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Family Farm

YOUR NEWS FOR LEGAL ISSUES AFFECTING FAMILY FARMS

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PROTECTING THE FARM — HOW THE UNEXPECTED DEATH OF A CHILD PUTS THE FARM AT RISK

Christine H. DeMarea shares an estate planning story illustrating the unfortunate outcome of not having a proper estate planning.

When we talk to clients about protecting the farm, the focus is often directed at the parents. This makes sense since the parents often die first. Unfortunately, in our practice, we have seen a number of tragic situations in which the child, who is essential to the farm operation, dies unexpectedly. (For this reason, attention must also be given to the kids.)

Example: Bill and Mary own a family farm that has been in the family for 3 generations. They are reaching the age of retirement but luckily they have a son, John, who is 40 years old and who has worked on the farm with his dad (Bill) for many years. Everyone wants the farm to remain in the family for future generations. In addition to John, Bill and Mary also have a daughter, Janet. Janet is married but is not involved in the farm. John is married and has a young family. John owns farm property that Bill and Mary have given him over the years. Tragically, John is killed in a car accident. His death creates a tremendous amount of pain and uncertainty in the farm operation. Along with the grief associated with losing their son, Bill and Mary must also deal with other questions:

1. Who is going to operate the farm? Without John, there is no one to step in to carry on the farm operations. Bill and Mary must now figure out how they are going to operate the farm. Their son-in-law wants to be involved but they do not trust him. This has created tremendous stress. There is no one to handle the day-to-day operations. They must now find someone to step in and help. This loss strains the farm operation and as a result Bill and Mary must get a line of credit to help them while they figure out what needs to be done. Without John, creditors and other business partners are unsure about the future of farm. In their twilight years, Bill and Mary must restructure their entire operations.

2. What happens to the farm property John owns? This is a more troubling problem. Unbeknownst to Bill and Mary, John titled the property jointly with his wife. At John's death, his property passes automatically to his wife. Two years after John's death, his widow marries another farmer in town, Bob. Bob has two children from a previous marriage. Bob's family has been eyeing Bill and Mary's farm property for many years. This marriage opens the door to allow Bob's family to get this property. After the marriage, the new husband convinces John's widow (Bob's new wife) to retitle the farm property so that Bob is listed on the deed. If the widow dies suddenly, the farm property would go to the new husband's children – and would not stay in Bill and Mary's family.

3. What happens to John's children, Bill and Mary's grandchildren? Unfortunately, John never established proper estate planning documents. This means the farm property Bill and Mary gifted to him could end up owned by someone outside the family. Bill and Mary's grandchildren could end up receiving none of the farm property Bill and Mary gave John during his lifetime. How could this happen? If John's widow remarries and retitles the gifted farm property so her new husband is named on the deed, the new husband would get the farm property at the widow's death – NOT THE GRANDCHILDREN.

This result could have been avoided by taking the following steps:

- John and his wife should have prepared a trust, will, durable power of attorney and living will. John's trust would have owned the farm property rather than the property passing outright to his wife. This way the property could not pass to his wife's new husband after his death. Instead, it would go to their children.
- A limited liability company (LLC) could have been formed to own John's farm property. The interest could have been held in trust and John's father (Bill) could have been named as the person overseeing the farm operations. The LLC provides creditor protection and establishes a structure to manage the farm operation. This is very important since John's farm operations is part of mom and dad's operations. It was not an operation that could be separated.

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PROTECTING THE FARM – *continued*

- Life insurance should have been purchased on John's life to give the farm liquidity, provide funds to Bill and Mary so they can retire. A second policy should be purchased to provide money for his widow and their children. Because John is young, the cost of the insurance would be small relative to the enormous benefits it gives the farm operations and his family. A second policy would be purchased and owned by his trust to provide an income stream for his widow and their children. It is so important to have the trust own the insurance policy. If John's wife owns the policy and she remarries, there is no guarantee the funds would be there for the children. Even a wonderful mother could be hurt by a new husband's horrible financial situation.

Being single does not solve the problem.

- What if John were single when he tragically dies? If John were single, there would still be problems.
- Liquidity issues. Regardless of whether John is single or married, it is important to have life insurance on John's life to provide liquidity to operate the farm.
- Property could pass to outside the family. If John hasn't executed a proper estate plan, the farm property that John owns at his death would be distributed under the laws of the state (known as intestacy laws). Depending on the state laws and who is alive at his death, John's farm property could pass to his parents and at their death to his sister. This could create problems. If it passes outright to his sister, Janet, her husband could own an interest in the farm property if he divorced his sister.
- There could be estate taxes. The other problem is the loss of John's estate tax exemption to shelter the farm property from estate tax.

