Estate Planning

All the other choices than "do nothing and hope for the best"

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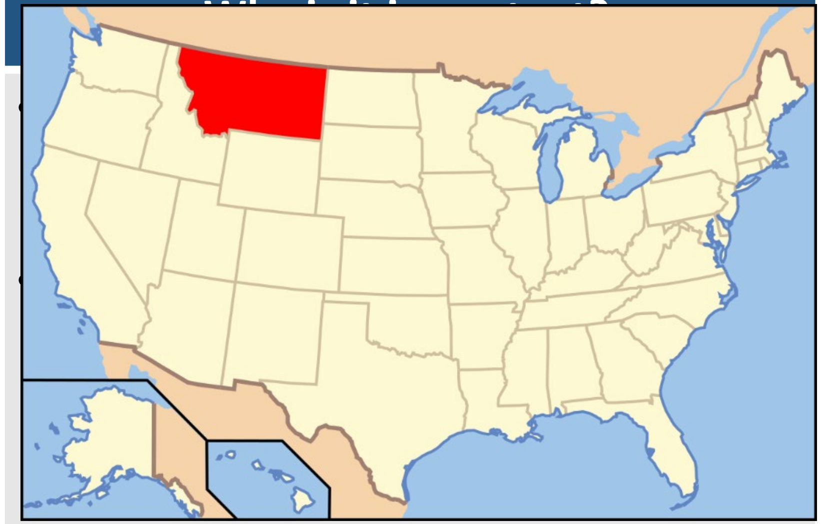
What is estate planning and why is it important?

What is an estate?

- One's gross estate is:
  - Financial assets- stocks, bonds, mutual funds, etc.
  - Real assets- houses, land, other tangible property, etc.
  - Share of jointly owned assets and life insurance proceeds
- Taxable estate is the above minus certain deductions:
  - Debts, funeral expenses, legal and administrative fees, charitable bequests, estate taxes paid to states

What is estate planning?

- The tools used in determining who should receive what and when.
- Succession planning: preparing your property and your family for a change in ownership and leadership.
- Estate planning is the set of legal tools available to make the succession planning happen efficiently.



- 58% of Americans have not written a will.
- If not structure properly, a significant amount of land may need to be sold off to pay taxes or court costs to settle an estate.

What are the major goals and considerations for estate planning?

What are the goals of estate planning?

- To reduce tax burdens
  - Estates greater than $11.2M are subject to federal estate taxes, usually taxes at 40%
- Minimize legal fees
- To make a clear, smooth transfer of assets
- To provide for the current owners' financial needs
- To minimize business interruptions
- Bring family members into the operation

Tool considerations

- How is it owned?
- How is it formed?
- How is it managed?
- How are profits AND losses allocated?
- How are profits AND losses distributed?
- How is ownership interests transferred?

Estate planning tools and options– outline of discussion

Estate planning buckets

1. Three buckets of estate plans
   a) Probate
   b) Non-probate
   c) Trusts

- Probate is the review of a will before a court to ensure that the will is authentic and the estate is distributed properly.
- Can take anywhere from 3 months to 2 years or longer. Assets are tied up in the estate during the process.
- If assets are owned in multiple states, probate will likely occur in multiple states
- Probate costs can quickly get to be greater than $10,000

Tools

1. Do nothing
2. Will
3. Trust
4. Entities
   a) Sole Proprietorships
   b) Partnerships
   c) Limited Liability Company
   d) Corporation

Allow us to address estate planning prior to death to avoid logistics and costs associated with probate and estate taxes.

