Chapter 19

The Benefit of Planning a Forest Estate—or the Cost of Not Planning

The following examples, although loosely based on real circumstances, are hypothetical. They are used to illustrate some of the principles that have been presented in this book.

Hypothetical Family Timberland

A husband and wife, both in their 80s, have enjoyed success with their investments in forest land. Over their life together, they have accumulated assets with a value of $10 million. These include a house and lot worth $300,000; 2,000 acres of forest land with a fair market value (FMV) of $3 million for the land alone; standing timber worth $5 million; life insurance policies with a face value of $700,000; and $1 million in stocks. The life insurance policies consist of a $500,000 policy on the husband with a cash value of $200,000 and a $200,000 policy on the wife with a cash value of $100,000. The husband holds title to all the assets—including both life insurance policies—so he can take timely advantage of investment opportunities as they arise. On the negative side, he also has $700,000 in business debts.

The forest land is very productive, but its value for timber production is well below its FMV for more developed uses. Nevertheless, the couple wants to keep the land in forest for their three married children and five grandchildren. Their other objectives are to ensure that, regardless of which of them is the first to die, the surviving spouse will be well cared for, and that their family, rather than the Federal government, benefits from their success. Assume that: (1) $75,000 in final medical and funeral expenses is incurred at each death; (2) administrative costs equal 5 percent of the gross estate, minus debts and final expenses; (3) the children's marriages are sound; and (4) the family works together harmoniously.

What impact will the Federal estate tax have on the family assets if the owner dies intestate (without a will) in 2008 and his wife dies later in the same year? In 2010? In 2015? Assume that State laws of descent and distribution require that half of the entire estate go to the surviving spouse, with the remaining half divided equally among the children.

Example 19.1—No Estate Plan

First death—The gross estate at the owner's death is $9,900,000 ($300,000 house and lot + $3,000,000 timberland + $5,000,000 standing timber + $500,000 face value of the insurance policy on himself + $100,000 cash value of the insurance policy on his wife + $1,000,000 in securities). The adjusted gross estate is $8,668,750 ($9,900,000 gross estate – $700,000 business debts – $75,000 hospital and funeral expenses – $456,250 administrative cost). The administrative cost is calculated as 5 percent of the adjusted gross estate, after debts and final expenses. This may be high for an estate of this size; however, it probably is low for an unplanned estate.

Half of the estate—$4,334,375 ($8,668,750 x 0.50)—goes to the wife. It is protected by the marital deduction and any estate tax on it is deferred until her death or other changes occur. The other half goes to the children. It is assumed that they engage competent professional advisors who help them qualify for special use valuation which reduces the FMV of their estate to $3,374,375 ($4,334,375 – $960,000; see chapter 12). Of this, $2,000,000 is shielded by the applicable exclusion amount. The tax on the remainder is $618,469 ($1,374,375 x 0.45). The tax is due within nine months unless an extension is granted under Internal Revenue Code (IRC) section 6166 or for other reasons as discussed in chapter 13.

The estate tax and administrative costs due after the husband's death total $1,074,719 ($618,469 estate tax + $456,250 administrative cost). This solution also leaves the surviving wife with access to only half of the couple's combined estate, which she helped to accumulate. There are unnecessary taxes, such as those on the face value of the life insurance policy on the husband and on the cash value of the policy on the wife. The size of the estate tax and administrative costs, combined with the division of the property, may well interrupt timber management and the continuity of the family forest enterprise.

Second death—What happens if the wife dies later in 2008? Her gross estate is $4,334,375. After subtracting final expenses and administrative costs, the adjusted taxable estate is $4,046,406 ($4,334,375 gross estate – $75,000 final expenses – $212,969 administrative cost). There is no marital deduction, but special use valuation can be used to reduce the taxable estate to $3,086,406 ($4,046,406 – $960,000). Of this, $2,000,000 is shielded by the applicable exclusion amount. The tax on the remainder is $488,883 ($1,086,406 x 0.45). The combined estate tax for both deaths is $1,107,352 ($618,469 + $488,883). Thus, although this solution fortuitously took advantage of the marital deduction at the first death, two allowable credits, and two elections to use special use valuation, the lack of a plan resulted in estate taxes equal to nearly one-eighth of the original estate.

If the wife lives until 2010, there will be no Federal estate tax under current law, due to the 1-year repeal of the tax for that year. All estate assets—minus final expenses and administrative costs—will pass tax free to the children.

If the wife lives until 2015, current law calls for the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107-16) to sunset and the Federal estate tax provisions to revert to those in place before 2002. Although it seems likely that Congress will address the situation before this occurs, it remains possible that the allowable credit will be substantially lower and estate tax rates higher after 2010. As it is, there is enough uncertainty that the most common sense strategy would be to keep the family's forest assets flexible as well as productive by avoiding irreversible situations.

Example 19.2—A Simple Plan

First death—What happens if the husband neglects actual estate planning, but has his attorney draft a will specifying that if he is the first to die, everything goes to his wife? This arrangement sometimes is called an "I Love You" will (assume this distribution is permitted under State law). At the husband's death, the marital deduction again reduces the adjusted taxable estate to $0 and no tax is owed. The tax is not eliminated, however, but simply deferred. Now the questions become: what happens if the wife dies later in 2008? And what happens if the wife dies first?

As above, after deducting business debts, hospital and funeral expenses, and the 5 percent administrative cost, the husband's adjusted gross estate is $8,668,750. Because of the unlimited marital deduction, the entire amount goes to the surviving wife and no Federal estate tax is due.