> To illustrate, if his parent's net worth is $10,000,000 and John's net worth is $5,000,000, at John's death, the $5,000,000 could be added to his parent's estate increasing it to $15,000,000. At both parent's death, their estate would have a combined federal estate tax exemption of $10,680,000 (for 2014) to shelter part of the farm value of $15,000,000 from estate taxes. The difference of $4,320,000 will be taxed at 40 percent (estate tax rate in 2014) resulting in an estate tax of $1,728,000. By comparison, if John had done proper estate planning, the estate tax would have been $0.

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The LLC provides creditor protection and establishes a structure to manage the farm operation.

IF YOU DON'T HAVE A PROPER ESTATE PLAN, THE GOVERNMENT HAS A PLAN FOR YOU — AND YOU WON'T LIKE IT. *HOW TO SPOIL THE GOVERNMENT'S PLAN.*

By Christine H. DeMarea

Many farmers work their entire lives building their farm operations with the expectation that the farm would pass to their family. However, without writing down your wishes, you lose control over your lifetime efforts and achievements. Instead, you leave important decisions about your assets to state laws, judges and creditors. The consequences or not executing proper documents clearly stating how farm assets are to be handled in the event you become disabled or die means you are in the "Government Plan". The IRS hopes you are in the Government Plan. This means more taxes paid and opportunities lost.

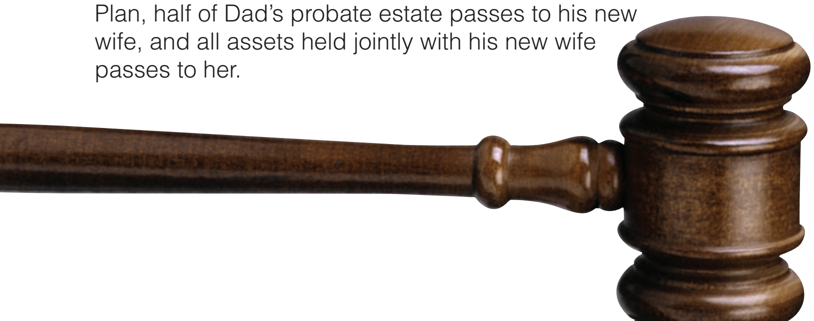
What is a Government Plan?

A Government Plan is essentially any arrangement that requires the use of state laws, probate courts and judges to decide how your property is to be titled and who will receive it should you or someone you love become incapacitated or die. The Government Plan is one that:

- Moves farm assets to individuals or in a way that could be contrary to your wishes.
- Could give assets outright to your children thereby exposing the farm assets to future divorce proceedings.
- Creates uncertainty and delay, and increased costs.

Common example of a Government Plan

Mom and Dad have worked together in the family farm their whole lives. All of the farm property is titled jointly. They have two children also involved in the farm. They have no estate planning documents. As a result ***Mom and Dad are in the Government Plan.*** Mom has a stroke and is unable to care for herself. Dad must go to court to be appointed as her conservator and guardian. In addition to the emotional drain, this process is very expensive and time consuming. After a couple of years, mom dies and now Dad owns the farm property in his name. His intent is for the farm property go to his two children so they can continue to operate the farm. After a couple of years, Dad is lonely and remarries. His new wife has three children. Dad never prepares documents indicating that the farm will pass to his children. When Dad dies, the new wife claims an interest in the farm property. Under the laws of the state, she is entitled to a portion of the farm. Legal action is taken and there are considerable legal fees involved to sort out how the farm will be divided. Under intestate succession rules in the Government Plan, half of Dad's probate estate passes to his new wife, and all assets held jointly with his new wife passes to her.



How to spoil the Government's Plan:

1. Implement your own plan.

If you have a proper estate and farm succession plan, you will spoil the Government's Plan. This plan should include:

- **a.** A trust: You and your spouse should establish trusts that provide how the farm operations will be distributed at your death. It will protect the farm property.
- **b.** Durable power of attorney: This document names a person to act as the agent in the event you become disabled. In our example, if Mom had executed this document, court action involving a conservatorship would not have been needed.
- **c.** Living will / healthcare directives: This would appoint a person to make healthcare decisions for you in the event you become disabled and are not able to make your own decisions.
- **d.** Pour-over wills naming a personal representative for your estate. A pour-over will is used to "pour over" all the assets subject to your will into your living trust after your death.
- **e.** Proper entities to protect your assets. It is extremely important to have farm property held in entities, such as limited liability companies ("LLCs") or limited partnerships ("LPs"). These entities not only protect the land from creditors but also include certain restrictions on ownership and transfers.