Do Nothing

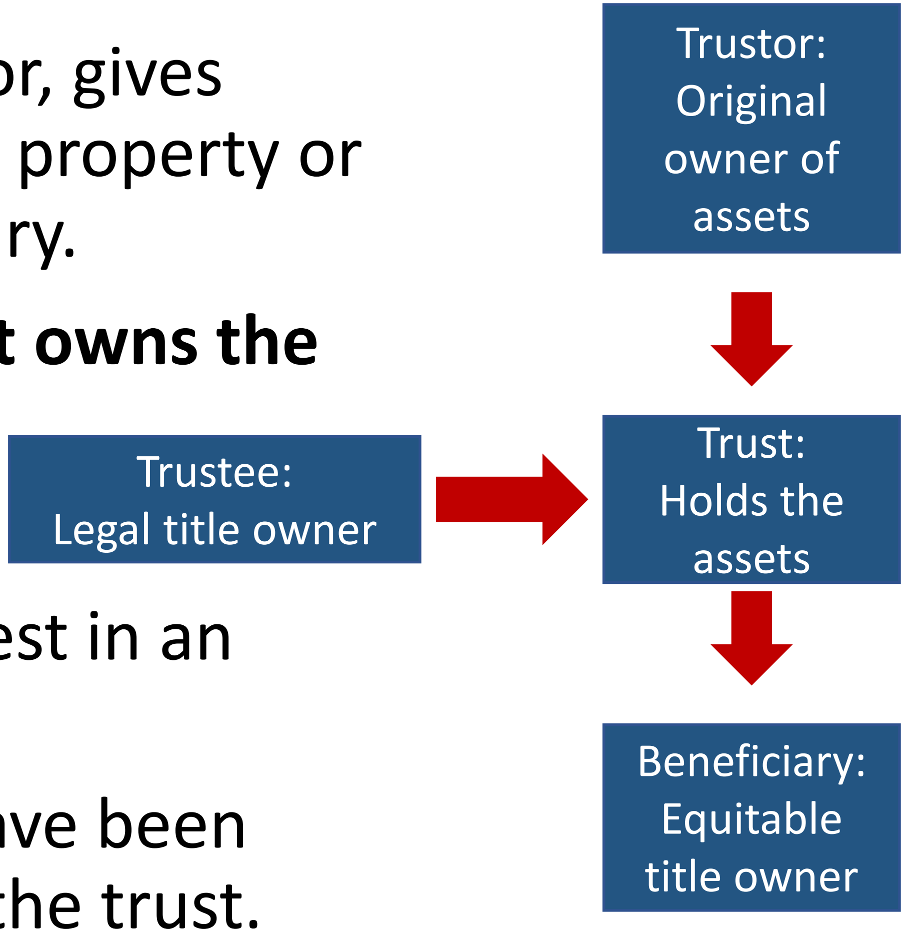
- “Laws of intestate succession”
  - If you have not written a will, in effect, the legislature has written a will for you.
- Your estate passes to heirs according to state law.
- Assets will still go through a probate process.
- Example:
  - Survived by a spouse and children who are children of the spouse
  - Surviving spouse:
    - Inherits all of the deceased spouse’s community property (property owned jointly by the married couple)
    - Plus 1/3 of the deceased spouse’s separate property
    - Has the right to use the real estate for life
  - The children
    - Inherit the balance in equal shares
  - Outline of several scenarios: https://www.thebalance.com/dying-without-a-will-in-texas-3505052

Will

- The bare minimum that should be done from the real estate asset perspective.
- A will provides instruction on the distribution of all one's separate property and their half of community property.
- Should assign an administrator of the will.
  - Recommended that his person is an independent, unbiased party.
  - Administrator is responsible for preserving the real estate.
- A will must go through the probate process

Trusts

- A fiduciary relationship where one party, the trustor, gives another party, the trustee, the right to hold title to property or assets for the benefit of a third party, the beneficiary.
- Once assets are transferred into the trust, **the trust owns the assets**.



- Assets can be real estate, cash, or ownership interest in an entity or company
- Trusts avoid the probate process because assets have been moved out of the estate of the deceased and into the trust.

