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Estate Planning newsletter

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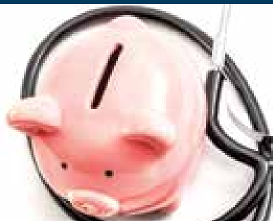

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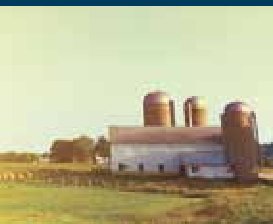

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Producing Good Results: Estate Planning Objectives for Farmers

GISLASON & HUNTER LLP
ATTORNEYS AT LAW
www.gislason.com

By Rhett P. Schwichtenberg
507-354-3111
rschwichtenberg@gislason.com

THE MINNESOTA ESTATE TAX:

An Explanation Through Examples

This article addresses everyone's favorite topic: tax. Specifically, Minnesota's estate tax. Before you say "no thanks" and decide not to read on, this article states the rule but focuses on examples and illustrations to demonstrate them. This style will limit complex discussion of the tax laws and maximize comprehension via straightforward examples.

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THE MINNESOTA ESTATE TAX: AN EXPLANATION THROUGH EXAMPLES

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1. Three Million Exemption

Rule: In 2020, Minnesota provides a $3 million "basic" exemption for each individual. Compare this with the Federal "Lifetime" Exemption of $11.58 million in 2020.

Example: A, a single individual, owns $2 million in assets.

- A dies.
- $2 million from A to A's descendants = no Minnesota estate tax liability.

2. MN Estate Tax Rates

Rule: Minnesota uses estate tax brackets to determine estate tax liability. These can be found in Minnesota Statutes section 291.03, subd. 1(b).

Illustration:

Amount of Minnesota Taxable Estate	Tax Rate
Not over $3,000,000 (or applicable Exemption)	No Minnesota Estate Tax
Over Exemption but not over $7,100,000	13% of excess over Exemption
Over $7,100,000 but not over $8,100,000	$923,000 + 13.6% of excess over $7,100,000
Over $8,100,000 but not over $9,100,000	$1,059,000 + 14.4% of excess over $8,100,000
Over $9,100,000 but not over $10,100,000	$1,203,000 + 15.2% of excess over $9,100,000
$10,100,000 or more	$1,355,000 + 16% of excess over $10,100,000

3. No Portability

Rule: Unlike the Federal Exemption, Minnesota provides no portability of individual exemptions for married couples. This means that if all property goes to the surviving spouse at the first spouse's death, the surviving spouse loses the other spouse's exemption.

Example: A and B are married and each own $3 million in assets. A dies unexpectedly, without a Will. B, as surviving spouse, inherits everything, then also dies.

- $3 million from A to B = no tax
- B's now $6 million estate - B's $3 million exemption = $3 million subject to Minnesota Estate Tax
- Total Estate Tax Liability = $390,000

Example: A and B are married and each own $3 million in assets. A's Will provides that an amount equal to A's Minnesota estate tax exemption passes to the Family Trust on A's death, with any remaining assets going to B outright. B has a right to the income from the Family Trust for life and can dip into the principal if needed for B's health or support. A dies, then B dies shortly after.

- $3 million from A to Family Trust - A's $3 million exemption = no Minnesota Estate Tax
- B's $3 million estate - B's $3 million exemption = no Minnesota Estate Tax

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4. Qualified Farm Property and Qualified Small Business Property Deductions: $5 Million Exemption

Rule: In addition to the $3 million "basic" exemption, Minnesota decedents receive up to an additional $2 million for Qualified Farm Property and/or Qualified Small Business Property Deductions. The rules for each are complex and must be strictly adhered to; consult your attorney for assistance.

Illustration:

QUALIFIED SMALL BUSINESS PROPERTY	BOTH	QUALIFIED FARM PROPERTY
• Property is assets used in a trade or business or ownership interest (stock) in a business entity engaged in a trade or business. • Business' gross annual sales in year of death are not over $10 million. • Not a "passive activity" under IRC 469(c) during year of death, and deceased or spouse materially participated. • Not a "passive activity" under IRC 469(c) during three years after death and qualified family member materially participates. • Estate and heirs agree to pay recapture tax (16%) if they fail to meet the three-year requirement.	• Person who receives the property must be a "qualified heir". • Decedent must own asset for three years prior to death.	• Property is Minnesota agricultural land (or ownership interest in a business that owns ag land and complies with Minnesota's Corporate Farm Law). • In the year preceding death, property classified as "Class 2a Agricultural Homestead". • Qualified heirs agree not to sell the land outside the family for three years. • Land remains Class 2a Agricultural Property for three years (note: homestead not required). • Estate and heirs agree to pay the recapture tax (16%) if they fail to meet the three-year requirement.

