

Preparing to Transfer the Farm Business

Agricultural Business Management

Gary A. Hachfeld, David B. Bau, & C. Robert Holcomb, Extension Educators

Introduction:

Transferring the farm business to the next generation is seldom an abrupt process. The transition generally takes place over a number of years. The entering generation needs to establish a firm financial footing as well as learning to manage the business. The retiring generation has to be willing to turn over control of the business and trust that the successor will do well.

Farming is a capital intensive business. Farms are made up of several classes of assets. Current assets include stored and growing crops as well as feed inventories. Intermediate assets include breeding and market livestock, machinery, and equipment. Farmland and buildings make up the long-term assets. The total of all these assets can equal millions of dollars.

The transition process must be well thought out and implemented prudently, given the potential financial consequences to all involved. The following information will help you with this process.

Factors to Consider Before Transferring the Farm Business:

Your Financial Security in Retirement:

Complete a projection of your anticipated income and living expenses during retirement. Will you and your spouse have sufficient annual income to get you through the retirement years? Have you made provisions for higher than normal medical expenses or long-term health care expenses? Remember, people are living longer and this requires more financial planning.

Financial Position of the Entering Generation:

Give serious thought and planning to the financial position of the entering generation. Do they have some equity to put into the farm business? Can they afford the payments to you and to other creditors? Will they have a business of sufficient size and efficiency to generate an adequate living? If the answer to these questions is "no", you may want to delay transitioning the business. The entering generation needs to improve their financial position or you need to plan on making major concessions to get them started in the business.

You're Social Security (SS) Position:

Every individual is different regarding their SS contributions and status. Changes in SS rules may affect your plan to exit from the farm business. Contact your local social security office about your contributions and benefits before making any decisions about when to retire or how to sell or transfer the farm business assets.

Your Willingness to Let Go:

Transferring assets and management of the farm to someone else means you no longer will be in control of the farm business. If you cannot let go or stand to see someone else in the decision making role, do not retire until you can accept this change in your role.

Your Emotional Readiness to Transition the Farm:

If the farm has been the major focus of your whole life and you have spent nearly every day building and working on this farm - expect some challenges. Leaving the farm under these circumstances should be planned for well in advance.

If you can view the following statements positively you may be ready to leave farming.

"I have plenty of ways to use my time after I retire. I can golf, fish, travel, socialize and finally get at some of my hobbies."

"I can continue to feel fulfilled as a contributing human being by volunteering or helping my children after I retire."

"Although we will do many things together, I plan to let my spouse have her/his own space. I will establish my own friends and time independently of hers/his at times."

"I am willing to move off the farm and out of my home, so that the younger family can work and live at the center of the farm business."

You're Health:

Transferring your farm business to someone else can afford you time to do the things you have always wanted to do. Retiring early while your health is good may give you more time to travel, pursue hobbies, spend more time with family, etc.

Successful retirees are usually committed to good physical and mental health. They eat right, exercise regularly and keep mentally fit by reading, thinking and conversing. Are you ready to do the same?

Key Questions You Need To Ask Yourself:

Transferring the farm to the next generation is a complex and serious undertaking. If not done properly, there can be serious financial and family relationship consequences.

Answer the following questions honestly before you start the transition process:

1. Is the farm, in its current format, generating enough income to support an additional family?
2. If not, are there farm income expansion possibilities or viable off-farm income possibilities available to support the entering family?
3. Is there a way to transfer the farm and keep everyone in the family happy? That includes exiting and entering families as well as non-farm heirs and in-laws.
4. Can the parents afford to give some financial assistance to the entering family while still maintaining an adequate retirement income?
5. Is the exiting manager willing to transition management skills and management decisions to the entering manager?
6. Have the parties involved in the transition had a positive, respectful and considerate attitude toward one another in the years before entering a transfer agreement?
7. Does the entering manager have the ability, desire and willingness to teach the farm management skills needed to manage a high risk, low margin, highly competitive business?
8. Can the involved parties communicate openly and freely with one another?
9. Are all parties involved, willing to develop a written plan of transition and a business agreement prior to starting the transition process?
10. Are housing facilities available which will provide acceptable, yet independent lives for each family involved?
11. Are all participants, including spouses, willing to be involved in decision making regarding work tasks, hours, vacation, finances, and family expectations?
12. Are all parties willing to start with a trial period of working together, through a wage agreement or farming independently while sharing resources, for a year or two before starting a formal arrangement?
13. Are the parents willing to provide security to the entering parties by agreeing to a buy/sell agreement and allowing the entering party the right to purchase assets in the future? The agreement should be binding on other heirs.
14. Are the parents willing to sell, lease, gift or otherwise transfer assets to the entering party at perhaps less than current market values?
15. Are the parents not only willing to transfer farm assets but are they willing to transfer management of those assets to the entering generation?
16. Are the parents willing to eventually move to town or to a residence off the farm to allow the new manager to be nearer the center of farm operations?
17. Can and will both parties put together a tax plan which will be acceptable to everyone as they transfer assets?
18. Are the parents insurable and will they permit the younger generation to carry life insurance on them for financial protection in case of premature death?
19. Are all parties willing to provide protection from premature pay out to off-farm heirs by establishing purchase options with installment terms for sale of assets in their Will or trust?
20. Are all parties willing to pledge that they will not try to control any aspect of the other parties' business and personal lives?
21. Are entering children willing to pay parents adequately for work done on the farm after retirement?
22. Are entering parties willing to sacrifice standard of living and go the "extra mile" with work to get started farming?
23. Are entering parties appreciative of the farming opportunity given to them by their parents? Are they willing to "give and take" to make the transfer process successful?
24. Do the entrants wish to farm because they have prepared for it educationally and feel it is their chosen field? This is in contrast to those who enter farming because they can't find anything else to do, or nothing else worked out, or it is an expectation of their parents.
25. Do the entering parties have a realistic grasp of current agriculture and what it takes to put together a profitable, competitive business?

If you can answer "Yes" to nearly all of these questions, you have a good chance for a successful transition of the farm. If you answered "No" to a few of the questions, you may want to evaluate the situation before you proceed.

Establishing Goals:

Essential to the business transfer process is the establishment of individual, family, business, and retirement goals. These goals guide the transfer process and help validate decisions that are made. Without being clear and firm about these goals, the transfer process will not succeed.

When developing your goals, think about all the issues listed earlier in this document - parent's willingness to turn over control and management of the business, the ability of the business to support multiple generations, the ability of the entering generation to manage the business, etc.

Think of goals as being what you want to have happen to your business and personal assets or perhaps more importantly what you do not want to have happen to your business and personal assets.

Goals need to be in writing in order to bring life and meaning to them. Research supports the fact that if goals are in writing, the probability of achieving them increases by 1,100 percent.

Goals should list specific actions and specific results of those actions. Goals need to have a timeline. Goals need to be attainable and realistic while also being flexible.

To help begin this process, think about the following questions:

- 1-What do you want from or for your farm or ranch business?
- 2- What do you **not** want from or for your farm or ranch business?
- 3-What do you want for your family?
- 4- What do you **not** want for your family?
- 5-What do you want for yourself?
- 6- What do you **not** want for yourself?
- 7-What do you want in your retirement?
- 8- What do you **not** want in your retirement?

One approach to establishing goals is to utilize a three step process outlined below:

Step #1: Each person involved in the business should list their individual short-term goals (3 years or less) and their long-term goals (4 years or more) for three areas. The three areas include your individual or personal goals (what do you want for yourself), family goals, and business/career goals (entering generation) or retirement goals (retiring generation). This process is done as an individual, by you, with no one else involved.

Step #2: Each generation (retiring generation alone and entering generation alone) comes together and using their individual goals list, prioritize those goals onto one list for their generation, within the three areas (individual, family, business/career or retirement goals).

Step #3: Both generations involved in the business come together and using their Step #2 lists, prioritize their goals under the three areas – individual, family, and business/career-retirement goals. To help with this final process, there are a few questions that may be useful. Those questions are:

- 1-Which goals are most important for family well- being, business success, and or retirement success?
- 2-Which short-term goals, if attained, would help us achieve our long-term goals?
- 3-Which short-term goals conflict with or may impede our long-term goals?

- 4-Which goals are so important that they should be attained even if it prevents us from reaching other goals?

Once your final list of priority goals is established, it becomes your road map for the transfer process. This list of goals becomes the foundation for your written business transfer and personal estate plan. It should include all the things you want to have happen to your personal and business assets, while alive and after your death. It should also include what you **do not** want to have happen to your personal and business assets, while you are alive and after your death. Each action you take, each decision you make, you do so based upon your list of goals. Check it every time you make a decision. Does your decision help to fulfill your goals or does your decision violate your goals.

Once this list of goals is complete, take it to your transition and personal estate planning team of professionals (attorney, accountant, financial planner, banker, insurance agent, etc.). Their responsibility is to put into place what it is you want, based upon the list of goals. These actions, on your part, will complete the development and implementation of your business transfer and personal estate plan.

HINT: There are many things to think about in the business transition and personal estate planning process. The key to success is to develop your goals list, call and make an appointment with an attorney and then use that list with your transition and estate planning team. **DO NOT** get involved in thinking about all the stuff there is to think about in the transition and estate planning process: Do I need a Will or a trust? Do I need a partnership or LLC? How do I prevent assets from being lost to divorce? Do not focus on putting all the pieces together - that is the responsibility of your transition estate planning team. Focusing on how to solve all these issues will confuse, frustrate and eventually paralyze you and prevent you from moving forward. All that stuff is nice to know information. Being familiar with the terms when your team talks about them is great. However, your responsibility and task in the process is to complete your goals list - period! It is the responsibility of your team to put your goals into action and address all those other questions and concerns you have.

For more information, see *Transferring the Farm Series #9-Preparing to Meet With Your Transition & Estate Planning Team*.

Caution: This publication is offered as educational information. It does **not** offer legal advice. If you have questions on this information, contact an attorney.

Farm Business Transfer Strategies

Agricultural Business Management

Gary A. Hachfeld, David B. Bau, & C. Robert Holcomb, Extension Educators

Introduction:

Transferring the farm business from one generation to the next can take several years. This is due, in part, to the large amount of capital involved. However, this time of transfer can also be used to share knowledge, shift responsibilities for management of the business, and become a trial period for the entering generation.

During this initial beginning period, parents can step back a bit from the farm business. The generation taking over can determine if farming is really what they want to do as a career.

For two generations to farm together or implement a transfer of the farm business there are several considerations. Those items are outlined in this information piece.

Communications:

In any joint operation it is vital that good communications exist between all parties. Cultivating good communications throughout the initiation, implementation and completion stages of a transfer is highly desired. Loss of communication leads to lack of trust and can eventually lead to devastating consequences.

