

Transferring The Farm Series # 1

PREPARING TO TRANSFER THE FARM BUSINESS



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Introduction:

Transferring the farm business to the next generation is seldom an abrupt process. The transfer generally takes place over a number of years. The succeeding generation needs to establish a firm financial footing as well as learn 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 long-term assets. The total of all these assets can be well in excess of \$1 million.

The transfer 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 retirement income and anticipated living expenses. 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 nursing home expenses? Remember, people are living longer and this requires more financial planning.

Financial Position of The Entering Farmer:

Give serious thought and planning to the financial position of the succeeding 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 for themselves. If the answer to these questions is "no", you may want to delay transferring the business. The succeeding generation needs to improve their financial position or you need to plan on making major concessions to get them started in the business.

Your Social Security (SS) Position:

Every individual is different regarding their SS contributions and status. Changes in SS rules may affect your plan to transfer out of 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 sellout.

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 role.

Your Emotional Readiness to Transfer the Farm:

If the farm has been 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."

Your Health:

Transferring your farm 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 transfer 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 transfer management skills and management decisions to the entering manager?
 6. Have the parties involved in the transfer 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 learn 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 transfer and a business agreement prior to starting the transfer 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, allowing the entering party the right to purchase assets in the future? The agreement should be binding on the 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 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?
 16. Can and will both parties put together a tax plan which will be acceptable to everyone as they transfer assets?
 17. 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?
 18. 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 living trust?
 19. Are all parties willing to pledge that they will **not** try to control any aspect of the other parties' business and personal lives?
 20. Are entering children willing to pay parents adequately for work done on the farm after retirement?
 21. Are entering parties willing to sacrifice standard of living and go the "extra mile" with work to get started farming?
 22. 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?
 23. 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.
 24. Do the entering parties have a realistic grasp of agriculture in the 21st century 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 transfer of the farm. If you answered "No" to any question, you may wish to evaluate the situation before you proceed.

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FARMING TOGETHER AS A TRANSFER STRATEGY

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11/2003

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 as a trial period for the succeeding generation.

During this period, parents often farm together with the generation who will be taking over the farm business. This can be an ideal time for the parents to step back a bit from the farm business. The generation taking over can determine if farming is really what they want to do.

For two generations to farm together, 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 eventually can 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.

A Trial Period:

This may be the best way to begin testing compatibility and commitment. One approach is the parents would hire the aspiring younger generation on a simple wage or incentive plan for a year or two. During this period, serious consideration should be given to the younger generation's ability to contribute to the business and its management, to personality compatibility and to the skill level of participants. 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 partnership or corporation, farming together but separately, may be an option to consider. An entering son/daughter might rent some additional land. He/she might use dad's machinery in exchange for work being contributed to dad's farm business. The son/daughter may or may not pay for his/her own fuel and repairs depending on the agreement. Perhaps he/she can also rent existing livestock facilities from a neighbor. In either case, the son/daughter 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 operation, and taking total charge of marketing decisions.

By farming together, a father and son/daughter can enjoy the efficiencies of working together and joint use of one line of machinery. At the same time, the son/daughter can build skills and confidence by managing their own enterprises.

As time progresses, the son/daughter can eventually take over more of the father's crop land or livestock enterprises.

As machinery needs replacement, they should begin to purchase the new items as they can. Eventually, dad may purchase no new machinery as he approaches retirement. This method provides a way for a son/daughter to buy the machinery gradually and for dad 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 Farming:

Without a partnership or corporation, multi-owner operations can get very complicated and 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 are owned 50 percent – 50 percent – 0 percent; some 33-33-33; others are 0-50-50 or 100-0-0 or 0-100-0.

In most cases of multiple ownership where more than two individuals are involved, a partnership or corporation may be a better form of business organization.

Partnership or Corporation:

If you have multiple enterprises and multiple operators, it is almost a necessity to form a partnership or corporation to adequately handle the transfer. Partnership units or corporation shares can be easily sold, gifted, or passed through a will among partners to transfer the assets.

Forming another business entity should not be done without thorough investigation of the ramifications. Both entities are very complex and require professional legal and tax advice. For more specific information on partnerships and corporations see Transferring The Farm Series # 3 entitled *Using Farm Partnerships or Corporations To Transfer Assets*.

