exclusion amount. If the second death occurs in 2004, that amount will be $1,500,000, meaning that the remaining $500,000 will be liable for estate tax in the amount of $205,000.**

This is a classic example of how joint ownership, and total reliance upon the unlimited marital deduction, can prove to be brutally expensive for families whose combined wealth approaches the applicable exclusion amount.

To avoid this result, and to preserve the benefit of the two exclusion amounts available to both spouses, it would be necessary for this couple to:

1. Divide the joint tenancy property more or less equally between each spouse, and without any rights of survivorship; and,

2. Provide that upon the death of the first spouse, his or her share of the property would pass in trust for the benefit of the surviving spouse, and not outright. The terms of trust would include certain technical limitations sufficient to prevent the property from being treated as the second spouse's own, thus preserving the "credit shelter", and allowing it to continue on -- tax free -- to the children upon the second spouse's later passing.

There are several kinds of traditional credit shelter/marital deduction formulas, each with distinct tax characteristics, but all serve the same purpose of separating the decedent's assets into two portions:

* one portion, equal to the decedent's remaining credit shelter/applicable exclusion amount[4], is geared to pass into a "credit shelter" or "family" trust, which is drafted so as not to qualify for (or "overfund") the marital deduction; and

* all the excess, if any, but without limitation, is channelled into a "marital trust", from which only the surviving spouse is allowed to benefit and which is crafted to qualify for the unlimited marital

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4 Remaining after consideration of: (i) any lifetime gifts; (ii) any non-marital benefits passing outside the will; and (iii) any specific non-marital legacies.

deduction under the rules generally set forth in Code Section 2056.

EXAMPLE NO 2: Consider the same married couple with total assets valued at $2,000,000, who divide ownership equally between the two and who provide for reciprocal "credit shelter" trusts in their estate plans. Upon the death of the first, his or her property will pass into a trust that is subject to tax -- and therefore sheltered by the unified credit -- which will <u>not</u> vest in the survivor, outright. This property can be made available for the benefit of the surviving spouse, but properly worded the trust will not be included in the taxable estate of the survivor. Should the second spouse die shortly thereafter, his or her estate will include only about one-half of the total, and will be completely covered by the current applicable exclusion amount. There will be no tax payable at the death of either spouse, and the entire $2,000,000 will pass tax free to the couple's intended beneficiaries.

Another option, favored by many practitioners (including this author), is to combine the credit shelter/marital deduction planning into a single "QTIP" trust. "QTIP" is the popular acronym for "qualified terminable interest property" as that term is defined and applied by Code Sections 2056(b)(7) and 2523(f), and is used to define a special type of marital deduction trust that satisfies three key requirements:

* the trust property must have passed from the decedent/donor;
* the spouse must receive all of the income from the property at least annually, and no person may have the power to appoint any of the trust property to anyone other than the surviving spouse during his or her lifetime (thus, a "qualifying income interest for life"); and
* an election to qualify any part of the transfer must be made on a timely filed gift tax return (IRS Form 709) or estate tax return (IRS Form 706)

Two features make QTIP trusts immensely flexible: First, the election to treat the trust as marital deduction property is optional. While other marital deduction plans automatically pass as part of the marital deduction (and risk over-funding), a QTIP qualifying trust can be used to fund the credit sheltered "family trust" so long as the QTIP election is not made. Second, the election may be expressed as a fraction or a formula, to apply to only a part of the trust, meaning the decedent's executor or personal representative may "zero out" the taxable estate by electing only so much marital deduction as is actually needed and leave the balance to be sheltered by the unified credit then available. By making only a partial election on the appropriate gift or estate tax return, the marital deduction and credit shelter portions can be calculated to a statistical certainty. This approach has the charm of simplicity and is attractive in those situations where family wealth is not excessive, and both clients are determined that the surviving spouse should have the benefit of all of the family wealth until the death of the survivor before any descendants step up to take an interest.[5]

For planning purposes, and notwithstanding which technical approach is finally adopted in crafting the credit shelter/marital deduction equation, the main point to remember is:

> **All trust property properly sheltered by the unified credit available to the first spouse will <u>NOT</u> be subject to tax at the death of the second. That property, including any interim increase in value, will pass transfer tax free to the next line of beneficiaries.**

3. <u>The Annual Gift Tax Exclusion</u>. Code Section 2503(b) allows every individual to make tax free gifts of present interests in property up to but not exceeding $11,000 per year to as many people as he or she wishes.[6] Husbands and wives may join to give $22,000 to a single individual so long as they both file and sign the proper elective gift tax return. A validly completed gift, even one made within three years prior to death, will generally not be included in the donor's gross estate for federal estate tax purposes.

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For technical tax reasons, the single QTIP trust is not the preferred formula for maximizing the benefit available from special use valuation under Section 2032A or the qualifying family owned business interest deduction under Section 2057. However, the QTIP format for the residuary marital trust is almost mandatory for effective generation skipping transfer tax planning.

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Since 1997, the annual exclusion amount -- then $10,000, but now $11,000 -- is adjusted for inflation. The base for adjustment is the Consumer Price Index for 1997, and the adjustments are limited to $1,000 multiples.

Note that Code Section 2503(c) also provides that direct payments for tuition or medical care are also excluded; however, this provision is narrowly construed, and gifts into a trust that would later make such payments do <u>not</u> qualify for the exclusion.

The annual exclusion amount is <u>not</u> considered part of the lifetime applicable exclusion amounts discussed above; it is an *extra* allowance which, when carefully considered, can provide immense opportunity for strategic lifetime wealth transfers for those who are prepared (financially and psychologically) to live without some of their accumulated assets:

EXAMPLE NO. 3: Consider a farm family consisting of: husband and wife, who own land, equipment, cash, securities and retirement funds totaling $5,000,000; three children, all of whom are happily married, and one of whom plans to take over the farm operation; and six grandchildren, two to each child. The parents may make annual exclusion gifts of $22,000 to each child, each child's spouse, and each grandchild, meaning that $264,000 can be passed to the next generation(s) each year, all without using any of either parent's unified credit/applicable exclusion amount. The gifts may consist of cash, equipment, land, or any combination that is consistent with their overall dispositive plan.

Planning for lifetime exclusion gifts is a highly developed field. Frequent strategies include:

* Outright gifts of cash or valuable property, with no restrictions -- usually suitable for adults or mature minors

* Outright gifts to minors, where the minor's actual benefit and/or control is deferred until reaching the age of 21. (Special rules for these minors' gifts can be found under Code Section 2503(c) and the Illinois Uniform Transfers to Minors Act)

* Present gifts to irrevocable trusts, including irrevocable life insurance trusts ("ILITS") and so-called "Crummey" trusts

Aggressive lifetime planning based on the annual exclusion amount can be of immense benefit to families with significant farm holdings, and when carefully prepared such plans can work like a charm. But, like so-many innovative tax strategies, there is more to the process than first meets the eye: Many different tax preference rules can collide in the process, often with unexpected and highly unfortunate results. For example, while the annual exclusion amount is also available to shelter some generation skipping gifts, the GST treatment is *far more restricted* than the Section 2503(b) gift tax exclusion.[7]

B. Lifetime Transfers. For those who can afford it, the lifetime transfer of property is the most efficient use of the unified credit/applicable exclusion amount (and the generation skipping transfer tax exemption, discussed later) because:

* the post-transfer appreciation in value attributable to the gifted property will grow tax-free outside the donor's estate; and,

* if any gift tax (or GST tax) is payable (that is, if the gift exceeds the applicable exclusion amount, or the GST exemption amount, one or both) the tax paid is also removed from the donor's estate on a *tax exclusive basis*.

A "tax exclusive" gift is a gift where the tax is paid by the donor/transferor only on the amount actually received by the donee, and the tax paid is not considered part of the taxable transfer. Gift taxes paid under Section 2501, and GST taxes payable on certain direct skips, are tax exclusive. Estate taxes, however, and most GST taxes payable other than on select direct skips, are "tax inclusive", meaning that the money needed to pay the estate tax on the legacy is necessarily includible in the tax base, causing substantially more tax to fall due.[8]

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Gift tax excludible gifts into trust will not qualify for this GST exclusion unless: (i) during the beneficiary's life no portion of the trust corpus may pass to anyone other than the beneficiary; *and,* (ii) if the trust does not terminate until the beneficiary's death the trust corpus must be includible in the beneficiary's Chapter 11 taxable estate. Code Section 2642(c)(1); Treas. Reg. 26.2642-1(c)(3). To shelter most gifts in trust a portion of the grantor's GST exemption will need be allocated on a timely filed gift tax return. Failure to do so can result in the entire trust having an inclusion ratio of zero upon termination/distribution, producing a massive GST tax due. FOR PRACTICAL PURPOSES, PLEASE NOTE: The 2642(c) exception will never apply to a gift to a trust that is not a "Skip Person", *i.e.*, a trust where all current and potential beneficiaries are deemed to be at least two generations younger than the transferor. This is a frequent source of practitioner confusion and error.

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As a "tax inclusive" testamentary gift, the money needed to pay the estate tax on the legacy is necessarily includible in the tax base. This requires an interdependent computation between the value of the legacy and the value of the total tax payments

EXAMPLE NO. 4: Assume Parent A has used all of her annual exclusion gifts and unified credit/applicable exclusion amount, and is in the highest (49%) transfer tax bracket for 2003. Assume further that A chooses to make an inter vivos gift of $500,000 to her son, S. The gift tax will be calculated only upon the $500,000 gift. A will pay the tax of $250,000 and S will receive the entire $500,000 gift. The total cost to A is $750,000.

EXAMPLE NO. 5: Assume the same facts as above, except Parent A leaves S $500,000 as a specific bequest under her will. As a tax <u>in</u>clusive transfer, A's personal representative will be responsible for paying the tax out of taxable estate assets. To fund the specific bequest, the Estate will need $980,392 in cash to: (i) fund the gift with $500,000 of principal; plus, (ii) $480,392 total estate tax due on the testamentary gift.

Experience shows that only the most far sighted or most affluent of clients will be inclined to make substantial taxable lifetime gifts, and thereby take advantage of the commensurate tax savings. However, there is a growing awareness of the benefits of such transfers, and a corresponding growth in the sophistication of lifetime transfer techniques.[9]

1. <u>Crummey Trusts</u>. The planning for deferred benefit gifts is complicated by the Code requirement that <u>only present interest</u> gifts qualify for the Section 2503(b) annual exclusion; <u>future interest gifts</u>, those that by their express terms cannot be taken and consumed by the donee immediately, are fully taxable gifts that

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needed to pay tax on the tax on the tax (etc.) on the legacy, based upon the applicable transfer tax rate. For planning purposes the following formula can be used: Gift value, divided by the product of (1 - the estate tax rate).