Good communication in family farming arrangements is a vital link in the success of the farming business. Here are some suggestions to improve communications:

- When speaking, be brief and be specific.
- Don't accuse, insult or blame.
- Don't label, moralize or judge your business associates.
- Try to be positive, constructive and willing to compromise.
- When listening, listen intently. Focus and try to understand what is being said. Try to interpret it as the speaker intended.
- Disregard negative statements. Paraphrase what you hear. Find points of agreement and state them.
- Explain your motives honestly and truthfully. Apologize when needed and admit your mistakes.

Implementing these suggestions is not a simple task but can greatly improve communications and avoid unintended, negative consequences.

Sole Proprietorships:

Farming Together - A Trial Period: This may be the best way to begin testing compatibility and commitment. With this approach, parents would hire the aspiring entering generation on a simple wage or incentive plan for a year or two.

During this period, serious consideration should be given to the entering generation's ability to contribute to the business and its management, to personal compatibility and to the skill level of participants. It is also a great opportunity for the retiring generation to assess if they are truly ready and willing to give up control and management of the business. This period should give both parties the ability to assess the farm situation and withdraw, if necessary, before becoming involved in a complicated joint operating agreement.

Farming Together but Apart: Farming together but still maintaining a separate entity may be another approach. This may provide a good training ground for a young farm operator. Instead of organizing a complex business structure, farming together but separately may be an option to consider. An entering son/daughter might rent some additional land. He/she might use the parent's machinery in exchange for labor being contributed to the parent's farm business. The son/daughter may or may not pay for their fuel and repairs depending on the agreement. Perhaps they can also rent existing livestock facilities from a neighbor. In any case, they should take over the total management of their enterprises. Management includes establishing a business account and records system, developing a credit relationship with a lender, ordering and making decisions on inputs and procedures, and taking total charge of marketing decisions. As time progresses, the son/daughter can eventually take over more of the crop land or livestock enterprises.

As machinery needs replacement, the son/daughter should begin to purchase the new items as they can. Eventually, the parents may purchase no new machinery as they approach retirement. This method provides a way for a son/daughter to buy the machinery gradually and for the parents to phase out of the farm business.

This method avoids the problems associated with the joint decision-making required in most complex

business arrangements. It also gives the younger generation pride in ownership and the incentive for gain.

Multi-Owner/Joint Ventures: Multi-owner operations can get very complicated and can end in chaos. Many farmers begin the transfer process by bringing in a son or daughter. They purchase assets together and own some individually. Later another son or daughter may come into the business. Invariably they end up with a record keeping nightmare with many different ownership levels: some assets owned 50-50-0; some 33-33-33; others are 0-50-50 or 100-0-0 or some other percentage mix.

In most cases, where there is multiple ownership with more than two individuals involved, some other business structure may be a best.

Partnerships and Corporations:

The huge challenge for sole proprietorship has to deal with many individual, specific assets during the transfer process. One solution to this is to form a business entity for the purposes of business transfer. In forming a partnership or corporation, you issue ownership units or shares which can be easily sold, gifted, or passed through your estate as a means of transferring the assets. This eliminates the need for transferring specific assets such as machinery or land. You effectively transfer those assets over time through the transfer of the ownership units or shares rather than specific assets.

Forming another business entity should not be done without thorough investigation of the ramifications. These entities are complex and require legal and tax advice. For more specific information see *Transferring the Farm Series #3-Utilizing Partnerships and Corporations to Transfer Farm Assets*.

When establishing another ownership entity, the entity must establish its own checking account. The account serves as the main vehicle for operations. Organizers contribute assets or cash to the new entity in exchange for ownership units or stock shares.

The business entity then begins operation with the assets. It deposits income and pays expenses out of the entity checking account. Expenses may include wages to workers or a wage draw to partners. It may also include rent payments to all parties for rent of machinery, livestock, buildings or land. At year's end, excess profits are used to reduce debt or to pay dividends to shareholders.

Ownership units or stock shares provide a convenient way to transfer ownership through sale, gifting, or passing them through your estate. Younger shareholders can buy shares or sell shares

to one another. This is very useful if an individual wants to enter or leave the business entity.

Many times it is desirable for owners to keep many of their assets out of the business entity. It makes it much easier to do tax planning and liquidation of the entity and may be less of a tax problem. Often land is kept out, as is machinery and breeding livestock. The new entity sometimes contains only "operating" assets. Again, seek legal and tax advice on which approach is best for you.

Farming together in one of these business entities can be a very rewarding experience if all parties remain focused and committed. However, if inequities exist or are perceived to exist, it can be a difficult experience. It also requires patience, good communication, tolerance, division of responsibility, delegation of authority, sacrifice, and trust. Are you ready for this kind of commitment?

Family Business Meetings:

To foster better communications, you may want to consider family business meetings where the farming partners meet often to discuss day-to-day operations, issues that arise, as well as short and long-term business goals. Here is an **example** of what a family business meeting schedule might look like:

- Each morning at 6:30 a.m. partners meet briefly to lay out plans and responsibilities for the day's work.
- On the first Monday of the month at 7:30 a.m. partners and spouses meet to discuss progress, problems, opportunities and other issues as presented.
- Quarterly meetings are sometimes held to review progress toward goals, finances and working arrangements.
- Annually, partners and spouses meet to review finances, establish goals, review operations, establish hours, payment rates, rents, vacation schedules, and other pertinent issues. This is also a time when they can celebrate a successful year of operation.

Summary:

Farming together requires good communications, mutual respect and trust. A willingness to give and take and a lot of "biting the tongue" on everyone's part is necessary. This is probably the most stressful part of farming. It is not impossible, but proceed carefully and in a planned fashion.

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.

Utilizing Partnerships & Corporations to Transfer Farm Assets

Agricultural Business Management

Gary A. Hachfeld, David B. Bau, & C. Robert Holcomb, Extension Educators

Introduction:

Transferring the farm business to the next generation can be a daunting task. However, there are strategies and methods that can help simplify the process.

When operating as a sole proprietorship, it can be challenging to establish a transition plan. There are many individual assets that need to be accounted for such as machinery, equipment, livestock, as well as land. It is difficult and time consuming to transfer separate, individual assets.

One possible solution is to establish a business entity such as one of the many partnerships or a corporation to accomplish the business transition. As members and owners of the entity, the parents are issued ownership shares or shares of stock in the entity. These shares can be sold, gifted or passed through an estate to the entering generation, over time, as a method of transferring the business. This does away with the need to transfer separate, individual assets. This also spreads out the parent's income and thus tax obligations. It allows the entering generation the ability to acquire assets over time thus minimizing their need for large amounts of capital.

Partnerships: Types & Characteristics:

In MN, there are two major categories of partnerships: 1) Partnerships and 2) Limited Partnerships. There are separate entities under each category which function differently.

1) Partnerships:

There are two entities: General Partnerships and Limited Liability Partnerships.

General Partnerships (GP): Two or more people are required for the GP and are referred to as general partners. All partners are generally liable for all debts and obligations of the GP. There is no liability protection for their personal or partnership assets. MN state law does not require a written partnership agreement. However, such an agreement outlining decision making and job responsibilities might be useful. If the name of the partnership is that of the

partners (Henderson Family Partnership), the entity does not have to be registered with the State of MN. The entity is taxed as a partnership, pass-through entity, with income being allocated to each partner based upon their ownership and included in their personal income tax.

Limited Liability Partnerships (LLP): The LLP is similar to the GP with exceptions. All partners are general partners (no limited partners) but their liability exposure is limited to the assets they have placed into the LLP. Their personal assets are protected from liability exposure. The LLP is required to register with the Secretary of State in MN. The LLP is taxed as a partnership, pass-through entity.

2) Limited Partnerships:

There are three partnership categories: Limited Partnership (LP), Limited Liability Limited Partnership (LLLLP), and Limited Liability Company (LLC).

Limited Partnership (LP): Two or more persons are required. There are both general and limited partners. General partners have no liability protection for their business assets but do for their personal assets. The limited partners' assets in the LP as well as their personal assets have liability protection under the LP. The LP is required to register with the Secretary of State in MN, and the MN Dept. of Agriculture. The LP is taxed as a partnership, pass-through entity.

Limited Liability Limited Partnership (LLLLP): Two or more people are required. There are both general and limited partners and they have liability protection of both their LLLL assets and their personal assets. The State of MN requires the LLLL be registered with the Secretary of State and the MN Dept. of Agriculture. The LLLL is taxed as a partnership, pass-through entity.

Limited Liability Company (LLC): Requires only one person as a member of the entity. From a tax standpoint, the LLC can be taxed as a partnership pass-through entity or as an S

Corporation. In addition, the LLC can afford tax savings via discounting assets and potential savings of self-employment taxes. The LLC provides liability protection much like that of a corporation.

The LLC has both members and managers. Members elect or appoint a board of directors. The State of MN requires that the LLC register with the Secretary of State and the MN Dept. of Agriculture.

The LLC can offer one additional level of liability protection by being registered in one of what are referred to as “protective states”. Although the list changes occasionally, currently those protective states include: Alaska, Arizona, Delaware, Nevada, New Jersey, South Dakota, Texas, Virginia, and Wyoming. These states have written their LLC statutes to include an additional level of liability protection as long as the LLC members abide by all the statute rules. It is legal to register, for example, your MN farm business in one of these protective states and still operate in MN. as you have been. You would need a contact in the state where registered. That contact would establish the entity on your behalf and at year end send you a K-1 form for income and you file your tax return just as you do now. This is a complicated process so seek expert legal help if you decide to develop an LLC in one of the protective states.

As mentioned, partnerships pay no income taxes. All profit/loss, capital gains and credits are passed through to the partners on a prorated basis, depending upon the percent of ownership. However, the partnership must file a Form 1065 informational tax return, which is due each year by April 15th.

An advantage over sole proprietorship is that the owners have ownership units or shares. These units or shares can be sold, gifted or passed through an estate as a means of transferring the business over time to the next generation.

One disadvantage with a partnership, except the LLC, is that the death of a shareholder or willful withdrawal by a partner can seriously disrupt partnership operations. The partnership agreement, if put into place at time of formation of the entity, should clearly describe buy-out provisions or state how the remaining partners are protected, no matter how circumstances change.

Partnership tax laws are similar to individual tax laws. A partnership can generally take over the depreciation schedule of contributed machinery or buildings. A partnership can claim the Section 179 depreciation expense which is passed on pro rata to the partners. Each partner can claim depreciation,

which includes his or her portion of the partnership allocation plus any other personal Section 179 depreciation.

Partnership members are self-employed individuals and must pay self-employment tax on their share of earned partnership profits. Partnerships do not receive the favorable tax treatment on fringe benefits (medical, accident and life insurance, housing and meals) as do “C” corporations. However, it generally costs less to form a partnership than a corporation and partnerships can be less formal to operate.

