

Farm & Ranch Estate Planning: Daddy's Gone, How Do We Move On?

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Fourth Annual Mid-South Agricultural and Environmental Law Conference

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DADDY'S GONE HOW DO WE GO ON?

Preparing for and Carrying on the
Family Farming Operation After Death



- **SCENARIO:**

- Client comes in to draft a will in February. He tells you that he, Son and Daughter farm together as a “partnership.” They have a cattle, tobacco and grain operation. Each operation area is segregated. Dad has the tobacco operation; Son has the cattle operation and Daughter has the grain operation. Each segment of the operation maintains its own equipment, operating money, leases, etc. Or so they think...



- On April 28, Dad has a massive heart attack. Sadly, he passes in early June. The tobacco crop for the year is set. Corn and full season beans are planted. Daughter leaves graveside and contacts Input Supplier, because the wheat crop needs one more application of fungicide. The supplier informs her that its relationship was with Dad. With his passing, the line is frozen and they are cash only from this point forward. Daughter remembers that there is some credit available on the line of credit at the bank. She calls the lender and is told the same thing.



- Daughter and Son have a meeting and discover:
- **ACTUALLY**
- All real property is either owned by Dad or leased in Dad's sole name. Oh, and the leases are all verbal.
- Tobacco contracts are in Dad's name only.
- All the equipment is either leased or owned by Dad.
- All cattle are on Dad's 1040 Schedule F
- Dad is the insured on the crop insurance policies.
- Grain Contracts are in Dad's name.
- H2A workers are under Dad's control
- All FSA certifications and programs are listed in Dad's name.
- **AND...**
- The operating line of credit at the bank and the its loan is in Dad's name only.



- Why and how does this happen?
 - This is a long list, but the following are my Top 5:
 - We've never had a problem before.
 - Dad didn't want the kids to be financially obligated.
 - This is how it worked for my dad.
 - The kids aren't ready for all this.
 - I didn't know/think it would be a problem.



- How do we prevent this from happening?
- **WE PLAN!**
- Review
 - Ask to review the “documents”
 - Leases
 - Partnership Agreements
 - Contracts
 - Tax Returns
 - Loan Documents
 - Explain the documents
 - Work with Client’s other professionals
 - CPA
 - Crop Insurance Agent
 - Lender



- Plan
 - Entity Formation
 - Limited liability company
 - Be mindful of USDA/FSA disaster payment guidelines
 - General Partnership
 - Provisions to Include;
 - Continuation of Entity at Death
 - Death of a Member of an LLC
 - Death of a Partner of a GP
 - Include the Children
 - Leases
 - Written Leases
 - Include successor language
 - Contracts
 - Financing



- Buyout Provisions

- Sale

- In the event a Member desires to sell, the remaining Members shall have an option to purchase the interest of the Selling Member as follows:
 - (A) The Member desiring to sell shall give written notice to the Company that such Member desires to sell his/her interest. The purchase price of the selling Member's interest shall be the fair market value of the real and personal property and investments owned by the Company as of the date of notice of intent to sell his/her interest. Fair market value shall be determined by agreement of the Members. However, if they fail to agree upon such value, the fair market value shall be determined by appraisal wherein the selling Member selects one appraiser and the remaining Members select one appraiser, and the average appraised value of the property shall be used to determine fair market value of the property. All expenses incurred as a result of any exercise of the option and the transfer of the assets shall be shared equally between the selling Member and the Company.

- Buyout Provisions

- Sale (cont.)

- (B) For sixty (60) days from receipt of the written notice of the Member desiring to sell, the Company shall have the option to retire the interest of the Member at the price determined in subpart (A) above.
- (C) If the Company does not retire the interest of the Member then the other Members or any of them shall have the option to acquire such Member's interest at the price determined in subpart (A) above. The Members who exercise this option may acquire such Member's interest in proportion to their respective capital interests unless they agree to a different percentage, within thirty (30) days after the expiration of the Company's option to retire the interest.