When establishing another ownership entity, partnership or corporation, 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 unit shares or stock shares

The business entity then begins operation with the assets. It deposits income and pays expenses out of the company checking account. Expenses include wages to workers or a living draw to partners and also includes rental 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 shares provide a convenient way to transfer ownership. Parents can gift or sell ownership units

or corporate shares to their heirs. Younger shareholders can buy shares or sell shares to one another. This is very useful if an individual wants to enter or leave the partnership or corporation.

Many times it is desirable for owners to keep many of their assets out of the partnership or corporation. It makes it much easier to do tax planning and liquidation of the entity is much less of a tax problem. Often land is kept out, as are machinery and breeding stock. The new entity sometimes contains only “operating” assets.

Farming together in a partnership or corporation can be a very rewarding experience if all parties remain focused and committed. If however, inequities 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, it is recommended that the farming partners meet often to discuss day to day operation, 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.

Conclusion:

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

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USING FARM PARTNERSHIPS OR CORPORATIONS TO TRANSFER ASSETS

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Partnerships:

Partnerships have been used for years in agriculture. They are used when two or more people wish to run a business jointly. The individuals pool their capital and labor and form a partnership. Partnerships are most successfully used for the operating side of the business. Often land is owned individually and kept out of the partnership.

Forming a Partnership:

To form a partnership a name must be selected and a bank account opened. Partners contribute cash or assets to get the partnership going. The partnership may then begin borrowing money to operate. It is best to have a written partnership agreement. It should state the purpose and detailed functions of the partnership. It should cover contingencies such as what happens at the death or withdrawal of a partner. Details of capital contributions, labor involvement, decision-making, check writing authorization and partner responsibilities should be included.

Partnership Operations:

A partnership pays no income taxes. All income, capital gains and credits are passed through to the partners on a prorated basis. The partnership must file a Form 1065 informational tax return, which is due April 15th each year.

A major drawback of a partnership is that each partner is **fully** liable for the debts and obligations of the partnership. A creditor can claim all partnership assets **and** the individual partners assets to the extent of any debt owed.

A partnership is not a stable organizational structure. Death of a shareholder or willful withdrawal by a partner can seriously disrupt partnership operations. The partnership agreement should clearly describe buy out agreements or state how 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 \$100,000 Section 179 depreciation expense (2003), which is passed on pro rata to the partners. Each partner can claim up to \$100,000 per

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

Partners are self-employed individuals and must pay self-employment tax on their share of earned partnership income. 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 costs less to form a partnership than a corporation and partnerships are less formal to operate.

Transferring Assets in a Partnership:

A partnership can be a valuable transfer tool. Each partner/owner holds partnership units. These units can be sold, gifted or willed to others. Parents can gradually transfer these units to the entering generation. Usually, the younger generation gradually purchases a percentage interest in the partnership from the parents. They may initially purchase or receive as a gift 10 to 25% of the partnership and gradually buy out the remaining percent as the parents retire.

Farm partnerships can provide a lot of flexibility in transferring to the next generation. Creative use of rents, wages, draws, and sales can aid a successful transfer.

The Limited Partnership:

A limited partnership may be formed to transfer assets. A limited partnership, limits the liability for debts or obligations of the partnership. The general partner is solely responsible for satisfying debts incurred by the partnership. A limited partnership may be useful in transferring land to the next generation. A parent can put land into a limited partnership yet remain as controlling general partner. He can then gift or sell limited partnership units to heirs.

Corporations:

A corporation is a separate and distinct entity from the individuals who own it, operate it or work for it. Corporations provide operating and tax alternatives as compared to operating your business as a self-employed individual or partnership.

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% of the stock gives you control. Minority shareholders have little if any decision making control unless permitted 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.

Two different taxation structures are available to corporations. A regular "C" corporation pays income taxes. An "S" small business corporation pays no tax itself, but passes all income through to shareholders on a proportionate basis. The shareholders pay the tax.

Generally, operating assets should be put into the corporation, while capital assets such as land should be kept out.