Corporations: Types & Characteristics:

There are two corporation entities available to farm businesses. They are: S Corporation and C Corporation.

1) **S Corporation:** The S Corporation offers a higher level of asset liability protection than a sole proprietorship and some of the partnerships. It must be registered with the Secretary of State in MN. The S Corporation is taxed as a pass-through entity with profits being allocated to the stock shareholders based upon their ownership percentage. The income then shows up on the shareholders personal income tax. There is no double taxation issue.

Business operating assets can be placed into the S Corporation or they can be left out with only the corporate checkbook as part of the corporation operating entity. Placing assets into the corporation is a non-taxable event but getting them out is not. For that reason, it is a general rule of thumb not to place land into the corporation. See your attorney and accountant for advice specific to your situation.

2) **C Corporation:** The C Corporation also affords a higher level of asset protection than the sole proprietorship or some of the partnership entities. The C Corporation offers longevity to the business because it is technically an entity onto itself with a life of its’ own. That is, people can enter and leave the C Corporation and it continues on without interruption. It also affords many tax advantages regarding deductible expenses.

The C Corporation however, can be subject to double taxation. The dividends paid to shareholders are taxed. If the corporation is not growing or acquiring new assets resulting in the corporation retaining earnings, those earnings can be taxed as well. Corporate tax rates are generally higher than other tax rates. Business operating assets can be placed into the C Corporation or they can be left out with only the corporate checkbook as part of the corporation operating entity. Placing assets into the corporation is a non-taxable event but getting them out is not. For that reason, it is a general rule of thumb not to place land into the corporation. See

your attorney and accountant for advice specific to your situation.

One additional point that applies to both S and C Corporations. Shareholders have to maintain an employer-employee relationship with the corporation. If the shareholders maintain personal ownership of what they consider corporate assets, charge corporate business expense against those assets, are audited by the IRS, they may be denied those expense deductions because the assets were owned by the shareholders, not the corporation.

A corporation is established under state law. Each state permits corporations the right to do business. A corporation consists of owners who are called shareholders. The shareholders are the basic decision making group. They elect a board of directors to act for them on most operational decisions. Majority vote governs corporate decisions. Ownership of 51% or more of the stock gives you control. Minority shareholders have little if any decision making control unless permitted to do so by the majority shareholders.

Once a corporation is created, it functions much as a self-employed individual might. Corporations must establish their own name and bank accounts. The corporation can become an employer, a lessor or lessee, a buyer or seller, or engage in any other business activity.

Farms incorporate for many reasons. Here are a few of those reasons.

- It is easy to transfer shares. Shareholders can gift, sell, or pass through an estate, shares to others as they see fit. A majority shareholder can transfer up to 49% of the outstanding shares without losing control of the business.
- A corporation may simplify estate settlement in that it may be easier to value shares than individual farming assets.
- Self-employment (SE) tax can sometimes be reduced with a corporate structure. Instead of paying SE tax on all the Schedule F income as a self-employed individual would, the farmer becomes an employee of the corporation and social security taxes are paid only on wages they receive. See your accountant.
- A portion of meals and lodging furnished to employees of a "C" corporation are generally deductible to the corporation, but not taxable income to the employee. If lodging is provided on the farm and is a condition of employment, the home's depreciation, heat, electricity and interest become deductible to the corporation. Remember the employer-employee relationship issue.
- Fringe benefits are deductible by "C" corporations. Health, accident, and up to

\$50,000 of term life insurance is deductible to the corporation, but not taxable to employees.

- The corporation offers perpetual life, some economic efficiencies regarding capital acquisition, and provides income and social security tax flexibility. It can also provide continuation of a farm business through several generations.

There can be concerns related to the corporation. Some of those are listed here.

- Getting into a corporation is generally a tax-free event. Getting out is a taxable event. Don't start a corporation unless you plan to continue it for many years.
- If the "C" corporation is profitable, but is not growing and acquiring new assets, it can be troubled with retained earnings or excess profits. This can result in a tax obligation.
- Corporations have a different set of rules. Corporate meetings, extra record keeping, corporate income tax returns, reporting requirements, and quarterly tax estimates are part of corporate life. Complying with extra legal and regulatory requirements cost time and money each year.
- Minority shareholders have no power in directing the corporate business and can be easily "frozen out". A majority shareholder (farming heir) can direct that no dividends be paid. Minority (non-farm heirs), may own shares that generate no income, and hence have no practical value.
- Corporate ownership of a house eliminates the use of the exclusion of gain or a sale of personal residence.
- Corporate ownership sometimes reduces independence and individual pride of ownership.
- It can be very difficult for a retired shareholder to receive any retirement income from an operating corporation. This is especially true if the retiree has no rental property, discontinues working for the corporation, and the corporation pays no dividends.

The farm corporation can be a valuable tool in tax planning and in the transfer process. However, it is a major commitment and a complex task to start a farm corporation. Before starting a corporation, make sure it fits your goals, objectives, and business personality.

Developing any business entity is a complicated process. Seek assistance from a qualified legal expert and accounting assistance if you plan to explore developing a business entity.

Self-Employment Tax on Land, Buildings, & Facility Rent Regarding Entities:

The U.S. Eight Circuit Court of Appeals has ruled that if you are a member of any business entity (such as a partnership or corporation explained above); own land, buildings, or facilities that are outside that entity; and rent those items to the entity; the rental income is exempt for self-employment tax **IF** the rent is fair and reasonable.

This applies only to those states in the Eighth Circuit which include Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota. With any of these laws, they are subject to change so seek legal advice on this matter.

Discounting Business Entity Assets:

An additional strategy that may be useful is the discounting of assets being placed into a business entity, such as any of the partnerships or corporations described earlier.

When you place business assets such as machinery or livestock into the business entity, you can elect to discount those assets. Generally a 25-40% discount is readily accepted by the IRS but some individuals have received larger discounts.

The main reason for discounting assets being placed into the business entity is to reduce the size of an estate in order to get below the federal and perhaps even the state estate applicable exclusion amounts. Doing so will reduce or eliminate any estate tax.

If you can afford to do some gifting of assets as a means of beginning to transfer the business, another advantage is you can gift more than the current \$14,000 annual gifting amount per person (2014) if you have discounted the assets. Assume you were granted a 25% discount on assets you placed into an LLC for example. You decide to gift assets in the form of ownership shares. Because of the 25% discount, you can then gift 125% of the current \$14,000 annual gift exclusion or an actual amount equal to \$17,500 per person.

One disadvantage of discounting is that you have artificially lowered the basis of the assets in the entity. This can be a problem if the entity is discontinued and the assets are sold as a result. This could result in a tax obligation. If the assets are replaced due to use, this is not an issue.

Assets being discounted and placed into an entity should be appraised. If, at a future date, the entity is audited by the IRS, you can document the value of the assets placed into the entity. For machinery and equipment, simply take the depreciation schedule to the local implement or equipment dealer and ask them to put a value on all machinery. Have them put the values in writing on their dealership letterhead along with a signature and date. For livestock you can take a list to a livestock auction facility or someone who deals in livestock and would have a grasp of the values. The values should be put in writing and listed on their letterhead with a signature and date. For land, seek the help of a realtor who deals with ag land. Simply have them do an estimate or appraisal of the land, put it in writing on their letterhead, with a signature and date.

With tax laws changing constantly, the discounting provision might be taken away by Congress. Seek legal and accounting assistance if you plan to use this strategy.

Farm Service Agency (FSA) Payments & Business Entities:

Under the current farm bill, there are some restrictions regarding commodity program payments made to individuals versus entities. Entities that limit member's liability exposure (all entities except the general partnership) are limited regarding FSA commodity program payments.

This is a complicated issue. If you have any questions or concerns related to your situation, check with your FSA Office for details of the program.

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.

Transferring Machinery and Livestock

Agricultural Business Management

Gary A. Hachfeld, David B. Bau, & C. Robert Holcomb, Extension Educators

Introduction:

At retirement, most farmers are faced with how to best dispose of their assets. The easiest assets to dispose of are the crops on hand and market livestock. They can simply be hauled to market and sold. The major concern here involves the issue of self-employment and income taxes.

Income Taxes:

For the farmer using cash basis accounting, income tax is due and payable immediately on any proceeds from the sale of crops and market livestock. Selling everything in one year can push you into a higher tax bracket. Spreading the income over a few years may provide some tax management. You might also use a deferred payment contract to spread income into future years.

Self-Employment (SE) Tax:

Self-employment (SE) taxes must also be paid when crops or market livestock are sold. Note, a new federal Medicare Surtax on some active and passive income and the sale of assets over certain thresholds has been established. For farmers there are exceptions so consult with your accountant and attorney before making the sales.

You may want to consider the following:

- Selling everything in one year may lessen your overall SE tax. The Social Security (SS) portion of the SE tax is adjusted for inflation each year and the income subject to this tax is capped. Bunching all SE income into one year to greatly exceed the threshold may result in less tax paid than if you spread out SE income over several years and paid SE tax on all of it. **Caution:** Take your expected Social Security benefits into consideration when doing planning. If several years of high SE contributions would greatly increase benefits, it may be worth the extra tax. Also, consider the effect of a higher income tax bracket when bunching income into one year and the potential use of income averaging. See your accountant.
- Watch the timing when selling crops or market livestock in your year of retirement. Farm inventory sold between your retirement date and the end of that year can count against your SS benefits for that year. If you exceed exempted amounts, your

benefits for that year will be reduced. However, if you sell crops or livestock after the year you begin taking SS benefits (and the crops or livestock were produced **before** you retired), benefits will not be reduced.

- If you wish to sell feed crops to the entering generation, you can do so and take payments as they fit your income and SE tax plan while spreading out the cost for the entering generation. If you sell and take a note as payment, the note is considered taxable income the year of sale, unless you elect to report it on the installment basis.
- An easy way to sell crops or livestock is to simply turn it over to the entering generation and let them assume any debt on it equal to the property value. If the buyer of your property takes over part or all of your debt in payment for the property, you must report taxable income to the extent you were relieved of debt.

Selling Breeding Livestock and Machinery:

When selling breeding livestock, machinery and equipment the sale income is not subject to SE tax. However, you will have to pay income tax on the difference between the adjusted basis (your cost) of these assets and the sale price. For example: Selling \$200,000 of machinery, cows and sows having an unclaimed depreciation amount of \$20,000 will result in \$180,000 of taxable income.

Machinery does not qualify for installment reporting to the extent of previously claimed depreciation. Therefore, it is nearly impossible to have a bulk sale of machinery without realizing a large income tax bill the year of the sale. Raised breeding livestock (never depreciated) can be reported to the IRS using installment sales reporting. This requires the filing of IRS Form 6252. Purchased breeding livestock (depreciation taken) does not qualify for installment sales when sold to a related party. See your tax professional for direction.