- **Death of a Member**

- In the event of the death of any Member, the Company books shall close with respect to that Member as of the date thereof and the remaining Members shall have the option to purchase the deceased Member's interest for a period of sixty (60) days from the date of the death of the deceased Member. In the event the surviving Members exercise this option, payment shall be made as follows:
 - (A) The purchase price of the deceased Member's interest shall be the fair market value of the real and personal property and investments owned by the Company on the date of death. Fair market value shall be determined by agreement of the Members and the deceased Member's personal representative. However, if they fail to agree upon such value, the fair market value shall be determined by appraisal wherein the deceased Member's personal representative selects one appraiser and the remaining Members select one appraiser, and the average appraised value of the property shall be used to determine fair market value of the property. All expenses incurred as a result of any exercise of the option and the transfer of the assets shall be shared equally between the deceased Member's estate and the Company.
 - (B) The purchase price shall be paid pursuant to this agreement.

- **Dissolution**

- The Company shall be dissolved and its affairs wound up, upon the first to occur of the following events (which, unless the majority of the Members agree to continue the business, shall constitute Dissolution Events):

- What happens when our words of advice fall on deaf ears?
 - Make certain someone has a power of attorney for Dad should he become incapacitated.
 - Make certain there is a will in place, which gives the Executor broad powers to manage the farming operation.
 - Make certain your suggestions are in writing to confirm Dad declined to heed your advice.



QUESTIONS?





June 5, 2017

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- JAMIE K. DURRETT *
- JOHN W. CROW
- PAIGE M. LYLE ◊
- COURTNEY L. LUTZ *
- SAMUEL W. SHORT
- JON T. GRAVES

Dear Mr. McClintock,

It has certainly been a pleasure to meet you and discuss your family cattle operation. It is remarkable what an operation you've built. With that being said, I believe it is important that we revisit our discussions over the last several weeks and the succession plan, I've proposed.

It is my understanding that you have only one daughter, Rebecca. You explained to me that she and her husband, Devlin, are actively involved in the operation to the point you consider both of them as partners; however, you continue to maintain control over the day to day operations, feed lot contracts and finances of the business. I also understand that you are somewhat estranged from your wife, Katherine, and you do not want her to take from your estate at your death.

As we discussed, I believe it is important that you have a written partnership agreement with your daughter and son-in-law. Furthermore, it is imperative that this agreement have specific buy-out provisions in the event of a death. We also discussed the need for you to begin to diversify your contracts and include the same as partnership assets, not just an individual asset. The same applies to your financing and the day to day operations of your ranch.

We also discussed why you should start to make these changes. I am concerned that at your death, your operation may be frozen because the contracts are solely in your name as are your bank loans. I have not read your loan documents or your cattle contracts and you couldn't remember if they terminate at your death.

In our last meeting, you advised me that you had never had a problem with your bank or your feed lot and don't see a need to make any changes at this time. You also advised that you did not

- * Of Counsel
- * Also admitted in KY
- ◊ Licensed as a TN Insurance Court rule 31 mediator in the field of general civil mediation
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want to execute a will. Please understand that if we do not take any of the steps we discussed, your assets could be frozen at your death. If the assets are frozen, the operation could be frozen. Also, if we do not execute a will, your wife will take some portion of your estate.

Thank you again for the opportunity to assist you with this matter. Please feel free to contact me if you have any additional questions or concerns.

Very truly yours,
BATSON NOLAN PLC
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REFLECTIONS ON TWENTY-FIVE
YEARS OF BEING A FARM LAWYER

Topics for Presentation

- Federal Taxes to Consider
- Most Common Estate Planning Mistakes
- Most Common Problem for the Farmer's Estate and Estate Plan
- Planning for Client's Imminent Death
- Final Thoughts on Being the Lawyer for the Farmer's Estate

Federal Estate Tax

- \$5,490,000 Applicable Exclusion Amount for 2017
- Portability (any DSUE from a predeceased spouse??)
- Unlimited Marital Deduction (U.S. Citizen)
- 40% rate above Applicable Exclusion