5. No State Gift Tax

Rule: Unlike the Federal Lifetime Exemption, where annual gifts made to an individual in excess of $15,000 cause either a reduction in the donor's lifetime exemption or gift tax (your choice), Minnesota does not reduce donors' exemptions or tax them for gifts made during life. An important exception to this rule is discussed in the next rule.

Example: A and B, , a married couple, each gift $20,000 to C in 2019. They die more than three years later.

- A and B's federal lifetime exemptions will each be reduced by $5,000 (or they can elect to pay gift tax on the $5,000 excess).
- A and B will each retain their $3 million Minnesota exemption and are not taxed on the gift.

6. Clawback Rule

Rule: Any taxable gift made within three years of donor's death will be "clawed back" into donor's estate. Non-taxable gifts include annual exclusion gifts ($15,000 per person per year), transfers to spouse, and direct payments of tuition or medical expenses.

Example: A has three children, B, C, and D. A gives all farmland to B, the farming child, and dies two years later. A's Will says that C and D split the remaining assets, after all estate taxes are paid.

- $3 million land gift "clawed back" into Estate (B keeps land)
- No Qualified Farm Property Deduction, because A did not own land for the three years prior to death.
- Without the clawback, there would be no Minnesota Estate Tax.
- With the clawback, there is a $260,000 Minnesota Estate Tax.
- A's Will instructs estate taxes be paid out of the remaining $2 million in assets.
- B gets to keep the land but C and D have to bear the tax burden (their inheritance is reduced by the $260,000 estate tax liability.

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7. Non-Minnesota Property

Rule (Non-Minnesota Property): Real estate and other tangible property located in Minnesota is always Minnesota property, regardless of whether the decedent is a Minnesota resident. For Minnesota and non-Minnesota residents, the $3 million exemption is reduced by the percentage of the estate located outside Minnesota.

Example: A owns $3 million of real estate located in Minnesota and $1 million of real estate located in South Dakota. Regardless of whether A dies a resident of Minnesota or not, A's Minnesota taxable estate equals $3 million. A's Minnesota exemption is reduced by 25% to $2.25 million, subjecting $750,000 of the Minnesota real estate to estate tax. Total Minnesota Estate Tax is $97,500.

8. The Look-Through Rule

Rule: If decedent is domiciled in Minnesota, intangibles (e.g., business interests) are considered Minnesota property. As an exception, if a non-resident owns an interest in a business entity, other than a C Corporation or publicly-traded securities, that owns Minnesota real estate or other property located in Minnesota, we "look through" the business entity and tax the Minnesota property it owns.

Example: A has the following assets:

- $1 million South Dakota agricultural real estate
- $3 million Minnesota commercial real estate owned in an LLC
- $1 million personal investments (intangible)
- Total Estate = $5 million

If A dies a Minnesota resident:

- Minnesota Taxable Estate = $4 million (everything except South Dakota real estate).
- Minnesota Estate Tax Exemption = $2.4 million (80% of $3 million exemption due to South Dakota real estate).
- $1.6 million over exemption = $208,000 Minnesota Estate Tax.

If A dies a South Dakota resident:

- Minnesota Taxable Estate = $3 million (Minnesota real estate in LLC is subject to "look-through" rule).
- Exemption from Minnesota Estate Tax = $1.8 million (60% of $3 million exemption due to South Dakota real property and personal investments).
- $1.2 million over exemption = $156,000 Minnesota Estate Tax

Conclusion: It is my hope that using brief rules and examples, instead of taking on a traditional article format, helped clarify both the more basic and complex Minnesota estate tax rules. As always, there are nuances to all of these rules. As such, you should always consult a legal professional when making estate planning decisions.