Leasing Equipment:

Leasing allows you to receive rent payments while retaining ownership and depreciation deductions. However, you need to be cautious when doing so. If you chose to lease please note:

- A “machinery only” lease is generally subject to self-employment tax.
- Combining a machinery lease with a land lease is an effective way to avoid self-employment tax.
- Leasing fails to add assets to the entering farmer’s net worth. A piecemeal sale may add to the buyer’s net worth.
- An alternative to leasing assets is to establish a rental contract for a set number of years at a given amount per year with no buy-out provision. Agree that the rental proceeds apply to the purchase price of the assets. Follow the rental contract with a simple sale agreement for the remaining value of the assets or gift the value. This will also help minimize self-employment tax.

This process can work for machinery as well as breeding livestock. Seek accounting assistance for information specific to your situation.

Gifts:

If you can afford to do so and it does not violate your business or personal goals, it may be prudent to gift crops, livestock, or pieces of machinery to the next generation. If you gift an asset that still has an adjusted basis (un-depreciated value), that asset and the associated adjusted basis leaves your depreciation schedule and appears on the recipient’s depreciation schedule. If the asset has debt on it at the time it was gifted, in excess of the adjusted basis, the difference between the debt and the adjusted basis will be considered taxable income to you as the donor.

If you have a business entity such as a partnership, LLC or corporation, you can gift ownership units or shares to the entering generation as a means of transferring the business. See *Transferring The Farm Series #6-Gifting Farm Assets*. Also, be aware of federal and MN gift tax laws and rules.

Piecemeal Sales:

Selling a tractor this year, a planter next year, and a one-fourth interest in the combine the third year may be a good way to transfer ownership. It spreads your tax burden and lets the buyer accumulate assets gradually without paying a lot of principal or interest. Each time a sale is made, the purchaser can add the value to their net worth statement.

If you decide to sell your machinery one piece at a time, the IRS will probably not allow you to deduct depreciation on any asset that is not used in your business or is under a lease agreement. You may wish to continue farming some acres after retirement so that you can claim some depreciation.

If you have a business entity such as a partnership, LLC or corporation, you can sell ownership units or

shares to the entering generation as a means of transferring the business.

Hybrid Methods:

When transferring breeding livestock or machinery, it may make sense to combine the above three strategies (leasing/renting, gifting and piecemeal selling).

- You might lease/rent a few items which have a lot of depreciation remaining, while gifting and/or selling other items.
- You might gift some assets annually (usually low basis items) while selling piecemeal (high basis) other assets.
- If you operate within a business entity, you can sell or gift ownership units or shares of the entity, over time, as a means of transferring business ownership.

Charitable Remainder Trust:

A Charitable Remainder Trust allows a donor to transfer assets to a qualifying charity to avoid taxation on the disposal of the assets. The charity provides taxable income to the donor for a fixed number of years, much like an annuity, after which the remaining assets go to a designated charity. Rules vary for gifts with and without basis so consult your accountant or attorney. If a donor transfers grain or market livestock, they may avoid paying self-employment tax on the transferred asset. This can be a rewarding strategy for the donors along with providing retirement income for the future. However, it can be a complicated process so seek advice from your accountant and attorney.

NOTE: Gifting assets can create problems if you need to file for Medicaid if entering assisted living or a nursing home. For more information on this issue See *Estate Planning Series #9-Long-Term Health Care Planning*.

Summary:

Selling, gifting or leasing/renting farm assets can be a useful strategy for the transfer of your business assets. To facilitate this process, it is helpful to develop a plan for the use of these strategies - a goals list if you will. Outline your wishes or goals – what you want to happen and what you do not want to happen to the assets. Having this written goal list or outline will expedite the process. Seek advice from your attorney and accountant for information specific to your situation as you proceed.

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.

Should You Sell Your Real Estate?

Agricultural Business Management

Gary A. Hachfeld, David B. Bau, & C. Robert Holcomb, Extension Educators

Introduction:

A major portion of assets for retiring farm families is usually real estate. Real estate assets may consist of land, buildings and a house. Disposition of real estate assets is usually a major decision.

Of all the real estate assets mentioned, land is usually the most valuable. Many farmers choose to retain ownership of most of their land into retirement. They do so for several reasons:

- Ownership can provide a fairly secure annual income throughout one's retirement years if it is rented to another operator. Most farmers prefer a simply cash rental contract rather than share renting their land. Share renting is more risky, income is unknown, and shared expenses must be paid. The landowner has to also assume responsibility for storage and marketing of their share of the crop produced. Cash rent provides a known income with less risk.
- Land ownership can be viewed as an inflation hedge and can nearly always be liquidated to willing buyers.
- Holding low basis land until death, with heirs receiving a stepped-up basis, can save many thousands of dollars of capital gains tax, especially if it is later sold by the heirs.
- Land is sometimes viewed as security and can be a valuable part of a diversified array of retirement assets which may also include stocks, bonds, savings, and retirement plans.

Some farmers choose to sell their land at retirement. Some of the reasons they give are:

- They want it to go to the farming children. They guarantee it will go to them by selling it to them.
- They don't want to be faced with the inconvenience of dealing with rental contracts including establishing and collecting rents, repair and maintenance, and the liability exposure.
- Some are fearful that land values (rents) will fall and real estate taxes will increase, leaving them with less and less income. Others fear land values will rise and increase their estate taxes.
- They feel they can get a better rate of return on their money if they invest it elsewhere.

Disposing of buildings and personal residence?

Maintaining farm buildings is expensive. There is a never-ending list of repairs, insurance, utilities, real estate taxes, and other costs. Also, tenants may request additions and improvements on a regular basis. Sometimes keeping good tenants is a challenge. Consequently, many farmers dispose of their buildings. Disposal usually takes place in two ways:

- Sale: Selling low basis assets may create a large tax bill. Selling a quarter section of farmland with a farm building site and home, that has a low adjusted basis, will result in a taxable gain. The farm sold represents several different types of property that is taxed at different rates. The sale price is allocated among the various properties. Each property has its own basis. The gain on the land portion would be taxed at the maximum federal capital gain rate applicable at the time of the sale. The portion of un-recaptured depreciation on depreciable buildings will be taxed at the current applicable rate, with the additional gain (if any) on the buildings taxed at the federal capital gains rate. There can be state capital gains taxes as well. In MN., capital gains are taxed as ordinary income at the current applicable rates. The gain on the sale of the house can usually be tax free, providing certain tax law rules are followed.
- Gifting: Buildings can be gifted to farm heirs as well. This is assuming the donor of the gift can afford to do so and it does not violate their business transfer and personal estate planning goals. Beware of federal and MN gift tax laws.

Selling your personal residence:

If you have a personal residence you want to sell, the sale can generally be accomplished tax-free under a change made in the tax code. For sales of your personal residence after May 6, 1997, up to \$250,000 of gain can be excluded from income and capital gains tax if you file a single tax return or \$500,000 of gain if married, filing a joint return.

To qualify, you must have used the home as your personal residence for two of the past five years.

This exclusion can be taken many times during your lifetime but not more than once every two years, providing you meet the “personal residence” qualification.

Methods of selling land:

If you decide to sell the land and/or buildings, you have several ways to accomplish this.

- Sell it for cash in a lump sum and pay the accompanying taxes.
- Sell it on a contract-for-deed. A contract puts you in the position of a lender. As the contract payments are made, you include them in your taxable income over a number of years. By signing a contract for deed with installment sale reporting, you do obligate yourself or your heirs to paying the income tax on the gain. However, the capital gains tax, if any, is paid over the course of the contract rather than in the year of the sale. Selling on a contract can provide the buyer with a source of credit and terms he or she can afford. This method, however, obligates the buyer to pay you a lot of interest over the life of the contract. Interest you receive from the buyer is fully taxable to you. If you become a contract for deed holder, you assume the risk of default by the buyer. You may get your land back through forfeiture or you may be forced to foreclose on the party in default. The contract-for-deed does not protect the assets from lawsuits or other adverse actions.
- Sell your land piecemeal as the buyer can afford to purchase it. Using this method, the buyer can apply all purchase money to principal and none to interest. This method does not protect the asset from lawsuits and other adverse actions.
- Consider a tax-free 1031 exchange. Exchanging like-kind property with your child can postpone the taxation of gain. A tax-free, 1031 like-kind exchange can be used if a farming son or daughter has land they wish to exchange for the parents’ home farm, which usually is the base of the operation. The parents end up with a piece of land with a low basis and the son or daughter end up with the home farm.

Certain types of property do not qualify for 1031 exchanges. They include:

- inventory or stock in trade
- stocks, bonds, or notes
- other securities or debt
- partnership interests
- certificates of trust

There are also two time limits that must be met in order to qualify for a 1031 exchange. The first

limit is that you have 45 days from the date you relinquish the property and you identify a new property. The identification must be in writing, signed by you and delivered to a person involved in the exchange like the seller of the replacement property or the qualified intermediary. However, notice to your attorney, real estate agent, accountant, or similar persons acting as your agent is not sufficient. The second limit is that the replacement property must be received and the exchange completed no later than 180 days after the sale of the exchanged property or the due date (with extensions) of the income tax return for the tax year in which the relinquished property was sold, whichever is earlier. The replacement property received must be substantially the same as property identified within the 45-day limit described above.

Caution: if property is disposed of within 2 years of the exchange, the property no longer qualifies for the like-kind exchange (see your accountant).

Medicare Surtax:

Effective January 1, 2013 a new federal Medicare surtax was initiated as part of the Affordable Care Act of 2010. One part applies to a 0.9% increase in Medicare tax (total 3.8%) on active income. The second part applies to a 3.8% surtax on passive income. These new surtaxes apply only to income levels over a given threshold: \$250,000 married filing jointly, \$125,000 filing separately, \$200,000 single, \$200,000 head of household and \$11,950 trusts and estates.

Active income applies to income generated from a trade or business activity. If actively farming this might affect you. There are material participation rules that need to be met each year. If you rent or sell assets the 3.8% might affect you. However, there are exceptions for farmers who are selling assets: if you materially participated in the farm operation 5 years in the 8 year period before drawing Social Security you are exempt. Check with your accountant and attorney for information specific to your situation.

As always, any of these strategies can be complicated and any mistake can result in tax consequences. Therefore, make sure you check with your attorney and accountant as you proceed.

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.

Gifts of Farm Assets

Agricultural Business Management

Gary A. Hachfeld, David B. Bau, & C. Robert Holcomb, Extension Educators

Gifts of Assets:

Gifts of assets to the entering generation can be a valuable tool in the transfer process. Gifting can be used to:

- Help reduce a taxable estate,
- Transfer income tax obligations to the children who may be in a lower tax bracket, and
- Help get the next generation established.