Federal Gift Tax

- \$5,490,000 Lifetime Gift Exclusion in 2017
- 40% rate above Lifetime Exclusion
- Unlimited Marital Deduction for Gifts
- \$14,000 Annual Exclusion for 2017
- Plus DSUE from a predeceased spouse??
- **DON'T FORGET ABOUT DIFFERENCES IN FEDERAL GIFT TAX AND STATE GIFT TAX LAWS**

Generation Skipping Transfer Tax

\$5,490,000 Lifetime GSTT Exclusion in 2017
40% rate above Lifetime Exclusion
Annual Exclusion (for lifetime taxable gifts) does not apply to GSTT
Requires allocation of Exemption on 706

Portability of Exclusion Amount

- Allows a surviving spouse (W) to elect to preserve (unused exclusion amount (DSUE) from deceased spouse (H1)
- Preserved from “last deceased spouse”
- DSUE can be lost with subsequent re-marriage of surviving spouse (W) and then W surviving death of second spouse (H2). W’s DSUE now comes from H2 not H1

Portability of Exclusion Amount

- Warning: Requires timely filed Form 706 for estate of first spouse to die even if estate does not meet filing threshold for 706
- Potential liability if attorney or CPA fails to advise client?
- Recommended for attorney/CPA to advise in writing of availability of Portability and have client sign statement not to file 706

Most Common Estate Planning Mistakes I Have Observed

- Failure to provide sufficient assets to fund credit shelter trust
- Failure to keep estate plan current with tax law changes
- Failure to properly draft QTIP Trust language
- Failure to seek appropriate counsel
- Failure to use appropriate tax clause
- Overuse of LLC’s
- Failure to designate beneficiary for IRA’s
- Case study: Post Mortem Planning: What not to do

Failure to provide sufficient assets to utilize exclusion amount

- The best drafted estate plan is worthless if the decedent has no assets to capture exclusion amount.
- Due diligence requires examination of all client assets to determine legal ownership.
- Re-titling assets and changing beneficiary designations is often more time consuming than drafting the estate plan.

Failure to provide sufficient assets to utilize exclusion amount

- Probate vs. Non-probate assets
- Probate assets consist of individually owned real property and personal property which do not have a separate beneficiary designation. Probate assets generally pass pursuant to the Decedent’s Will
- Non-Probate assets typically pass to a surviving joint owner or designated beneficiary
- Consider disclaimers to realign assets
- Portability can potentially minimize this problem

Failure to properly draft QTIP Trust

- A properly drafted QTIP Trust qualifies for the federal estate tax marital deduction.
- The QTIP Trust must provide that all trust net income will be distributed to surviving spouse for life. Undistributed trust net income at spouse’s death must be distributed to estate.
- No Trustee discretion allowed with respect to income distribution.

Failure to revise estate plan when estate tax laws change

- Consider common estate plan when exclusion amount was \$600K
- Will leaves to children from prior marriage “amount equal to federal estate tax exemption (\$600K when Will was drafted in 1996)
- Excess passes to surviving spouse outright
- In 2017, kids would receive \$5.49M before spouse receives any property
- Wills and Trusts should be reviewed at least every 4-5 years
- Are we responsible to notify client’s of tax law changes? Consider “dis-engagement letter”

Failure to seek appropriate counsel to prepare estate plan

- Most general practice attorneys in rural communities do not understand the federal estate tax laws
- Unfortunately, many attorneys will attempt to prepare an estate plan when they should engage co-counsel
- If a mistake is made, the attorney should have malpractice insurance, but client will have to make a claim against attorney and possibly file a lawsuit for economic damages

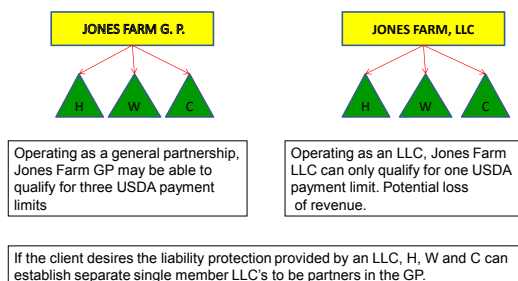
Failure to use proper tax payment clause in Will