For example, a $500,000 legacy at the top estate tax rate can be roughly calculated as $500,000 ÷ [1 - .49 = .51], or $980,392; $500,000 of gift and $480,392 of tax. A similar calculation can be used for the tax inclusive GST events.

Because of this steep advantage, the *gift causa mortis* rules will require that A's estate recapture the gift tax paid (but not the gift) on any taxable transfers occurring within the three year period prior to death. *See,* Code Section 2035(c).

[9] In addition to sanguine tax planning, inter vivos transfers have an inherent asset protection component as well: valid gifts that do not run afoul of the fraudulent transfer rules are perfectly effective for removing assets beyond the reach of prospective creditors.

necessarily use some of the available unified credit. Parents and grandparents often want to use their annual exclusion rights to pass funds to minor children, but prefer that control or benefit be deferred until maturity.

Among the ways devised to get around the present interest restriction is to give the beneficiary -- either an adult, or a minor acting through his parent or guardian -- a right of withdrawal limited by a relatively short period of time. When the withdrawal right lapses, only that portion of the funding in excess of $5,000 (or 5% of the value of the gift, whichever is larger) is treated as a taxable gift by the beneficiary to the trust remainderman. When the gift is in excess of $5,000, as many are, the withdrawal right for the excess may be crafted so as to be suspended, or "hang" until future years when its lapse will fall under the “5 and 5" shelter.[10]

These arrangements are frequently referred to as "Crummey" trusts[11], and are now widely employed for a host of estate planning purposes. They are especially popular for irrevocable life insurance trusts, where the present annual exclusion gifts can combine with the later policy payouts to leverage immense wealth transfer at significant estate tax and GST tax savings. For farm families with substantial land, and minimal interest in life insurance, some practitioners (including your author) favor funding similarly structured irrevocable trusts with cash or other property -- or *fractional pieces* of property, such as LLC or partnership or land trust interests.

The technique is now well refined: Some valuable property is transferred by a donor to the trustee of an irrevocable inter vivos trust. That trust agreement will provide

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10 The difference between the $11,000 annual exclusion amount under Code Section 2503(b), and the $5,000 non-taxable lapse shelter afforded by the general power of appointment rules under Code Sections 2514 and 2041, is highly technical but of immense practical importance, especially when planning for multi-generational gifts. A proposal to increase the power of appointment limit to equal the gift tax exclusion amount -- which would have simplified a lot of estate planning -- died in committee.

11 Named after the famous tax court case, *Crummey v. Commissioner*, 397 F 2d. 82, 68-2 USTC ¶12, 541, 22 AFTR 2d 6023 (CA-9, 1968).

that some beneficiary (or beneficiaries) shall have the immediate and unrestricted right to withdraw some or all of the property from the trust, but only for a limited period of time -- usually, 30 days.[12] When the stated withdrawal period ends, or lapses, it then falls to the Trustee to administer that property according to the terms of trust.

The specific provisions can vary widely, reflecting each donor's purpose, circumstances, and imagination, but generally the trust will provide for deferring the beneficiary's ultimate benefit until some future event, such as the beneficiary's majority, or the death of the insured(s). For farm planning, the trust provisions will frequently include detailed management provisions, including restraints on the sale of land, and perhaps preferred farm tenancy rights for the descendant who intends to continue farming the land – all much like the farm operating provisions discussed under Section IV. B. 3. below.

Usually these transfers will involve taking maximum use of the donor's annual exclusion potential, as a means of transferring value in a manner wholly insulated from the donors' own ultimate gift or estate tax equation. However, in light of the advantages of shifting potential appreciation to the next generation(s) as early as possible, there is significant incentive to fund these trusts with more than just the annual exclusion amounts.

Properly structured these *Crummey* trust arrangements can work like a charm, but great care is required to consider and provide for the confluence of conflicting tax rules. For example:

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How long that period for withdrawal should be is the subject of some debate. Interestingly, in the Crummey case itself, no notice was given at all. Since Crummey, the Internal Revenue Service has acquiesced to many of the key components of this stratagem but insists that the donee must receive some reasonable notice if the withdrawal right is not to be deemed illusory. Rev. Rul. 81-7, 1981-1 C.B. 474; Rev. Rul. 83-108, 1983-2 C.B. 167. Notice need not be in writing (although proof of notice, and receipt, is a good idea), and there is no stock "reasonable" time, although allowing less than 15 days is asking for it. *See, Cristofani v. Commissioner,* 97 T.C. 74.

* **The annual gift tax exclusion under Code Section 2503(b).** So long as the transfer qualifies as a present interest, any number of benefactors may contribute up to $11,000 annually, on behalf of each withdrawal right holder, without gift tax treatment. Typically, an affluent husband and wife will want to place their combined maximum of $22,000 for each intended beneficiary.

* **The annual GST non-taxable transfer exclusion under Code Section 2642(c).** As mentioned above, the GST exemption rule is much more narrow than the Section 2503(b) exclusion, meaning that plans for the benefit of children can be much more flexible than plans involving grandchildren as current <u>or</u> future interest takers.

  It is not uncommon to create a Crummey-style trust that uses little or none of the donors' applicable exclusion amount yet requires a significant part of the donors' GST exemption.

* **The "5 and 5" general power of appointment exclusion.** A Crummey withdrawal right is nothing more or less than a general power of appointment over the contributed property. Code Section 2042(b) provides that the lapse of a general power shall be treated as a taxable release of the power. Taxability is avoided only when the lapsing power is limited to the right to withdraw no more than the greater of $5,000 and 5% of the corpus annually.

The divergence in benefit and impact, in each case, requires the most careful study of the client's tax equation and donative purposes. Like every estate planning project the best approach will depend upon each client's priorities and circumstances.

There is no stock answer or formula around this conundrum. However, your author has frequently used irrevocable trusts that mirror the precise administrative provisions of the farm owners' own dispositive trusts -- with the ultimate intention that the two sets of trusts will one day merge -- for the purpose of assuring funding to discharge transfer tax while keeping coveted family land under family control.

2. <u>Valuation Principles and Discount Theory</u>. If estate planning is largely dependent upon transfer tax analysis, that analysis in turn is absolutely dependent upon a sound appreciation of how the taxable values are calculated and reported. This is especially important for small businesses and farm operations where transferring the business intact can require the very closest shaving of the calculator's

pencil.

In general, if a gift is made of property, the value of that property on the date of the gift is considered the amount of the taxable gift. The value of the property is the price at which the property would change hands between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. Determining this value is a question of fact, and a sound valuation is based upon a consideration of all relevant facts and elements of value, although the weight to be accorded each element of value depends upon the facts peculiar to each case.

In valuing gifts of interests in a business, the cited relevant factors include, but are not limited to:

* the fair appraised value of all the underlying assets of the business
* the demonstrated earning capacity of the business
* goodwill
* the economic outlook of the particular industry
* the degree of control of the business represented by each separate transfer of ownership interest (without aggregation or family attribution)
* the value ascribed by the market place to the sale and purchase of similar interests in similar businesses.[13]

In applying the valuation factors certain adjustments, or "discounts", to gross appraised value are recognized by the courts to reflect particular economic and management realities such as:

* the minority interest/lack of control represented by each separate transfer of ownership interest, and the presence or absence of enforceable liquidation rights in the donee after the gift transfer

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See generally, Treas. Reg. §§ 25.2512-1, 25.2512-2, and 25.2512-3; *United States v. Cartwright*, 411 U.S. 546, 551 (1973); *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981); *Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996); Rev. Rul. 93-12, 1993-1 C.B. 202; Technical Advice Memorandum 9449001 (March 11, 1994).

* the lack of marketability of the ownership interest in the absence of a recognized market for such interests

* the presence or absence of enforceable fiduciary duties under state law in favor of other persons having a present or future interest in the business entity as a whole.[14]

The recognized types of adjustments are not mutually exclusive; each is to be considered and applied independently of the others where warranted. Although many of the same factors may support both an adjustment for minority interest/lack of control, *and* the lack of marketability of the ownership interest, the two "are conceptually different, and an award of the latter does not preclude application of the former." [15]

As more and more farm operations evolve from sole proprietorships to more intricate business organizations the methods for valuing closely held entities has grown to become one of the most important subjects in estate planning. While a sole proprietorship, or the unrestricted fee ownership of farm land, may be comparatively easy to value, it is a far different question when the underlying assets are owned by an entity -- a limited partnership, a corporation, a limited liability company, a land trust or even a traditional trust with limited ownership interests -- which in turn is owned by (or exists for the benefit of) a number of different owners who are bound by restrictions and

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See generally, *Estate of McCormick v. Commissioner*, 70 T.C.M. (CCH) 318, (1995); *Ward v. Commissioner*, 87 T.C. 78 (1986); *Estate of Frank v. Commissioner*, 69 T.C.M. (CCH) 2255, (1995); *Mandelbaum v. Commissioner*, 69 T.C.M. (CCH) 2852 (1995) affd. without published opinion 91 F.3d 124 (3d Cir. 1996); *Estate of Newhouse v. Commissioner*, 94 T.C. 193 (1990); *Estate of Curry v. United States*, 706 F.2d 1424 (7th Cir. 1983). However, as to some transfers of interests in business entities among family members, certain restrictions on rights of liquidation that might otherwise support a discount adjustment must be disregarded if the restriction is "more restrictive than the limitations that would apply under the State law applicable to the entity in the absence of the restriction." Treas. Reg. § 25.2704-2(b). Internal Revenue Code Section 2704(b).

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Estate of Wheeler v. United States, (U.S.D.C. - W.D. Tex. 96-1 USTC P 60,226; 1996 WL 266420 at p. 2 [not reported in F.Supp.]. Cf., *Estate of McCormick v. Commissioner*, supra, "Marketability discounts may apply in addition to a minority or lack of control discount where the interest under consideration is illiquid." 70 T.C.M. (CCH) 318 at ___ .

restraints which purposely limit control and impair transfers. In that instance, the above-mentioned modifying factors should be considered in calculating the actual taxable value attributable to those fractional owners.

The courts have consistently acknowledged that the fair market value of a minority interest in an enterprise is less than the corresponding percentage in the whole, primarily because the minority owner lacks the capability to control management, business strategy or policy, the acquisition or disposition of assets, or the liquidation, sale, recapitalization or reorganization of the venture.