2. Title your property properly so the government doesn't need to get involved.

It is common for family farm owners to title property in joint names instead of placing the property in trust or in LLCs / LPs. By titling the property jointly, you are increasing the risk that the farm would be subject to the probate court thereby increasing the cost to administering the estate. In addition, if property is titled jointly, there is also the danger that the property could be retitled so it passes outside the family. Finally, if you own the farm property in your individual name, a creditor could go after the farm. By placing the farm property in an LLC or LP, the farm would be protected from potential liability.

3. Don't create a situation where the government requires you to sell the farm.

Most farm owners spend considerable amount of time and energy accumulating farm property and wealth. As you do this, there comes a time when the focus needs to switch to preserving and protecting this wealth for your enjoyment and that of future generations. Under the Government Plan, you will probably fail to take advantage of tax planning opportunities. You need to have your assets structured properly so to minimize taxes.

Without a proper plan, farm assets will be distributed in accordance with state law. A solid effective estate plan ensures that your family farm will pass in tact to those you intend to receive instead of being siphoned off to pay expenses and taxes. Remember, the less taxes you pay, the more assets are passed to your designated beneficiaries.

TRUST VERSUS LLC — WHY THE FAMILY FARMER NEEDS BOTH

By Christine H. DeMarea

Many farm clients mistakenly believe that because they have a trust they do not need to establish a limited liability company ("LLC"). This is simply not true. The purpose for using an LLC is very different than using a trust. In practice, a family farm should consider both.

The purpose of a trust is to allow the creator (often called the grantor) to specify exactly how he wants his property to be distributed at his/her death. A trust avoids probate because it never dies so if property is transferred to the trust, at the grantor's death, the assets are distributed according to the grantor's wishes. A trust also protects against disability issues. If a grantor becomes disabled, the trust provisions apply and a successor trustee takes over administering the trust. Without a trust, a court would need to establish a guardianship/ conservatorship. A judge would closely supervise all actions taken.

An LLC has a very different purpose. It is a business structure. It provides creditor protection and provides a vehicle to transfer the ownership at a later time to the son /daughter who will take over the family farm operations. The trust will own the LLC. Without an LLC, the trust would own the farm property.

Example without an LLC: Mom and Dad own a family farm and have established a trust. As part of establishing the trust, they transfer the farm property to the trust. They feel very safe because they believe the trust will protect them from creditors and other risks. The farm has several employees. On an unfortunate day, one employee is in an accident during work hours. Several people are killed. The families of the victims eventually file a lawsuit against the employer / family farmer. Because the employee worked for the farmer, the farmer's assets – including the farm property – are now at risk. The employee's family wins the case and a judgment is entered against the Mom and Dad. The farm is their primary asset. To satisfy the judgment, the farm property is forced to be sold.

Example with an LLC: By comparison, Mom and Dad establish an LLC and transfer the farm property to the new LLC. They also establish a trust and transfer ownership of the LLC to the trust. The LLC provides a firewall. The farm is an operating entity and the leases the property of the LLC. The employees work directly for the farmer's operating entity. When the farmer is sued by the victim's family and a judgment is entered against the farmer, the family will not be able to reach the farm because it is owned by the LLC.

Having both an LLC and a trust are important steps in protecting the farm. Each structure serves a very different but essential role in the farm operation.

Attorney Contacts

Christine H. DeMarea, J.D., L.L.M. in Taxation I Kansas City, MO I 816.983.8186 I christine.demarea@huschblackwell.com

Christine is highly regarded in business and estate planning and charitable planned giving. She counsels clients on business succession, estate planning and trust issues and works extensively with family-owned businesses, family farms and tax-exempt organizations, assisting in administrative, legal, tax and compliance matters. Christine specializes in using sophisticated estate planning techniques such as Buy-Sell Agreements, Family Limited Partnerships, Grantor Retained Annuity Trusts, Sale to Intentionally Defective Grantor Trusts and Qualified Personal Residence Trusts. She is a frequent speaker in the area of farm and business succession.

James R. (Bud) Strong, J.D., M.B.A. I St. Louis, MO I 314.480.1636 I bud.strong@huschblackwell.com

Bud is Chair of the firm's Private Wealth Advisory Group. His multistate practice is concentrated in the areas of sophisticated estate planning, business succession planning, estate tax avoidance, trusts and estates, buy-sell agreements, charitable planning, asset protection and corporate law. He has more than 30 years of experience in these areas, as well as prior experience in managing his family's closely held business.