Why Do Farms Incorporate?:

Farms incorporate for many reasons:

- It is easy to transfer shares. Shareholders can gift or sell 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 is easier to value shares than individual farming assets.
- Many farms lower their income taxes when they form a "C" corporation. They, in effect, create a new taxpayer, who is taxed at 15% on the first \$50,000 of income.
- Self-employment taxes 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. The corporation can also rent land from shareholders. Recent court rulings maintain that land rent received from your partnership or corporation is not subject to SE tax when received by shareholders.
- 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.
- Fringe benefits are deductible by "C" corporations. Health, accident, and up to \$50,000 of term life insurance are deductible to the corporation, but not taxable to employees.
- A corporation provides some liability protection not available to self-employed individuals. Generally, assets owned individually by shareholders (except for

corporate shares) are protected from liability claims made against the corporation.

- 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.

Concern with Farm Corporations

- 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 excess profits. Profits paid out to shareholders as dividends are taxed twice, once as income to the corporation and again as dividend income to the shareholders. Excess profits retained by the corporation may be subject to accumulated earning taxes.
- 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 (off farm heirs), may own shares that generate no income, and hence have not 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.

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TRANSFERRING LIVESTOCK & MACHINERY

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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 chief concern here involves self-employment and income taxes.

Income Taxes:

Income taxes must be paid on sales of crops and market livestock when received by a cash basis farmer. Selling everything in one year can push you into a high tax bracket. Spreading the income over a couple of years may provide some tax relief. 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. Consider the following:

- Selling everything in one year may lessen your overall SE tax. The SE tax is currently charged on all income up to \$87,000 (2003). Bunching all SE income into one year to greatly exceed the \$87,000 threshold may result in less SE tax paid than by spreading out SE income over several years and paying 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.
- 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 Social Security (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** your retired), benefits will not be reduced.

Other Tax Considerations:

If you wish to sell feed crops to an entering farmer, you

do so and take payments as they fit your income and self-employment tax plan. 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 entrant and let them assume a 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.

Example #1: Transferring a market hog operation. A date should be established for the transfer to occur. A fair market value appraisal of assets should be taken as of that day. Here are two ways to transfer the market hogs:

- Entering farmer (son) buys the small piglets still nursing the sow, while exiting farmer (dad) retains ownership in all weaned pigs through market weights. Dad sells off his pigs as they become ready for market. Feed and operating expenses must be split between the two entities while dad sells off his remaining hogs. This method keeps the son's initial investment proportionally low, but he also receives no cash flow until his first hogs are sold.
- Entering farmer (son) buys all market hogs on a given day and assumes all feed and operating expenses as of that day. Exiting farmer (dad) could receive payments based on a percent or fixed dollar amount for each hog sold to ease financing demands on the son. For example, son pays dad 60 - 80 % or \$60-80 per market hog sold. Payment is made each time hogs are sold until they are all paid for. This method gives the son immediate cash flow of both income and expense, but he assumes more market price fluctuation risk.

Example #2: Transferring a cattle feedlot operation. Most transfers begin when the younger person buys several cattle and runs them into dad's lot. Often there is an exchange of feed for the son's labor. As the son's equity grows, he may buy a 20 or 30% interest in a certain lot of cattle. Later he may purchase an entire lot when dad begins to phase out. (These same principles can be used as a young

son or daughter phases into a crops or dairy operation.)

Selling Breeding Stock and Machinery:

The good news about transferring breeding stock or machinery and equipment is that sale income from these assets is not subject to (SE) tax. However, you will have to pay income tax on the difference between the adjusted basis 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 the year of sale. Raised breeding stock can be reported to the IRS using installment sales reporting, unless the buyer is a related party.

Leasing Equipment:

Leasing lets you receive rental income while retaining ownership and depreciation deductions on the property. If you chose to lease please note:

- Your lease agreement should not indicate any specified buy out provision. If you have a buy out provision, IRS will probably disqualify the lease and call the entire transaction a sale subject to immediate taxation.
- Leasing fails to add assets to the entering farmer's net worth. A piecemeal sale may add to the buyer's net worth.
- Leasing any personal property may require you to pay self employment tax on the net proceeds. IRS has an increasing tendency to treat leasing activity as a leasing **business** subject to SE tax. If the IRS treats your machinery leasing activity as a business, the income may reduce the social security benefits you are currently receiving.