A similar -- but vitally distinct -- analysis also applies in considering the fair market value of the beneficial interests in light of their limited marketability. In the *Mandelbaum* decision, Circuit Judge Laro identified ten specific "elements of value", generally applied by investors, that impact upon the marketability, or lack of marketability, of any particular investment interest:

> "(1) The value of the subject corporation's privately traded securities vis-a-vis its publicly traded securities (or, if the subject corporation does not have stock that is traded both publicly and privately, the cost of a similar corporation's public and private stock);
>
> "(2) an analysis of the subject corporation's financial statements;
>
> "(3) the corporation's dividend-paying capacity, its history of paying dividends, and the amount of its prior dividends;
>
> "(4) the [business] nature of the corporation, its history, its position in the industry, and its economic outlook;
>
> "(5) the corporation's management;
>
> "(6) the degree of control transferred with the block of stock to be valued;
>
> "(7) any restriction on the transferability of the corporation's stock;
>
> "(8) the period of time for which an investor must hold the subject stock to realize a sufficient profit;
>
> "(9) the corporation's redemption policy; and
>
> "(10) the cost of effectuating a public offering of the stock to be valued, e.g.,

legal, accounting, and underwriting fees."[16]

Judge Laro went on to concede that "the valuation of property is an inexact science." Calculating adjustments to the appraised value of underlying assets is always a question of opinion shaded by established precedents and arguments over the weight to be applied to any one or another set of pertinent factors. Still, when the *Mandelbaum* factors are compared to the realities of the property transferred, a close, skilled evaluation should sustain a gift base valuation significantly less than the total represented by the sum of the parts.

C. Section 2032A Special Use Valuation. Internal Revenue Code Section 2032A offers a vital estate tax break for the family farm. The effect of Section 2032A is to reduce the estate tax value for qualified farm land from its full fair market value to its "special use value" by using a formula that combines property taxes, prevailing fair market cash rents, and the effective rate for new Federal Land Bank loans as published by the Internal Revenue Service.

To qualify for Section 2032A *all* of the following requirements must be satisfied:

* The decedent must have been a U.S. citizen
* The subject land must be located in the United States
* The family must have used that exact land (not replacement § 1031 land) for farming (which is a "qualified use") for 5 out of the last 8 years before death, or retirement, or disability
* The decedent, or a member of his or her family must have "materially participated" in the farming for a period of 5 years out of 8 before death. [17]

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16 *Mandelbaum v. Commissioner*, 69 T.C.M. (CCH) 2852 at 2864.

17 "Material Participation" is defined by cross reference to the net earnings tests applicable for self-employment tax purposes; *See* Code Sections 2032A(e)(6) and 1042(a)(1). Note that "material participation" is a nebulous term of art, for which the regulations offer the following guidance:

> "No single factor is determinative of the presence of material participation, but physical work and participation in management decisions are the principal factors to be considered. At a minimum, the decedent and/or a

* Total farm assets (real or personal property used in farming, at full fair market value less debts and mortgages) must constitute at least 50% of the decedent's total gross estate for federal estate tax purposes

* Farm real estate (at full fair market value less secured debt) must constitute at least 25% of the decedent's total gross estate for federal estate tax purposes

* The real estate for which Section 2032A value is elected must pass from the decedent to a qualified heir; i.e., a "member of the family" which includes:

    * ancestors

    * spouses

    * lineal descendants of the decedent, his or her spouse, or the decedent's parent (thus, nephews and nieces are qualified heirs, but cousins are not!)

    * a spouse of any lineal descendant of the decedent, his or her spouse, or the decedent's parent

    * a trust, provided that only qualified heirs receive the present interest in the trust

* The qualified heirs must continue to operate the property for a qualified

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family member must regularly advise or consult with the other managing party on the operation of the business. While they need not make all final management decisions alone, the decedent and/or family members must participate in making a substantial number of these decisions. Additionally, production activities on the land should be inspected regularly by the family participant, and funds should be advanced and financial responsibility assumed for a substantial portion of the expense involved in the operation of the farm or other business in which the real property is used. In the case of a farm, the furnishing by the owner or other family members of a substantial portion of the machinery, implements, and livestock used in the production activities is an important factor to consider in finding material participation. With farms, hotels, or apartment buildings, the operation of which qualifies as a trade or business, the participating decedent or heir's maintaining his or her principal place of residence on the premises is a factor to consider in determining whether the overall participation is material. **Retention of a professional farm manager will not by itself prevent satisfaction of the material participation requirement by the decedent and family members. However, the decedent and/or a family member must personally materially participate under the terms of arrangement with the professional farm manager to satisfy this requirement.**"
Treas. Reg. § 20.2032A-3(e)(2).

use -- production risk farming -- for a period of ten years following the decedent's death

* The 2032A valuation must be properly elected on the estate tax Form 706.

* All "qualified heirs" who receive any present or future interest in the property valued under Section 2032A must sign an agreement agreeing to the 2032A terms, otherwise recapture tax can be imposed during the ten year period following death

If ALL of the foregoing requirements can be satisfied, then the decedent's personal representative may report the value of the subject land for federal estate tax purposes according to a special formula based upon the following fraction:

* the numerator is the average annual gross cash rental for comparable local properties, LESS the average annual real estate taxes on such comparable properties

* the denominator is the average annual effective interest rate charged on new Federal Land Bank loans

EXAMPLE NO. 6: Assume Illinois Decedent T satisfies all of the 2032A criteria, and died owning 650 acres of debt-free qualified real property having a fair market value of $3,750 per acre. Comparable cash rents in the vicinity of the land average $145/acre; the average property taxes on the comparable tracts average $24/acre; and, the Farm Credit Bank interest rate for the St. Paul District is 6.39%. T's personal representative may elect to value the qualifying farmland according to the following formula:

$$\frac{\$145 - 24 = \$121}{.0639} = \$1{,}893 \text{ per acre special use value}$$[18]

Unfortunately, there is a $840,000 cap (indexed for inflation beginning in 1999; see, Rev. Proc. 2002-70) in total value reduction allowed under Section 2032A. To determine the amount of land to which the reduction may apply, the personal representative must compare the total fair market value of the decedent's land (in this example, $3,750 per acre) against the calculated special use value ($1,893 per acre), and then divide the result -- $1,857 -- into the $840,000 maximum reduction ceiling. $840,000 ÷ $1,857 =452,

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Note that the lower the interest rate denominator, the less benefit afforded by the election. Had the interest rate been 8.39% the 2032A value would have been less than $1,450 per acre.

meaning that in this example the personal representative may elect to apply Section 2032A to only 452 acres. The remaining 198 acres are not eligible for Section 2032A treatment, and must be reported at their full fair market value.

It is important to note that Section 2032A does not represent a tax *deduction*, or an *exclusion* of fair market value from the decedent's taxable estate; the statutory formula includes no reference to the actual market price of the qualifying land. Instead, the Section 2032A special use valuation method is based upon Congress' almost unique tax policy decision, codified by this fictional formula, that qualifying farm land is more fairly valued in accordance with the predictable rate of return that similarly valued assets could earn if they were not dedicated to continued family farm use. In the preceding example, the net cash income of $121/acre from $3,750/acre land reflects an actual rate of return of 3.23%, while the same net income earned from $1,893/acre special use value produces a formulaic rate of return of 6.39%.

The Internal Revenue Service has long held the position that cash leases of specially valued land following the death of the decedent is not a qualified use because the heirs no longer bear the production risk. Several court cases have upheld this position. In 1997 an important technical relief provision was added to Section 2032A to reverse this position, in part, by providing that a cash lease <u>from the surviving spouse or a lineal descendant to another lineal descendant</u> who continues to operate the farm in an otherwise qualifying fashion will not be deemed a recapture event. This provision applies retroactively to cash leases entered into after December 31, <u>1976</u>, and eliminates a major tax trap that has haunted extended family farm operations from the inception.

What should be the predictable discussion of Code Section 2057 -- the "Qualifying Family Owned Business Interest" deduction -- which has proved so very valuable in reducing death taxes in concert with Section 2032A, is now regretfully omitted from these materials. Section 2057 is scheduled for repeal on January 1, 2004 when the applicable exclusion amount is increased to $1,500,000 and the maximum benefit allowed under Section 2057 is subsumed into the newer ceiling. In your author's opinion that revision is unfortunate tax policy, as the Section 2057 election/deduction has frequently proved to be more flexible, and more suitable, than Section 2032A special use valuation.

D. The Generation Skipping Transfer Tax. As mentioned earlier, the basic gift and estate tax scheme is geared to tax the *transfer* of property from its owner, but not its subsequent beneficial use. Once launched, that property has traditionally been left alone, free from further tax until after it vested in some new outright owner, who would then be taxed only when he or she transferred it again. The mere termination of each intervening limited interest was effectively ignored.[19]

This way, an owner of property could devise an estate plan whereby first a spouse, then children, then grandchildren and great grandchildren, each in succession or concurrently, could use as much of the trust estate as needed, yet none of these successors would have a taxable "interest" in the property -- at least not until the trust terminated and the property finally vested outright in some distant descendant.

Unfortunately, Congress has concluded that these extended suspended transfers are unfair, and that *some* tax should be imposed on property at least once per generation even if the intervenors have only limited interests along the way. The result of this determination is the generation skipping transfer tax, which provides:

> **except as exempted, property that is not subject to transfer tax in each successive generation must face its own, separate GST tax**

A "generation-skipping transfer" can be defined as:

* a transfer of property
* that is subject to either gift or estate tax calculus at the time of the transfer (irrespective of whether tax is actually paid, meaning that credit sheltered and annual exclusion gifts are specifically covered)

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[19] This presumes that the intervening interest was not so broadly framed as to be realistically equivalent to ownership, such as a taxable general power of appointment. *See*, Code Sections 2041 and 2514.

* to or for the benefit of someone who is (or is deemed to be) two or more generations younger than the person charged with making the taxable transfer

* without a second gift or estate tax being assessed on the property along the way.

In GST jargon the donor of that property is called the "Transferor", a technical term that applies to: (i) the person charged with transmitting the property, directly or indirectly; (ii) in a way that will (or might) avoid tax in the next generation. This generally will include:

* the owner of the property, whether as decedent or the inter vivos donor

* the surviving spouse beneficiary of a marital deduction trust taxable in the surviving spouse's estate, or

* any one burdened with a taxable general power of appointment over the property

All GST analysis returns, eventually, to the question: "Who is (or who will be) the Transferor?" The answer will almost always be found by focussing on where the gift and estate tax burden last fell, or will fall.

