

KEEPING LIFE INSURANCE OUT OF YOUR ESTATE

By Toni M. Porter, CPA, MST

The fact that life insurance is not generally subject to income tax is discussed quite frequently, but an issue that may be more important that is not discussed is the topic of whether the life insurance will be subject to estate tax. Few people realize that, even though they may have a modest estate, their families may owe hundreds of thousands of dollars in estate taxes because they own a life insurance policy with a substantial death benefit.

This is because life insurance proceeds, while not subject to federal income tax, are considered part of the taxable estate and may be subject to federal estate tax. It is important to make sure that the life insurance benefits the family will receive after a person's death avoid the federal estate tax. This is important because once the federal estate tax applies, the rates are high (beginning at 37% and going up to 49%; though the top rate drops to 48% in 2004, 47% in 2005, 46% in 2006, and 45% in 2007, 2008, and 2009).

Insurance on someone's life will be included in their taxable estate if either:

- (1) The decedent's estate is the beneficiary of the insurance proceeds.
- (2) The decedent possessed certain economic ownership rights ("incidents of ownership") in the policy at the time of their death (or within three years of their death).

Avoiding the first situation is easy: the insured just makes sure their estate is not designated as beneficiary of the policy.

The second rule is more complex. Clearly, if the insured is the owner of the policy, the proceeds are included in their estate regardless of who the beneficiary is. However, simply having someone else possess legal title to the

policy will not prevent this result if the insured keeps so-called "incidents of ownership" in the policy. Rights that, if held by the insured, will cause the proceeds to be taxed in their estate include:

- the right to change beneficiaries
- the right to assign the policy (or to revoke an assignment)
- the right to pledge the policy as security for a loan
- the right to borrow against the policy's cash surrender value
- the right to surrender or cancel the policy

It is important to make sure that the life insurance benefits... avoid the federal estate tax.

It is important to remember that merely *having* any of the above powers will cause the proceeds to be taxed in the insured's estate even if they never exercise the power.

Buy-Sell Agreements

Life insurance obtained to fund a buy-sell agreement for a business interest under a "cross-purchase" arrangement will not be taxed in a person's estate (unless the estate is named as beneficiary). For example, Al and Bob are partners in A&B Farms and they agree that the partnership interest of the first of them to die will be bought by the surviving partner. To fund these obligations, Al buys a life insurance policy on Bob's life. Al pays all the premiums, retains all incidents of ownership, and names himself beneficiary. Bob does the same regarding Al. When the first partner dies, the insurance proceeds are not taxed in his estate.

A properly drafted life insurance trust keeps the insurance proceeds from being taxed in the insured person's estate as well as in the estate of their surviving spouse.

Life Insurance Trusts

A life insurance trust is an effective vehicle that can be set up to keep life insurance proceeds from being taxed in the insured's estate. A properly drafted life insurance trust keeps the insurance proceeds from being taxed in the insured person's estate as well as in the estate of their surviving spouse. It also protects the trust beneficiaries from their own "excesses," against their creditors, and in the event of divorce. Moreover, the trust also provides reliable management for the trust assets. Typically, the policy is transferred to the trust along with assets that can be used to pay future premiums. Alternatively, the trust buys the insurance itself with funds contributed by the insured. As long as the trust agreement never gives the insured any of the ownership rights described above, the proceeds will not be included in his estate.

An irrevocable life insurance trust is created to be the owner and beneficiary of one or more life insurance policies on a person's life. The insured contributes cash to the trust to be used by the trustee to make premium payments on the life insurance policies. If the trust is properly drafted, the contributions made to the trust for premium payments will qualify for the annual gift tax exclusion, so gift tax will not have to be paid on the contributions.



The life insurance trust typically provides that, during the insured person's lifetime, principal and income, in the trustee's discretion, may be paid or applied to or for the benefit of the spouse and descendants. This allows indirect access to the cash surrender value of the life insurance policies owned by the trust, and permits the trust to be terminated, if desired, despite its being irrevocable. On the death of the insured, the trust continues for the benefit of the spouse during his or her lifetime. The spouse is given certain beneficial interests in the trust, such as the right to income, limited invasion rights, and eligibility to receive principal. On the death of the spouse, the trust assets are paid outright to, or held in further trust for the benefit of, the descendants.

If a person owns a life insurance policy with a significant death benefit, an irrevocable life insurance trust may be of substantial benefit.

The Three-Year Rule

If someone is considering setting up a life insurance trust with a policy they own currently or simply assigning away their ownership rights in such a policy, the insured must live for at least three years after these steps are taken or the proceeds will be taxed in the insured person's estate. For policies in which the insured never held incidents of ownership, the three-year rule doesn't apply.

If you have any questions about keeping life insurance out of your estate, or any other estate planning issues, do not hesitate to call us at 559-432-2346 to discuss them.

BENCHMARKING DAIRY INDUSTRY

By Nancy Ervin, MBA

One of the most challenging aspects of any business is knowing how to measure your performance. Although the “bottom line” is obviously important in the agriculture industry, net income alone can be deceiving. So many factors outside of your control, particularly price, can have a devastating effect on the bottom line despite your best efforts at management and cost control.