Gifts:

If you can afford to do it, it may be prudent to gift crops, livestock, or pieces of machinery to the next generation. See Transferring The Farm Series #6 entitled *Gifts Farm Assets*.

Piecemeal Sales:

Selling a tractor this year, a planter next year, and one-half of a combine the following 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 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 a 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 80 or

160 acres after retirement so that you can claim some depreciation.

Hybrid Methods:

When transferring breeding stock and machinery, it makes sense to combine the above three strategies (leasing, gifting and piecemeal selling) to some degree.

- You might lease 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.

Example 1: A dairy farmer might transfer his/her cows by leasing the cows for a set amount per year. Cull income comes to the owner while replacements must be purchased by the son or daughter. After 4 or 5, years all remaining cows are purchased at a price negotiated at that time of the sale.

Example 2: Selling machinery for cash or on a contract usually triggers the immediate taxation on the proceeds. A farmer might instead decide to sell a machine or two each year while occasionally gifting another machine to his farming children.

Charitable Remainder Trust:

A Charitable Remainder Trust allows a donor to transfer assets to a trust to avoid immediate taxation on the disposal of the assets. The trust provides taxable income to the donor for a fixed number of years, after which the residual or remainder is paid to a designated charity. Generally, the trust sells the transferred asset and invests the proceeds to provide income to the donor. If the donor transfers appreciated property to the trust, they will also receive a charitable deduction at the time of the gift. If the donor transfers property with no basis, they will not receive a charitable deduction. However, if a donor transfers grain or market livestock, they will avoid paying self-employment tax on the transferred asset.

Selling, gifting or leasing machinery and breeding stock is an area of major tax impact. Seek good tax and legal advice before implementing any transfer plan.

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SHOULD YOU SELL YOUR REAL ESTATE?

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Introduction:

A major portion of most retiring farm family's asset base is 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 out. 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 or landlord has to also assume responsibility for storage and marketing of their share of the crops 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 house?

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 maintaining good tenants is a problem. 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 or a farm building site for \$320,000 that has a cost basis of \$50,000 will result in \$270,000 of taxable gain. This can result in \$40,000 to \$70,000 of federal taxes alone. Selling the house can usually be done tax free as well, providing certain tax law rules are followed.
- Gifting: Buildings can be gifted to farm heirs as well. This is assuming the grantor of the gift can afford to do so.

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, filling 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 any number of times during your lifetime, providing you meet the “personal residence” qualification.

Ways 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 income 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. 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.
- 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.

Example: In 2003, Mom decides to sell a designated 10 acres to her son, Bill, for \$10,000. In 2004, she sells another 5 acres for \$5,500. In 2005, Bill has a good year and is able to purchase 15 acres for \$16,000. Bill has acquired 30 acres in 3 years, has them paid for, and has no debt or further obligation to Mom. Bill may wish to enter into an "option to buy" with Mom for various parcels over a number of years. This would guarantee his right to purchase an entire 80 or 160 acres even though Mom may die.

- Consider a tax-free exchange. Exchanging like-kind property with your child can postpone the taxation of gain.

Example: Assume you own a 160 acre farm worth \$320,000 with a tax basis of \$40,000. You exchange it even up for similar property worth \$320,000. You now own the new property with a basis of \$40,000. No income taxes are paid on tax-free exchanges if no money or unlike kind property is involved.

A tax-free 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.

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GIFTING FARM ASSETS

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11/2003

Gifting Assets:

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

- Help reduce a taxable estate
- Transfer income tax obligations to children
- Help get a young farmer established

Gifts are always valued at fair market value (FMV) at the time of the gift. Federal law allows you to give \$11,000 per recipient per year and pay no gift taxes. A married donor who owns property individually can treat a gift as though the non-donor spouse has given half of it, so that together they can give \$22,000 per recipient per year.

Example: A husband and wife could join together and give the husband's 80 acre farm worth \$176,000 to their eight children in a single year. Each child would receive a gift valued at \$22,000 with no gift tax incurred by the parents. You can give unlimited gifts to your spouse or to a charity in any year with no gift tax consequence. You can also gift unlimited amounts for tuition or medical care.