Code Section 2631(a) allows every individual an exemption from GST tax. [20] The GST exemption may be allocated to any property with respect to which that individual is the "Transferor"; i.e., for which he or she may be charged with gift or estate tax upon the transfer. Once allocated, the exemption value is elastic, matching all increases or decreases in the trust value; a wholly exempt trust (one with an "inclusion ratio" of zero) will never be exposed to GST tax, no matter how large it grows before termination/

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[20] The amount and value of this exemption has itself been the subject of significant transition. At first equal to $1,000,000, the 1997 tax act indexed the amount to inflation, resulting in a 2003 exemption equal to a total of $1,120,000 worth of combined transfers made at any time during the Transferor's lifetime or at death. The 2001 Act increased the exemption to equal the applicable exclusion amount effective January 1, 2004 –- $1,500,000 (which eliminates a lot of drafting headaches). And, while the GST tax is also scheduled to be eliminated in 2010, that relief is also "sunsetted", with the relief to last only one year, and the tax restored on January 1, 2011.

distribution. The exemption is also indefinite, at least so long as the trust property maintains its tax nexus with the original Transferor. Just like the "credit shelter" trust, so useful to marital deduction estate plans, the GST exempt trust will not be subject to transfer tax until:

1. It has vested (or deemed to have vested, as with a general power of appointment) in another owner; and,

2. That new owner transfers the property to or for the benefit of someone else.

If, however, exempt trust property is somehow taxed to a beneficiary under Internal Revenue Code Chapters 11 or 12, as will occur with a general power of appointment, that just-taxed beneficiary will step into the box as the new Transferor and the prior exemption will vanish. That is <u>not</u> a good thing.

NOTE WELL, however, that all generation skipping transfer gifts that exceed the exemption amount will trigger a punitive tax equal to the maximum rate of estate tax applicable to estates at the time the generation-skipping transfer occurs (presently, 49%). Since this tax is to be avoided at all costs, standard GST planning calls for assuring that all excess amounts <u>are</u> subject to transfer tax once in each generation.

The generation skipping transfer tax has thus made multi-generational estate planning immensely more difficult. However, the need for such extended planning -- especially for traditional farm families -- has never been greater. And given the opportunity to shelter significant amounts of property from transfer tax over multiple generations, thereby consolidating land holdings and cementing future farming opportunities to the family, it has forced estate planners to adopt new, comprehensive, and earnestly complicated approaches to traditional farm estate plan techniques.

Although wildly different from the unified gift and estate tax scheme of Chapters 11 and 12, the Chapter 13 GST tax is still an extension of the existing transfer tax system; it cannot, and does not, exist without several shared points of reference. The most important of these is the segue between the familiar unified credit/marital deduction provisions, on the one hand, and the individual GST exemption on the other.

The gift and estate tax planning must come first, for two reasons:

* the burden of estate tax is more immediate (GST tax issues emerge only after this first tax hurdle has been cleared); and,

* the applicable exclusion amount has traditionally been smaller than the GST exemption, meaning that most credit shelter trusts can be GST exempt but not all GST exempt property can pass estate tax free.

Thus, generation skipping planning begins with the traditional credit shelter/marital trusts of gift and estate tax planning, on which is then built a second structural overlay in order to keep the property insulated *after* it has been plotted through that first transfer tax thicket. This second overlay expands upon the formulas and administrative provisions to embrace the full use of the GST exemptions available to each individual and his or her spouse. The result is the transfer of the property, in trust, to distant descendants without exposing it to estate tax or GST tax during the intervening beneficial use.

Despite the technical advantages inherent to lifetime transfers most clients will feel a need to retain most of their property in order to sustain their standard of living through the lives of both spouses. In other cases, where family wealth consists of already appreciated assets -- such as small business stock, or farmland -- the availability of stepped up basis may argue in favor of including those assets in the grantor(s)' estate(s).[21]

What is usually needed is an extrapolation of existing tax formulae and trust administration provisions to provide for both: (i) an additional GST tax matrix; <u>and</u> (ii) the flexible administration of trusts that continue not just for the limited term of a surviving spouse's life, but for the extended term of "lives in being plus 21 years."

For gifts effective at death formula language is unavoidable. That was essentially true before the GST tax was imposed, and is absolutely true now. None of us can know,

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[21] *See*, Code Section 1014.

at the date of preparing an estate plan:

* which spouse will die first, or when

* how much property value, if any, will pass by contract (like pension plans) or by joint ownership, or

* the total fair market value of the first spouse's estate

Only formula clauses, designed to accommodate financial realities at an indeterminable future moment, can accomplish the optimal tax management result.

Multi-generation skipping trusts are especially suitable for farm estate planning, for several reasons;

* Where the owner's purpose is to retain the land for future generations, there is little practical difference between the child's receiving the property outright or as the lifetime beneficiary under a GST trust, except for the enormous transfer tax savings at the death of the child

* The transfer in trust can specify key farm administration requirements, including restraints on sale of farm land and preserving the farm tenancy rights of the farming child in the face of the non-farming children's desire to liquidate the farm assets

* Similarly, asset protection features and disability provisions can protect the trust from dissipation

* The "Final" GST regulations now confirm that Section 2032A values are to be adopted without restriction for Chapter 13 purposes, provided that the Section 2032A recapture agreement is revised to charge the qualified heirs with personal responsibility for <u>both</u> any "additional [estate] tax" and any additional GST tax that may fall due for failing to adhere to the post-election requirements. Although the amount of 2032A reduction rises or falls as a function of the interest rate, and the total reduction is (presently) limited to $840,000, a Section 2032A qualifying trust could, in theory, allow a $1,000,000 credit shelter trust ($1,500,000 in 2004) to be funded with $1,840,000 (more like $2,370,000 in 2004) worth of qualified real property. Using 2032A values for GST would mean, again in theory, that a wholly exempt trust could be funded with like amounts -- and twice as much for a married couple acting in tandem.

IV. PLANNING AND DRAFTING FOR THE MULTI-GENERATION FARM (?) TRUST:

A. Concepts. On the strength of the foregoing tax and administrative analysis, it is thus possible to design a multi-generational trust vehicle[22] that is:

* Designed for continued, long term, family ownership and control of hard won farm ground; yet

* Flexible enough to be suitable for the administration of substitute assets in the event the traditional family business model evolves away from farming as a result of fresh economic opportunities.

The purposes of the trust will vary from family to family but will usually include many of the following:

* Assuring all farm income for family members, including surviving spouses, descendants, and options for descendants' spouses.

* Protecting the "active" farmer child's right to farm the ground while preserving the other, non-farming descendants' right to the landlord's share of the income.

* Restricting the sale of land for as long as practical, but with enough wiggle room to invade principal for real needs.

* Applying the suitable (complex) formulae to assure the best advantage of marital deduction, credit shelter and GST exemption amounts, and preserving the 2032A Special Use Valuation option if the family qualifies and desires to accept the long term restrictions on use and transfer.

* Insulating the trust property -- not just land but other assets -- from the claims and demands of predators.

All of these can be fine-tuned with specific trust instructions to maximize flexibility and assure family fairness.

Extending the trust framework beyond a single generation calls forth a number

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Administratively there are a number of alternatives. Some practitioners prefer the organizational options allowable within partnership and LLC frameworks, but on balance your author believes that the trust format -- which in turn can hold land trust, corporation, partnership and/or LLC interests -- generally provides the greatest flexibility and suitability.

of non-tax generation skipping concepts.[23]

"Generation-skipping" is an unfortunate term, implying as it does that the first generation is somehow being tax-planned out of its inheritance. The real purpose, of course, is to afford the first generation (the children) virtually unrestricted access to income and principal, while protecting the trust property from avoidable taxation AND the potential claims of those children's creditors. Indeed, it seems that modern tax and practical planning realities almost require generation skipping planning. People are living longer; a surviving spouse can easily live into his or her 80s or 90s, meaning that the children may not receive their full inheritance until after reaching their 60s or 70s. This places those assets at risk of being taxed a second time, and at best complicates the children's own estate plans.

Planning to avoid those risks, while preserving benefit, access, and control in each immediately successive generation, and without undue taxation, includes procedures that:

1. Names the children as Trustees or Co-Trustees, or each child as Trustee or Co-Trustee of his or her own portion (a sub-divided trust)[24]

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Generation skipping transfers of property are governed by the Illinois rule against perpetuities, modified for transfers after September 22, 1969, by the Illinois Statute Concerning Perpetuities, 765 ILCS 305/1-6. Although the Illinois statute helps insulate most unintended breaches, the fundamental public policy against extended restraints on the alienation of property represented by the common law rule that "no interest is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the interest" is still the fundamental rule of law in Illinois [*see*, *Martin v. Prairie Rod and Gun Club*, 39 Ill. App. 3d 33, 348 N.E. 2d 306 (3d Dist. - 1976)], although vesting is different from postponed enjoyment [*Deiss v. Deiss*, 180 Ill. App. 3d 600, 536 N.E. 2d 120 (4th Dist. - 1989)]. Note, however, that the Illinois statute was amended in 1997 to provide for "Qualified Perpetual Trusts", and to exempt such trusts from application of the rule. Careful wording is required to take advantage of this relatively new exception.

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Choosing the initial and successor Trustee -- a crucial control feature -- requires a lot of thought: naming family members -- surviving spouse, child or children, grandchild or grandchildren -- as Trustee or Co-Trustee preserves family control, and can balance personal interests with the control features. But naming an experienced professional fiduciary (such as the First Midwest Bank Trust Division of Joliet) as Co-Trustee can add practical management expertise, independent discretion, continuity and a balancing weight for potential intra-family disputes.

2. Allows access to principal for health, education, maintenance and support (the "ascertainable standard" safe harbor afforded under Sections 2041 and 2514.) This standard is very broad in practice, but insulates the interested Trustee's access from being taxable as a general power of appointment.

3. Gives each child/beneficiary a *limited* power of appointment to end the trust or continue it on – or to redirect it – as he or she thinks best.

   This option extends planning discretion to each successor generation and preserves priceless flexibility; however, this flexibility can also be limited by terms restricting the class of permissible appointees and other terms of appointment.

The net effect is to give the children – and their children – substantially all of the practical benefit of outright ownership without the tax burdens or risks of loss. Since the child/beneficiary is not the outright owner (as distinct from being the Trustee):

1. The trust assets can't be reached by the beneficiary's personal creditors.

2. Spouses can never have a marital interest in the trust assets, which are thus exempt from divorce property settlements.

