Evaluating Your Estate Plan: Farm Transfer Strategies

Many families spend years accumulating wealth and are interested in keeping another generation on the farm. However, not all farms will or should be transferred to the next generation. Many farms are not large enough or the next generation may not be interested in being in agriculture. Some children may be interested in farming as a part-time occupation. Other families may look outside their own family for non-related parties to bring into the farming operation. Some families will retain ownership of the land, following the parents' deaths, as an investment.

Building a Management Team

The first step towards a successful business transfer is to build a management team. Team is the key word. Over time, it needs to be a team decision. Early on many of the decisions may be made by the older party. Ultimately, the younger party may make most of the decisions. The older party should focus on improving the management skills of the younger party. The training should cover all parts of the business so they gain an understanding of how all components of the business fit together.

The next key phrase is open communication. Everyone needs to feel that their ideas and opinions are respected. All involved parties are encouraged to speak up. There also needs to be a strategy for dealing with conflict or differences of opinions as well as regular performance evaluations that highlight both strengths and weaknesses in the business and relationships.

The parties have to work together. They also may need to have other players on the team such as insurance agents, accountants, legal experts and others. Better record keeping may help facilitate better team work.

Transfer Strategies

To increase the ease of transferring, several critical issues should be addressed in the succession plan.

These critical issues are the:
- transfer of labor
- transfer of management
- transfer of assets
- identification and management of possible risks or barriers

These issues tie in with potential areas of conflict that should be addressed in the business plan. The first area of concern is "Hierarchy of Control." Who will be in control of the decision making process? How will decisions be made? In a farm business, the older generation may not be willing to give up control. Often the first area the older generation is willing to give up is labor. The business plan should outline a timeline for the transfer of management as well. It should also address the topic of the transfer of assets and the process for doing that. Which assets first? What are the barriers and how might they be dealt with?

Another area is "Stability versus Growth." If we are going to have more people living off of the current farm operation, is it large enough to provide the needed income? If it isn't, how will this issue be addressed? If the operation is in a growth mode it may have reduced available cash for distributions for living expenses.

The "Business Life Cycle" for a typical business is an initial shortage of capital and profits matched with an abundance of labor. Over

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time the business builds up capital and management. Eventually the owners want to start taking capital out for retirement and reducing labor contributions. By bringing in new people we can restart the business cycle before it peaks and build upon the capital and management already in place.

Another area the transition plan should address is the issue of "Personal versus Business Goals." This relates to the issue of where the capital gets allocated as well as individuals' time and management. Small businesses often have goals besides maximizing profits. Do we shut the combine down to go to a son or grandson's football game? Do we remodel the kitchen or do we put money into new farm equipment?

Another area to be addressed is the "Lack of Formality" that is often a part of ag businesses. Are we going to have a formal business structure such as a Limited Liability Company or are we going to be more informal? Do we develop an in-depth operating agreement that lays some of these things out?

Transfer of Labor and Fair Compensation

Often the younger party only brings labor to the ongoing business. However, along with this labor they bring new ideas and reason to continue and grow the business. They may also bring skill sets that are currently lacking in the business such that fair compensation is sometimes difficult to assess. There are surveys for general compensation information, and it is vital to pay today what each party deserves today. Statements like "someday this will all be yours" or "if you stick with me in the tough times I will take care of you someday" should be approached with caution. Look for ways to compensate people today; perhaps with an equity position in the business.

Usually, the older generation is looking to reduce the amount of labor they contribute. The business plan should give some indication for the time frame and the level of reduction of labor. It should also give some indication as to the labor requirements for the younger party.

Transfer of Management

The issue of who controls the management can be a barrier to successful transitioning. This can also be an issue for spouses or siblings depending on the business structure and how it has operated in the past. Young people bring new ideas to the business and often would like to try to implement them as quickly as possible. Often they require additional capital to implement.

The older party may have a different view of what retirement is compared to others. Retirement to some means slowing down, doing the things one likes to do, and taking off time when one likes. For others retirement means that one is not involved in any of the management or daily operations. Many farmers are somewhere in between. With today's technology one is able to farm much longer than past generations and as life expectancies have increased some farmers have farmed into their 80s or even 90s.

If we are to be successful in transitioning the business there has to be a plan to transition management. By the third year the younger party should be involved in management in some form. It may be they are responsible for all of a small area or they are part of the decision making process for the total operation. In grain farming it may be easy to have the younger party farm his own piece of land that he rents from the older party. This will give them some experience in financing, buying inputs, machinery expenses, and marketing.

The speed at which management is transferred and the level of which it is transferred is based on many factors. It must happen and the older party should actively push to make it happen.

Transfer of Assets

At some point the transfer of assets will need to occur. How fast and which assets are based on many of the things already discussed. The method for transferring will also be impacted by the type of business structure.

The control of machinery is often transferred by lease or by sale. Related parties may also involve gifts. In the very early stages the older party may trade the value of machinery for the value of labor. Or they may rent machinery to the younger party on a "per acre per trip" basis at a rate that covers repairs and depreciation.

Another method is the "buy and trade" where the older party sells a piece of equipment to the younger party and then the younger party trades it in on a new piece of equipment that the younger party owns. This allows for the sale of the equipment to be stretched out over time and the younger party to stretch out the time to purchase a line of equipment.

Another strategy is the "trade and buy back" where the older would like to buy more equipment but doesn't want to lose use of a piece of equipment. For example, the older farmer wants to buy a new tractor, and also would like to sell the old tractor to the younger party. The older party trades in the tractor on the new one and then the younger party buys the old one back from the dealer.

