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MontGuide

Transferring Farm or Ranch Property to the Next Generation Through a QTIP Trust

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There are no easy answers to the question of how best to pass on your ranch, land or other property to your spouse or children. This Montguide examines some concerns you may have, presents some important considerations and explores several available options to meet estate planning goals of farm and ranch families.

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LAST WINTER, THE NEWS ABOUT THE UNEXPECTED sale of a neighbor's ranch created quite a lively discussion at the local cafe. Everyone at the table assumed that after the father died his son (age 55), who was operating the ranch, would continue to do so. Unfortunately, his two sisters wanted their inheritance in "dollars." Because the son could not afford to buy the sisters out, the ranch was put up for sale.

John and Kathy, who are also parents of three children, overheard the discussion and wondered, "Could the same thing happen to our ranch after we pass away?" This MontGuide examines some of the couple's concerns about transferring their ranch to the next generation and explores several alternatives for transferring property to the next generation.

John and Kathy's Current Situation

John and Kathy operate the ranch they inherited from John's father in 1954. They have assets of approximately $3 million including investments, land, equipment and livestock. As the sole owner, John has all of the ranch assets in his name. Because John does not have a written will, the ranch would pass to Kathy upon his death. None of the ranch assets would pass to their children because Montana intestacy (dying without a will) statutes require that all property held in sole ownership by a married decedent pass to the surviving spouse, as long as all the children are of that marriage. If both parents die in a common accident and they do not have written wills, the ranch passes equally to all three children.

John and Kathy are now acutely aware that the issues that led to the sale of their neighbor's ranch could also cause their ranch to be sold if their children wanted their inheritance in dollars instead of an interest in the ranch. And, just like their neighbor, only one of John and Kathy's children has been involved in the ranching operation. Their other two children have moved out-of-state. Neither is interested in ranching as a career, although they are still concerned about getting their "fair share" of their parents' estate.

Estate Planning Concerns

John and Kathy have three concerns about passing their ranch to the next generation. Would federal estate taxes be due on their estates? How can they treat their children "equitably?" And, will the surviving spouse have enough money to live?

After countless hours of discussion, John and Kathy decided that they want their son, who is working on the ranch, to inherit it. Their life insurance agent suggested that their other two children become both the owners and beneficiaries of John and Kathy's life insurance policies. The premiums could be paid annually with money gifted to the children by John and Kathy.

With the two adult children owning the life insurance policies, the proceeds will not be included in either John or Kathy's estates for federal estate tax purposes. Yet, the proceeds would provide a substantial inheritance for their off-ranch children. While John and Kathy realize this is not exactly an equal division among their children, they believe it is an equitable division that recognizes the son's contributions to the ranch operation.

Federal Estate Tax Consequences

John and Kathy attended a seminar sponsored by MSU Extension and learned that if John died in 2007 or 2008, there would be no federal estate tax due. This "good news" assumes that Kathy takes advantage of the unlimited marital deduction. This deduction allows an unlimited amount of assets to be transferred to the surviving spouse free of the federal estate tax.

The “bad news” is that, when Kathy dies, her estate value now includes the $3 million from John’s estate. This amount is more than the 2007 or 2008 federal estate tax exemption of $2 million. If Kathy dies in 2007 or 2008, her estate will be required to pay a federal estate tax of $450,000. In other words, that’s $450,000 in ranch assets that will not get passed on to her son.

Information from an Attorney

John and Kathy discussed the “bad news” with an attorney who specializes in estate planning. They realize that many of the assets on their ranch are not liquid. They wonder whether their son would have to sell off some land, cattle or equipment to pay the $450,000 federal estate tax. Their son could pay the estate tax over time, but he is not keen about the U.S. government putting a lien on the property. John and Kathy believe that any of these possibilities could hamper their son’s operation of the ranch.

John and Kathy shared with the attorney their two estate planning objectives: minimizing federal estate taxes and passing the ranch, intact, to their son. The attorney pointed out several options that would reduce or, in some cases, avoid the potential 2007 or 2008 federal estate tax bill of $450,000 while meeting their goal of passing the ranch to their son.