Currently every person has a lifetime credit with the Internal Revenue Service, which will offset gifts of up to \$1,000,000 (2003). Gifts given in excess of the annual exclusion (\$11,000) reduce the lifetime \$1,000,000 exempted amount.

Example: Sally Smith gave \$51,000 to her son, Paul, in 2003. Subtracting the \$11,000 annual exclusion there remained a taxable gift of \$40,000. This amount is subtracted from her \$1,000,000 lifetime gift credit amount. This would leave \$960,000 of the credit to be used for future gifts.

No gift tax is payable until the total \$1,000,000 credit 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 exceeds the annual \$11,000 exclusion.

If gift taxes are payable, they are paid by the donor (giver) not by the donee (receiver).

Gifts of Cash:

Gifts of cash are neither deductible to the donor nor taxable to the donee. They have no income tax consequences.

Example: You give each of your children \$5,000 for Christmas. No one has any income tax consequences.

Gift of Appreciated Property:

Gifts of appreciated property held long enough to qualify for long-term capital gain treatment could be gifted by high tax bracket parents to children in low tax brackets to save taxes.

Example: Parents in the 25% income tax bracket gift cull dairy cattle to their son who is in the 10% bracket. The parents would have paid 15% capital gain tax on the cattle. Instead, the son pays 5% capital gain tax. Since the dairy cattle were raised and over 24 months old, they have no basis, so are taxed as 100% long-term capital gain.

Be cautious when gifting appreciated property to children under 14 years old. If the child's income is above certain levels, generally \$1500 of unearned income, they will be taxed at the parents' top marginal tax rate.

Gifts of Grain or Market Livestock:

Gifts of commodities are often used in parent-child transfers. If a parent gives grain or livestock produced in the farming operation to the children here, are the consequences:

- If FMV of the commodity is under \$11,000, no gift tax is required.

- The cash basis parent does not include the commodity on his/her tax return, thus reducing both income and self-employment (SE) taxes.
- The child must show the income on his/her tax return and pay income tax, not self-employment tax, on the income.
- If the parent gifted the grain or livestock in the year of production, he or she must reduce deductible expenses by the cost of producing the grain (basis), 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 basis is zero. When giving commodities, the best advice is to give crops or livestock produced in a year prior to the time of the gift.

Gift of machinery:

Gift of equipment to the next generation provides several advantages to both parents and children. Since it is a necessity that the younger generation receive substantial financial aid to get started farming, gifting of machinery can provide equity on their balance sheet. It gives needed equity to the farm successor. Gifting machinery can reduce the tax burden of the parents. Gifted assets are never "sold" on the parent's tax return, thus reducing taxes. 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.

Any of your remaining basis for depreciation on the gifted machine passes to the receiver of the gift.

Example: You give a tractor to your daughter which has \$3000 of value left to be depreciated. You lose the \$3000 deduction; however, your daughter can claim depreciation on the remaining \$3000 basis.

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

Example: John gifts a completely depreciated combine valued at \$30,000 to May and she assumes a \$25,000 debt on it. John has \$25,000 of taxable gain and made a \$5000 gift.

When you gift a machine, document the gift by stating it in writing. Sign and notarized the document effective the date of the gift.

Gift of Land:

You can gift land by deeding over actual acres. For example, you may give the west 20 acres to John and the east 20 acres to Mary. Giving actual acres requires legal work and legal descriptions of the property when each gift is given.

You can also gift land by deeding an undivided interest in property to children. You can give a 10 percent interest in the 160 acres to John and Mary (together or separately). This method may require less legal work.

Some families form family limited partnerships for the purpose of gifting land to the next generation. The parent stays in control as the general partner, but transfers limited partnership shares to children over time. There are often estate considerations when considering limited partnerships as well.

Gift of contract for deed payments:

After executing a contract for deed with children, some parents decide they would like to discontinue the contract or forgive the annual payments.