Gifts are always valued at fair market value (FMV) at the time of the gift.

Federal Gift Tax Provisions:

For federal gift tax, each individual currently has an Annual Gift Exclusion of \$14,000 allowing you to gift that amount per person per recipient per year to as many persons as you wish and pay no gift taxes. Married donors who own property together can treat a gift as though each spouse has given half of it, so that together they can give \$28,000 per recipient per year. They need to write two separate checks for \$14,000 each or file and IRS 709 gift tax form.

You can give unlimited gifts to your spouse (Marital Deduction). If your spouse is a non-US citizen, there are gifting limits - number changes each year. You can gift unlimited gifts to a qualifying charity in any year with no gift tax consequence. You can also gift unlimited amounts for tuition or medical care.

Federal law has permanently established the federal Lifetime Exclusion amount at \$5,000,000 and indexed it for inflation. For 2014 every person has a Lifetime Gift Exclusion of \$5,340,000. Gifts given in excess of the annual exclusion (\$14,000 per person, \$28,000 per couple) reduce this lifetime exempted amount. **NOTE:** Each individual, for the purpose of federal estate and gift tax purposes, has one exclusion amount equal to the applicable annual exclusion (2014 is \$5,340,000). One does not have a \$5,340,000 exclusion for estate tax and a second exclusion of \$5,340,000 for gift tax. Each person has one exclusion amount and you can decide how to spend that exclusion amount - on estate taxes or gift taxes or a combination of both.

No gift tax is payable until the total federal Lifetime Exclusion amount is used up. **However**, a gift tax return (IRS Form 709) must be filed on gifts to any

individual, other than your spouse, which exceed the annual \$14,000 exclusion (\$28,000 for couple). If gift taxes are payable, they are generally paid by the donor (giver) not by the donee (recipient).

Minnesota Gift Tax Provisions:

The MN Gift Tax law that was to take effect July 1, 2013 was repealed to the effective date of July 1, 2013 through MN legislation that was signed into law on March 21, 2014.

However, for property located in MN, the value of gifts in excess of the annual exclusion amount (recorded on the IRS 709 form) made within 3 years of the decedent's death will be added back into the decedent's estate to determine if MN estate tax is due. The 3 year add back provision is retroactive applying to estates of decedents dying after Dec. 31, 2012.

The MN gift add back provision applies to the transfer of property located in MN only. The add back applies to MN residents. It also applies to gifts of real estate and tangible personal property located in MN but owned by any non-resident to determine if the non-resident must file a MN estate tax return.

MN residents transferring real and tangible personal property located outside MN are not subject to the MN gift add back provision.

Summary:

- For annual gifts of \$14,000 individually (\$28,000 couple) - no tax, no IRS 709 or M709 form.
- For annual gifts \$14,001 up to federal & MN gift exclusion individually (\$28,001 - up to federal & MN gift exclusion per couple) - no tax due while the donor is alive, file IRS 709 and M709 forms.
- For annual or lifetime gifts greater than federal or MN gift exclusion - tax due by April 15 the year following the year of the gift and file IRS 709 and M709 forms.

Gifts of Appreciated Property:

Gifts of appreciated property held long enough to qualify for long-term capital gains treatment (longer

than 12 months for land, breeding livestock, and machinery) could be gifted by high tax bracket parents to children in low tax brackets to save taxes.

Gifts of appreciated property to children under 18 or who are full-time students ages 19-23 can cause their income to be taxed at the parents' top marginal tax rate or greater ("Kiddie" tax provision). If recipient exceeds unearned income limits (amount changes each year - see your accountant), sale income will be taxed at the parent's marginal tax rate if greater than the child's rate.

Gifts of Grain or Market Livestock:

Gifts of commodities are often used in parent-child transfers. Here are some consequences if gifting grain or livestock produced in the farming operation to the children:

- If FMV of the commodity is under \$14,000, no gift tax or Form 709 is required.
- The cash basis parent does not include the commodity on their tax return, thus reducing both income and self-employment (SE) taxes.
- The child must show the income on their tax return and pay income tax, not self-employment tax, on the income (remember "Kiddie tax provision").
- If the parent gifted the grain or livestock in the year of production, they must reduce deductible Schedule F expenses by the cost of producing the grain, but the child gets to use that carry over of basis as an expense. If the gift is made with grain produced in a year prior to the gift, the basis is in the hands of the parent donor and the child donee's basis is zero. When giving commodities, the best advice is to give crops or livestock produced in the previous tax year.

Gifts of Machinery:

Gifts of machinery and equipment to the next generation provides several advantages. It is often necessary for the entering generation to receive financial help in getting started in farming. Gifts of machinery can provide equity on their balance sheet. Gifts of machinery can reduce the tax burden of the parents. If the parents are in a weak financial position and cannot afford to give away some property, perhaps the entire transfer process should be reevaluated as to its viability.

The donor's remaining basis for depreciation on the gifted machine passes to the receiver of the gift.

If indebtedness on the gifted asset exceeds the donor's basis, the excess is considered a taxable gain to the donor at the time of the gift.

When you gift machinery, document the gift by stating it in writing. List the date of the gift, the donor and donee, the adjusted basis, the fair market value

of the gift, the make, model, and serial number. Sign and notarize the document effective the date of the gift. This eliminates any confusion over ownership and you have protected the asset for your farming heir(s) if that is one of your goals.

Gifts of Land:

You can gift land by deeding actual acres. This requires legal work when each gift is given.

You can also gift land by deeding an undivided interest in property to someone. This method may require less legal work.

Forming a business entity for the purpose of gifting land can be used and the parent stays in control but transfers entity ownership units or shares to the entering generation or other children over time.

Gifts of Contract for Deed payments:

After executing a contract-for-deed with their farming heir, some parents decide they would like to occasionally forgive the annual payment.

The best procedure is to collect a check for the principal and interest payment and then issue a check to the farming heir for any gift you wish to make. Ignoring the check exchange can result in the farming heir not having complete evidence of having paid for the property. Drafting a payment schedule listing all principal and interest payments and payments dates is a good idea. When a payment is made, the parents should initial and date the payment schedule eliminating any doubt the farming heir has made payments and has control of the property in the event of the parent's death.

Can you afford it? Does it violate your goals?

Gifts can be a very useful transfer and estate planning tool. However, don't do it unless you can afford to give up the assets. Once an asset is gifted away you have no control of it and can expect no income stream from it. If gifting jeopardizes your financial security or violates your farm transfer and estate planning goals, you might want to reconsider the strategy.

CAUTION - Medicaid law change regarding gifting:

Gifts of assets can cause eligibility issues if you are considering application for Medicaid for long-term health care costs. See an elder law attorney for help. For information on this issue, see *Estate Planning Series #9-Long-Term Health Care Planning*.

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.

Tax Considerations When Transferring Assets

Agricultural Business Management

Gary A. Hachfeld, David B. Bau, & C. Robert Holcomb, Extension Educators

Income Tax Basis:

When selling an asset, you pay tax on the difference between the selling price and your adjusted basis (cost plus improvements minus depreciation) of the asset.

Example: If you sell land for \$100,000 and your adjusted basis for the land is \$20,000, your taxable gain is \$80,000.

Adjusted basis is your cost to recover when you sell the asset. This adjusted basis is determined by how you acquired the asset.

If you purchased the asset:

Generally, your basis is what you paid for the asset, plus improvements, minus any depreciation you've claimed on the asset.

Examples:

1) If you purchase a tractor for \$120,000 and depreciated it for 3 years claiming a total of \$42,850 depreciation, your adjusted basis would be \$77,150 (assuming no improvements).

2) If you purchased land and have claimed no depreciation on it, your basis is what you paid for it, plus any improvements (tiling, etc.).

If you inherited an asset:

Your basis is the Fair Market Value (FMV) or Special Use Value assigned the asset as it passed through the estate to you.

Example: You inherited some land from your mother. Her adjusted basis was \$70,000. Upon her death, the land received a step up in basis and is valued in her estate at \$160,000. Your adjusted or cost basis is \$160,000.

If you received an asset as a gift:

Generally, your basis is the same as the adjusted basis of the donor.

Example: You received a gift of farmland valued at \$160,000 with a basis (purchase price) to the donor of \$25,000. Your basis is then \$25,000.

Asset basis is extremely important to the property holder since it determines the amount of tax that will be paid upon the sale of the asset.

Assets that pass through an estate receive a

"stepped up" basis. The "stepped up" basis is usually the fair market value on the decedent's date of death. This provides a strong incentive to hold low basis property until death to achieve the stepped up valuation for heirs.

Example: Sally Smith sold 160 acres of farmland for \$4200/acre or \$672,000. It had an adjusted basis of \$100,000. Her taxable gain whether sold for cash or by installment method would be \$572,000. Because of the sale, she or her heirs must pay tax on the \$572,000 gain. However, if Sally had retained the property until her death, the estate would assign a stepped up basis to FMV of \$672,000. The heirs could later sell the property for that amount and pay no tax.

Personal residence:

If you sell your farm, which includes your personal residence, up to \$250,000 per individual (\$500,000 for married filing jointly) of the gain on the residence portion may be excluded from taxation. To qualify for the full exclusion, you must have owned and occupied the residence for at least two out of the five years before the sale. Property held under 2 years may qualify for a partial exclusion under certain conditions.

Homestead Classification:

Rural residence and ag land both qualify for the Minnesota homestead classification. Rural residence includes the home, garage and one acre of property. For ag land only, qualifying owners who live on the farm or in the house on the farm can receive reduced real estate tax payments due to Minnesota homestead classification. Farm owners who have a qualified family member operating their farm may qualify for a double homestead classification - one on their personal residence and a second on the farm. Distance limits as well as dollar and acre limits apply to the designation. If you place your land and buildings, previously classified as homestead, into a trust or any of the other MN business entities, you will have to reapply for homestead classification. If both husband and wife have their own trust with land separated into each trust, both cannot qualify for homestead classification. Husband and wife having one trust with all the land in that trust with each having an undivided interest in the land qualifies

them for homestead classification on all the land. Maintaining homestead classification until death is one of the criteria for qualifying for the \$4 million dollar MN estate tax exclusion on qualified small business qualified farm property.

For more specific details on this issue see *Transitioning the Farm Series #12-Maintaining Farm Land Homestead Classification and Qualification for Minnesota \$4 Million Qualified Small Business Property Qualified Farm Property Exclusion*.

Check with your county assessor for more details. They have final say on homestead classification.

