Leaving a Legacy
Wills and Trusts

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The average Texas landowner is 60 years old. As that age increases, the discussion of estate and succession planning takes on a new sense of urgency. Experts estimate 10 percent of farmland in the United States will be passed down over the next five years. That represents approximately 91 million acres, an amount close to the size of Montana.

The Takeaway

With the average age of Texas landowners increasing, estate and succession planning has taken on a new urgency. Lack of proper planning could result in large amounts of land being sold, divided, or tied up in court. Tools such as wills and trusts can help, although each has its own advantages and disadvantages.

Current estimates show 58 percent of Americans have not written a will. Lack of estate plans and insufficient communication between benefactors and heirs, especially for estates with large real estate holdings, could result in substantial amounts of land being sold, divided, or tied up in court proceedings.

Estate planning provides the tools that define who gets which assets, and when. A will is the bare minimum estate-planning tool used for real estate assets. Other tools have emerged that not only manage one's assets postmortem but allow the succession process to begin before the final transfer of assets.

Succession planning allows benefactors and heirs to communicate their goals and introduce potential heirs to the management logistics of the estate. It uses estate-planning tools to prepare one's property for a change in ownership and one's family for a change in leadership. Succession planning can also help one avoid taxes, minimize court costs, make gifts, and transfer ownership to heirs before death.

Previously, estate planning was instrumental in managing potential federal estate taxes. On January 1, 2019, the federal estate tax threshold increased to $11.4 million per person and $22.8 million for a married couple. That threshold is subject to expire in 2025. If an estate surpasses the threshold, it is taxed anywhere from 18 to 40 percent. The Tax Policy Center estimates this threshold affects only 0.1 percent of those who died in 2018 (about 1,890 people). Given that so few are affected by federal estate taxes, estate planning has shifted focus to the management and minimization of income taxes. Estate-planning tools can minimize taxes paid on the appreciation of assets, especially when a significant amount of assets is real estate. Many states also have a state estate tax and an inheritance tax. Texas has neither.

The following scenarios serve as an introduction to two estate- and succession-planning tools: wills and trusts. Business structures such as partnerships, limited liability companies, and corporations will be discussed in a future article.

Where There's a Will

Luke and Morgan have three children—Mary, Kyle, and Ronald. They have a home and some cattle on 400 acres outside Fredericksburg. After much discussion, Luke and Morgan decide to create a will to distribute all of their property and their ownership portion in jointly owned assets when they die. They will leave their land and all assets associated with it to their children to be co-owned in equal shares. Ownership like this occurs frequently and is referred to as "tenancy in common."

After both parents pass away, the will goes through a probate process. The will takes legal effect when it is proven to be the true last testament of the deceased. The probate process can take two years or longer. Assets owned in multiple states go through separate probate processes in each state. During the process, the executor of the will chooses to either manage the assets or hire someone to manage them, which is common when the assets include land operations. In some cases, one of the children may manage the property and its assets. Ultimately, though, it is the executor's responsibility to determine how the assets contained in the will are managed. The estate pays the cost of managing the assets during the probate period, including the cost of a manager.

According to the will, each of Luke and Morgan's children will own one-third undivided interest in the land and its assets. The tenancy-in-common structure gives each child the right to use the land so long as it does not restrict the other owners' use of the land. Communication of Luke and Morgan's goals for their property to their heirs is extremely important for the success of this ownership structure. Disputes are likely and can be costly to an estate. Open and continual communication helps reduce potential costs and minimizes stress on family relationships.

Luke and Morgan must also know their children's goals and management abilities. They must understand that the children are not bound by the parents' stated goals unless conditions of or restrictions on land use are placed in the will. If the parents want the land kept and managed as it currently is but the children live several hours away from the property, it is likely not feasible for the children to uphold the current land use on their own. The children also may not be able to afford to pay someone to manage the land. If not, the parents and children should talk about the best outcome for the land.

Tenancy in common can be a difficult structure if the children have different goals. Mary may want to live in the house and raise cattle like her parents did. Kyle may see the potential of increased tourism in Fredericksburg and wish to capitalize on it by selling the land to a developer. Ronald, meanwhile, may wish to have nothing to do with the land and want his portion of the value of the assets in cash. Disputes like these are common and may result in litigation or court-provided mediation. At any time, any of the cotenants has a right to partition the property. Partitioning can be costly for the heirs and the estate.