If you wish to do so, the best procedure is to collect a check for the principal and interest payment and then issue a check to the children for any gift you wish to make. Ignoring the check exchange can result in the children not having complete evidence of having paid for the property. You must declare payments received on a contract on your tax return. These payments must be declared even if you forgive the payment.

Can you afford it:

Gift of 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, proceed carefully.

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MAJOR TAX CONSIDERATIONS WHEN TRANSFERRING ASSETS

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Income Tax Basis:

When selling an asset, you pay tax on the difference between the selling price and the income tax (or cost) basis of the asset.

Example: If you sell land for \$100,000 and your income tax (or cost) basis for the land is \$20,000, your taxable gain is \$80,000.

Income tax basis is your cost to recover when you sell the asset. Your income tax, or cost basis, is determined by how you acquired the asset.

If you purchased the asset:

Generally, your basis is what you paid for it minus any depreciation you've claimed on it.

Example: 1) If you purchase a tractor for \$20,000 and depreciated it for 3 years claiming a total of \$7000 depreciation, your basis would be \$13,000. 2) If you purchased land and have claimed no depreciation on it, your basis is what you paid for it.

If you inherited the asset:

Your basis is the Fair Market Value (FMV) or special use value assigned the asset as it passed through the estate.

Example: You inherited some land from your mother, which was valued in her estate at \$160,000. Your tax base is \$160,000.

If you received the asset as a gift:

Generally, your basis is the same basis as 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.

Basis of assets is extremely important to holders of property since it determines the amount of income 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 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 300 acres of farmland for \$1500/acre or \$450,000. It had a tax basis of \$100,000. Her taxable gain whether sold for cash or by installment method would be \$350,000. Because of the sale, she or her heirs, must pay income tax on the \$350,000. However, if Sally retained the property until her death, the estate would assign a stepped up basis of (FMV) \$450,000. The heirs could later sell the property for that amount and pay no income tax.

House:

If you sell your farm, which includes your personal residence, up to \$250,000 (\$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 Credit:

Qualifying owners who live on the farm, or in the house on the farm, can receive reduced real estate tax payments due to the Minnesota Homestead Tax Laws. This credit can reduce real estate taxes substantially each year. Structure your transfer plans to make the best use of this credit. Farm owners who have relatives living on their farm, may qualify for a double homestead credit. They receive one credit on their personal residence and a second credit on the farm, if a relative lives on the farm or farms the land.

If you sell your home but retain a life estate, you may be disqualified from using the personal residence exclusion. You can still maintain the Minnesota Homestead Credit.

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 received. Most items can be sold using the installment method. However, 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 Exchange:

If the younger generation owns tradable property, a **like-kind** tax-free exchange might be used to transfer farmland or buildings. This is a complicated tax move, but can move the younger generation onto the home farm and leave the older generation with more remote, low maintenance farmland. Using the tax free exchange can avoid or postpone taxation of the parents' capital gains on low basis property.

Spread Out Income:

In most cases, 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 or three-year period. Leveling income usually results in lower taxes paid compared to bunching income into one year.

Capital Gains:

Current Federal law allows taxpayers to pay tax at a 5% or 15% rate (depending on income level) on many long-term capital gain items. Those items include stocks, bonds, and land held longer than one year, as well as some raised breeding stock. Farm building sales are generally subject to different tax rates. State taxes must also be paid on capital gains. Care should be taken when planning a transfer to maximize use of the lower tax rates available on capital assets. Sales of capital assets are not subject to self-employment tax.

Income Averaging:

Income averaging allows farmers to utilize lower tax brackets available from the previous three years, in a high income tax year. It 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 at a high level during your lifetime to the Social Security system, your best option may be to retire at age 62. Retiring at 62 may generate \$6000 - \$12,000 or more in annual social security checks for you and your spouse. You will receive a reduced monthly benefit compared to retiring at your full retirement age. However, it will take many years of higher benefits to offset drawing reduced benefits for several additional years. In addition, farmland rental income is not subject to social security taxes. Not retiring at 62 could cost you up to \$20,000 or more per year due to not collecting monthly benefits and having to pay added tax on SE income.

If you delay retirement 3 years, the penalty for delayed retirement could total \$60,000 or more. If you've been a high-income person and contributed for 35 years, it is unlikely that additional contributions will significantly raise your benefits.

