The Illiquidity Problem of Farm and Ranch Estates

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Overview

Concerns about the possibility of a reduction in the federal estate tax exemption is significant in agriculture. If a significant drop in the exemption would impact the farming or ranching business, is there a plan in place to pay the resulting tax? It's a real problem because ag estates are typically illiquid – as you've probably heard it said, ag estates are often "asset rich, but cash poor."

The issue of illiquidity in an ag estate, and some thoughts on what can be done about it – it's the topic of today's post.

The Problem of Illiquidity

Farmers and ranchers engaged in the production of agricultural commodities often face the same estate and succession planning problems that confront all businesses. But there are unique issues that face those engaged in agriculture, and the law often treats farm and ranch businesses differently than it does other business types. In numerous other posts, I have highlighted these differences. Entity structuring can aid in taking advantage of some of those differences. But, those differences often don't provide any relief from a common issues for agricultural estates – that of illiquidity. capital assets, but little cash or assets that are readily convertible into cash. If the federal estate tax exemption falls significantly as current proposed legislation promises to do starting next year, an estate's tax bill could pose a significant burden. That raises a question – has the estate plan been structured in a manner that provides liquidity to pay costs associated with death? Planning for the potential problem of illiquidity at death That means that planning for this potential problem at should be part of the farm and ranch estate plan.

What is at the heart of the liquidity (or the lack thereof) issue? Farming and ranching often involves a substantial investment in farm capital assets (land, buildings, equipment, etc.). It also commonly involves large borrowings that can carry significant interest charges. This is typically coupled with fluctuating income (or loss) from year-to-year because of diverse weather and market conditions. On the positive side, ag land values tend to rise over the long-term, but short-term shocks to the land market do occur and can present timing issues for the estate planner. All of these factors require the use of estate planning strategies that will minimize death taxes and estate administration costs, preserve liquidity of the estate and provide for a systematic and economic disposition (or continuance) of the farm business on the death of the farm owner. In addition, it's important that the estate plan take full advantage of the ag-tailored tax provisions designed to alleviate the tax burdens of farmers.

Illiquidity of the farm or ranch estate makes it difficult for the estate executor to find readily available cash, or assets that are readily convertible to cash, with which to pay monetary legacies (such as the buy-out of an off-farm heir), administration costs, debts, taxes and other estate obligations. Planning to improve the liquidity of the estate before death can prevent losses which might otherwise be incurred through a quick or forced sale of estate assets to meet post-death obligations. It can also avoid the necessity of borrowing funds and can avoid post-death disputes (and possible litigation) among beneficiaries over the sale of assets. Planning can also help minimize the resulting income and capital gain taxes triggered by assets sold to generate funds to pay obligations associated with death.

Pre-Death Liquidity Planning

Where an objective of the estate plan is to preserve as much of the farm business in the hands of the farmer's heirs, proper planning for liquidity can minimize or eliminate the sale of farm assets. Various steps can be taken *during the lifetime* of the farmer or rancher to improve the liquidity of the estate. Some common planning steps include deliberately building up liquid assets; buying life insurance; properly using buy-sell agreements; and utilizing other available techniques to reduce the potential estate tax liability at death.

One approach to liquidity planning is to make a current estimate of existing monetary obligations that the estate is expected to face upon death. Given the current uncertain status of the transfer tax system, the estimate should involve various projections based on anticipated levels of the federal estate tax exemption and applicable rates at death, with those estimates serving as a rough guide to the amount of funds needed in the estate. The plan should be reviewed periodically to account for changes in asset values.

During profitable years, post-tax investments can provide additional liquidity. While farmers and ranchers tend to reinvest any surplus back into farm/ranch capital assets, a liquidity planning strategy might be to invest surplus funds in liquid assets such as interest-bearing bank deposits and marketable stocks and bonds. Likewise, surplus funds could be invested in other agricultural real estate with a potential for appreciation, such as from development, with an eye toward later sale. This could be accomplished without interfering with any objective to keep the original farming operation in-tact for subsequent generations of the farm family.

Life insurance under a policy on the life of the estate owner can provide an appropriate amount of cash for the estate. Those funds can then be used to meet estate obligations upon death. This can substantially improve estate liquidity. But care must be exercised to minimize or eliminate estate tax on the life insurance proceeds. This can be accomplished by properly structuring the ownership of the policy and the beneficiary designation(s).

Where the farm is operated in partnership or corporate form, a buy-sell agreement among partners or stockholders is often a good planning tool. A well-drafted buy-sell agreement with well-defined triggering events that is properly funded (likely with life insurance) can ensure that there will be a buyer for the decedent's ownership interest upon death. Likewise, a buy-sell agreement can ensure that the estate will have liquid funds from the sale of the decedent's interest in the farming/ranching entity.

There are also provisions included in the tax Code that can aid in providing liquidity at death. Special use valuation allows the agricultural land in the estate to be valued at its use value for agricultural purposes rather than fair market value at death. *I.R.C. §2032A*. There are many rules that must be satisfied for the executor of the decedent's estate to make a special use valuation election and reduce the land value in the estate by up to (for 2021) $1,190,000. In addition, the family (knowns as "qualified heirs") must continue to farm the elected land for 10 years (and, possibly, 12 years) after the decedent dies.

Another Code provision allows the decedent's estate to pay federal estate tax in installments over 15 years coupled with a special rule for interest payments. *I.R.C. §6166.* Normally, federal estate tax is due nine months after the date of the decedent's death. But, again, this is a complex provision that requires proper pre-death planning for the estate executor to utilize it.

Conclusion

The possibility of a decline in the federal estate tax exemption raises real concerns about liquidity in an ag estate. While the estate of a farmer or rancher valued at $12 million net worth at death would presently have no federal estate tax bill, for instance, that same estate would likely owe more than $2 million in federal estate tax if the exemption were to drop to $3.5 million as currently proposed. That makes liquidity planning very important to farm and ranch families – particularly those intending on keeping the family business intact for future generations.