

ESTATE PLANNING FOR RANCH OWNERS

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ESTATE PLANNING FOR RANCH OWNERS

I. INITIAL CONSIDERATIONS.

A. Legacy or Recreational Retreat.

One of the threshold questions in planning for a ranch is whether the owner intends for it to be passed on to subsequent generations in perpetuity. While many Texas ranches are multi-generational family legacies, recreational rural properties for high-net-worth individuals are also quite common and may not hold any specific sentimental value for the owner or his or her descendants. In the latter case, the owner may expect the ranch to be liquidated during his or her lifetime or shortly after his or her death.

1. Liquidation.

If liquidation is anticipated, tax efficiency will be one of the most significant considerations in structuring the estate plan for the ranch. Even if the client's estate is not likely to be subject to estate taxes due to the current high estate and gift tax exemptions, consideration should be given to the income tax aspects of liquidation, including the possibility of securing the step-up in basis for the ranch if still owned at death. Due to rapid increases in real estate prices in many parts of Texas, even recently purchased ranches may have a relatively low basis compared to the current market value. For clients who may be exposed to estate taxation, there may be a trade-off between the transfer tax efficiencies of obtaining discounts for gifts of fractional interests in real estate (either directly or through a family entity) and the loss of the step-up at death. However, as discussed in more detail in VI.A., below, if the owner intends to liquidate a ranch during his or her lifetime, liquidation following a gift of ranch interests to an intentionally defective grantor trust (IDGT) can be an efficient method to reduce estate exposure.

Consideration should also be given to the possibility of disputes between beneficiaries as to the appropriate sales price, method of offering the property for sale, and other aspects of liquidation. While many planners generally grant broad discretion regarding sales to the applicable fiduciary and expect that he or she will act in accordance with his or her fiduciary duties to make a reasonable decision regarding these matters, if the ranch is a substantial component of the person's estate, more specific guidance may be warranted. In addition, if there is a known "problem" beneficiary, adding a specific clause exonerating the applicable fiduciary for the exercise of his or her discretion in conducting the sale might be prudent. Further, consider the following:

- Must the ranch be listed publicly, or can the sale be made without listing (for example, to an interested neighbor or family friend)?
- May the ranch be auctioned rather than listed at a set price?
- Must the buyer pay cash (and secure third-party financing if needed) or may the buyer pay partially in cash and partially with a promissory note?
- Must the ranch be sold whole, or may it be parceled out?
- To what extent may the fiduciary expend funds to improve the ranch and ready it for sale?
- If someone is living at the ranch (a tenant, family member, etc.) at the time a sale is contemplated, may he or she continue to reside in the property until it is sold? See V.B. and V.C. for further discussion of considerations when third parties reside at the ranch.

2. Multi-Generational Ownership.

If long-term ownership through multiple generations is anticipated, beneficiary exit options and conflict resolution mechanisms should be given high priority in designing the estate plan. Families may fail to anticipate that the family ranch could become a significant temptation for descendants looking for a large cash windfall. However, as real estate prices rise across Texas, so does the tension between those who see family ranches as sources of identity and family legacy and those who desire access to the monetary value of the land. Even if all members of the next generation are equally interested in owning the ranch at the time the plan is created, it is still important to consider the possibility that unanticipated disagreements might arise among them or that members of subsequent generations might want to exit the ownership arrangement. Accordingly, the planner should talk through options for exit strategies with the client regardless of whether an immediate need is expected. Some examples of exit strategies are discussed at IV., below. Cash flow management (discussed at I.B., below) should also be given careful consideration, particularly if the ranch is a significant component of the overall estate.

3. Cemeteries on Private Property.

If the ranch has been in the family for multiple generations and/or if it is intended to stay in the family, it is worth inquiring whether the family has or intends to establish a private cemetery on the ranch. The Texas Cemeteries & Crematories Association publishes an informative handout regarding the topic and applicable laws, which can be accessed for free on its website : <https://www.txcca.us>. The topic is also explored in detail in "Oh Bury Me (Not) On the Lone Prairie: Establishing Family Cemeteries on Texas Farms and

Ranches” by Doug Jordan, May, 2010, Texas Bar Journal.