Sometimes the older party will want to sell all of his equipment on contract. The problem with this is that all of the depreciation is recaptured in the year of sale and if sold to a related party the capital gains is taxable in the year of sale. You will also see the older party lease the equipment in five or seven equal payments with ownership being transferred to the younger party after they make the final payment. This would be a disguised sales contract subject to recapture as well.

Another method is to lease the equipment with the valuation adjusted each year and the payment based on a capitalization rate and the buyout based off of market value. Consult with your tax person before entering into any agreements.

The transfer of livestock can be at an inventory time such as the start of the fiscal year or when the inventory is lowest. It could involve the sale of the finishing livestock or just the breeding livestock or both. The older party might sell part or the entire breeding herd to the younger party.

If you sell part of the breeding herd and jointly own livestock you need to realize that you may now look like a partnership with the associated benefits and liabilities.

The sale of land to a younger party is usually very limited because of the capital requirements and the younger party can normally get higher returns from other types of assets. However, there are some beginning farmer programs to encourage and assist in purchasing land.

Leasing land is covered at the end of this publication and may be a more viable strategy. There may be beginning farmer tax credit programs to provide incentives to lease to beginning farmers.

Transfers by gifts or by will are covered in another publication.

Business Structures

There are two common models for setting up the new business to bring in another party. One is the "Super Firm"; the other is the "Separate but Share." A variation of this is the "Spin Off" where they start out together as a super firm but spin off the new business at some point.

With the super firm the younger party usually starts off as an employee of the business. As time goes on he may invest his own capital in the firm and he becomes more involved in the management. Eventually he may take over management of the super firm and acquire some or all of the assets of the firm.

A variation of this is when at some point in time the younger party takes their capital out of the super firm and creates his own firm. This may come as the result of a conflict, but there are several other reasons to do this.

With the "separate but shared" approach the younger party starts his own firm. They may lease equipment or land from each other, share in the purchasing of equipment or inputs to attain economies of scale, jointly market grain and trade labor. Each operation stands on its own merits. They do not operate as a partnership. They operate as sole proprietors.

A partnership is when two or more persons share in ownership (not necessarily equally) in the operating of a business. Partnerships end at the retirement, sale or death of one of the partners which often limits the use for transitioning.

More common for "Super Firms" would be the use of C corporations, S Corporations or Limited Liability Companies. You will also find these used in combination with sole proprietors or in combination with each other. It is also more common to see Family Limited Partnerships being used for estate tax planning.

These entities have shares or units of ownership which can be sold, gifted or inherited or transferred as compensation for management provided.

Risks or Barriers

In transferring a business there are many areas where problems could occur. It could be as basic as communication. It could be an untimely disability or death. It could be a period of low or negative profits. Your transfer plan needs to identify as many of these as possible and develop possible strategies to deal with them. That might include insurance, buy-sell agreements, operating agreements, first right of refusal on offers to rent or sell. It could also involve the use of trusts to maintain control of assets after the death of a key person.

There are situations where transferring the farm business will not be feasible. Other options such as liquidation or leasing may then come into play.

Liquidation

Some farms will be liquidated during the current owners' life. Parents may want to maintain or improve their standard of living and they may not have other resources. As people live longer, inflation and health care costs may result in the need to generate more income than the land might provide.

In this situation managing income taxes and investing the additional capital generated become the focus. Deductions for health care costs may offset some of the tax liability. Selling land on contract will allow you to stretch out capital gains taxes. Keep in mind that capital gains from contracts are treated as "income in respect of decedent," for income tax purposes if you die before the contract is paid off. You also have to evaluate what future tax brackets you might be in, how long you might live, and the current as well as future estate tax laws.

In some situations, family members may want to buy the land. There are special tax rules for sales to family members. Review IRS Publication 537 "Installment Sales." Sales below fair market value or sales with discounted interest rates may involve gift tax issues.

Keep in mind that there are special rules for the sale of your home. If you decide to sell off the acreage and move, you will find very favorable tax laws relating to the sale of the home.

Leasing Land

Much of the land is leased out when farmers retire if there isn't a plan to continue the business. Sometimes this isn't a total stoppage but more of a transition. It may include the selling of the livestock, a shift to some custom farming, or renting out a portion of owned land.

Generally, when you shift to a rental arrangement you are no longer subject to FICA taxes on the income if you do not meet the "material participation rules." You can have a crop share lease and not be materially participating. In recent years there has been more of a trend toward cash rent leases. Some of these do involve a bonus or flex payment based on yield, price or more commonly both price and yield.

Retaining ownership until death allows the heirs to receive a "step up" in basis at the death of the owner, often eliminating a significant amount of capital gains tax.

For larger estates, qualifying for "special use valuation" may be a useful way to reduce federal estate taxes. To qualify you must look at the use of the land before retirement, after retirement and ten years after death.

Resources

IRS Publication 537 Installment Sales - www.irs.gov/publications/p537/ar02.html#en_US_2010_publink1000221591

Material Participation - www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Chapter-4-Material-Participation

Special Use Valuation - http://www.irs.gov/instructions/i706/ch02.html#d0e1826

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Transferring Business Ownership - www.extension.iastate.edu/agdm/wholefarm/html/c4-14.html

The Farm Business Transfer Process - www.extension.iastate.edu/agdm/wholefarm/html/c4-13.html

Dividing Business Income - www.extension.iastate.edu/agdm/wholefarm/html/c4-16.html

Transferring the Farm-University of Minnesota Extension - www.cffm.umn.edu/publications/pubs/farmmgttopics/transferringthefarmseries.pdf

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USDA United States Department of Agriculture National Institute of Food and Agriculture

North Central Risk Management Education Center

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Prepared by Kelvin Leibold
farm and business management specialist
kleibold@iastate.edu, 641-648-4850