PLANNING FOR MEDICAL ASSISTANCE: A STARTING POINT ON WHAT YOU NEED TO KNOW

By Jennifer Gish
507-387-1115
jgish@gislason.com

Medical Assistance, Minnesota's version of Medicaid, provides more than 600,000 Minnesotans with coverage monthly. Many of these individuals are seniors. When looking forward to retirement, it is important to consider future health care needs as well as how such needs will be paid for. This includes possible long-term care. While private options, such as out-of-pocket spending and long-term-care insurance are possible for a period of time, national statistics indicate the majority of Americans will have some need for government-backed health coverage as they age. The Kaiser Family Foundation, a non-profit organization that focuses on national health issues, found that Medicaid is the primary payer for both institutional and community-based long-term services and support. This is partly due to the limited coverage under Medicare and few affordable options in the private insurance market. While many individuals may not initially qualify for Medical Assistance due to income or asset levels, they know they will eventually need coverage.

The rules and regulations for the Medical Assistance program are complex and can change often, including the calculation of income and assets (which affects eligibility). Some factors that affect the calculations are marital and veteran status.

The application process, completed through the local county office, is only the first step. Attempting to "spend down" assets to meet the threshold of Medical Assistance can have negative affects if not planned carefully. Minnesota has a five-year "look back" period for asset inclusion. That means Minnesota looks back five years for any assets sold or transferred for less than fair market value (including gifts). Minnesota then implements penalties related to the amount of value lost in the transfer. Penalties result in a period where the applicant is not eligible for coverage. There are some exceptions, such as certain transfers to spouses or qualifying children, but the law is intricate.

This "look back" period makes estate planning critical. Gifts of non-exempt assets need to occur well before the application for Medical Assistance and the need for coverage. Non-exempt assets, even if illiquid (such as agricultural land) remain assets for purposes of eligibility. Gifting may have tax implications or affect other plans you have made, such as any arrangements regarding trusts. Make decisions early, in consultation with your financial advisor and your attorney, to best protect your eligibility for Medical Assistance and to make sure your family is well taken care of.

By Christopher J. Kamath
507-387-1115
ckamath@gislason.com

PRODUCING GOOD RESULTS: ESTATE PLANNING OBJECTIVES FOR FARMERS

Estate planning for farmers is simply different than estate planning for non-ag business owners and typical families because of the challenges presented from specialized economic, climate, and business conditions, as well as legacy goals tied to the farmland itself. These issues heighten the need for farmers to reduce estate taxes and other deathbed costs, cut estate administration costs, equalize distributions among farming and non-farming heirs, and preserve liquidity of your estate.

Whether you're nearing retirement or just beginning to build your farming operation, it is important to keep the following objectives in mind so that your legacy isn't thwarted by a poorly conceived estate plan.

This article is part of a series addressing estate planning objectives for farmers. This article focuses on reducing estate tax liability and protecting farmland from medical assistance claims.

Reducing Estate Taxes

Reducing your estate tax liability is an important objective and first step in constructing an estate plan. Reducing your tax liability will help you maximize the value of property you can transfer to your heirs. At the federal level, the government taxes estates on the value of assets above $11.58 million. The first $11.58 million of an estate is exempted from federal estate tax (married couples can exempt double this amount). The federal exemption eliminates the need for most farmers to plan around the federal estate tax.

However, Minnesota also imposes an estate tax on its residents, as well as all tangible property located in the state. The first $3 million of an estate is exempted for Minnesota estate tax. Certain qualified small business and farm property can also be sheltered from the estate tax. As a result, up to $5 million can escape Minnesota estate tax upon the death of a Minnesota resident.

Section 2032A of the Internal Revenue Code ("IRC") provides one important method for reducing the value of your Minnesota taxable estate. Section 2032A was enacted to preserve the family farm and prevent estates from having to liquate farmland in order to pay their estate tax liability. Section 2032A authorizes a special valuation method of certain qualified farm property. For individuals who died in 2019, an election under Section 2032A can reduce the value of a taxable estate by $1,160.000.

Many people believe that you cannot make a state-level 2032A election unless you have a federal estate tax liability; however, there is no such requirement in federal regulations and Minnesota allows farm property to be valued under Section 2032A for estate tax purposes so long as your personal representative (1) files a federal estate tax return and makes the election at the federal level; and (2) a 2032A election is made on your Minnesota estate tax return.

The above requirements are in addition to the requirements under federal law. Section 2032A is notoriously complex. A complete discussion of Section 2032A's requirements is beyond the scope of this article, but it is important to note that many farmers lose their eligibility to use this valuation method because they or a qualified family member fail to "materially participate" in the farming operation for at least five years during the eight years preceding the landowner's death. The material participation requirement raises many concerns in crop share arrangements where a third party unrelated to the farmer is performing most of the physical labor.