3. Trust assets are not included in the child's (or grandchildren's) taxable estates, thereby avoiding duplicate taxation.

Conceptually, the trust can endure indefinitely; however, even if the trust does not qualify as a perpetual interest trust, it may endure for "lives in being plus 21 years", which under existing facts should be sufficient to cover two, three, four or more generations after creator's death -- an ample term.

It is your author's experience that once these advantages are explained and considered, the children are often the most enthusiastic advocates of the plan.

B. Select Provisions. As will always be the case, there is no substitute for careful, even detailed planning and drafting when putting complex estate plans together. The following provisions represent only a few of countless possible approaches that might be suitable in select instances:

1. The GST Apportionment. As suggested earlier, there are two kinds

of generation skipping trusts: (i) those that are intended to be wholly exempt, and thus insulated from GST tax and estate tax for more than one generation; and (ii) those that are not.

Exempt trusts will have an inclusion ratio of “0", and remain exempt so long as no beneficiary is charged with gift or estate tax during its term.

Non-exempt trusts will have an inclusion ratio of “1", and each taxable distribution and taxable termination will subject the fund to the maximum (currently, 49%) tax. Such non-exempt trusts are employed more for their asset protection features than for tax planning, and need to be protected from the GST tax by applying a taxable general power of appointment upon each successor beneficiary.

Here is a living trust formula for a non-married grantor that is intended to allow the surviving trustee to divide the common fund into exempt and non-exempt portions to maximum advantage:

__ARTICLE SEVEN__: Disposition Upon Grantor's Death.

This Agreement, as amended from time to time, shall become irrevocable upon Grantor's death. At such time the Trustee shall collect any property directed to pass to the Trust as a result of Grantor's death, whether under Grantor's Will or otherwise, and shall thenceforth hold, administer and distribute the Trust Estate according to the following provisions:

A. [debts]

B. [taxes and costs]

C. [personal effects]

D. Subject to the foregoing, the Trustee shall then divide the Trust Estate then remaining (the "Net Trust Estate") into two portions, hereinafter referred to as the "Non-Exempt Portion" and the "Exempt Portion".

1. The Trustee shall allocate to the Non-Exempt Portion a pecuniary amount equal to the amount, if any, by which the value of Grantor's Trust Estate (as finally determined for federal estate tax purposes) exceeds the "GST Exempt Amount".

2. The Trustee shall allocate the balance and remainder of the Net Trust Estate to the Exempt Portion.

3. Any property allocated in kind to the Non-Exempt Portion shall be valued for the purpose of satisfying the pecuniary amount required at its fair market value as of the actual date of allocation.

4. To the extent possible while consistent with the preceding requirements of this Paragraph D., Grantor's "Farm Property" (as hereinafter defined) shall be allocated to the Exempt Portion.

5. The "GST Exempt Amount" described in Subparagraph D.1. above means the unused portion of Grantor's generation skipping tax exemption allowable to Grantor under Internal Revenue Code Section 2631, reduced by the aggregate amount of allocations of such exemption before or after Grantor's death other than any allocations to the Exempt Portion.

E. Both the "Non-Exempt Portion" and the "Exempt Portion" shall pass to the "Descendants' Trusts", to be further divided, held, administered and distributed pursuant to Article Eight below.

F. In furtherance of the foregoing provisions, and not in derogation thereof, it is the Grantor's intention that the Trustee shall not be required to administer any Trust Estate that is only partially exempt from generation skipping taxes, but instead shall monitor the Trust Estates throughout the term of the Trust(s) provided for herein so as always to provide that: (i) the "Exempt Portion" shall consist of that portion of a Trust Estate to which sufficient generation skipping transfer tax exemption (as that term is defined under Internal Revenue Code Section 2631 and supporting regulations) has been allocated by the Transferor of that property (whether the Grantor as aforesaid, or some successor interest holder in the manner hereinafter provided) so as to produce an inclusion ratio of zero for that Portion; and, (ii) that the "Non-Exempt Portion" shall consist of all that part of a Trust Estate other than the Exempt Portion. It is the Grantor's desire, which is not binding on any beneficiary hereunder, that a taxable general power of appointment will be kept in effect over the Non-Exempt Portion property when the beneficiary believes that the inclusion of the property subject thereto in such beneficiary's gross estate for federal estate tax purposes may achieve a significant savings in transfer taxes by subjecting the property to the federal estate tax rather than a generation skipping transfer tax imposed under Chapter 13 of the Internal Revenue Code; and, that by providing for the creation of taxable general powers of appointment by certain beneficiaries as hereinafter provided the beneficiaries may make optimum use of the generation skipping transfer tax exemption (as that term is defined under Internal Revenue Code Section 2631 and supporting regulations) available to each such beneficiary, so that property previously held as part of the "Non-Exempt Portion" might thereafter be held as part of the "Exempt Portion." In apportioning property between the Non-Exempt Portion and the Exempt Portion:

1. The Trustee may rely upon the allocations of generation skipping transfer tax exemption made by the Transferor of the property to the Trust, and shall adjust the apportionments to conform with any later allocations, or revisions to allocations or values upon audit, in order always to maintain a zero inclusion ratio for the Exempt Portion; and,

2. If any such property was valued for the purposes of allocating generation skipping transfer tax exemption at a value other than the fair market value as of the date of the transfer (or deemed transfer), any property so apportioned to one or another Portion to maintain the zero inclusion ratio shall be selected in such manner that such property shall have an aggregate fair market value fairly representative of the appreciation and depreciation in fair market value since the date of the original transfer of all property available for apportionment on each date of apportionment (or re-apportionment).

G. All references herein to the administration or distribution of Trust property or to a "Trust Estate" (whether one or more) shall apply to both the Non-Exempt Portion and the Exempt Portion unless otherwise stated; provided,

however, that each such Portion, and any subdivision of each such Portion, shall at all times be segregated from the other as distinct Trust Estates.

2. The Descendants' Trust(s). These provisions govern the transition into the long term trust or trusts. Both parents are gone, and the property that has made its way to this stage is now net of estate tax and segregated for GST tax purposes. One of two things can now occur. The Descendants' Trust can become a functional single entity, in which the children (or a predeceased child's descendants) have undivided interests[25], or the Trustee may, after gathering things together, promptly disperse them again by creating a separate "Descendant's Trust" for each beneficiary.

This is an ultimate decision for the family, and deserves a lot of consideration of such factors as: the degree of family cooperation; whether family members or professional fiduciaries shall serve as Trustee; the desire to hold a single asset or business together; the relative competence or special needs of the family; and so forth. On balance, however, experience seems to show that most first generation beneficiaries -- those who are being skipped for tax benefit and asset protection purposes -- will more readily accept the totality of the plan if each feels that he or she is in nominal control of his or her own inheritance and its destiny. More often than not this will mean forming separate trusts , and probably naming each adult beneficiary as at least a Co-Trustee:

ARTICLE EIGHT: The Descendants' Trusts Provisions.

The Trustee shall divide all of the "Exempt Portion" and "Non-Exempt Portion" property directed to pass to the Descendants' Trusts (while maintaining the distinction between the Exempt Portions and Non-Exempt Portions) pursuant to the foregoing into equal shares of each such Portion. One share of the Exempt Portion and one share of the Non-Exempt Portion shall be created for each of JoANN BEAUDRY, RICHARD J. BEAUDRY, and THOMAS R. BEAUDRY, (the "Grantor's Children" or "Child") living at that time, and one share of the Exempt Portion and one share of the Non-Exempt Portion shall be created for each deceased Child of Grantor who has one or more descendants then living, which shares shall be further divided into shares for such descendants, per stirpes. Each resulting share of the

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25 Thus invoking the "substantially separate and independent share" requirements of Code Section 2654 and Treas. Reg. 26.2654-1(a).

Non-Exempt Portion and the Exempt Portion shall be named for the Child or other descendant beneficiary for whom it was created and thereafter held and administered as a separate Descendant's Trust for his or her benefit according to the following provisions:

How liberal or tight the beneficial terms should be during the children's lives is another hot topic. Most parents (and the skippee children) will want the kids to have rather broad access because, after all, "it's their inheritance." Many GST planners recommend discretionary, as opposed to mandatory income distributions, to avoid leakage and to facilitate greater trust appreciation. But while that is undoubtedly true in principle, the reality is that undistributed income now hits a 35% income tax threshold at only $8,900.00. Moreover, if the trust mandates annual income distribution the first generation beneficiaries will feel comfortable taking their full income share without worrying about generational equity. In short, from an accounting, tax, and psychological perspective, providing for mandatory income distribution is the easiest way to go.

Similarly, access to principal should in most cases be limited only by an "ascertainable standard".[26] More broadly drawn instruments may even include a "5 and 5" power. Consider this treatment for the kids:

A. The Trustee shall pay to or for the benefit of the beneficiary all of the net income of the Trust in regular monthly or other convenient installments, and at least annually.

B. The Trustee shall also pay to or for the benefit of the beneficiary so much of the Trust principal (other than "Farm Property", as hereinafter defined) as

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The ascertainable standard is defined under Code Sections 2041 and 2518 as relating to the "health, education, support, or maintenance" of the eligible distributee(s). Treas. Reg. §25.2514-1(c)(2) and 20.2041-1(c)(2) include the following specific qualifiers: "support"; "support in reasonable comfort"; "support in his accustomed manner of living"; "education, including college and professional education"; "health"; "medical, dental, hospital, and nursing expenses, and expenses of invalidism".

These standards are in fact more generous and less restrictive than may first appear. The terms "support" and "maintenance" are not limited to the bare necessities of life, and it is immaterial whether the beneficiary is required to exhaust other income before the power can be exercised. Treas. Reg. Sections 25.2514-1(c); 20.2041-1(c)(2). The ascertainable standard exception prevents the subject property from being included in the beneficiary holder's estate yet places little practical restraint on the beneficiary's access.

may be required from time to time to provide for his or her health, education, maintenance and support in reasonable comfort only. Grantor's primary concern during the life of each Descendant's Trust's current beneficiary is for the support in reasonable comfort of that current beneficiary, without regard to that beneficiary's other assets or income, and in priority over the interest of any potential successor beneficiary; provided, that all such distributions of principal pursuant to this Paragraph shall always adhere to this ascertainable standard.