Parties in a Trust

Trustee

- Trustee has a fiduciary duty to the beneficiaries. They answer to the beneficiaries and must manage the trust in the
of the beneficiaries.
- Trustee holds the **legal title** of the assets held by th
- Position can be held by the original owner of the as
also be a beneficiary or one person could be all thr
- Trusts should provide a clear procedure for remova
replacement of Trustees in the event of incapacity
the current Trustee. ("terms of death/ retirement/
and "successor trustee")
- Trust should have sufficient conditions put on the t
they do exactly what is required of them.

Beneficiaries

- The person or persons deriving benefit from the trust
- equitable title to the assets held by the trust
- or or original owner can be a beneficiary
- ons can be assigned in varying proportions
trust may also place constraints on receiving benefits–
t complete a bachelor's degree, must be married, etc.
- t should have flexible distribution provisions
  - If a unique circumstance arise– incapacitation of a beneficiary, drug abuse, etc. – the trustee should have the authority to use discretion in distributions
- Contingent beneficiaries should be addressed
  - Who will inherit should something happen to the initial beneficiaries

Issues arising in trusts

Common Issues Arising in a Trust		
Failure to Fund the Trust	The Trust as a Standalone Document	Continual Maintenance
• Failure to properly fund assets into the trust. The trust only applies to assets that it owns. • Pour-over will: states any remaining assets that have not subsequently been transferred into the trust, should be transferred upon death.	• The trust should be apart of a complete estate plan. • Other necessary documents: durable powers of attorney, medical power of attorney, health care directives, HIPAA authorizations, pour-over wills, etc.	• Need to pay attention to changes in the law, taxes, assets, personal life or the life of a beneficiary or trustee.

Entities

Sole Proprietorship	Partnerships
Limited Liability Company	Corporation

- Probate logistics and cost
- Personal liability
- Flexibility in management
- Tax considerations

Taxes on profits of entities and estate are considered
***Federal Estate**: up to 40% tax on estates greater than $11.2 million*
***State Estate Tax**: None in Texas*
***Inheritance Tax**: Only a state tax and none in Texas*
***Federal Gift**: gift over $15K/ year/ recipient ($30K if joint gift) taxed up to 40% and erode your lifetime exemption threshold*
***Capital Gains**: Tax on sale of capital assets applied to the appreciation of the assets*

Sole Proprietorship

Ownership	• Owned by one person • The business is not a separate entity- one and the same as its owner
Liability	• Owner is personally liable for the business obligations • No limitation on personal liability
Management of Business	• Owner has complete control of the operation • Not required by the state to register the business
Taxation	• All business income and losses are reported on owner's individual tax return • Owner must pay self-employment tax which contributes to social security and Medicare

DBA: "Doing Business As…" Certification of a business name. Reserves the right to use a name. It does not create a separate entity. The owner and the business are the same person. If the business is sued, the business owner is actually being sued.

Non-business assets are not protected from business-related liabilities

Partnerships

Ownership	• A business with more than one owner. • No specific registration is required to start a partnership. • Owners share profits and losses
Liability	• All general partners are personally liable for **ALL** debts and obligations, including court judgements. • Each general partner is responsible for the wrongful acts of the other partners committed in the normal course of the business.
Management of Business	• Is considered a separate entity from owners. • Joint authority- any one partner can enter into legally binding arrangements on behalf of the partnership itself. • The authority is not unlimited.
Taxation	• A "pass-through" or "flow-through" entity: all business income and losses are passed to the owners in proportion to their interest to report on their individual tax returns. • Partners who actively run the firm (GP) are responsible for self-employment tax.

General Partners (GP)

- General partners act as agents for the business.
- Make all management and investment decisions.

Limited Partners (LP)

- Limited partners are investors in the entity but do not participate in the management of the business.
- Their limited position allow them limited liability protecting them from personal risk for the actions of the partnership.
- Value of interest for limited partners is discounted.

Family Limited Partnership

- Same as limited partners but are required to be family members.

Partnership Agreement

Statement of Business Purposes

- Limits the potential activities of the business and partners
- Limits on what the partners can do on behalf of the partnership–what decisions require the consent of all partners?

