<u>All Things Being Equal</u>

By Jacqueline N. Davie

If I were at a party cutting a cake, no one would complain if a piece was slightly larger than another. Let's say you came early to the party, you helped set up, you spent the evening serving other guests and making sure everything went smoothly. Do you deserve a larger piece of cake? Am I right to reward you? If however, I am a landowner dividing my property and you are a recipient, you may be troubled to watch that large corner piece with the icing rose passing you by.

As a comprehensive financial planning firm that specializes in working with large landowners, we are often asked to resolve the issue of "fair vs. equal" for couples with multiple children. Often one child is active in the family business while another is not. It is a delicate issue that can cause family division and resentment but when done correctly can avoid even larger issues down the road.

When tackling the issue of "fair vs. equal", the first step is identifying your personal definition of what these words mean. Webster's defines fair as "agreeing what is thought to be right or acceptable; treating people in a way that does not favor some over others". Equal is defined as "the same in number, amount, degree, rank or quality; having the same mathematical value; not changing: the same for each person".

For individuals who favor a "fair" distribution of property, planning can be fairly simple. Land can pass via a Will or Trust in equal shares to children and/or grandchildren. Sounds simple but in reality it can cause strife between heirs. Remember the analogy of the guest who arrived early, helped set up and spent the evening serving guests? If you are the heir that actively manages the land, you may feel like a fair distribution of property ignores your contributions. Then again no one said life is fair.

For families that want to equalize the inheritance they leave their children, the process is a bit more complicated. In the following paragraphs, we'll walk through a case study of succession planning for an equal distribution of property.

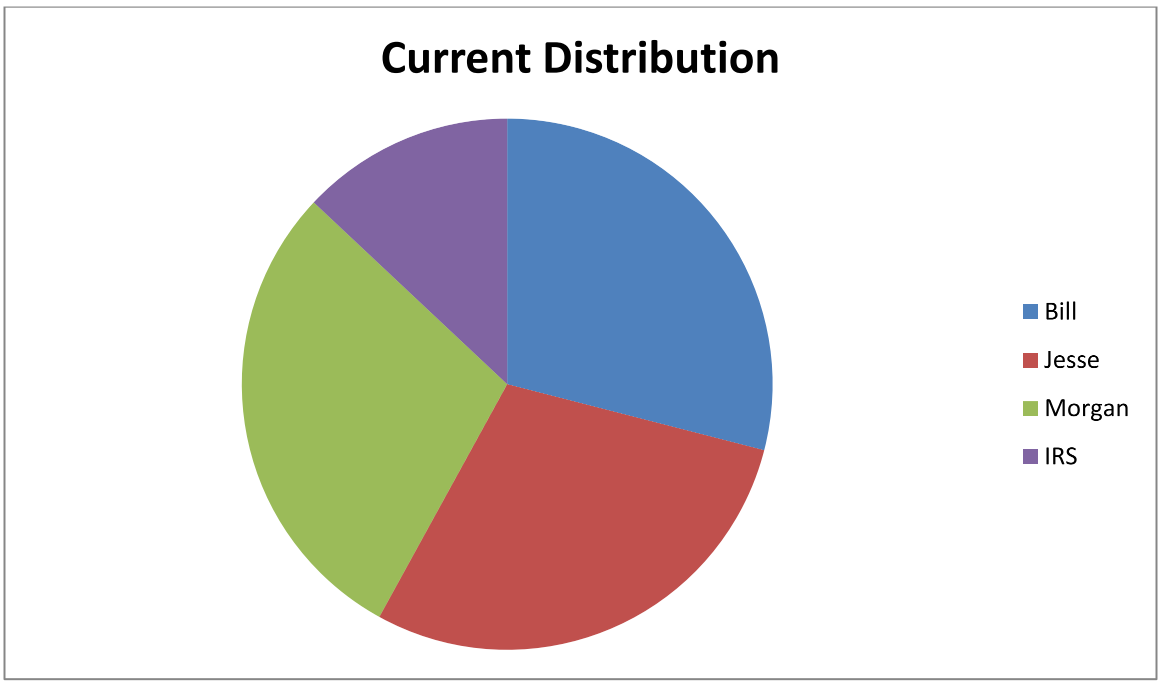
William and his wife, Cassie, came to our firm for assistance in reviewing their estate and succession planning. They have three children between the ages of 38 and 45. Their oldest child, Bill helps William run their livestock operation. Bill's youngest sister, Morgan is married but spends as much time helping on the property as she can and plays a major role in keeping the books for the business. Their brother Jesse is an attorney with no interest in the land or business. William wanted to leave the land and business to Bill but Cassie was worried Morgan and Jesse would feel they didn't love them as much.