When an industry experiences a down cycle, as the dairy industry did in 2003, it can often be beneficial for a business owner to compare a wide variety of common financial ratios to an industry benchmark. Some may discover they actually performed relatively well, despite a poor showing on the “bottom line.”

For example, compare the average profit before taxes for dairy farms¹ to the average milk price² over the past five years (Figure A below). Even though many dairy farms struggled to break even in 2003, it appears their loss is largely due to a drop in overall milk prices. But that may not be the case for everyone.

So how does a banker or other interested party know if your business is still solvent in a net loss year? Conversely, how can they be sure your business isn’t a high risk despite a profitable year? The most common method is to analyze financial ratios.

Financial ratios can measure a company’s liquidity, activity, leverage and operational performance. When you compare your financial ratios to an industry benchmark, you can gain better understanding as to how you are performing compared to others in the same industry.

For example, a **Liquidity Ratio**, such as the “Current Ratio,” is calculated by dividing total current assets by total current liabilities. This ratio is a rough indication of a company’s ability to pay current obligations. Generally, a Current Ratio should be greater than 1.0, which would indicate an equal amount of current assets and liabilities. A number slightly greater than 1.0 would be preferred to allow for some cushion between current obligations and the ability to pay them. However, if you were a

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¹ Source: RMA 2003 – History for NAICS 112120 Dairy Cattle and Milk Production

² Source: California Department of Food & Agriculture (www.dairy.ca.gov) Average modified quota price per CWT for years ending March 31st.



Figure A
DAIRY CATTLE AND MILK PRODUCTION

Profitability & Milk Prices

	1999	2000	2001	2002	2003
Profit before taxes	17.3%	13.7%	4.9%	10.1%	-1.7%
Milk price	\$16.51	\$13.51	\$12.87	\$14.72	\$11.59

dairy farmer in 2003 with a Current Ratio of 0.9, you would actually be performing above the “norm” for that year of 0.8 (see Figure B below).

Another important liquidity ratio measures a business’s ability to at least make interest payments on their debt by calculating earnings before interest and taxes (EBIT) divided by annual interest expense. A higher ratio is better, from a lender’s point of view.

Leverage ratios measure a company’s vulnerability to downturns. Highly leveraged firms (those with heavy debt in relation to net worth) are considered at higher risk.

The ratio of fixed assets divided by net worth measures the extent to which owner’s equity has been invested in plant and equipment (fixed assets). In this case, a lower number is better from a lender’s point of view.

The same is true for total debt divided by net worth. A lower number generally indicates

that a company has greater flexibility to borrow in the future.

Operating Ratios are designed to assist in the evaluation of management performance. Return on Equity (ROE) measures the percent of profit (before taxes) divided by net worth. While a higher number is generally considered a positive indicator, the analyst is cautioned to consider that a higher return could indicate an under-capitalized (low equity) business. Similar cautions are considered for Return on Assets (ROA). Calculated by dividing profit before taxes by total assets, a higher number is generally better, but could also be distorted if the assets have been heavily depreciated.

Other ratios can be calculated for your business, but some are less applicable to specific industries, such as inventory turnover on a dairy farm. If you need assistance with calculating your key financial ratios or comparing them to industry benchmarks, give us a call at 559-432-2346. We would be happy to provide you with additional information.

Leverage ratios measure a company’s vulnerability to downturns.

Figure B

**Dairy Cattle and Milk Production
Key Financial Ratios – RMA 2003³**

	1999	2000	2001	2002	2003
Liquidity Ratios					
Current Ratio	1.1	1.0	0.9	1.0	0.8
EBIT/Interest	3.6	3.9	1.7	3.2	0.7
Leverage Ratios					
Fixed Assets/Net Worth	1.4	1.3	1.8	1.8	2.3
Total Debt/Net Worth	1.6	1.5	1.9	1.9	2.5
Operating Ratios					
ROE	26.2%	21.7%	7.7%	21.0%	-1.2%
ROA	10.0%	8.7%	2.4%	7.4%	-0.6%
Sales/Total Assets	0.8	0.8	0.7	0.7	0.6

³ Source: RMA 2003 – History for NAICS 112120 Dairy Cattle and Milk Production

INCOME AVERAGING FOR FARMERS

By Patricia R. Pipkin, CPA

That's right! Income averaging is still available for the elite few. As a farmer, taxable income generally varies greatly from year to year. Because of this variation, the applicable tax rate a farmer pays might range from zero to thirty-five percent. The farmer faces the problem of paying more taxes overall if a substantial portion of taxable income is bunched into one year. The United States government allows possible alleviation of this problem through the Internal Revenue Code by allowing farmers to income average over three years. California does not allow income averaging.