Ownership Interest and Responsibilities

- Ownership share: the portion of ownership assigned to each partner
- Outlines the contribution of each partner, timing of contribution and consequences of failure to contribute-- money, property, services, etc.
- Delegation of duties

Distribution of Profits and Losses

- Distributive share: the portion of profit and losses assigned to each partner
- When to distribute profits

New Partners

- Will the partnership allow other partners to enter?
- Are there requirements of potential partners?
- How is a potential partner decided on?

Transfer of Partnership Interest, Exit, Retirement or Death of a Partner

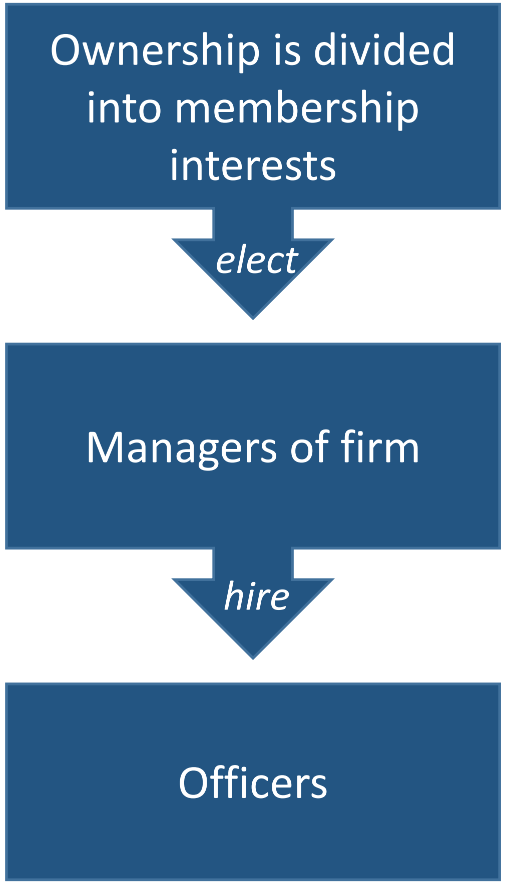
- How new partners can be added.
- How partners can buy out of the arrangement.

Length of Partnership

- Is there a pre-specified length of the partnership?

Limited Liability Company

Ownership	• Creates a separate entity. • Once assets are transferred into the LLC, the LLC owns those assets. • Can transfer cash, property, automobiles, stocks, art, other belongings • Profits and losses are allocated based on ownership percentages. • Must file articles of organization with the secretary of state.
Liability	• Shields the owners from personal liability for the acts, errors, omissions, debts, contracts, and obligations of the company. • Only the company's assets are at risk to the company's claims and obligations. • Owners can only lose what they've invested.
Management of Business	• Owners can manage the LLC themselves or can elect managers who function like a board of directors.
Taxation	• Pass-through entity: owners report their portion of the profit/ losses on their tax returns. • The owners are required to report their portion of profits even if a distribution was not made (i.e. funds are reinvested in the company). • Those active in running the business are required to pay self-employment taxes.



LLC Operating Agreement

Statement of Business Purposes	Ownership Shares	Distributive Shares	Voting	Transferring Interest
• Governs the conduct of the business and affairs of the LLC	• Allocates the percent of ownership to each member • Allocate managing shares and non-managing shares	• Determines distributive share- may be according to ownership or by special allocation • The amount of profit distributed each year • How and when profits will be distributed	• Voting power of members • What decisi[illegible]ns require a unanimous [illegible]e	• Conditions for transfer of membership interests • Buy-sell or buyout provisions • Specifying how to value the membership interests. • May place restrictions on who becomes a member.

Regular distributions or at-will draws

By ownership or per capita

Corporation

"Alter Ego" a common way to "pierce the corporate shield" is if the corporation is treated as an extension of the owner's personal affairs rather than a separate entity

Shareholders also approve the sale of assets, M&A's and the dissolution of the corporation.