The Basic Plan *(John maintains sole ownership of ranch)*

Assuming that John wishes to maintain the property in his name only, one method of reducing federal estate taxes is to transfer a portion of the ranch ($2 million) directly to their son when John dies, with the balance going to Kathy and qualifying for the estate tax marital deduction. Transferring some property outright to their son upon John’s death does mean that the transfer ($2 million) is subject to the federal estate tax but that tax is eliminated by John’s applicable credit amount (discussed below). Such a transfer allows John’s estate to take advantage of the exemption that would be wasted if all $3 million was transferred to Kathy. Of course, Kathy loses the income from the $2 million transferred to their son.

The federal estate tax on the $2 million transferred outright to their son at John’s death is $780,800. But, because John’s estate has a federal estate tax applicable credit of $780,800, there is no federal estate tax due. And, instead of Kathy’s taxable estate being valued at $3 million when she dies, only the $1 million that was transferred to her upon John’s death is included. This assumes that the value of Kathy’s portion does not increase beyond $1 million after John’s death. Kathy’s estate liability is avoided on the $1 million she received from John’s estate because her estate can also claim her federal estate applicable credit of $780,800 in 2007 or 2008. This basic plan saves John and Kathy’s estate $450,000 in federal estate taxes.

However, this basic plan assumes that the property remains in John’s name. But, what if Kathy should die first? Technically, she does not have an estate so there is no federal estate tax when she dies. If John dies in 2007 or 2008 with assets totaling $3 million and no surviving spouse to whom the assets of his estate can be transferred, then his estate will have a federal estate tax of $450,000. John and Kathy do not believe the basic plan adequately addresses their concerns about providing income for Kathy and minimizing the federal estate tax.

Modification of the Basic Plan (*John and Kathy own equal amounts*)

The attorney informed John and Kathy that to accomplish their goal of providing income for the surviving spouse for the rest of his or her life and minimizing the federal estate tax, they should not have all the property in John’s name because no one knows which spouse will die first.

The attorney recommended that they divide the estate into equal parcels of $1.5 million. These could be two distinct parcels, one owned by John and one by Kathy, or one parcel owned as tenants in common by John and Kathy. Next, he suggested that John and Kathy each write a will explaining how his or her property is to be transferred upon death.

John’s will could state, for example, that when he dies, their son receives John’s share of the ranch, a $1.5 million value. And, Kathy’s will could state that when she dies, their son receives her share of the ranch--also valued at $1.5 million. This modification of the basic plan would avoid the federal estate tax of $450,000 upon the death of both spouses because each has an estate less than the exemption amount of $2 million (2007 or 2008).

The attorney cautioned John and Kathy that under the “modified basic plan” there would be no income for the surviving spouse or control by the surviving spouse over the assets inherited by their son after the death of the first spouse. For example, if their son decided to sell any of the inherited land or livestock, there would be no legal way for the surviving spouse to stop him. If their son placed the property in joint tenancy with his wife and was divorced, that asset would be subject to marital division.

Their son would also have no control over the assets still owned by either John or Kathy. If the surviving spouse remarries, the remaining $1.5 million still owned by the surviving spouse could be placed in the new spouse’s name. Or, the surviving spouse could decide, in a will written years later, to transfer the property to someone other than the son. In other words, the $1.5 million held by the surviving spouse is totally under his or her control.

Both John and Kathy would like to live on the ranch until they die and are concerned about the possibility that parts of the ranch might be sold before then. And, who knows, they are both young so if something happened to one of them the other might consider remarriage.

QTIP Trust

John and Kathy asked the attorney if there was any way to get the tax advantage of the modified basic plan but still retain some control of the estate while either one is still living. The attorney suggested that a qualified terminable interest property (QTIP) trust could meet both of these concerns. John wants the property to remain in his name so the attorney suggested that, when John dies, $1 million of the ranch assets transfer to a QTIP trust while the remaining assets, $2 million, transfer to their son.