C. In addition, and during the month of June of each calendar year only, the beneficiary shall have the right to withdraw or demand distribution, free of trust, an amount of Trust principal (other than "Farm Property", as hereinafter defined) that does not exceed the greater of: (i) FIVE THOUSAND DOLLARS ($5,000.00); or (ii) FIVE PERCENT (5%) of the value of the Descendant's Trust on June 1 of each year. This right of withdrawal shall be non-cumulative, may be exercised only by a signed written instrument delivered to the Trustee during the month of June each calendar year, and shall lapse if not exercised on or before June 30 of each year.[27]

D. Notwithstanding the provisions of Paragraphs A. - C. above, all distributions of income and/or principal from each Descendant's Trust, however or whenever created, shall be subject to the specific restrictions that apply in the event of the disability of a beneficiary that are hereinafter provided.

E. The Trustee may, in its sole discretion, but without any obligation, pay to or for the benefit of any one or another descendant of the beneficiary such part of the Trust Estate necessary for medical or educational purposes as those terms are defined and applied by Internal Revenue Code Sections 2503(e) and 2611(b) and supporting Regulations.

F. It is Grantor's expectation that no distribution of principal shall be made from any Exempt Portion until substantially all of the Non-Exempt Portion of that Descendant's Trust has been exhausted.

G. Upon the death of each Descendant's Trust beneficiary his or her Descendant's Trust Estate shall pass as follows:

1. Each such beneficiary shall have the limited testamentary power to appoint the entitlement to all the annual income from any specific part, or all, of the Non-Exempt Portion of his or her Trust Estate, to or for the exclusive benefit of his or her spouse, for the term of the beneficiary's spouse's entire life only. This power may be exercised by a Will which specifically refers to this limited power of appointment; provided, however, that the exercise of this limited power of appointment shall not be effective unless it creates in the beneficiary's spouse the additional general testamentary power to appoint the property from which the income entitlement flows to the beneficiary's spouse's estate.

2. Subject to the foregoing, each such beneficiary shall also have the general testamentary power to appoint any specific portion, or all, of the "Non-Exempt Portion" of the Trust Estate, not effectively appointed pursuant to Paragraph F.1. above, to or for the benefit of the creditors of his or her estate, but

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See, Code Sections 2514(e) and 2041(b)(2). The price of this flexible access is that the 5% value of the trust will be includible in the beneficiary's estate if he or she dies before the power lapses. That is why the window is open for just 1 month during the year.

only by a Will which specifically refers to this general power of appointment.

3. Subject to the foregoing, each such beneficiary shall also have the limited testamentary powers:

a. To appoint the right to receive any part or all of the income from the "Exempt Portion" of his or her Trust Estate to or for the benefit of his or her spouse for any period of time not to exceed the spouse's lifetime.

b. To appoint all, any portion of, or any beneficial interest in the Exempt Portion, and that part of the Non-Exempt Portion not effectively appointed pursuant to Subparagraph F.2. above, of his or her Trust Estate (including principal, income, the power to appoint successor interests or successor Trustees, the power to create successive limited or general powers of appointment, and any other right, prerogative or privilege not elsewhere restricted by this instrument), outright or in trust, but only to or for the benefit of such one or more of Grantor's descendants (other than the beneficiary/power holder) then living or thereafter born.

c. In each case these powers may be exercised in such portions, amounts or manner as that beneficiary may appoint by a Will which specifically refers to the power of appointment being exercised; provided, however, that no exercise of a limited power of appointment shall be effective:

i. to appoint the Exempt Portion of the Trust property in a manner resulting in any trust having a federal generation-skipping transfer tax inclusion ratio greater than zero;

ii. to allow the distribution of Trust principal free of trust to any person who has not attained the age of 25 years;

iii. to direct the sale, partition, distribution free of trust, or other disposition of any separate parcel of "Farm Property" (as that term is hereinafter defined) except in strict compliance with the provisions therefor that are hereinafter provided; or,

iv. to create in any appointee a taxable general power of appointment over the Exempt Portion of a Trust Estate or Trust property (although the limited power may be exercised to create in the appointee a general power of appointment over any Non-Exempt Portion so appointed).

4. Except as otherwise effectively appointed, then upon the death of: (i) the beneficiary; and/or (ii) the death of the last to die of the beneficiary and the beneficiary's spouse, to the extent that an interest in property appointed for the lifetime benefit of the beneficiary's spouse should inure to the Descendant's Trust upon the death of the beneficiary's spouse, the Trustee shall collect all the property remaining in or passing to the Descendant's Trust pursuant to the foregoing; reapportion the Exempt Portion and Non-Exempt Portion property to reflect any allocations of generation skipping transfer tax exemption taking effect upon the death of the beneficiary and/or the beneficiary's spouse, if any; and then divide all the Exempt Portion and Non-Exempt Portion property (while maintaining the distinction between the Exempt Portions and Non-Exempt Portions) into equal shares of each Portion so as to provide:

a. One such share of the Exempt Portion and one such share of the Non-Exempt Portion for each living child of the deceased beneficiary, and one such share of each Portion for each deceased child of the deceased beneficiary who has one or more living descendants, which shares shall be further

divided into similar shares for such descendants, per stirpes; or

b. If the beneficiary is not survived by any descendants, then to provide one such share of the Exempt Portion and one such share of the Non-Exempt Portion for each surviving sibling of the beneficiary, and one such share of each Portion for each deceased sibling who has one or more living descendants, which shares shall be further divided into similar shares for such descendants, per stirpes.

c. If the beneficiary is not survived by any descendants or siblings, then to provide shares of each such portion for those persons who would inherit from the beneficiary's intestate estate, in the manner and proportions prescribed by the Illinois rules of descent and distribution, but: (i) assuming that all of the Grantor's descendant's spouses were then deceased; and (ii) subject to the definition of "descendants" hereinafter provided.

d. Each share allocated to one of the Grantor's descendants for whom a Descendant's Trust then exists shall be added to his or her Trust Estate. Each share allocated to a new descendant beneficiary shall thereafter be held and administered as a new Descendant's Trust. The Trustee shall administer the Exempt Portion and Non-Exempt Portion of that new Descendant's Trust, and shall distribute the income and principal thereof to or for the benefit of that beneficiary in the same portions, amounts or manner, and subject to the same restrictions, prerogatives and powers of appointment (including specifically the defined general power of appointment over the Non-Exempt Portion and the defined limited powers of appointment over the Exempt Portion) accorded by this instrument to each of the Descendant's Trust's beneficiaries initially.

H. Each Descendant's Trust, however and whenever created pursuant to or as a result of this instrument shall terminate at the end of twenty-one (21) years after the death of the last to die of all of Grantor's descendants who are living at the date this instrument becomes irrevocable. Upon such termination, and except as otherwise effectively appointed, each Trust Estate shall vest in those descendants of the Grantor then entitled to or eligible to receive or have the benefit of its income in proportion to his or her fractional income interest(s), per stirpes and not per capita; provided, that with regard to any interest in a Trust Estate which is subject to a then-current entitlement of the income in a spouse of a descendant created through the exercise of a power of appointment, then that interest shall vest, subject to such current income entitlement, in those persons entitled to or eligible to receive or have the benefit of its income immediately upon the death of the entitled spouse, in proportion to his or her fractional income interest(s), per stirpes and not per capita.

Paragraph A., of course, is a QTIP-type mandatory income requirement. But Paragraph B. is a discretionary option creating a power of withdrawal over principal that is subject to an ascertainable standard, suitable for practical purposes by either a corporate fiduciary or a descendant beneficiary acting as his or her own trustee (but note the limitation on withdrawal of "Farm Property" principal.) The statement of the grantor's priority of purposes instructs the trustee to be generous within the confines of this standard, and provides the trustee some shelter from any remainderman's impatience to get his or her hands on his ancestor's money.

Paragraph C. is intended to strike a compromise between the grantor's desire to provide generous access, while limiting the period during which the 5 and 5 amount will be vulnerable to inclusion in the survivor's gross estate. In targeting the mid-year, 30-day term of June, the thought is that the survivor can plan for this withdrawal if he or she wants some extra cash,[28] or let it lapse (with relief) on July 1 if not.

Paragraph D makes all payments of both income and principal are subject to the self-amending disability provisions that will convert each Descendant's Trust into a special needs trust if necessary. (See, Section IV. B. 4. below).

The layered testamentary powers of appointment in Sub-paragraphs G.1 - G.3 provide a dispositional control mechanism while also assuring that the unused Non-Exempt Portion will be subject to transfer tax in the estate of the beneficiary, and thereby avoid any GST tax. These powers will afford each child the opportunity, presumably many years after the death of the grantor, to reconsider the needs, desires and deserts of the family, and to adjust the distribution of the fund as circumstances may then indicate. The limitation on the class of permissible appointees is inserted as an example, and need not be so limited; it would be equally effective (for tax purposes, if not family sociology) to limit the class to "such persons or entities other than the grantor's spouse, his or her estate, his or her creditors, or the creditors of his or her estate".[29]

Finally, Subparagraph G.4 provides one of many possible alternatives for

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The grantor trust income tax rules cannot be ignored for this period, but since the survivor has a mandatory income right anyway it would seem that in all but the very largest trusts that burden can be handled with skilled tax reporting on the fiduciary income tax return.

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Another advantage of placing this power in the first tier beneficiary -- whether a child or a surviving spouse -- is to encourage the children and grand children to be kind to the power holder. Cynics can have a field day with this one, but there are plenty of times when the first spouse's primary purpose is to extract that very contribution -- of kindness and attention -- from the potential takers.

distribution in default of appointment. The fact is that the vast majority of powers are never exercised, and a clear statement of who takes in default of appointment is always desirable.

3. Farm Property and Management. These provisions allow the family to make critical non-tax administrative decisions, such as: (i) the scope of the continued farm operation; (ii) the degree of control to be afforded the continuing farm operator; (iii) the restrictions – if any – that should apply on the disposition of "Farm Property" (a carefully defined term); (iv) the implications and consequence if one or another child refuses to participate in certain tax savings maneuvers; and, (v) the source of payments that cannot practically be charged to trust principal. The provisions of this Article are limited in the main by only the family's intentions and imagination:

ARTICLE NINE: Farm Property and Management.