Partitioning can be done in two ways—by agreement or by filing a partition suit. If an agreement can be made, the cotenants either sell the property and split the proceeds or agree on a physical separation and partitioning of the land. If an agreement cannot be made and a partition suit is filed, three special commissioners are appointed to determine whether the land can be partitioned in kind or if it must be partitioned by sale. Partitioned in kind means they can divide the land into near-equal-value parcels for each of the tenants. If the land cannot be divided into equal-value parcels, it will be partitioned by sale and the proceeds (minus court costs and sale costs) will be distributed to each heir according to the respective shares of ownership.

The children receive a step-up in basis on the assets they have inherited from their parents. The basis is the value of the asset used in calculating capital gains on the appreciation of an asset for tax purposes (the sale price minus the cost basis). The basis determines the amount of tax paid or deducted on the asset after the sale of the asset. The assets need to be appraised to determine the new cost basis at the time of death. If the children sell any of the assets at that time or in the future, the new cost basis will be used to determine their tax liability. The step-up in basis has the potential to substantially reduce or eliminate the heirs' income tax liability when assets are sold.

A will leaving land to heirs in undivided interest is common, especially when land or property is involved. Other tools serve additional goals and help with the logistics of passing on ownership of assets that require operational management and experience, such as land holdings.

Matters of Trust

Ben and Jessica have been discussing setting up a trust to support their investment and retirement goals as well as to support their children if anything were to happen. They understand there are two types of trusts: revocable and irrevocable. Both create a management structure that will continue after Ben and Jessica pass away. Because a trust specifically outlines a succession process for the trustee and beneficiaries, the assets in a trust avoid the probate process and add a level of privacy. With a will, assets and the recipients of those assets become public record once the will is admitted to probate. Ben and Jessica like these attributes of a trust but would still like to maintain control of their assets. The couple wants to manage and build the assets' value for their own benefit and the benefit of their children when the assets are passed on.

Their lawyer tells them a revocable trust that becomes irrevocable when they die would achieve their estate-planning goals. They are happy to hear that but would like to know more about the advantages and disadvantages of both kinds of trusts. Their lawyer says if they were to set up an irrevocable trust, they would not maintain control of their assets and would no longer receive benefits from the assets transferred into the trust. One benefit of the irrevocable trust is the protection it provides assets from creditors. Creditors would not be able to force distributions from the trust to cover the beneficiaries' or the trustor's personal debts.

The revocable trust allows them to maintain control of their assets as well as make amendments. The couple would also continue benefiting from the assets. Because Ben and Jessica maintain control of the assets and receive benefits from them, the revocable trust does not provide protection from creditors.

Taxes also concern the couple since the majority of their assets are in real estate. They are not necessarily worried about surpassing the federal estate tax threshold, but they do worry about the income taxes that may need to be paid if their children sell the assets in the future. If the couple chooses to gift the assets to an irrevocable trust, the assets would not benefit from a change in basis. Therefore, the original cost basis would be used when calculating the taxes paid on the asset. In a revocable trust, the assets step up in basis at the time of the parents' death. The appraised value of the assets at that time are used to calculate the taxes paid on the appreciated value.

For example, a piece of property Ben and Jessica bought for $100,000 is now valued at $250,000. If they gifted the property to an irrevocable trust, the property would maintain the $100,000 cost basis. If the asset is sold, taxes would be due on the $150,000 in appreciation. The revocable trust, on the other hand, steps up the basis to $250,000. Therefore, the children have a new cost basis of $250,000, reducing or eliminating their income tax liability.

If Ben and Jessica decide on a revocable trust, the assets will still be included in their estate. This is not the case with an irrevocable trust (this is an important caveat). Trusts reach the highest income tax rate of 37 percent at $12,000. Ben and Jessica would not reach a similar income tax rate until $600,000. By keeping the assets in their estate, they reduce the potential tax liability associated with the assets.

The couple agrees with their lawyer that a revocable trust that becomes irrevocable on their death is the best strategy. They will designate their children as beneficiaries of the irrevocable trust. They have also identified a trustee to manage it. Ben and Jessica create strict guidelines and conditions for the trustee role to ensure the assets are managed effectively. They have outlined steps to remove and replace the trustee if those conditions aren't met. The trust defines the procedure for transferring the trustee position to the successor trustee, which avoids court involvement. The court may determine incapacitation of a trustee; otherwise, management of the assets transfer to the successor trustee and operations continue. Ben and Jessica work with their lawyer and others on their estate-planning team to create their revocable trust.

Each estate- and succession-planning tool has advantages and disadvantages. Individuals should work with experienced professionals—estate and tax attorneys, certified financial planners, certified public accountants, and appraisers—to determine the best estate-planning strategy.

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