B. Liquidity and Cash Flow.

Regardless of the size of the overall estate, a critical question in planning for a ranch is whether it produces sufficient income to meet its expenses (such as property taxes and the maintenance and repair expenses) as they arise. Even if the ranch is income producing, is not uncommon for ranch owners to depend on other sources of income to meet the ranch’s cash flow needs. If other sources of income may be required from time to time, the estate plan should be structured to take this need into account, particularly if the owner intends for the ranch to be passed down to subsequent generations rather than liquidated immediately at death.

1. Capital Calls for Ranch in FLP or LLC.

It is common for ranches to be held in a family limited partnership (FLP) or limited liability company (LLC). Consideration should be given to whether the governing document of the entity should allow discretionary capital calls to meet ranch expenses. Permitting capital calls may produce fair results if all owners have roughly equal financial situations and all desire to retain ownership of the ranch. In other circumstances, they may lead to inequitable results and conflict. For example, if one of the owners does not wish to retain ownership but is prohibited from liquidating his or her interest due to the transfer restrictions in the governing document (which is quite common in family entities), a mandatory capital call could appear quite unfair. Discretionary capital call provisions also have some potential for abuse in the event the governing persons wish to squeeze out a financially disadvantaged minority owner. If capital calls are permitted, the provisions should be carefully drafted to address the consequences of default. The Texas Business Organizations Code provides a list of potential consequences of default that can be included in the company agreement of an LLC; for example, the company agreement may provide that a defaulting member's ownership interest is reduced, subject to a forced redemption or sale, or the member may be made subject to other penalties or consequences. Tex. Bus. Orgs. Code Ann. § 101.153(b). In the family context, it may be appropriate to provide that in the event an owner defaults on a contribution obligation, the other owners have the right (but not the obligation) to cover the defaulted amount and adjust the ownership percentages accordingly. In such event, consider providing expressly that the reduction of the defaulting owner’s percentage is the sole consequence of default (and prohibit the entity and other owners from seeking specific performance and/or damages in addition to the reduction in ownership).

2. Oil & Gas and Other Energy Revenue.

It is very common in parts of Texas for ranch owners to utilize oil and gas income as a key source of liquidity to meet ranch expenses. The planner should be cognizant of this issue if the estate plan separates the ownership of the surface from the ownership of the minerals in either the disposition of the estate or in the family’s entity structure (for example, if one FLP owns the surface and one FLP owns the minerals). For some ranches, solar or wind leases may also be a significant source of revenue, and both the income and obligations under such leases should be taken into consideration in planning for the ranch. The negotiation of solar leases and their potential impact on ranch owners is covered in detail in “Drafting Solar Leases from the Landowner Perspective: Negotiation of Key Provisions,” by F. Parks Brown, 2020 State Bar of Texas Advanced Real Estate Drafting Course.

3. Liquidity for Ranch in Trust.

If the ranch will be left in trust, the planner should consider whether the trust will be funded with sufficient liquid assets to maintain the ranch indefinitely. Even in non-taxable estates, it is generally unwise for a beneficiary to make contributions to a trust for his or her own benefit. Doing so diminishes the creditor protection and marital property protection benefits of the trust. It can also significantly complicate the income taxation of the trust (causing a portion of the trust to be taxed under the normal trust rules and the portion attributable to a beneficiary to be taxed under the grantor trust rules). Accordingly, while there are potentially reasonable methods for a beneficiary to add liquidity to a trust (for example through loans or purchases of trust assets), it is unwise to plan on future liquidity routinely coming from the beneficiaries while the ranch is held in trust. If there will be insufficient liquidity in the trust to maintain the ranch, the Trustee should be given the flexibility to sell some or all of the ranch. If the grantor of the trust wishes the ranch to remain in the family, the trust could provide that certain beneficiaries will have a right of first refusal or option to purchase if a sale is contemplated. If a sale to a beneficiary (or to the Trustee) is possible, the trust instrument should specifically address the potential conflict of interest and self-dealing; in addition, specific guidance on the sales price and terms of any sale to a related party would be advisable to protect both the beneficiaries and the Trustee. Even if a sale to a related party is authorized by the trust agreement and the sale price is objectively reasonable, related party transactions can give the appearance of impropriety and lead to litigation.

C. Property Taxes.

Detailed analysis of the property tax rules applicable to rural landowners is outside the scope of this paper. However, a basic understanding of relevant

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First appeared as part of the conference materials for the
2023 Stanley M. Johanson Estate Planning Workshop session
"Estate Planning for Ranch Owners"