Installment Sales:

Many farmers opt to report sales of property on the installment method. This allows the taxation to be spread out proportionally over the years that principal payments are made. This option may be useful to keep as many dollars in the lower tax brackets as possible. Using installment reporting late in life on low basis assets may not be wise since no stepped up basis is received on installment contracts. Heirs must continue to pay the income taxes on principal and interest payments when the asset passes to them. Most items can be sold using the installment method. Any gain, to the extent of depreciation on equipment and all other Sec. 1245 property as well as depreciable business property sold to related parties, will not qualify for installment tax treatment.

Tax Free 1031 Exchange:

If the entering generation owns tradable property, a like-kind tax-free exchange might be used to transfer farmland or buildings. This is a complicated tax issue but can aid in moving the younger generation onto the home farm. Using the tax free exchange can avoid or postpone taxation of the parents' capital gains on low basis property. Rules for IRS 1031 state that you have 45 days to locate a like-kind piece of property, 180 days to close the transaction and you cannot take possession of any funds that are involved - the funds must go through an intermediary such as a realtor, bank, etc.

Caution: make sure your attorney and accountant communicate regarding this type of transaction so no detail is overlooked. Non-compliance can result in forfeiture of the transaction and tax consequences.

Spread Out Income:

As a farmer retires and sells off his or her assets, a large income and self-employment tax bill emerges. It may be wise to plan ahead and spread the final sales over a two, three or more year period. Leveling

income usually results in lower taxes paid compared to bunching income into one year.

Capital Gains:

Long-term federal capital gains tax rates are currently 0%, 15%, 20%, 25% and 28%.

For those in the 10 & 15% federal tax bracket, capital gains tax rates are 0% on any gain included in taxable income totaling less than the maximum for the 15% federal tax bracket. Capital gain amounts in excess of the maximum federal income tax bracket will be taxed at 15%. Assets included in this calculation include stocks, bonds, and land held longer than one year, as well as some raised breeding stock.

Example: John & Jane Sample sell land with a capital gain total of \$60,000. Their taxable income without the gain is \$43,800. They can add \$30,000 of the \$60,000 to their income bringing the total to \$73,800 (top of 15% federal tax rate for 2014) and pay 0% federal capital gain tax on \$30,000 of gain. The remaining \$30,000 of gain is taxed at 15%. Gain amounts in excess of the top of the 15% federal income tax bracket will be taxed at the 15% rate. Gain above the new 2013 federal income bracket of 39.6% will be taxed at 20%. Farm building sales are taxed at 25%. Gain on collectables is taxed at 28%.

Capital gains in Minnesota are taxed at ordinary income tax rates: 5.35%, 7.05%, 7.85% or 9.85%.

Note: sales of capital assets may be subject to the new Medicare Surtax which is part of the Affordable Care Act of 2010 taking effect January 1, 2013. See description on next page for more details. Consult with your accountant and attorney for the best strategy for minimizing the tax consequence of any transaction.

Income Averaging:

Income averaging allows farmers to spread their income in a high income year over the past three years which may have been lower income years. This can significantly reduce taxes paid in a high-income year. Income averaging does not affect self-employment tax on either the current or previous years. Income averaging applies to ordinary (Schedule F, Form 1040) farm income as well as gain from the sale of assets used in the farming business except from the sale of land or timber. It also applies to an owner's share of net farm income from an S corporation, partnership, or limited liability company and wages received by an S corporation shareholder from the S corporation.

Self-Employment (SE) Tax:

If you have contributed to the Social Security (SS) system at a high level during your lifetime, you may be considering retirement before your Full Retirement Age (FRA) to begin drawing SS benefits. This would result in a reduced monthly benefit compared to retiring at your FRA. However, it might take many years of higher benefits to offset drawing reduced benefits for several additional years. In addition, farmland rental income is not subject to SS taxes. Not retiring early could cost you more per year due to not collecting monthly benefits and having to pay added tax on SE income.

However, if you have contributed to SS on a low level of earnings during your lifetime, it may be advantageous to delay retiring until your FRA. Hopefully during these last few years you can build your benefit package by making larger contributions to SS. High earnings and high contributions could have a significantly positive effect on your Social Security benefits.

This is a complicated issue but also a crucial issue to you and your farm business transfer and retirement planning. Seek advice from a qualified Social Security representative.

Medicare Surtax Provisions:

As a result of passage of the 2010 Affordable Health Care Act (ACA), there will be two new Medicare tax increases that will apply to higher income individuals. These new taxes could affect someone liquidating land, machinery or other farm assets depending upon their situation. The new taxes take effect January 1, 2013. Tax income threshold amounts are as follows:

- Married filing jointly - \$250,000
- Married filing separately - \$125,000
- Single - \$200,000
- Head of Household - \$200,000
- Trusts & Estates - \$11,950

The tax increases apply to earned/active income and unearned/passive income. The thresholds are no indexed for inflation.

Earned/Active Income: First is an increase in the former 2.9% Medicare tax equal to 0.9%. That will result in a total maximum tax rate 3.8%. The increase applies to earned/active income which includes self-employed income, farming wages as well as non-farm income. The tax applies **only** to taxpayers with income above the threshold amounts list above.

Income is classified as earned/active income if the

income is from farming or a business where the farmer/owner has material participation. There are several criteria for determining if the farmer has qualified for material participation.

Material participation criteria include:

- More than 500 hours spent participating in the farm business.
- Farmer's participation in farming activity represented substantially all of the total participation of all persons who participate.
- Farmer participated more than 100 hours and more than anyone else in the activity for the year.
- Farmer participated on a regular and continual basis during the year based on all facts and circumstances.
- If done regularly & continuously, a farmer who makes independent management decisions for the farm is generally considered to materially participate (crop rotation, buy or sell grain, manage labor, etc.).
- Participation of the farmer's spouse will count toward material participation in the business.

Material participation must be determined each and every year. If material participation is met and the taxpayer's income **is above** the applicable threshold amount, the amount above the threshold amount is subject to the additional 0.9% Medicare tax. If the taxpayer's income **is not above** the threshold amount, their income is not subject to the additional 0.9% Medicare tax.

Unearned/Passive Income: Second is a new tax applicable to unearned or passive income. The tax rate is 3.8% for amounts over the threshold amounts. This tax is imposed upon what the law refers to as new investment income for certain individuals, estates and trusts. Threshold amounts are the same as listed earlier in this section.

Net investment income includes the following:

- Gross income from interest, dividends, annuities, royalties and rents.
- Gross income derived from businesses that are passive activities (includes land rent).
- Gross income derived from businesses trading financial instruments or commodities.
- Net income from disposition of property taken into account in computing taxable income (net capital gain from the sale of property or assets, including farm assets, if not used in trade or business). This could affect someone selling land.

A passive activity is a trade or business where you do not materially participate. For example, you no longer farm but rent your land to your son, daughter, or a neighbor. This is a passive activity. Another example is if you owned a hardware store with an apartment above the store. You rented the business and the apartment to your niece or nephew and collected rent from them. This is also a passive activity. The only way renting the store and apartment would not be a passive activity is if you were in the real estate rental business - that would qualify the income as earned/active income because you were conducting your real estate rental business.

With regard to passive income, there is an exception for farmers. A farmer who materially participated in the farm operation for 5 years in the 8 year period before the farmer begins to draw Social Security are exempt from the 3.8% surtax on the sale of farm assets.

One additional issue is that capital gain from the sale or liquidation of a closely held C corporation, even though the taxpayer may have materially participated, is subject to the 3.8% Medicare surtax. Because this is a complicated area and this can affect farmers selling farm assets, check with your attorney or accountant for information specific to your situation.

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.

Treatment of Heirs in the Transfer Process

Agricultural Business Management

Gary A. Hachfeld, David B. Bau, & C. Robert Holcomb, Extension Educators

Protecting the On-Farm Heirs:

The farm business can be a fragile structure. The high risk nature of farming coupled with huge start-up costs and generally narrow profit margins, dictate the need for safeguards to protect the farming heirs.

In today's economy, it usually takes a great deal of parental help to get a young person started in farming. This help is usually provided through reduced charges for housing, lower machinery and land rents, lower interest rates, gifting of assets, financial supplements, and various other types of help. Unless the young person starts out with a nest egg, parental concessions are needed if the young farmer is to get started successfully.

Farming heirs can protect themselves by carrying life insurance on the parents, by carrying risk insurance on their assets and by seeking continued education to upgrade farm management skills. However, the parents also have to play a key role in protecting the financial vulnerability of the farming heirs.

It is not enough to say "You'll be taken care of when we are gone". You need to take legal written action to make the transfer happen. Farming heirs who are insecure as to their future in the business are unhappy, often indifferent and easily alienated from farming.

There are several steps that can be taken to insure a successful transfer while at the same time providing for non-farm heirs. These steps are outlined in this information piece.

How Parents Can Help Secure the Financial Future of Farming Heirs:

1. Develop and implement a transfer plan:

Formulate a detailed written transfer plan with the help and input of all farming parties involved, especially spouses and in-laws. Discuss it. Work with your transfer team (attorney, accountant, etc.) to implement the plan so everyone knows what is ahead. Transfer some assets soon so the farming heirs can begin business and feel some pride of ownership. This process includes transfer of management and control of those assets as well.

2. Offer a purchase agreement/buyout provision:

If you haven't made any commitments as to the sale of assets, a purchase option may be useful. The purchase option gives the buyer the right, but not the obligation, to buy farm property at a later date. The agreement can involve land, buildings, livestock or machinery. It should state price, terms of payment and date of execution. It is binding on the spouse and non-farm heirs, so the agreement gives the farming heirs a definite and reasonable purchase price and terms for buying farm assets. This may prevent the farming heirs from having to buy out non-farm heirs in an unsatisfactory lump sum after your death.

3. Provide Protection in Your Estate Plan:

When writing your Will or trust, include the purchase agreement or buy-out provisions. You might wish to establish provisions as to how, when, at what price, terms, etc. the farming heirs can buy out the other heirs.

Example 1: Farm site and adjoining land and equipment to the farming heirs with cash or non-farm assets to the non-farm heirs.

Example 2: Enact a provision allowing your son/daughter to buy the land from your trust over a 15 year period at a stated interest rate with specified principal payments per year.

Example 3: Pass farm property to all children equally but establish reasonable terms, through a buy-out provision, as to how the farming heir(s) might buy out the other heirs.

4. Life insurance planning:

Parents have several options regarding life insurance. Following are a few examples for your consideration.

- Parents carry enough life insurance on themselves to provide adequate dollars at death to pass to the non-farm heirs, leaving farm assets to the farming heirs.
- Parents gift some money to the farm heir during their lifetime which would be used to purchase life insurance on the parents with the farming heirs as beneficiaries. This would provide money to enable the farm heir to exercise the buy-out provision and buy out non-farm heirs when the parents die.

- If you are in debt, a life insurance policy on yourself can provide money for debt payments and for estate tax obligations. This can relieve heirs of having to liquidate vital farm assets to pay off those expenses.