- Many Wills use a generic tax clause which says “Pay all death taxes from residuary estate”
- So, the taxes get paid out of the probate estate
- However, the death taxes are calculated based on all assets included in taxable estate, not just probate assets
- Beneficiaries receiving non-probate assets may not have to pay any taxes
- This can potentially wipe out bequests under the Decedent’s Will
- Consider blended families where Decedent has children from prior marriage and new spouse
- If significant assets pass as non-probate assets, better choice may be to use apportionment tax clause

Overuse of LLC’s

- Frequently estate planning attorneys not familiar with agriculture will convince client to form LLC or Corp to carry on farming operation
- LLC is now “operator” for USDA purposes
- LLC or Corp considered one “person” for USDA payment limit purposes
- Joint operation operating as general partnership may qualify for multiple limits

Over Use of LLC’s



Failure to Designate Beneficiary (DB) for IRA

- Naming a spouse as DB allows for rollover and continued tax deferral
- Naming a child may allow the child to withdraw over life expectancy
- Naming Estate as DB requires payout in no more than five years
- Failure to name a DB usually defaults to Estate being DB and five year payout
- Relief may be available if spouse is sole beneficiary of Estate (PLRs 8911006; 9402023; 9351041. Also see “Life and Death Planning for Retirement Benefits,” Third Edition; by Natalie Choate)

Case Study: What Not To Do

- H & W have Wills with basic credit shelter trust and marital deduction language
- H & W have \$1.2 M in assets
- Each spouse had \$600K exclusion amount available
- W dies first
- Attorney and CPA fail to review Deeds
- Turns out all assets held by H & W as JTWROS
- So, all assets pass to H as surviving owner

Case Study: What Not To Do

- W has no assets to fund credit shelter trust
- H now has \$1.2 M in assets and \$600k exemption amount
- Easy solution was for H to disclaim W's ½ interest in jointly owned real estate
- The disclaimed ½ interest then falls into W's estate and can be used to fund credit shelter trust. Problem solved, right?

Case Study: What Not To Do

- Attorney and CPA decide H should transfer all real estate to general partnership (GP) in which Son owns ½. H & W's Trust for H also owns ½ of GP
- H has just made taxable gift to Son
- H dies shortly thereafter
- Forms 706 prepared poorly claiming 2032A discount for W's and H's Estates
- IRS audits Forms 706, reviews deeds, determines neither W's nor H's Estates qualify for 2032A valuation discount; IRS wants \$

Case Study: What Not To Do

- Client forced to make malpractice claim against their first attorney (a friend)
- After 2 years of brief writing and going to IRS Appeals conference, IRS settles for \$30K tax deficiency.
- Attorney's malpractice insurance paid tax deficiency and attorney fees to fix the situation.
- The Rest of the Story

Case Study: What Not To Do

- The initial attorney had three opportunities to fix the situation
- First, attorney should have reviewed client's deeds to discover survivorship provision
- Second, attorney should have advised H to file qualified disclaimer for ½ interest in jointly owned real estate. Reg. §25.2518-2(c)(4)(i)
- Third, even after missing opportunity to file disclaimer, if H had not transferred real estate to GP, H could have avoided entire estate tax liability through use of 2032A valuation discount

Most Common Problem for a Farmer's Estate: Jointly Owned Real Estate

- Dealing with jointly owned real estate
- Will leaves land to children in equal shares
- One child farms and wants to keep the land and buy out siblings; Can not agree on price
- Other children want to auction land
- Partition action pursuant to state law
- Consequences: legal fees, anger, animosity, farmland is sold (a/k/a "LAWYER FUEL")

• Most Common Problem for a Farmer's Estate:
Jointly Owned Real Estate

- Solutions to avoid jointly owned real estate:
- Specific devise of real estate to one child
- Option to purchase in Will
- With multiple parcels, allocate specific parcels of land to each Child as part of equal shares; equalize with cash or life insurance
- Devise land to one child, purchase life insurance for other children (use ILIT?)
- Deed parcel of land to Child with parents reserving life estate (Prevents "Will Contest")
- Include limited powers of appointment in Trusts to provide surviving spouse flexibility to adjust

