Plan for income tax consequences

Estate-Plan Edge
By CURT FERGUSON

Key Points

- Meaningful estate planning is about more than estate taxes.
- Estate-planning strategies can also have good or bad income tax consequences.
- Forming a family limited partnership can mean Uncle Sam gets less.

MANY families think of estate planning as primarily about taxes — estate taxes, to be precise. The fact is, estate taxes are only a part, even a relatively small part, of what you can accomplish with estate planning. The personal goals that can be achieved for yourself and your loved ones are what make estate planning most meaningful. Keeping the farm in the family while treating all heirs fairly, protecting assets from lawsuits and divorces, preserving and passing on your heritage — these are often more compelling than simply minimizing taxes.

Another angle often overlooked is income taxes. At this time of year, we are or have been making the annual trek to our accountants to pay our taxes. Many estate-planning strategies have good or bad income tax consequences.

■ Spread income taxes around

Bill and Mary form a family limited partnership, or FLP, (similar planning might use an LLC or subchapter S corporation) to transfer some of the ownership of the farm to the next generation while retaining control. The property placed in the FLP is worth $2,500,000. Over time, they give each of their four children 10% of the limited (nonvoting) shares of the FLP. Thereafter, only 60% of the FLP will be included in Bill or Mary's estate at death. As the general (voting) partners, Bill and Mary maintain control.

After expenses each year, the FLP nets $100,000 of rental income. After paying income taxes, they want to reinvest what they will have left into more farm ground.

The tax liability on the $100,000 will be attributed to the partners: $10,000 for each child, $60,000 for Bill and Mary. If the children are in lower tax brackets, Uncle Sam gets a little less of the family money.

■ Re-characterize income

Creating an entity — FLP, corporation or LLC for instance — may allow you to avoid some self-employment tax. John and Linda created an LLC to operate their farm and pay their hired help. Their estate-planning purpose was to help insulate their land and home from liability if one of the employees had an accident and caused a lawsuit. The LLC owns almost nothing, but it pays the employees and serves as conduit for the overall farming income and expenses.

John and Linda found that they could shift some of their earnings from self-employment income over to rental and interest income, which receive better income taxes treatment.

■ Pay taxes on income that isn't yours

Tom and Sue have a large farm worth several million dollars. They want to transfer as much of their wealth as possible without estate or gift taxes. Each year they are giving the maximum $12,000 tax-free gift to each of their descendants. They want to give more to shrink their estate.

They create a "grantor deemed ownership trust" and (through various steps too numerous to cover here) transfer $4,000,000 worth of farmland into it. Tom and Sue are considered the owners of the trust assets for income tax purposes, but not for estate and gift tax purposes.

The trust generates $160,000 in net income for 2006. The $4,000,000 is not considered part of their estates (i.e. when they die) and the $160,000 is given to, or reinvested for, their children. However, for income tax purposes Tom and Sue are "deemed" to have received the $160,000 and must report it with their taxable income. At 28%, they pay $44,800 in taxes on money that went to their children.

As a result, Tom and Sue are able to pay the $44,800 on behalf of their children in addition to giving "maximum" annual gifts.

■ Use shortsighted A-B trust

I recently reviewed a typical "A-B" trust for a couple. While they are both living, it has no tax effect. But on the death of one, it will require all income to be reported to the surviving spouse. This requirement will cost the widow or widower between $7,000 and $14,000 per year in unnecessary income taxes. (The detailed analysis is on my Web site.)

That living trust is not unusual; the offending terms are common. Much estate planning is done that way; legal forms drafted with little or no real counsel or advice, and without considering all income tax consequences.

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