Life insurance should not be your only strategy but it can be a valuable strategy in your planning. Do not buy more than you need or can afford. Remember, if you own the insurance policy regardless of beneficiaries, the death benefit amount will be included in your estate value upon your death. This could cause a tax issue so check with your insurance agent, attorney, or accountant.

5. Passing on your farming know-how:

Pass on your wisdom. Share your "rules of thumb" and "things that went bad" and "what has always worked" philosophy. The younger generation may not always be receptive to your ideas, but this transfer of knowledge and know-how can give them a competitive edge on others. It can also help insure their success in running the farm business.

How to Be Fair With Non-Farm Heirs:

One of the most difficult questions many retiring farm families face is how to get a young son or daughter started farming while being fair to the non-farming heirs.

Non-farming heirs often leave the farm in their late teens for careers elsewhere. Most parents are concerned with being fair to all of their children at estate settlement time. Fairness, however, may not mean equal treatment of heirs.

Many farm families have reasons for unequal treatment of heirs. Some of those reasons include:

- Non-farm children received college tuition, a down payment on a house or other compensation, so they received their inheritance early.
- The farming heir helped create part of the final estate of the parents by actively contributing to the parents' business over the years, so they may be entitled to more. This is an issue of "Contribution vs. Compensation" – fair does not always mean equal! See *Transferring the Farm Series #11- Putting a Value on Sweat Equity* by Dave Goeller, University of Nebraska, Lincoln.
- Parents want the farm to "stay in the family". Consequently they are willing to give more to the farming heir whose goal it is to stay on the farm.
- Farming heirs are getting delayed compensation for work performed in years when they were underpaid.
- Farming heirs have been or will be attending to the majority of the physical and business needs of the parents in their declining years.

There are several methods farm families can use to transfer assets unequally but, in their minds, fairly to their heirs. They include but are not limited to the following:

- Parents write buy/sell agreements with farming heirs, committing to exact sale prices, terms, and timing of payments on farm properties. These agreements are binding on non-farm heirs; provide the farm heirs a guarantee of property purchase at an acceptable price and price, and guarantee off-farm heirs a fair price.
- Use of life insurance as mentioned earlier. In addition, parents purchase life insurance on themselves and list the off-farm heirs as the beneficiaries. In this case, farm heirs get farm assets and non-farm heirs get the cash generated by the insurance.
- Parents establish a Testamentary Trust (through a Complex Will) or Revocable Living Trust. It states that the farm heirs have the right to purchase farm assets from the trust at predetermined prices, terms and conditions over a number of years. This guarantees the non-farm heirs their percentage of the estate over time.
- The parent's Will has been used to equalize or to make fair any previous distributions to heirs. The Will may make special provisions to fit the situation. If the farming heirs or any heir has received earlier compensation, they may now get less than other heirs. Non-farm heirs may be given an inheritance of cash, non-farm assets or remote land holdings. Farm assets are transferred to the farming heirs.

It may be beneficial to involve all heirs in the transfer process but certainly to communicate to all heirs the final plans for distribution and transfer of assets. This communication should be done prior to your death so farming heirs are not left in the embarrassing position of trying to explain your actions. Doing this can avoid catastrophic family controversy.

One final point. Parents who develop a business transition and personal estate plan DO NOT have to stop farming the day they sign the plan. Developing a plan preserves what they have worked so hard to build. The plan insures the parent's wishes of having assets pass to whom they want them to go.

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.

Preparing to Meet With Your Transition and Estate Planning Team

Agricultural Business Management

Gary A. Hachfeld, David B. Bau, & C. Robert Holcomb, Extension Educators

Introduction:

Your business transition and personal estate plan is your road map into the future. The process necessitates discussion between involved individuals resulting in a prioritized list of goals for your business, your family, your retirement and yourself as an individual. It clears up questions and potential misunderstandings between family members. It is the document you take to your transition and estate planning team to begin the process. Without this list, your team cannot begin their work. They need to know what you want to have happen to your assets and more importantly what you do not want to have happen to your assets.

The entire process must be based upon your individual, family, business/retirement goals. See *Transferring the Farm Series #1-Preparing to Transfer the Farm Business*.

Who Should Be Involved In Preparation Process?

All exiting and entering farm business parties must be involved in the preparation process. This includes spouses as well as in-laws. Spouses and in-laws, who are informed about the process and actively involved in the process, are more supportive than if not involved in the process. They also bring a unique perspective to the process and often ask the kinds of questions needed to be addressed to accomplish a fulfilling end result.

There are a number of steps involved as well as a whole host of questions you will need to address before your preparation to meet with your transition and estate planning team is complete. The key here is to focus on completing your prioritized goals list for your business in addition to your goals for your family, yourself and your retirement. Do not get mired down in all the details of all the complex items around business transition and estate planning: which business entity should I have, do I need a trust or a Will, how does capital gains tax work and how do I avoid the tax, etc. Thinking about that detail will frustrate you, confuse you and ultimately keep

you from moving forward with your business transition and estate planning. Again, the key is to focus only on completing your prioritized list of goals. Once that is complete you are ready to meet with your transition and estate planning team.

To aid you in your preparation, here are some items to think about which may help you clarify where you want to go and also help clarify your preparation process. These items can be used to develop your goals list as well.

- How will the land be rented? What are rental rates and payment dates? How will rental rates be determined in the future?
- How will the machinery be transferred - gift, sale, lease with piecemeal buyout or exchange of labor for machine use? Who will pay the insurance, fuel, major and minor repairs? When will the machinery be transferred?
- How will livestock be transferred - lump sum sale, gradual sale, shared income for a few years, or livestock share lease?
- How will buildings and the house be handled? Use rent free? If not, what rental rate? Is it included with land rent? What arrangements are made for the transfer, sale, gift, or tax free exchange of real estate? Who will pay for insurance, real estate taxes, repairs, and utilities? Does the plan make maximum use of the Minnesota Homestead Credit?
- Are arrangements made to improve the security of the entering farmer – life insurance on parents, a buy-out provision giving the option to buy assets later, parents' living trust or Will to bind other heirs to sale terms?
- Will land be sold? If so, when and how will price and terms be determined? Would a buy-sell agreement be in order?
- Have adequate and acceptable housing arrangements been made for the long run? Is everyone happy with those arrangements?
- If parents will be working for their children, what is the method and rate of compensation? How much

will parents be expected to or want to work on the farm after retirement?

- If families will be working together through several transition years, who will be responsible for what segments of the business? Who will be responsible for and manage the livestock, crops, machinery, marketing, farm records, employees, etc.? How will work be divided? Are hours and vacation times agreeable to all?
- What are the arrangements for transition of management and who is responsible for overall decision making? In other words, who has the final word and when does that right transition to the next generation?
- How will the debt be handled? Does the entering farmer assume the existing debt, borrow elsewhere and pay off old debt? How will this impact existing farmer's tax situation?

When Should You Begin The Preparation Process?

The sooner a plan is established and implemented, the more confident the participants will feel. Once you decide to transfer the farm, the planning and preparation process should begin.

The process and resulting plan should provide for the complete transition of the business. Depending upon your situation, this may have to cover a period of 10 years or more.

As your goals, business, or family circumstances change, the transition and estate plan should be reviewed and revised when necessary or appropriate. Also, the exiting generation does not have to stop farming the minute they sign off on the plan.

Put It In Writing!

Put your goals and other thoughts in writing. If not written down, details are easily forgotten and often misconstrued as time goes by.

After a first draft, all farming parties should review the goals list and any other thoughts in the list. As soon as the document has agreement from everyone involved, a final list can be completed. As soon as the list is agreed upon, you are ready to meet with your transition and estate planning team.

Example Goals List (parent's perspective):

- We want to retire from farming in 5 years. Until then we want to continue to farm with our farming heir.
- We want to keep the farm land in our name until death.
- When we retire, we want to rent the land to our farming heir at a discounted rate.

- When we retire, we want our farming heir to purchase and move onto the farm site.
- After retirement, dad is willing to supply labor for the farm but our farming heir should be able to complete all farming tasks without having to rely on dad.
- Because of liability issues, we want to explore the possibility of forming a business entity.
- Beginning this year, we want to gift to our farming heir and spouse \$56,000 worth of equipment value each year for five years, with the farming heir purchasing any equipment not owned after that time.
- Beginning this year, we want to sell livestock, grain and feed inventory over a three year period with the farming heir buying what they need and can afford.
- We want to minimize any estate, capital gain and other tax obligations whenever possible.
- We want to avoid the probate process.
- We want to explore the possibility of purchasing long-term health care insurance.
- We want to retire to a house in town.
- Upon our deaths, we want the farming heir to get the farm land.
- Upon our deaths, we want our non-farm heirs to receive our house in town, our investments and our life insurance.
- Household and family heirlooms will be distributed through a private family auction with heirs using Monopoly money to bid on items.
- We want to include a plan for us and our family members in the event either or both of us become disabled.
- Upon the second death, we want to bequest \$25,000 to our church and \$5,000 each to our grandchildren.

Once the final version is complete, all farming parties should review it and determine if it is consistent with your goals. You may want to include non-farming heirs also. If the final plan it is what you want, have all farming parties sign off on the document. Consider giving them a copy.

Once complete, parents might want to consider having a family meeting where they share their plan. Share what you did and your reasons for doing it. This may prevent family disagreements after the death of the parents. If the farm business changes over time or the environment in which the farm business operates changes in the future, it is crucial that all parties review the transition plan. If necessary, the plan can be modified to reflect the current situation.

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.

Financial Help for Beginning Minnesota Farmers

Agricultural Business Management

Gary A. Hachfeld, David B. Bau, & C. Robert Holcomb, Extension Educators

Introduction:

Every farmer, when starting a farm business, has had to deal with how to finance his/her operation. Parental financing, the local bank or Farm Service Agency (FSA) financing and state government financing are all possible funding sources.

Parental Financing:

Parents often directly or indirectly help with financing. Many give direct help through gifting of assets such as feed, machinery, grain or livestock as well as possibly providing down payment money for land purchases. Others loan money to their children for various farming needs.

When lending money to children it is important to:

- Write up a promissory note which stipulates the terms of the agreement including interest rate, repayment schedule, and default remedies.
- Charge a reasonable interest rate which is similar to market place loans. You can charge less than commercial interest rates and also less than the Applicable Federal Rates (AFR). The AFR change monthly and can be determined by contacting your accountant or going to www.irs.gov and doing a search for AFR. If you charge less than the AFR, the difference will be considered a gift and may trigger gift tax consequences and Medicaid ineligibility - see your attorney or accountant.
- Expect and demand payments when due.
- Be prepared to write off the debt if it is not repaid. The Internal Revenue Service will not let you deduct it as a bad debt. Most bad debts to family members are considered gifts by the IRS and are not deductible to you as the lender. See *Transferring the Farm Series #6-Gifting Farm Assets*.