Another Frequent Problem:
Old C Corp holding appreciated farmland

- Pre 1986, C Corps were great choice for farmers until repeal of General Utilities doctrine (resulted in double taxation on liquidation of C Corp)
- Built In Gains Tax ("BIG Tax"): IRC §1374 adopted to prevent old C Corp from making S election and liquidating appreciated assets without double taxation
- IRC §1374 establishes separate corporate level tax to capture gain on liquidation of appreciated assets soon after S election

Another Frequent Problem:
Old C Corp holding Appreciated Farmland

- Watch out for old E & P still on the books at the time of the S election
- Can result in separate corporate level tax on "excess passive investment income" (IRC § 1375)
- Results in termination of S election if Corp derives more than 25% of gross receipts from passive investment income (farm rent?) for three consecutive taxable years after S election.
- Solution: Dividend (or deemed dividend) to shareholders to clear old E & P off the balance sheet

Most Common Problem for a Farmer's Estate:
Jointly Owned Real Estate

- Problem: Multiple children; none involved in farming operation
- Parents want children want to continue to own farmland and not sell. How to keep farm together?
- Solution: Parents convey farmland to LLC
- Draft LLC operating which requires super majority of members to sell land or amend operating agreement
- Include first right of refusal in operating agreement if any child wants to cash out

Another Frequent Problem:
Old C Corp holding appreciated farmland

- 10* year holding period after S election to avoid BIG Tax (*holding period has been adjusted from time to time by tax legislation)
- Solution: Make S Corp Tax Election ASAP
- Appraise ↓ farmland at time of S Election to minimize exposure to BIG Tax (IRC §1374)
- Appraisal establishes appreciation at time of S election
- Wait out holding period before liquidating assets to avoid BIG Tax

Another Frequent Problem:
Operating Entity Owns all the farmland

- Family operates farm as general partnership
- Parents, children & spouses all general partners (to max out FSA payment limits)
- GP owns all the farmland
- Creates significant income tax and gift tax issues when family members want to enter or exit farming operation
- Solution: Conduct farming operation through GP that owns very few assets. Minimizes tax issues with change of general partners

Planning for Eminent Death

- Terminal Diagnosis for Farmer/Client
- Makes sure Wills, Trusts, POA's & LWD's in effect and updated
- Consider transferring depreciable assets to healthy spouse to obtain stepped up basis at death
- But don't forget about IRC§1014(e). Transfers of appreciated property to decedent within one year of death do not obtain basis adjustment on DOD
- Consider shifting ownership of assets to help qualify for 2032A limitations

Planning for Eminent Death

- Consider growing crops and grain inventory
- If not contracted for sale, "tax basis" for growing crops and grain inventory should adjust to fair market value on date of death [IRC§1014(a)(1).
- If crops already contracted for sale, no basis increased for sale. Considered IRD
- Also, no basis increase for land owner crop share proceeds
- If time allows, don't contract but utilize futures market to protect price points

Consider Crop CRUT for retiring Farmer

- H & W establish CRUT reserving income for lifetime (maybe kids lifetimes?) and designating charitable beneficiaries
- Unsold grain transferred to CRUT and sold by Trustee. Grain must not be contracted for sale prior to transfer to Trust
- Trustee sells grain & re-invests proceeds
- Sale of grain by Trustee not subject to income tax or SEP. H & W obtain current income tax charitable deduction.
- Assets eventually pass to charity and provide estate tax charitable deduction
- But no charitable income tax deduction if crop inputs deducted by H & W
- See PLR 9413020, Rev. Rul. 55-531, Rev. Rul. 55-138

FINAL THOUGHTS ON 25 YEARS OF BEING A FARM LAWYER

- Consider all the tax issues. If you do not have the skill set, bring in someone that does. Establish an Estate Team (attorney, CPA, appraiser, family)
- Communicate with the Team frequently
- Never forget about Basis [IRC§1014(a)(1)
- Insist for client to obtain appraisals for all assets included in gross estate even when federal estate tax is not an issue
- We often create more in tax savings for the client than we charge. Remind client of the value you are providing