The assets in the QTIP trust qualify for the marital deduction and pass to the trustee of the QTIP trust for Kathy's benefit during her life. She has some control over these assets while she is living, but she cannot give or sell the property to anyone else. The trust document established by John predetermines that the $1 million in property in the QTIP trust will pass to their son upon Kathy's later death. If Kathy remarries, she has no ability to place the QTIP trust assets in her new husband's name.

The attorney indicated several steps that John needs to take to use an estate plan with a QTIP. The first step is for John to draft a will that establishes a testamentary QTIP trust. The will directs that $1 million of the ranch assets pass to the QTIP trust, but only at John's death.

The will instructs the personal representative of the estate to pass the remaining $2 million in assets to their son upon John's death. By transferring ownership of these assets directly to their son and not to Kathy, John's estate can claim a credit that, in 2007 and 2008, allows the $2 million to pass tax-free to their son (*the same applicable credit that was used in the basic plan*).

When Kathy dies, her taxable estate will include the assets in the QTIP trust, currently valued at $1 million as of the date of her death. If the assets of the QTIP trust are still worth $1 million at the date of Kathy's death, Kathy's estate can then claim her applicable credit and pay no federal estate taxes because her *applicable credit* of $780,800 is greater than $345,800 tax.

The amount of the *applicable credit* will increase over the next few years. Table 1, shows the credit with the exemption amount that can pass tax-free to beneficiaries other than a spouse. The applicable credit is applied to the tax due. The *applicable exclusion amount* is simply the dollar amount that can pass to persons other than a spouse without a federal estate tax. Under the unlimited estate tax marital deduction, upon the death of the first spouse, unlimited amounts can pass to the surviving spouse. Under the current law, estate planning must be viewed through the death of both spouses, not just at the death of the first spouse. During 2007-2008, the dollar amount of an estate that can pass tax free is $2 million.

Table 1: Applicable Federal Estate and Applicable Exclusions 2007-2011*

Year of Death	Applicable Credit Amount	Applicable Exclusion Amount
2007	$780,800	$2,000,000
2008	$780,800	$2,000,000
2009	$1,455,800	$3,500,000
2010	Repealed	Repealed
2011	$345,800	$1,000,000

*Under current law March 2007.

The use of the QTIP trust allows John and Kathy to enjoy their ranch during their lifetimes and for their son to inherit the entire estate without paying any federal estate tax. This alternative plan reduces their original estate plan's federal estate tax by $450,000. However, if Kathy dies first, this plan does not offer the same tax savings because all the property is in John's name. Furthermore, even if Kathy survives John, the QTIP trust still does not give Kathy any rights to the portion of the ranch that John left to their son. Instead, Kathy would have rights only on the portion that John's will passes to a QTIP trust for her benefit. Perhaps both a bypass trust (See MontGuide 200509 HR *Using a Bypass Trust to Provide for Children from a Prior Marriage*) and a QTIP would better address the issues of income for Kathy, estate tax savings and passing the ranch to their son. If John keeps all the property in his name and Kathy dies before John, there is still a problem.

Before making a decision, John and Kathy decided to spend time thinking about which plan would best meet their needs.

Conclusion

Estate planning professionals are often consulted to help establish transfer plans because of the complexity of federal and state rules and regulations. Review your situation with an attorney whose practice focuses on estate planning to determine if a QTIP trust meets your estate planning goals.

Other resources:

- Using a Bypass Trust to Provide Children from a Prior Marriage (MontGuide 200509 HR)
- Life Estate: A Useful Tool in Estate Planning (MontGuide 200510 HR)

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Disclaimer

This publication is not intended to be a substitute for legal advice. Rather, it is designed to help families become better acquainted with some of the devices used in estate planning and to create an awareness of the need for such planning. Future changes in laws cannot be predicted, and statements within this fact sheet are based solely upon those laws in force on the date of the publication.

http://www.montana.edu/wwwpb/pubs/mt200508HR.pdf

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