Second death—If the wife dies later in the same year, her adjusted gross estate is $8,164,062 ($8,668,750 gross estate – $75,000 final expenses – $429,688 administrative cost). As before there is no marital deduction, but the executor can elect to use special use valuation to reduce the taxable estate to $7,204,062 ($8,164,062 – $960,000). An estate tax of $2,341,828 [($7,204,062 – $2,000,000) x 0.45] is due—nearly one-fourth of the original combined estate. This huge tax bill is due in 9 months although deferral and extension is possible, as discussed in chapter 13. This solution ignores the needs of the children. Further, it shields only $2 million from tax instead of $4 million, and provides only one opportunity to elect special use valuation instead of two.

Since the husband held title to all family assets, the results are the same if the wife is the first to die. Although it recognizes the contribution of both spouses to the family's financial success, the "I Love You" will wastes the opportunity to use the allowable credit and to elect special use valuation at the death of the first spouse, resulting in an unnecessarily large estate tax bill.

The results in both these examples are unsatisfactory because each fails to consider the needs of some family members and results in excessive amount of estate tax. What if the couple had worked with estate planners familiar with forest land assets to evaluate other possible solutions?

Example 19.3—A Balanced Estate Plan

Equalize ownership of family assets—Assuming a full inventory of the family assets is in hand, the first step toward a more balanced estate plan is to equalize asset ownership between the husband and wife. This is necessary to take full advantage of two estate planning tools: the special use valuation election available under IRC section 2032A, discussed here, and formula marital deduction wills, discussed below. Ideally, there is sufficient trust and skill for the husband to gift ownership of a full half of the family assets to the wife. More than simply balancing the dollar value of the spouses' individual estates, the gift should include sufficient land and timber to take advantage of the special use valuation election at each spouse's death, regardless of whom is the first to die. In this example, at the husband's death in 2008 a special use valuation election could reduce his taxable estate by up to $960,000 compared to the simple plan, saving up to $432,000 ($960,000 x 0.45) in estate tax.

Remove the insurance policies from the husband's estate—Both life insurance policies should be removed from the husband's estate, by transferring ownership either to a trusted child (this option is possible only if the family works together harmoniously) or to an irrevocable life insurance trust with the children and grandchildren as beneficiaries (an aggressive plan also could include the children's spouses, but that option depends on the family culture). Depending on the spouses' expected longevity, the transfer could be made using the annual gift tax exclusion of $24,000 per beneficiary per year for split gifts and/or a portion of the husband's lifetime gift tax exclusion of $1 million. Use of the gift tax exclusion may be advisable here, to remove the life insurance policies from the husband's estate as quickly as possible. This would remove $600,000 ($500,000 face value of the policy on the husband + $100,000 cash value of the policy on the wife) in taxable value from his estate at a cost of using $300,000 ($200,000 cash value of the policy on the husband + $100,000 cash value of the policy on the wife) of his gift tax exclusion. In this example the transfer would have had to be made in 2005 or earlier, since under IRC section 2042 the transfer of a life insurance policy only is effective if made 3 years before the transferor's death; had this been the case, it could save up to $270,000 ($600,000 x 0.45) in estate tax compared to the simple plan.

Formula marital deduction wills—Both spouses should have wills structured to take advantage of the applicable exclusion amount at each death, regardless of whom is the first to die, as discussed in chapter 9 and illustrated in figure 9.1. At the death of the first spouse, the children would receive a bequest equal to the full amount shielded from estate tax by the applicable exclusion amount, and the surviving spouse would receive the balance of the estate. This would remove the amount shielded by the applicable exclusion—$2 million in 2008 and $3.5 million in 2009—from the surviving spouse's estate. If there was any question whether the assets remaining to the surviving spouse are sufficient, the bequest to the children could be made in the form of a bypass trust that provides the surviving spouse a life interest in the trust proceeds and perhaps the right to invade the trust principal, subject to an ascertainable standard of living; otherwise, the bequest to the children could be made outright. In this example, at the husband's death in 2008, a formula marital deduction will could remove $1,700,000 ($2,000,000 applicable exclusion amount – $300,000 part of the applicable exclusion amount used to gift the life insurance policies) from his estate compared to the simple plan, saving up to $765,000 ($1,700,000 x 0.45) in estate tax.

Fully used and timely implemented, these three strategies could reduce the family estate tax bill by nearly $1.5 million compared to the simple plan. But the family still faces considerable estate tax exposure. If the spouses' health permits, they should consider organizing the forest enterprise as a Family Limited Partnership (FLP; see chapter 15) or Limited Liability Company (LLC; see chapter 17). This would solidify the business purpose of the forest land and facilitate the transfer of FLP partnership interests or LLC membership interests equal to the annual gift tax exclusion (or double with split gifts). At least initially, the gifts would be of minority interests and could contain marketing constraints—such as, ownership must be kept within the family—that would allow valuation discounts varying from 20 to 50 percent. For example, a 50 percent discount would allow the couple to transfer $48,000 (2008, as indexed) to each donee in discounted, split interests. If they made such gifts to each of their three children, $144,000 per year could be transferred. If they added their five grandchildren, a total of $384,000 per year could be transferred, and if they added their children's spouses, $528,000 per year could be transferred.

With a $10 million family estate earning an expected $600,000 to $800,000 per year, perhaps an aggressive gifting plan should be considered. With an FLP, the husband and wife could retain control and the heirs would be passive limited partners; with an LLC, all members who desire to could become active participants. There are numerous options depending on family health, cohesion, and goals that permit business continuity and keep the family forest together. In the absence of family harmony, other alternatives might be necessary. The strategies described above will save taxes and keep the forest assets productive. When some family elements are missing, various types of trusts provide alternative methods to meet these needs.