Direct lending of money to relatives is often the cause of broken relationships. Misunderstandings often occur. Proceed with caution when lending money to your children.

Another way parents can help is to give a loan guarantee to the local lender through the use of a co-signature. One could also assign collateral to secure the loan for a child. If the child pays off the note as agreed, loan guarantees can work well.

However, if adversity strikes and the loan is not repaid by your child, you must be ready to make the payments.

If you decide to make a loan guarantee for your child, limit the dollar amount you will guarantee. Don't co-sign an unlimited loan. It's like signing a blank check. Ask the lender to notify you immediately if payments are not made on schedule.

Farm Service Agency (FSA) Loans:

A better approach may be to encourage the use of FSA loans. You may be better off giving some cash or equity to your child so they can qualify for a FSA loan. Doing so can limit your risk of loss to what you gave your child rather than having to pay off an entire co-signed loan.

FSA has long been a source of funding for younger, beginning, low equity farmers. Availability and terms of loans vary as programs are started and terminated. Contact your local county FSA office about your particular financing situation and current financing availability.

The Minnesota Rural Finance Authority (RFA):

The Minnesota RFA is a department within the Minnesota Department of Agriculture. RFA has several financial programs available for beginning farmers. They include programs for the purchase of real estate, purchase of livestock equipment, livestock expansion, farm debt restructuring, farm improvements, purchase of value-added coop shares, and more.

To be eligible for any RFA programs, you must be a Minnesota resident purchasing Minnesota property. You must farm the land being purchased and have a financial need for the loan. In addition, you must have the educational background to succeed in farming, be enrolled in a farm business management program and file a soil and water conservation plan with local SWCD offices.

Interest rates, net worth requirements, and participation levels change annually in the RFA program. RFA also works with connecting retiring farmers with beginning farmers. It hopes to link up suitable retiring farmers with appropriate entering buyers, renters, leasers, or share arrangements. If

you are interested in this program and others mentioned, contact:

MN Department of Agriculture
625 Roberts Street N.
St. Paul, MN 55155-2538
Phone: 800-627-3529 or 651-201-6556

Internet website: <http://www.mda.state.mn.us>. Once there, click "Funding" top center of page and then click "Loan Programs".

Local Lenders:

Local banks can be excellent sources of financing for young farmers. Young farmers are most successful getting loans if they start early in their career, borrowing money and repaying it in a timely fashion. Establishing a good credit history and a good bank relationship, even while in high school, can result in good financial support from that bank as financing needs develop.

In addition, many local banks will work with you and assist with acquiring a FSA or RFA loan. Check with your local bank about these options.

Procedure When Applying For a Loan:

1) Be Well Prepared: Whenever you approach a lender for money it is best to be well prepared. This is especially true if you are approaching a lender who does not know you or your business. To have the best chance of getting your loan, you should clearly and professionally show the lender where you stand financially and how the money will be used and repaid. You can greatly influence a lender psychologically if you are well prepared and present yourself and your case well.

2) Items to Prepare in Advance: Your lender would like to see several statements. They include a net worth or financial statement, a projected cash flow, the last three year's income tax returns and a complete business analysis if possible. In addition, your particular lender may have other specific requests for information such as a business plan including goals.

When applying for a loan to add a new enterprise or expand a current enterprise, be sure to have accurate cost data on assets you will be purchasing. Secure certified bids or good estimates and bring them with you.

3) Records: If you have good records, assembling all of the above information is much easier. If you have a set of good records, you may wish to briefly show them to your lender during your presentation to further convince him or her of your business skills.

What It Takes To Get A Loan Approved:

Not all loans get approved. Following are some of the most common reasons loans do not get approved.

- You are not able to provide a substantial part of the asset value from your own funds. Many lenders will have lending limit percentages on the market value of land, machinery, livestock and buildings. Lenders generally insist that you share a portion of the purchase and therefore share some of the risk.
- If your cash flow projections show a poor repayment capacity, getting the loan will be difficult.
- If your net worth is small and you have nothing to lose if you default on the loan, you will have a more difficult time getting the loan.
- If you have a history of bad credit or late payment on previous loans, expect some difficulty in getting a new loan. Bankers will check out your credit reports. Protect your credit rating by paying off all loans (including credit cards) on time.
- If your business profit projections show a low profit or a loss, your lender will also hesitate to give you the loan.

Where to Get Help:

Your local MNSCU adult farm management instructor may be able to help you get started in the process of applying for a loan. You can find that local person in MN by going to www.mgt.org, selecting "farm business management" then selecting "deans & instructors" and then selecting your location in the state.

Also available is the U of M Southwestern MN Farm Business Management Association (SWMFBMA). Your local Extension SWMFBMA field person can also provide you with some help. To contact them call 507-752-5081.

Your accountant is another person who can help you prepare the above forms. You can also purchase FINPACK financial planning software through the Center for Farm Financial Management, University of Minnesota, by phoning 1-800-234-1111. The software will enable you to do cash flow planning, long-range planning, and year-end analysis.

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.

Putting a Value on Sweat Equity

Agricultural Business Management

David Goeller, Transition Specialist, Dept. of Agriculture Economics, U of Nebraska-Lincoln

For some farm/ranch families, deciding what to do with the family business can be very troublesome. How can we pass the farming business to the next generation while at the same time not create animosity or envy between the heirs? If we divide it equally between all the children, will it create such small pieces that the successor child cannot make a living operating the family farm? If one child is required to buy out his/her siblings will the business generate enough income to make this a feasible option? Most parents would say "We want to treat our children fairly." Is dividing the farm equally between all the children always a fair solution?

Last week I found myself thinking about a family farming operation struggling with the dilemma of planning their estate. Let's call this family the Smiths. Like many families, Dad and Mom Smith would like to keep the "farm in the family." Fortunately for them, son Jimmy, the youngest of three children, decided to return to the business in 1990. But unfortunately, if the farm business were divided into three equal pieces, the resulting slice would not be of adequate size to create a viable operation.

When Jimmy came back into the family business in 1990, the fair market value net worth of the business was \$600,000. Dad and Mom discussed the contribution that each child had made over their "growing up" years and decided that each child had contributed more or less about equally to the business during those years. So \$600,000 divided equally between the three children is \$200,000 each. Today's net worth of the business has grown to \$1,500,000. If divided equally between the three children \$500,000 would be left to each. The contributions from the three children toward the success of the farm business have very definitely not been equal since Jimmy's return, however.

There were no promises made to Jimmy when he returned to the farm, but many decisions were made differently because he was part of the business. When the neighbor's land came up for sale, Dad and Mom would not have been interested in purchasing that land if Jimmy had not been involved. It was Jimmy's idea to increase the rented land and add a cow/calf enterprise to the business. It was also the labor and new energy provided by Jimmy that

allowed the business to profit, expand and grow. Jimmy has been paid a modest wage and allowed the use of machinery as he has developed his own farming business. But Dad, Mom and Jimmy all know that his contribution to the family farm has resulted in Jimmy developing a sizable investment of "sweat equity" into the farm business.

There are two dilemmas present in this example. The first arises because most of us want to treat our children fairly. Many of us think that the only way to treat each child fairly is to treat them equally. Maybe that's the way it was always done in our family. We certainly don't want to be the cause of any hard feelings. We don't want our non-farm kids to feel that they have been mistreated or slighted, but if you were to divide the farm business into equal pieces would that equal slice be of adequate size to create a viable business? What about the contribution of the farming child to the success and growth of the business? The second dilemma occurs because farm asset values have increased so dramatically. Earning adequate income to pay for the increased value of the assets may be difficult, if not impossible for a successor to accomplish. If the Smiths want their son Jimmy to be successful, they need to consider the income the operation will generate as well as the market value of the farm assets.

Let's look at how the Smith family valued the contribution of their son Jimmy by putting a value on his "sweat equity." Once completed, they used this to explain to the non-farming kids how they reached their estate planning decisions.

Today the farm's net worth is \$1,500,000. If the Smiths were to divide the assets equally, they would leave \$500,000 to each child. But as they considered the contributions made by each child and the impact in the business growth because of Jimmy's return, they thought of it this way. There has been \$900,000 of increase since 1990. The business has grown and diversified. Profits have been reinvested into the farm, and farm assets have appreciated in value. Jimmy has contributed a substantial amount of "sweat equity." Both parents feel that they may have actually retired several years ago and sold some of the original land (prior to the recent jump in land values) had Jimmy not decided

to return to the farm. After much evaluation and discussion Dad and Mom decided that they would equally divide the 1990 value of the farm between their three children, but they decided that Jimmy was responsible for 50 percent of the business growth since 1990. They therefore decided to allocate their assets as follows:

1990 Jimmy Returns to the Family Business:

- 1990 Net Worth of the family business = \$600,000
- 1990 Net Worth divided equally
between 3 heirs = \$200,000

Business Growth, Appreciation, Inflation and Diversification:

- 2009 Net Worth has increased to = \$1,500,000
- 1990 Net Worth of family business = \$ 600,000

Net Worth Growth is = \$ 900,000

Parents Attribute 50% of Growth in Net Worth to Jimmy:

- 50% of \$900,000 = \$450,000 attributed to
Jimmy's contribution
- 50% of \$900,000 = \$450,000 attributed to
parent's contribution
- \$450,000 parent's portion divided by three
equals \$150,000 each child

Asset Distribution in Estate Plan:

- Jimmy receives \$800,000 total:
\$200,000 (1/3 of 1990 net worth) plus
\$450,000 (50 percent of growth contribution)
plus \$150,000 (1/3 of parent's contribution).
- Non-Farm Siblings receive \$350,000 each:
\$200,000 (1/3 of 1990 net worth) plus
\$150,000 (1/3 of parent's contribution).

Jimmy's contribution of 50 percent is simply an example. Every operation will have different factors and likely arrive at a different percentage for the value of the successor's contribution. In the Smith's case, Jimmy will receive more than twice as much as his brother and sister. However, they all understand the basic process. Contributions equal compensation. The family business looks much different today because Jimmy came back to become part of that business.

Each family situation will be different. The next family may have decided that their successor had contributed to only ten percent or maybe 80 or 90 percent of the growth. The question is how much has the "sweat equity" contributed to the growth of the farm? It is the business owners that are in the best position to evaluate the contribution and adjust the compensation accordingly. The Smith children understand how the estate is to be distributed, and hopefully, they will all be eating Christmas dinner together for years to come.

Treating unequal's equally, may be the most unfair thing you can do!

University of Nebraska Extension educational programs abide with the non-discrimination policies of the University of Nebraska-Lincoln and the United States Department of Agriculture

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.