The Grantor is convinced that the Beaudry family has been blessed with the fruits of the land - land which has passed to her upon the strength of several lifetime's worth of hard work, frugality, and foresight. Preserving that land intact for the benefit of her descendants is of utmost importance to Grantor and shall be a primary objective of the Trustee. Accordingly, the Grantor hereby declares and directs:

A. That she considers the Beaudry farmland and any and all other agricultural real estate held at any time by any one or more Trusts created by or as a result of this instrument, however acquired and wherever situated, (including, without limitation, the real estate described on Exhibit A hereto; that portion dedicated to residences, sheds, bins, and other agricultural support facilities without the requirement that said agricultural real estate actually be dedicated to producing crops; and, including specifically any interest in any business or other legal entity that owns an interest in the Beaudry family farmland or other agricultural real estate including without limitation shares in a corporation, a partnership interest in any limited or general partnership, a beneficial interest in or power of direction over a land trust, a membership interest in any limited liability company, or otherwise, all of which being referred to herein for convenience as "Farm Property"), to be a sound and proper investment and, subject to the following provisions, expressly authorizes the Trustee to invest in or retain indefinitely any part or all of any Trust Estate in Farm Property, to the exclusion of all other investments if necessary.

B. That in supplement to the foregoing statements of purpose and declarations and directions, and not in limitation thereof, the Grantor also imposes the following restrictions upon the sale, partition, mortgage and/or distribution of said Farm Property, which restrictions shall be immune from revision through the exercise of any power of appointment otherwise conferred by this instrument:

1. For so long as the Grantor and any of the Grantor's three Children is living, no beneficiary shall have the right to demand or withdraw and no Trustee shall have the power to sell, mortgage, petition for partition, or distribute as principal free from trust any portion of the Farm Property except:

a. As may prove actually necessary to discharge any federal or state death taxes remaining due upon the death of the Grantor after all other assets available for that purpose have been exhausted; or,

b. In compliance with or upon the untaxed release of any Internal Revenue Code Section 2032A/2057 lien pertaining to such Farm Property; and

c. Upon the request by or prior written consent of all persons having a current income interest in said portion of Farm Property (and in the event any said beneficiary has not attained the age of majority, said consent or withholding of said consent may be made conclusively by his or her legal guardian); or,

d. Upon the order of any court of competent jurisdiction having first made its finding that such is in the best interest of all the beneficiaries of all Trust Estates generally.

2. Following the death of the last to die of the Grantor and all three of the Grantor's Children, no beneficiary shall have the right to demand or withdraw and no Trustee shall have the power to sell, mortgage, petition for partition, or distribute as principal free from trust any portion of the Farm Property except:

a. In compliance with or upon the untaxed release of any Internal Revenue Code Section 2032A /2057 lien pertaining to such Farm Property; and

b. Upon the request by or prior written consent of all persons having a current income interest in said portion of Farm Property (and in the event any said beneficiary has not attained the age of majority, said consent or withholding of said consent may be made conclusively by his or her legal guardian); or,

c. Having first offered the subject portion of Farm Property for sale and purchase by any one or more of the Grantor's descendants who, as a condition of such purchase will agree not to reconvey said portion of the Farm Property without first offering it for purchase by another descendant of Grantor. (The preferred right of purchase shall be for a purchase price equal to an average of two appraisals prepared by licensed Illinois land appraisers familiar with farm values in Vermilion County. The terms of sale shall be those prevailing for similar sales of farm land on an "arms length" basis within the area. If more than one descendant of Grantor wishes to exercise the preferred right to purchase then each shall be allowed to do so in fractional proportions equivalent to the number participating in the purchase.); or,

d. Upon the order of any court of competent jurisdiction having first made its finding that such is in the best interest of all the beneficiaries of all Trust Estates generally.

3. The restrictions of Subparagraphs B.1. and B.2. immediately above shall not apply, however, to that portion of Farm Property constituting a natural, separate residential homestead. In the event any such residential

homestead passes into Trust hereunder, the Trustee shall at any time have the power, but not the obligation, to survey, partition, and set aside any said farm homestead (including houses, support buildings, storage facilities and land traditionally not employed for growing crops, and as may otherwise be required by state or local zoning or land use authorities) and offer it for sale at its then-current value upon such terms and conditions as may then be in the best interest of the Trust(s), giving preference to any adult descendant of Grantor who may wish to buy it at its then-current value; or in the alternative, the Trustee may maintain and preserve said homestead for any beneficiary's residential use or as an income-producing property.

4. The restrictions of Subparagraphs B.1. and B.2. immediately above shall also not apply to prevent the Trustee from exchanging one or another tract of Farm Property for another, similar tract (or tracts) if the Trustee believes such an exchange would benefit the Trust Estate(s) generally.

C. That the Grantor's sons, RICHARD J. BEAUDRY and THOMAS R. BEAUDRY, shall have the right and opportunity to tenant-farm the Farm Property as long as either or both desires or is capable of doing so, in accordance with the crop-share lease arrangement now existing between them and the Grantor. This right to farm the Farm Property shall not disqualify either or both from serving as a Trustee or Co-Trustee; but to the contrary, the Grantor emphasizes her intention that each may serve in the multiple capacities of Trustee, farm tenant and/or farm manager, none of which shall be construed or interpreted as an actual or potential conflict of interest, nor limited by any duty that either disgorge his individual tenant's share of the profits according to said lease arrangement. At such time as both of the Grantor's sons shall cease to farm the Farm Property, the Trustee shall give preference to such person or entity as the last of them to farm the land may designate in writing to be the next farm tenant; and if no such person or entity is designated, then to an adult descendant of the Grantor (or spouse of a descendant of Grantor) who is capable of farming the land properly.

D. That in addition, the Grantor's sons, RICHARD J. BEAUDRY and THOMAS R. BEAUDRY, shall serve as farm manager for all Trusts created pursuant to or as a result of this instrument. When selecting a successor farm manager each Trustee shall give preference to a "qualified heir" of the Grantor, as that term is defined and applied by Internal Revenue Code Sections 2032A and/or 2057.

E. That the Trustee is specifically authorized and directed to continue to engage in farm operations and the production, harvesting and marketing of farm products; to retain farm management consultants; to enter into farm programs; to purchase or rent and operate farm machinery and equipment; to improve the Farm Property, and to repair, improve, and construct farm buildings, fences, and drainage facilities; to develop, lease, or otherwise dispose of any mineral, oil, or gas property or rights; to borrow money for any of the purposes described in this Article; and in general to do all things customary or desirable in farm operations; provided, however, that the Trustee shall at all times conduct its farm management in compliance with any Internal Revenue Code Section 2032A Special Use Election at any time made and/or any Internal Revenue Code Section 2057 Qualifying Family Owned Business Interest deduction at any time taken.

F. That, because of the illiquid nature of the Farm Property, the Trustee shall first pay currently from gross income all of the expenses of holding and administering the Trust, including by way of example but not limitation: any taxes; special assessments; insurance payments; costs of preserving productivity; reasonable cash reserves for depreciation and repairs; costs of administration of the Trust; and all other necessary and reasonable expenses, all of which costs shall be borne by the income beneficiaries without contribution from principal.

G. That the Trustee shall pay all taxes and special assessments which may be levied against Farm Property in a timely manner, and before penalty may accrue; keep the buildings and improvements thereon insured for their fair insurable value; keep the buildings, waterways, and drainage thereon and easements appurtenant thereto in a reasonable state of repair and upkeep; and, use reasonable efforts to maintain the fertility of the soil; however, the Trustee shall not be required to maintain or insure improvements that become unproductive due to changing circumstances.

H. That the Trustee may consent to special use valuation of Farm Property for death tax purposes or a deferral of payment of federal estate tax or state death taxes, and may accept property which is subject to a lien for the payment of deferred death taxes or which has been specially valued; and, accordingly, the Trustee may take any action consistent with such consent or acceptance including execution of any agreement, consent to imposition of any lien, substitution of any security, acceleration of any payment, assessment of any tax or any other proceedings pertaining to special valuation, in each case without regard to the effect on the relative interests of any beneficiary.

I. That the Grantor expects those benefitting from her bounty to take all reasonable steps to protect its value from avoidable dissipation from taxation. Accordingly, and notwithstanding any dispositive provision herein contained to the contrary, if the refusal of any beneficiary to agree to special use valuation results in a failure to qualify for the election under Internal Revenue Code Section 2032A and/or the deduction otherwise available under Internal Revenue Code Section 2057, and as a result the Trustee (or Grantor's executor) is required to pay the federal estate tax and state death taxes attributable to the failure to qualify, then such payment shall be charged without interest as an advancement against the property otherwise distributable to or in trust for such refusing beneficiary and his or her descendants or appointees. All such tax payments shall be reimbursed to the Trustee or executor before any property shall be distributed to or for the benefit of the refusing beneficiary, and before any income or principal distribution shall be made to the beneficiary and his or her descendants or appointees from any trust created by or as result of this instrument.

4. <u>Disability Provisions and the Special Needs Conversion</u>. Long term trusts require looking out for the unforeseeable, even the unimaginable, including the possibility that a tall strong healthy child or grandchild may fall victim to accident and permanent disability.[30] Rather than cringe from the thought, we should address the problem by availing the "special needs and comforts" trusts for loved ones without exposing trust principal to seizure for reimbursement by public aid agencies that may have provided basic shelter, sustenance and medical care. Volumes have been written

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[30] Even more probable is the eventual long term disability of a surviving spouse. It is an axiom that we are either taken swiftly from this world, or our faculties diminish with age.

on the subject of drafting trusts for the benefit of third parties that can be used for special needs, and while Congress (and the assorted state agencies) are growing ever more aggressive in seeking recovery of assistance payments, it makes sense to at least try to anticipate the problem with self-amending disability provisions.

ARTICLE TWELVE: Disability.

A. Wherever used in this instrument the term "disability" means any legal, mental or physical condition which renders a person less than fully able to manage his or her person or estate, or his or her medical, personal or financial affairs.

1. The term shall include, but is not limited to, the stricter standard of "a medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than twelve months"; or, "any condition of comparable severity evidenced by marked functional limitations." Any person who has been determined to be disabled: (i) in the manner provided by Illinois statutes governing adjudication of disability [e.g., Article XIa of the Illinois Probate Act; 755 ILCS 5/11a-1 through 11a-23, or any similar or successor provision governing the same substantive topic]; (ii) for any purpose by the Social Security Administration; and/or, (iii) who has been determined (by any federal or state agency) to be disabled for Medicaid purposes, shall during the term of such determination be deemed to be disabled for the purposes of this instrument. Any person who has suffered a medically determinable condition of such severity as to be sufficient, in the judgement of his or her attending physician or physicians to require his or her institutionalization as a long-term resident of a nursing home or other health care facility, or require long-term nursing or other professional health care on an "in-home" basis, shall during the term of such condition be deemed to be disabled for the purposes of this instrument.