An election can be made to average all or part of your taxable "farm income" over three years. If the election is made, the farm income subject to the election is treated as if earned in the three previous years. Therefore, the elected farm income would be allocated in equal amounts to each of the three previous years. A simple example of this follows: taxable income for 2003, 2002, 2001 and 2000 is \$50,000, zero, \$5,000 and \$10,000, respectively. Under the income average method, if the farmer elected to average \$30,000 of his farm income, taxable income would be recomputed at \$20,000, \$10,000, \$15,000 and \$20,000 for 2003, 2002, 2001 and 2000.

What qualifies as farm income? Income derived from the trade or business of farming is farm income. A farming business includes operating a nursery or sod farm and raising or harvesting ornamental trees or trees bearing fruit, nuts, or other crops. Farm income does not include income, gain or loss from the sale of development rights, grazing rights and other similar rights nor does it generally include compensation received as an employee. However, a shareholder of an S corporation or a partner in a partnership engaged in a farming business may generally treat compensation or guaranteed payments from those entities

as farm income. Also included in farm income are income from certain crop-share arrangements and the sale or disposition of property (other than land) regularly used for a substantial period in a farming business. Contract harvesting of an agricultural or horticultural commodity grown or raised by someone else does not constitute farm income.

Who benefits? Farmers who have high farming income in the current year and low income in at least one of the three prior years may benefit from income averaging.

When and how do I make the election? A farmer can elect income averaging by filing Schedule J on a timely filed return, including extensions, for the year in which the election is made. Also, as long as the statute of limitations (i.e., the time for filing a claim for refund) has not expired for that election year, you generally may file an amended return making or changing the election within three years from the date you filed your original return or two years from the date you paid the tax, whichever is later.

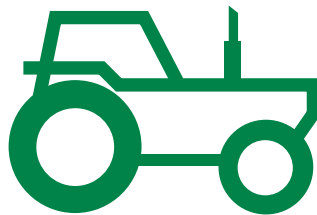
The following items are calculated prior to determining your elected farm income:

- the amount of self-employment tax
- whether, in the aggregate, sales and other dispositions of business property produce long-term capital gain or ordinary loss
- the amount of any net operating loss carryover or net capital loss carryover applied and the amount of any carryover to another year
- the limit on itemized deductions based on adjusted gross income
- the amount of net capital loss or net operating loss in a base year

Farmers who have high farming income in the current year and low income in at least one of three prior years, may benefit from income averaging.

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Careful year-end tax planning will assist you in determining the maximum benefit from income averaging. Sometimes it is beneficial to accelerate farm income into the current year in order to take advantage of the tax rates in the prior three years. There is one potentially major obstacle that must be addressed in determining the portion of farm income you will include in the election of farm income for purposes of income averaging and that is the dreaded alternative minimum tax. Remember that income averaging cannot be utilized in determining your tentative minimum tax. All of the tax implications need to be considered in making an election to income average since the amount allocated as elected farm income could impact the amount of income subject to the alternative minimum tax in the current year or in the base years.



ICE CREAM FACTS

- It takes about 50 licks to eat a single-scoop ice cream cone.
- Vanilla has long been America's favorite ice cream flavor.
- Americans eat about 48 pints of ice cream per person per year, more than people in any other country.
- The ice cream cone was invented at the St. Louis World's Fair 100 years ago.
- California leads the nation in both producing milk and ice cream production. Milk from dairies in the Golden State is used to make about 150 million gallons of ice cream a year.
- One serving of ice cream can contain up to 10 percent of the daily allowance of calcium, vitamin C and vitamin A.
- More ice cream is sold on Sunday than any other day of the week.
- Ninety-eight percent of all U.S. households purchase ice cream
- The biggest ice cream sundae ever made was assembled in Anaheim in 1985. It was 12 feet high and was made with 4,667 gallons of ice cream and 7,000 pounds of topping.



Courtesy of the Dairy Council of California, Dreyer's Grand Ice Cream and U.S. Department of Agriculture.

Source: California Country, July-August 2004

WE'VE MOVED

As of June 1, Baker, Peterson & Franklin moved to our new building in the Palm Bluffs Corporate Center near Palm and Alluvial Avenues in northwest Fresno. This is the fastest-growing commercial development area in Fresno, and BP&F is located on a cul-de-sac near the south edge of the San Joaquin River bluffs.

The building contains 12,744 square feet, and Regency Investment Advisors is located in the rear of the building.

Our new address is 970 W. Alluvial, Suite 101, Fresno 93711. Our phone and fax numbers remain the same.



CALENDAR

- September 12** Ag Boosters' Barbeque, Dennes Coombs' Ranch in Madera. Ticket information (559) 432-2346 or (559) 278-4266.
- October 15** Due date for 2003 individual tax returns including extensions
- October 21** Ag One Fresno-Madera Alumni and Friends Wine Tasting, California State University Fresno Winery. Reservation information (559) 278-4266.
- November 4** 23rd Annual AgriBusiness Management Conference, sponsored by California State University Fresno and Bank of America Corporation. Reservation information (559) 278-4405.
- November 17** Fresno Chamber of Commerce Ag Awards Luncheon honoring the Agriculturalist of the Year and the Baker, Peterson & Franklin Ag Business Award winner. Reservation information (559) 495-4800.

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