If you have contributed to Social Security on a low level of earnings during your lifetime, it may be advantageous to delay retiring until age 65. Hopefully during these last few years you can build your benefit package by making larger contributions to Social Security. High earnings and high contributions could have a significantly positive effect on your Social Security benefits.

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TREATMENT OF THE HEIRS IN THE TRANSFER PROCESS

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11/2003

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 narrow 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 handsome nest egg, parental concessions are needed if the young farmer is to get started successfully.

Farming children 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 children.

It is not enough to say "You'll be taken care of when we are gone". You need to take 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 a transfer plan:

Formulate a detailed written transfer plan with the help and input of all parties involved, especially spouses and in-laws. Discuss it, sign it and work from it, so everyone knows what's ahead. Then execute it and transfer some assets soon so farming heirs can begin business and feel some pride of ownership.

2. Offer a purchase agreement:

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 off-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 off-farm heirs in an unsatisfactory lump sum after your death.

3. Provide Protection in Your Will or Living Trust:

When writing your will or living trust, make sensible provisions for your farming heirs. 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 farming heirs, but cash or non-farm assets to non-farm heirs.

Example 2: Enact a provision allowing your son 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 as to how the farming heirs might buy out the other heirs.

4. Life insurance planning:

Parents have several options regarding insurance:

- Carry enough insurance on yourself to provide adequate dollars at your death to pay off the non-farm heirs, leaving farm assets to the farming heirs.
- Gift some money to the farm heirs during your life time which they would use to purchase life insurance on you. This would provide money to help buy out off-farm heirs at your death.

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

5. Passing on your farming know-how:

A key to protecting your farming successor is to spend some quality time with them during the transition years. This time should be devoted to the transfer of management and farm operation skills.

- Show them how to do the physical things. Pass on your electrical, carpentry, mechanical, and equipment operation skills.
- Teach them to handle the management of the farm business. Share how you make decisions, who you listen to for advice and how you make the best use of your resources. Pay particular attention to successes you've had in terms of financial matters.
- 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. However, whatever you can do to transfer your knowledge and know-how to your successor 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 Off-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 off-farm 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:

- Off-farm children received a college education, a down payment on a house or other compensation, so they may get less at estate settlement time.
- The farming heir helped create part of the final estate of the parents by actively contributing to the parents' business over the years, so may be entitled to more.
- Parents want the farm to "stay in the family". Consequently they are willing to give more to the 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 or will attend to the physical and business needs of the parents in their declining years. Non-farm heirs may not have helped.

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 off-farm heirs, provide the farm heirs a guarantee of property purchase at an acceptable pace and price, and guarantee off-farm heirs a fair price.
- Life insurance on the parents has sometimes been purchased and paid for by the farming heirs. This method provides money to buy out off-farm heirs at the time of the parent's death.
- Parents purchase life insurance on themselves and list the off-farm heirs as the beneficiaries. In this case, farm heirs get farm assets and off-farm heirs get the cash generated by the insurance.
- Parents establish a living or testamentary 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 off-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. Off-farm heirs may be willed cash, non-farm assets or remote land holdings. Farm assets are willed to the farming heirs.

It is a good practice to involve all heirs in the transfer process and 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.

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FINANCIAL HELP FOR BEGINNING MINNESOTA FARMERS

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11/2003

Introduction:

Every farmer, when starting a farm business, has had to deal with how to finance his/her operation. Parental financing, bank or Farm Service Agency (FSA - formerly FmHA) 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 but not 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.
- 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* entitled *Gifting Farm Assets*.

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

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 and 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.

Local Banks:

Local banks are excellent sources of financing for young farmers. Young farmers are most successful getting loans if they start early borrowing money and repaying it. 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.

The Minnesota Rural Finance Authority (RFA):

The Minnesota RFA has several programs available for beginning farmers. They include:

1) Basic Farm and Seller Assisted Loan Programs:

These are land purchase programs in cooperation with local lenders. RFA provides 45% of the first mortgage to a maximum loan of \$125,000. A minimum payment of 10% down is required. You negotiate with the lender for terms on their portion of the loan. To be eligible you must currently own less than 240 acres of farmland. Sales are allowed between related persons and funds can be used for land or improvements. You must farm the land to be eligible for this program. You can have a maximum net worth of \$263,000.