Ownership is divided into shares among shareholders

elect

Directors are the leadership of the corporation

hire

Managers run the corporation

owners

n are o … wners.

n with the secretary of state.

- "Corporat
  - The … ities

Directors manage the corporation; authorize the issuance of stock; elect officers; set officer and key … es; mortgage, sell or lease real … ove loans. Parents can maintain … s by being the only board members.

… e.

… or does

… able.

Deductible expenses: salaries and bonuses, interest payments on loans, rent payments, fringe benefits (health insurance, medical expenses, retirement plans) provided to all employees, and the cost of annual director and shareholder meetings

often ov

Managers run the day-to-day affairs of the business.

Taxation	• The entity pays its own taxes. • Because not pass through, shareholders cannot deduct corporate losses. • Net income is taxable whether it is kept as retained earnings or distributed to shareholders as dividends.

Corporation can elect to be an "S" corporation where they are taxed as a pass through entity

Double Taxation and the Transferring of Land out of the Corporation

Double Taxation

- Income is either distributed as dividends or kept in the company as retained earnings.
  - Dividend are subject to double taxation– taxed as corporate income (subject to corporate taxation) and again as personal income to the shareholder.
- To avoid double taxation:
  - Retain the earnings in the company.
  - If shareholders are employees, pay out in the form of salaries or bonuses.
  - The shareholder makes a loan to the company and the interest payments are deducted from the corporate tax amount.
  - Rental payments to the shareholder if they own the building or land being used by the corporation.

Transferring Land

- If a shareholder wishes to transfer land out of the corporations, the gain on the land will be taxed twice.
  - The corporation will be taxed for the capital gain on the appreciation of the land.
    - Corporations do not have favorable capital gain tax rates
  - The shareholder will then be taxed as it will be thought of as a dividend distribution or as a liquidating distribution.

Transferring ownership using an entity– **Gift Taxes** in more detail

U.S. Federal Gift Tax

- Annual
  - Allowed to gift $15K per year per person
- Lifetime
  - The total amount you can give over your lifetime free of tax
  - Both the gift and estate taxes share the same exemption-- $11.2M
  - If you gift away any amount of your lifetime gift exemption, that amount is subtracted from you estate tax exemption.

- I give my daughter $120K in 2018.
  - $105K of that amount is the taxable gift
  - My estate and gift exemption is now $11.075M

Transferring ownership using an entity– **Creating and transferring assets**

Mom & Dad create and transfer assets into entity:
Partnership
LLC
Corporation

Partnership:
Mom and Dad each own:
2% general partnership interest
+
48% limited partnership interest

LLC:
Mom and Dad each own:
50% membership shares

Corporation:
Mom and Dad each own:
50% shares

Mom and Dad **gift**
x% limited partnership interest

x membership shares

x shares

to each child

Parents maintain management control:

- Gift limited partnership interest
- Retain more than 50% ownership interest
- For LLC, can structure the operating agreement so the children are not managing members.

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Kid A is interested in operating the business. They can receive a salary for their work. If a partnership, they may inherit the GP upon death or retirement of the parents, or receive the managing membership interests in the LLC or be placed on the board of the corporation.

Gifting Structure:

- Parents can decide how much they want to give each child at the onset thereby reducing their lifetime and estate exemptions.
- Can continue to gift ownership interests annually- each year gift is given, a valuation must be done.
- Each time the parents gift ownership interests, the value of the interests must be appraised.

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By gifting restricted ownership, the value of the ownership interest is discounted.

