Determining the Future of Your Business

Frequent farm and ranch estate-planning mistakes.

by ***Troy Smith***

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Consider the case of the family patriarch who had no intention of dying. The lifelong farmer and rancher, now an octogenarian, held tightly to the reins of a business in which three generations of his family were involved. But the old gentleman had long ignored his own mortality and avoided making plans for passing on the land and other property that remained largely in his name. There was not an estate or succession plan for the business he controlled. He simply didn't plan to die.

When Roger McEowen, Iowa State University (ISU) agricultural law specialist, speaks to rural audiences about farm and ranch succession, the director of ISU's Center for Agricultural Law and Taxation sometimes shares a similar story. His is a true account of a strong-willed grandfather who almost waited too long. In McEowen's story, the man was ill and bedridden by the time he finalized the plan for transferring ownership of his property and determining the future of a multi-million-dollar family operation.

"He died just seven and a half minutes after signing the papers," tells McEowen. "But he saved his heirs one and a half million dollars in estate taxes."

Grandpa took care of business in the nick of time, but McEowen calls such procrastination dangerous. Granted, estate planning isn't much fun. It is important, however, if the principals involved want a say in what happens to their estate. Even if they are cash-poor, many farmers and ranchers own considerable land and other valuable property. Failure to plan could put those assets at risk.

Planning and prioritizing

"Estate planning must be driven by the specific objectives of the parties involved," says McEowen. "Those might include bringing the next generation into the operation. It might provide for financing the business in the future. It might be to provide an exit for the older generation, or transfer assets in a way that's fair to all heirs. Succession, estate and business planning all thread through each other. You must decide what you want to happen afterward, and the objectives must be clearly articulated."

It's often complicated, admits McEowen, because estate planning is unique to the individuals involved. There is no "one size fits all" estate plan. Even after going through the process of developing a plan, revisions may be needed later. Some tweaking to the plan may be necessary, over time, simply because life happens. Objectives may change. Family situations and tax laws change, too, and all of those things could affect an estate plan.

"This is not something you do and then it's done, once and for all," warns McEowen. "It's crazy how often the tax rules change. The original objectives may change, due to divorce or deaths in the family. An estate plan needs to be reviewed routinely, probably every two to three years. It might need a little tweaking, which often can be handled with an amendment."

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The hardest step is the first one — getting started on an estate plan. Putting it off won't make it any easier. And people need to realize, adds McEowen, that developing an estate plan is going to take a little time and money. It's technical stuff, and generally requires professional counsel. Savvy advisors can help their clients avoid or correct mistakes that may be far more costly.

Titling property

So, what are the mistakes most commonly made during estate planning? McEowen says the list is lengthy, but problems frequently arise because of the way property is titled — especially land. This may occur, for example, when ownership of property is not balanced, on a value basis, between husband and wife.

Placing ownership of a portion of a couple's property in the name of one spouse, and another portion in the name of the other spouse can be advantageous to large estates. The spouse first to die is currently allowed to pass on property valued at up to $5.12 million without paying estate tax. The exemption cannot be used if that spouse has no property titled in his or her name.

Keep in mind, however, that the law that set the current exemption amount is due to expire at the end of 2012. The maximum exemption may change when Congress acts on this matter.

Titling property under "joint tenancy with right of survivorship" is a fairly simple way to transfer property, particularly for small estates. According to McEowen, however, having too much property owned in joint tenancy can be a problem for large estates. Under joint tenancy, two or more people may own property together, with each having an undivided interest. When one owner dies, ownership goes to the survivor(s). Therefore, if a couple owns property in joint tenancy, ownership goes to the surviving spouse. Because of the right of survivorship, joint tenancy can simplify administration of the first estate, minimizing probate fees and ensuring that assets pass to the intended person.

"The problem comes in the second estate," says McEowen. "Only half of the joint tenancy property was subject to estate tax at the time of the first spouse's death. All will be subject to tax when the second spouse dies."

McEowen says a title held in joint tenancy must include the language "with right of survivorship." If not, it may be presumed to be another type of co-ownership known

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as "tenancy in common." As tenants in common, each co-owner has an undivided interest, but there is no right of survivorship. When one co-owner dies, that person's interest in the property goes to beneficiaries designated in his or her will. If there is no will, interest is divided among the deceased person's heirs. McEowen says joint tenancy with right of survivorship is more commonly used, but tenancy in common can sometimes be used to good advantage.

"By using tenancy in common, an estate plan can be set up so Dad's share (upon his death) bypasses Mom and goes to the kids, while Mom still has her share," explains McEowen.

In situations like that, it's also advisable to have buy-sell agreements in place. This may help avoid problems that arise when siblings receive farm or ranch land as tenants in common, with one or more siblings wishing to keep the land in an agricultural operation while others want their share as money. In the absence of a pre-arranged buy-sell agreement, siblings preferring cash to land could take partition action and force a sale of the property.

When couples are trying to simplify property transfers, McEowen urges them to remember that it's possible to leave too many assets to a surviving spouse. Arranging for all property to pass to a surviving spouse does avoid estate taxes at the time of the first death, due to the unlimited marital deduction, but it may lead to a burdensome tax obligation at the second death. It may be better to pay some estate taxes, at lower rates, when the first spouse dies.

Regular reviews and updates

Another common mistake is the failure to review and update beneficiary designations. McEowen says a lack of understanding these rules can create huge problems in the transfer of property such as life insurance or IRA accounts. Many farmers and ranchers assume their wills control all transfers. However, these types of assets have beneficiary designations that direct their transfer.

If a life insurance policy is owned by the insured, and is payable to the insured's estate, the proceeds are taxable. If a husband owns a life insurance policy on the wife, and she owns the policy on the husband, the proceeds are not part of the estate. But beneficiary designations do not change automatically when a divorce or death occurs. The owner must keep designations current.

"What happens if you get a divorce and forget to change the ex-spouse to your new spouse? The ex-spouse will inherit the life insurance proceeds if you don't fix it," states McEowen.

The biggest estate-planning mistake may be avoiding the issue and doing nothing, but nearly as big a blunder is preparing an estate plan but failing to review it periodically. Economic, health and family circumstances change and may need to be addressed through revisions in the estate plan. Often, says McEowen, a simple amendment is enough. It's best to work with an experienced financial planner who can help make the necessary modifications.

Plan for liquid assets

Offering one more warning, McEowen advises farmers and ranchers to consider whether their estates include some liquid assets that their heirs may need very badly.

"Farmers are great at creating non-liquid net worth (represented by land, livestock and equipment), but not as good at creating liquid assets to pay estate taxes," says McEowen. "Do you know how much your estate is going to cost your heirs and where the money is coming from? Will it negatively impact the operation? It's something to think about."