2. To the extent a disability is not established by the findings set forth in Subparagraph A.1. immediately above, then:

a. The determination of a present disability, or the recovery from a past disability, affecting the Grantor or any person who is serving as Trustee shall be made in a signed writing by that person's attending physician after a personal examination. That written determination shall contain: (i) a description of the nature and type of the disability and an assessment of how the disability impacts on the ability of the person to make decisions; (ii) an analysis and results of evaluations of the person's mental and physical condition, and immediately apparent prospects for recovery; (iii) a statement expressing an opinion on whether the person shall require institutionalization as a long-term resident of a nursing home or other health care facility, or require long-term nursing or other professional health care on an "in-home" basis; and, (iv) a conclusion and opinion on whether that person is disabled on the basis of the criteria herein provided. This written determination shall be delivered to the current and successor beneficiaries and, if applicable, to any person nominated as successor Trustee hereunder, who shall then assume the office of Trustee in the manner provided elsewhere in this instrument.

b. The determination of a present disability, or the

recovery from a past disability, affecting any beneficiary other than the Grantor or a person who is serving as Trustee hereunder shall be made by the Trustee in his, her, or its sole discretion on the basis of the criteria herein provided and such reasonable inquiry as the Trustee deems appropriate in the circumstances.

B. Notwithstanding anything in this instrument to the contrary, in the event any beneficiary (other than Grantor) suffers a disability then the Trustee's powers, discretions and obligations under this instrument with respect to the disabled beneficiary shall thenceforth, immediately, and without further acts in furtherance be amended, restricted, and governed by the following provisions:

1. In the event that the disabled beneficiary is then serving as Trustee, he or she shall immediately, and for the remaining term of that disability be disqualified to serve as Trustee. This disqualification shall endure through the entire period of disability, but shall end when the disabling condition ends, at which time the beneficiary may be restored as Trustee. The successor Trustee shall be as elsewhere provided in this instrument.

2. Commencing immediately upon the disabling event, the Trustee shall withhold payment of Trust principal or income for basic support requirements such as food, clothing, medical care and shelter which the disabled beneficiary is able to receive from any local, state or federal government agency or agencies or any other source, whether public or private, and the beneficiary's power to withdraw, and the Trustee's discretion to distribute principal from any Trust shall thenceforth be limited accordingly.

3. During such period as the disabled beneficiary is receiving or eligible to receive assistance from local, state or federal government sources, or from private agencies, Trust principal or income shall be distributed to or for the benefit of the disabled beneficiary, if at all, only for the special needs, comforts or luxuries suitable for the beneficiary's happiness (including but not limited to travel, expenses for travelling companions if requested or necessary, entertainment, supplemental medical and dental expenses, social services, and transportation) which will not otherwise be provided by any local, state or federal government agency or agencies, and no distribution shall be made for the basic support and care of the disabled beneficiary.

4. In no event may Trust principal or income be paid to, on the demand of, or for the benefit of any governmental agency or department and the Trustee shall do all things reasonable or necessary to at all times preserve the Trust Estate free of the claims of such governmental bodies.

C. The entitlement, discretion, privilege or interest of any beneficiary (other than the Grantor) to receive benefit from the income or principal of any Trust Estate during his or her lifetime is contingent upon the restrictions hereinabove set forth. In the event any proceeding is initiated by any governmental agency to breach, set aside, avoid, or otherwise revise these restrictions on any beneficiary's interest for the purpose of seeking reimbursement from the principal of any Trust Estate for goods, care, or services provided by or at the expense of any governmental body, private agency, or individual, or for any other purpose, then in such event the Trustee's power to distribute income principal of the Trust to or for the benefit of the disabled beneficiary at any time during the period of disability shall immediately and without further action by any person terminate, and in such event all provisions for the demand or distribution of income or principal free of trust to, on account for, or for the benefit of the disabled beneficiary (other than the provision pertaining to termination of the trust in compliance with the Illinois "Rule Against Perpetuities") shall be suspended during the period of disability. If the disability endures until the beneficiary's death, then the beneficiary shall be

deemed to have predeceased the date stated for distribution of principal free of trust.

5. Administrative Preferences and Additional Authorities.

a. Priority of Benefit and Investment Discretion. If the client's beneficial purpose is to provide each current beneficiary maximum latitude in the administration of his or her separate share, subject only to the tax avoidance and asset protection features built into the plan, it may be worth identifying that priority in concrete terms. The following could be a suitable addition to the Trustee's administrative powers.

> **No Trustee shall be liable for any mistake in judgment in the making or retaining of investments, or any other discretionary decision made by the Trustee, so long as any such decision is made in good faith. The Trustee shall have maximum latitude in making investments and shall not be bound by any duty to consider both the reasonable production of income and the preservation of capital value. [Subject to the overriding requirements of the marital deduction provisions provided elsewhere in this instrument,] [and subject further to the limitations to the disposition of "Farm Property" provided elsewhere in this instrument] the Trustee is otherwise specifically authorized to invest the entire Trust Estate: (i) in income producing assets; (ii) in assets selected for the potential of capital growth; (iii) any combination of income and growth investments; or, (iv) assets which neither produce income nor offer potential for capital growth but which the Trustee believes benefit the beneficiary generally. While relying upon the Trustee's fiduciary duties in all other respects as a material term of this Agreement, the Grantor exempts the Trustee from the duties of impartiality in investing with respect to current and successor beneficiaries, it being Grantor's intention to provide maximum benefit to each current beneficiary in priority over the interest of successor beneficiaries. The Trustee may but shall not be required to retain investment advisers, the cost of which shall be borne by the Trust Estate generally. In addition, the Trustee may but is not required to delegate investment functions in any manner consistent with the provisions of the Illinois Trusts and Trustees Act.**

It is hard to imagine a more clear cut grant of individual discretion and priority. Nevertheless, note the bracketed limitations pertaining to the marital deduction requirements, and the possible application of "Farm Property" limitations.

b. No Conflict of Interest: Similar provision can be made to further head off conflict-of-interest issues while addressing the interested trustee tax problems:

> **Any individual acting as Trustee who is also a beneficiary of any Trust or Trust Estate created hereunder may deal with any Trust on an "arms-length" basis without obtaining the approval or confirmation of any Court or any other beneficiary, and such dealings made in good faith shall be as binding and conclusive as though no such relationship or possible conflict of interest existed. Any such Trustee shall not be required to account for or disgorge any direct or indirect personal benefit he, she or it receives, or liable for any loss that results, except by reason of gross negligence or willful malfeasance, it being the Grantor's intention to empower as Trustee persons who are the natural objects of his bounty. Any**

power to make discretionary distributions of Trust principal to or for the benefit of a person who is serving as Trustee of a Trust (including distributions to the person's spouse and distributions in discharge of any legal obligation of the person) or any other discretionary power, the exercise of which could result in distribution of the principal to or for the benefit of such individual, shall be exercisable solely by the Trustee or Trustees other than that person. If no other Trustee is then serving, such power shall not be exercisable; provided, however, that the provisions of this paragraph shall not apply to a power to make distributions which, under this instrument, is limited by an "ascertainable standard" relating to the beneficiary's health, education, support or maintenance as that term is defined and applied by Internal Revenue Code Sections 2511, 2514 and 2041, and supporting regulations.

c. Authority to Continue Farming: If the lengthy "Farm Management" article is not used the following alternative could be added:

The Trustee is further authorized to continue to engage in farm operations and the production, harvesting and marketing of farm products; to participate or decline to participate in governmental agricultural or land programs; to retain farm management consultants or advisors and to engage agents, managers and employees and delegate powers to them; to lease land, equipment or livestock for cash or on shares; to purchase and sell, exchange or otherwise acquire or dispose of farm equipment and farm produce of all kinds; to make improvements, construct, repair, or demolish and remove any buildings, structures or fences; to engage in drainage and conservation programs and to terrace, clear, ditch and drain lands and install irrigation systems; to repair, improve, and construct farm buildings, fences, and drainage facilities; to develop, lease, or otherwise dispose of any mineral, oil, or gas property or rights; to borrow money for any of the purposes described in this paragraph; and in general to do all things customary or desirable in farm operations.

d. Power to Merge Trusts. Left unmentioned in the GST drafting example provided above is the liklihood that upon the death of one or another of the key players two or more trusts of substantially identical beneficial terms -- a Descendant's Trust and a parallel ILIT, for example – could be coming together the benefit of a single beneficiary. In such not event the beneficiary/Trustee should have the specific authority to merge his or her two trusts into one:

The Trustee shall have the power to merge any Trust with any other Trust or trust property held for the benefit of the same beneficiary(ies) (under this or any other instrument) into one single Trust Estate if, in the opinion of the Trustee, the terms and federal transfer tax attributes of such trusts are substantially identical or such a merger can be effected without materially adversely affecting the interests of such beneficiary or beneficiaries.

e. Power to Allot Property. To avoid the administrative headache of fractionalizing property when funding the various trusts, and to take advantage of the latitude afforded by the pecuniary funding formula built into the example, the Trustee should have broad authority to pick and choose assets:

The Trustee shall have the power to allot to any trust an undivided interest in property, make joint investments for two or more trusts hereunder, distribute property in cash or in kind, or partly in each; to allot different kinds or disproportionate shares or undivided interests in property among the distributed shares, without regard to the income tax basis of such property or interest; and, except as specifically required elsewhere in this instrument, to determine the value of any property so allotted or distributed.

f. Tax Elections. This one should be obvious:

The Trustee shall have the power to exercise any discretion, election, or power permitted under any federal or state tax law that the Trustee deems advisable, without regard to its effect on the relative interests of the beneficiaries, and the Trustee shall make no corresponding adjustment between principal and income, or to the relative interests of the beneficiaries to compensate for the effect of the exercise of discretions, elections, or powers.

g. Spendthrift Provisions. These provisions are practically essential if the trust assets are to be insulated from claims:

With respect to each Trust or Trust Estate created by virtue of this instrument, and notwithstanding any provision herein contained to the contrary:

1. Neither the principal nor the income of any interest in a Trust Estate shall be liable for or charged with any debts, contracts, liabilities or torts of a beneficiary, or for any duty of support that may or may not be owed by a beneficiary, and no interest in a Trust Estate shall be subject to seizure or other process by any creditor of a beneficiary.

2. No beneficiary shall have the power to anticipate, petition for partition, encumber or transfer his or her interest in the Trust Estate in any manner, and any purported anticipation, partition, encumbrance or transfer shall be void.

3. No beneficiary shall have any right to compel any discretionary distribution, or to partition any assets held in trust.

4. Nothing in this Paragraph shall limit the lawful exercise of any power of withdrawal retained by Grantor, or the effectiveness of any disclaimer or release.