- Not traded and cannot be easily sold (i.e. illiquid) and does not have immediate value.
- The owner has little or no right to participate in the management and therefore does not control decisions that affect income or profits.
- Discount can be anywhere from 20% to 50%`

Transferring ownership using an entity– **Creating and transferring assets**

Example of discounted market value of shares:

- Value 1 share of the LLC at $1,000
- Discounted rate for restricted asset= 40%
- Discounted value = $600

Annual gift:

- Can gift Kid A 50 shares instead of 30 and stay under the annual gift exemption
- 50 shares x $600 = $30,000

Transferring ownership interest of a sole proprietorship

Business assets and liabilities are owned by owner

The owner can transfer their interest in the business freely by transferring or gifting the assets and liabilities of the business

Pass assets through a will

Will goes through probate

During this period, management of the company may be interrupted until the assets are transferred

Divide assets among heirs

"Tenancy in Common" Property or assets owned by heirs in undivided interests

Issues commonly arise when multiple people own a single asset and have different motivations or goals for the asset or value of the asset

Ownership interest previously transferred into a trust

If the original owner of assets is the trustee, the successor trustee takes on role according to the terms of death

Trust and asset management continue as before, heirs receive equitable title

Transferring ownership interest in a partnership following death

General partner

Pass ownership interest through one's will

Will goes through probate

The ownership interest is passed according to the will

During this period, business is run by other partners but major decisions made by **owners** may be postponed until the ownership interest is transferred

General partners usually pass ownership interest which is a transfer of the value of the assets owned by the partnership. The actual partnership position is voted on by current partners due to certain criteria required of the position or voting requirements.

Ownership interest previously transferred into a trust

If the owner of assets is the trustee, the successor trustee takes on role according to the terms of death

Trust and asset management continue as before, heirs receive equitable title

Transferring ownership interest in an LLC

LLC Member

Pass membership interest through one's will

Will goes through probate

The membership interest is passed according to the will

During this period, the business will operate as usual– management is uninterrupted–decisions made by **the board** may be postponed until the ownership interest is transferred

Membership interest previously transferred into a trust

If the owner of assets is the trustee, the successor trustee takes on role according to the terms of death

Trust and asset management continue as before, heirs receive equitable title

Transferring ownership interest in a corporation

Shareholder

Pass shares through one's will

Will goes through probate

During this period, the business will operate as usual– management is uninterrupted–but decisions made at the **shareholder level** may be postponed until the ownership interest is transferred

The membership interest is passed according to the will

Shares previously transferred into a trust

If the owner of assets is the trustee, the successor trustee takes on role according to the terms of death

Trust and asset management continue as before, heirs receive equitable title

Pros and cons of each

Sole proprietor	• Most flexible in terms of maintaining ownership and control of assets. • Personally liable for business obligations. • Does not bring heirs into operation prior to death. • Business operations are likely to be interrupted if assets go through probate.	**Limited Liability Company**	• Personal liability is restricted. • Can still maintain controlling interest of the operations by having the controlling membership interest. • More flexible in management than limited partners and corporations.
General Partners	• Potential for introducing heirs into business either in a management capacity as a general partner or in ownership capacity as a limited partner. Both introduce them to the operations. • Drawback is you are still personally liable for business and now liable for the action of the other general partners.	**Corporation**	• Good if there are many investors • If money is kept in the company, the corporate tax rates may be preferable. • Business expenses such as salaries are deductible from the taxable profit. • Real estate investments are subject to corporate capital gains tax and personal income tax when distributed to shareholders when transferred out.

Conclusions

Estate Planning Buckets	Estate Planning Tools
• Probate • Non-Probate • Trusts	• Need to understand: who owns the assets • Liability and taxation • Transferring assets–need to understand costs, business logistics and estate planning logistics
Team	**Communications**

• Attorney
• Certified Financial Planner
• Tax Attorney or Certified Public Accountant
  • Always double check their work. Can result in excess taxes paid if not done correctly.
• Appraiser
  • Needed when the entity is created.
  • Needed every time ownership interested is transferred or gifted.
	• Open communication is needed. The next generation needs to know your goals and you need to know theirs.
	• The next generation also needs know how to run the operations
	  • Negotiating and preparing leases, negotiating and documenting surface damages, easement and pipeline right of ways, crop insurance and USDA forms, appraisal districts, CRP contracts
	  • Need to keep good records and provide heirs with access to them