2) Aggie Bonds – Beginning Farmer Program:

This loan may be used to purchase real estate, farm improvements or to buy machinery or breeding stock.

Sales between family members are **not** allowed. Refinancing of existing debt is **not** allowed and a 1.5% loan origination fee has to be paid. The maximum aggregate loan is \$250,000 of which \$62,500 may be used to buy depreciable assets.

This program allows participating lenders or contract for deed sellers to offer interest rates below the present market rate. Your net worth must be under \$263,000 (2003) to qualify. Also, you can never have owned more than 30% of the county median size farm.

3) RFA also has available an Agricultural Improvement Program, Livestock Expansion Program, Restructure II Program, and a Value Added "Stock" Loan Program.

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:

Rural Finance Authority
90 West Plato Blvd.,
St. Paul, MN 55107
Phone: 651-297-3557 FAX: 651-296-9388

Internet: <http://www.mda.state.mn.us/agfinance>

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. Here 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 only lend up to 60 percent of market value on land, 70 percent on housing and 80 percent on machinery or buildings. In some cases, if you have the feed, 100 percent will be advanced on feeder loans or you have a trade-in machine, the lender will finance 100 percent of the "to boot" money. 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 low** 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 vocational agriculture or Technical College ag instructor may be able to help you get started in the process of applying for a loan. Your local Extension Educator or Farm Management Association field person can also provide you with some help. Your accountant is another person who can help you prepare the above forms. You can 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.

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DEVELOPING A WRITTEN TRANSFER PLAN

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Introduction:

Developing a written transfer plan is an important part of a successful farm transfer. The process necessitates discussion between involved individuals resulting in a more focused plan. It clears up questions and potential misunderstandings. The completed plan provides a “road map” to follow even though you may have to make a few detours. It provides all parties with an early commitment to follow through with all phases of the transfer process.

Who Should Be Involved In Plan Development?

If the transfer is between two or more families, it is important that all entering and exiting parties and their spouses be involved in developing the plan. Spouses who are informed about the plan and actively involved in plan development, are more supportive than if not involved in the process.

There are a number of steps involved as well as a whole host of questions you will need to address. The process is outlined in this information piece.

A key contributor to the development of your transfer plan will be your tax accountant. He/she will make sure your plan makes good tax sense.

There are several other individuals that can be instrumental in the development of your transfer plan. They include your farm management association consultant, Extension educators, vo-ag instructor, your banker or financier, and your insurance agent and financial planner.

When your plan is nearly developed, you will want

to seek your attorney’s opinion. Ask him/her to do the final drafting and all required legal work. The key here is to have a solid, nearly complete plan before going to the attorney. That will save you time and money.

It is a good idea to inform or involve the non-farm heirs as to the details of the plan. Point out to them that you are taking a business-like and systematic approach to transferring the business. Let them know why you have chosen to do certain things. Share with them your goals for the farm business and that the steps being taken are necessary to achieve those goals. This process alone can greatly reduce potential clashes within the family.

What Should Be Included in the Plan?

The key is to develop a plan that fits your situation. Do not use a generic plan or template because it may not fit your farm transfer situation. Include as many specific details as possible. Details make it more useful and reduce future questions. Here are some items to think about.

- 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 transfer - sale, gift, tax free exchange? 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, 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 transfer of management and who is responsible for overall decision making? In other words, who has the final word and when does that right transfer 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 a Plan Be Established?

The sooner a plan is set up, the more confident the participants may feel. Once you decide to transfer the farm, the planning process should begin. The plan should provide for the complete transfer of the business, so it may have to cover 10 years or more.

Put The Plan In Writing!

Putting it in writing is a must. If not written, details are easily forgotten and often misconstrued as time goes by.

After a first writing, all parties should review the plan and check it out with their advisors and tax planner. As soon as the document has agreement from everyone involved, a final transfer plan can be written. All involved parties should read and sign the final agreement.

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 transfer plan. If necessary, the plan can be modified to reflect the current situation.

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