In order to meet the material participation requirement, an owner or a qualified family member must participate in making a substantial number of the farming decisions. Additionally, production activities on the land should be inspected regularly by the owner or qualified family member. The owner or a qualified family member should also advance funds and assume financial responsibility for a substantial portion of the expense involved in the operation of the farm. Finally, the owner or qualified family member should furnish a substantial portion of the machinery, implements, and livestock used in the production activities.

Material participation presumes that the owner or family member is subject to self-employment taxes. If it is determined by the IRS that self-employment taxes are owed, the 2032A election will be denied until all such taxes (including interest and penalties) have been paid.

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PRODUCING GOOD RESULTS: ESTATE PLANNING OBJECTIVES FOR FARMERS

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Medical Assistance Claims

Medical Assistance liens filed by the state to recover the cost of certain benefits paid to a recipient is another expense that can result in a forced sale of the family farm. Minnesota's medical assistance recovery statute is broadly written and designed to ensure every individual uses their own assets to pay their share of the benefits received by them under our state's medical assistance program. The statute authorizes a lien against real property owned by a person at their death for the amount of medical assistance they received during their life.

Additionally, an individual with income or assets above a certain threshold will not qualify for medical assistance and will need to spend their own assets on their long-term care needs. The threshold for disqualification can be as low as $862 per month in income and as low as $3,000 in assets, depending on your circumstances and household size.

Although many planning techniques exist to preserve the family farm and establish medical assistance eligibility, most of these techniques come with significant tradeoffs. One such technique is for the owner to gift the farmland to the farming child. The state counts uncompensated transfers within five years of an application for medical assistance. For this reason, the gift should be completed before the five year look back period. The biggest drawback of making such a gift is that the owner no longer has control over the asset or a right to all income from the land.

A better technique is the installment sale method. In an intrafamily installment sale, the owner would sell the farmland to the farming child on a contract for deed or promissory note. Title to the property would transfer immediately to the child and the contract or promissory note would be a new asset in the owner's estate. Depending on the amount of income payable to the owner, he or she might be able to spend down the money on qualified expenses to maintain medical assistance eligibility.

The advantage of an installment sale is that it removes all future appreciation on the land from the selling farmer's taxable estate. The cash payments under the installment sale may also provide the farmer's estate with liquid assets upon the his or her death. This additional liquidity can help the estate avoid having to sell property to pay the farmer's medical bills, funeral expenses, and estate administration costs. Even so, the benefits of an installment sale must be weighed against its disadvantages, which include income tax liability and loss of control over the farmland, among other things.

Conclusion

In conclusion, farming is a specialized business that requires specialized planning to maximize the transfer of wealth and fair distribution of assets to your heirs. The content of this article should not be construed as legal advice. If you have estate planning or farm succession questions, it is recommended that you contact a qualified estate planning attorney for advice specific to your needs and circumstances.

Gislason & Hunter Estate Planning Services

Estate Planning is important to ensure the orderly transfer of family assets, as well as to protect those assets from unnecessary taxation. The Gislason & Hunter Estate Planning Practice Group offers a variety of services to assist you in creating the best plan for you, your family, your business or your farm.

Some of the many services our attorneys offer include the following:

- Drafting wills, trusts, codicils and powers of attorney
- Preparing health care directives and living wills
- Creating family business succession plans with emphasis on each family's particular goals and values
- Farm estate and succession planning
- Evaluating estate and gift tax issues and structuring planning options to minimize tax obligations
- Administering and assisting clients with probate proceedings, conservatorships and guardianships
- Advising on Medicaid, Medicare, nursing home and elder law issues
- Handling disputed estate and probate matters in litigation, arbitration or mediation formats

Gislason & Hunter Wills, Trusts, Estate Planning & Probate Practice Group:

Jennifer Gish	jgish@gislason.com
Reed H. Glawe	rglawe@gislason.com
Chris Kamath	ckamath@gislason.com
Kaitlin M. Pals	kpals@gislason.com
Rhett Schwichtenberg	rschwichtenberg@gislason.com
Andrew A. Willaert	awillaert@gislason.com

LOCATIONS

Mankato Office
111 South 2nd Street, Suite 500
Mankato, MN 56001
507-387-1115

New Ulm Office
2700 South Broadway
New Ulm, MN 56073
507-354-3111

www.gislason.com

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