Our process began by gathering data on William and Cassie's current financial plan. Their current situation looked like the following:

Residence	$500,000
Land	$8,000,000
Livestock	$250,000
Equipment	$100,000
Stocks/Investments	$5,000,000
Savings	$250,000
Total Net Worth:	$16,350,000

Reading through their current estate documents, all assets went first to one another then equally to their children. Our first concern was that none of the assets were passing in Trust, giving up the protection from creditors, lawsuits or claims of divorcing spouses. Another common mistake we see in estate documents is the outright distribution of assets at certain predetermined ages. While you may feel your child will be ready to receive the assets at 35, these documents fail to take into consideration future issues that may arise with the child such as substance abuse.

Another issue that needed to be addressed were the estate taxes that would be due on the second death. At present, the estate tax is spoken of in terms of permanency. The definition of permanent in this scenario simply means there is no sunset provision currently on the horizon when exemption amounts and tax rates will revert to previous amounts. In 2016, individuals can pass $5.45 million ($10.9 million per couple) estate tax free. Any amount over the exemption is taxed at a 40% rate. William and Cassie's children would owe approximately $2,180,000 in estate taxes at the second death. While there were plenty of liquid assets to pay the taxes, they did not realize it was that high and were concerned that estate taxes would be the heir to 13% of their estate.



In addition, taxes were going to significantly reduce the liquid assets to each child.

	Bill	Morgan	Jesse	Estate Taxes
Residence	$166,667	$166,667	$166,667	$0
Land	$2,666,667	$2,666,667	$2,666,667	$0
Livestock	$83,333	$83,333	$83,333	$0
Equipment	$33,333	$33,333	$33,333	$0
Stocks/Investments	$1,023,333	$1,023,333	$1,023,333	$1,930,000
Savings	$0	$0	$0	$250,000

After some soul searching and discussion, William and Cassie decided they would be comfortable with Bill inheriting all of the business if Morgan and Jesse received assets equal to the value. If possible, they wanted a provision included that Morgan would continue keeping the books for the operation in exchange for compensation. Most important was ensuring the surviving spouse was able to live on the property until death. We had our marching orders; reduce estate taxes, equalize and protect the surviving spouse.

To reduce estate taxes, we implemented an entity gifting strategy. The land, livestock and equipment was placed into an LLC. The LLC contained both voting and non-voting shares. An appraisal was completed for the fair market value of the LLC assets. The appraised value was $8,520,000 ($85,200 voting shares and $8,434,800 non-voting shares). If gifted at full value, the gift would erode a large portion of the $10,900,000 lifetime exemption amount. Therefore, a partial interest valuation was completed by an appraiser that specializes in discounted values for family gifting. The valuation discounts the shares based on two factors: lack of marketability and lack of control. A lack of marketability discount applies when there is no market for the shares of the LLC. Any member would be hard pressed to find a buyer for a percentage of non-voting shares. A lack of control discount is applied to shares that have no control to act without agreement of other shareholders or no vote in operations. The discounted given the non-voting shares of the LLC was 35%. Thus instead of using $8,434,800 of the $10,900,000 exemption, William and Cassie only used $5,482,620. Once the land, livestock and equipment value was removed from their estate, they fell below the exemption amount effectively erasing any estate taxes due.

Non-voting shares were gifted via transfer assignments to Bill (80%), Jesse (10%) and Morgan (10%). Jesse and Morgan were given shares to maintain the partial valuation discounts. The strategy solved the issue of the estate taxes due at death but what it created was an even wider chasm of inequality between heirs. Bill's value of the LLC, should he inherit all voting shares in addition to the non-voting shares he received via gifts would total $4,471,296. The value Morgan and Jesse received would be $548,262 each or $3,923,034 less. Excluding assets now in the LLC, the balance of William and Cassie's assets was $5,750,000. This was insufficient to equalize dollar for dollar. If there were sufficient assets outside the LLC, William and Cassie's estate documents would have been amended to pass $3,923,034 each to Morgan and Jesse before remaining assets were divided equally.

The most effective strategy available to William and Cassie was leveraging remaining assets with the use of life insurance. A policy was issued with William and Cassie as joint insureds. The policy was owned by and payable to a Trust. At the second death, the policy would distribute $8,000,000 to Jesse and Morgan income tax-free. The premiums were gifted to the Trust annually by William and Cassie from income on investments.

At the end of the process, William and Cassie's estate tax liability had been reduced, under current law, to $0 and each of the children received equitable dollar amounts. These were William and Cassie's objectives. Each family we have worked with has a different set of assets to work with and different goals for those assets. It is important to work with an advisor that takes the time to get to know you and your goals above (and before) all else.

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