



Will Your Family Farm Continue?

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“Son, some day this will all be yours!” This statement reflects the good intention of many a farm parent. If this is a stated goal of the family, some action must be taken to ensure that it will happen. If steps are not taken to do so, son can end up with very little, and be unable to continue farming when the final estate settlement is made.

The process seems difficult. But don't despair. The steps are simpler than you might think. Let's divide the process and look at each of the component parts. Hopefully this outline can be a recipe that most farm families can follow.

Planning the Business Transfer

Before any physical transfer takes place many questions need to be answered. Let's look at what needs to be considered:

1. Is the business viable?

To be viable, a business needs to have adequate resources (equity), current technology, and the potential to be profitable for many years into the future. If the business is so deep in debt that it cannot update facilities or equipment, it may not be possible for the next generation to turn it into a viable operation. It might support the present generation for the rest of their working life, but it could be an intolerable burden for the next generation to carry.

Assuming that the business has good potential then we can proceed with the next step.

2. Is a family member willing to farm?

If no potential heirs are working the farm now, chances are slim that they will want to take it over later. When there are members willing to farm, then parents must take the steps to equip them to continue the business.

3. Is son/daughter assuming responsibility?

A smooth transition will be achieved when the next generation has experience with the responsibilities of both production and financial management. With responsibility there must be authority to make decisions and execute control measures in the business.

A parent who has delegated authority to an heir will work under the direction of that heir when performing duties in the heir's department of the operation. In most cases, by the time parents are 65 years old the heirs should be managing the entire business operation.

4. Is the farming heir building equity?

Children who leave the farm go out into the world and normally build **hundreds of thousands of dollars of equity** in their homes, businesses, retirement accounts, yachts, motor-homes etc. The farming heir must build **at least that much equity** in the farm business if he or she is to survive.

Farming is a very capital-intensive business. Typical farms have grown over a period of one generation, from 100 acres and 40 cows to 400 acres and 200+ cows. When parents examine such a situation, they need to ask themselves: "How much did the kids who left the farm contribute to this growth?" They also need to ask:

5. How much will non-farming heirs inherit?

Unless estate planning is done and sweetheart wills are changed, most non-farming heirs will share equally in all the farm assets. In the above

situation, with four children, the farming heir could finish up with the equivalent of only 100 acres and 50 cows.

Let's assume that there were 100 acres and 50 cows when the non-farming heirs left the farm. A valid argument could be made, that the three of them are each entitled to only one quarter of the 100 acres and 50 cows. That was all that was there when they chose to find fame and fortune elsewhere. They contributed nothing to the

further growth of the farm while they built sizeable estates of their own.

If parents wait until the estate settlement to transfer farm assets, the farm business probably will not survive. Estate and inheritance taxes are almost never a problem. Failure to build farm assets in the hands of the next farming generation is usually the problem. Building their equity as a continuous life-time process will facilitate farm continuity.

Transferring Your Farm Assets

There are many ways to accomplish a smooth transfer of assets without creating taxable situations. Sometimes this might require special agreements and legal arrangements. The farm is a very complex business. Transferring it is normally not just a matter of signing over a bunch of stock in "Farm Incorporated." In most cases we need to divide the farm into its component parts. Each of these parts can be transferred separately. A different timeframe and a different strategy can be considered for each part. The farm can be divided into four basic categories:

1. The business operation

This is the heart and soul of the business. It is the annual production of crops and livestock and milk. It includes everything that we list under annual income and expenses on the Schedule F. of our tax return. Inventories of inputs and product, and the accounts receivable and payable are included. Only assets and liabilities in the "Current" section of the Balance Sheet are included.

It is possible to transfer the "operation" from one person to another party just by opening up a checking account and a new account book in the new party's name. All the assets listed below can be leased or hired. Feed and input inventories can be purchased as needed by the new operation from the old owner.

The next generation should get some ownership, management responsibility and authority in the operation soon after they are committed to the farm or at least by age 30. This gives them experience in control of the production and finances of the business. How this can be organized and accomplished will be discussed later.

2. Breeding livestock and machinery

These are the capital assets where the junior generation can easily and rapidly build substantial equity. Dairy cows in a herd are turned over every 3 or 4 years. Farm machinery

on average is replaced about every 10 years. Parents' cows and machinery can be leased by the new operation.

The business agreement can specify that, from the start of the new business, all heifers (calves?) born will belong to the new operation. From a specified date all machinery will be purchased by the new operation. Then after 4 years most cattle, and after 10 years most machinery will be owned by the new business.

3. Buildings and structures

These are depreciable assets. If there is any remaining useful life they can be leased from the owners by the new operation. Grandparents often own the land and these structures, while grandkids are running the operation. There is nothing wrong with that.

But it is important that any new facilities, built and paid for by the new operation, be owned by the new business. The structures should not add to grandparents' estate just because they stand on their land. Some negotiations with lenders and special legal agreements will be necessary to make this possible. That's better than to make junior buy his own facility from a family estate.

4. Farm residence and land

These should be the last things on the ownership priority list of the younger farm

generation. They can generally be leased for a fraction of the mortgage payment to purchase them. They are good things for the grannies to hold onto for security and retirement income. Until Federal Estate Taxes are eliminated, they get a stepped-up basis in granny's estate.

When they are in a sound financial position, having built sufficient equity, the junior

generation should purchase the neighboring farm - if that fits the plan for the future of the business. This will keep it totally out of the parents' estates.

Now that we have dissected the farm business into its component parts we are ready to consider business structures which can facilitate the transfer process.

Farm Transfer Vehicles

Assets can be owned and businesses operated by individuals as sole proprietorships, as some form of partnership, or as one of many kinds of corporation. Four physicians may join together in a corporation to practice medicine. Two of them might be in a partnership with 10 others who own the building in which they and 6 other groups operate. Two of them might be shareholders in a corporation that owns an MRI machine. There might be a different pair in each situation.

In the farm business transfer process we need to be more creative. Forcing everything (including real estate) into a partnership - just because father brings son into the business - may create more estate problems in the long term than it solves. We need to select the best business organization to do a specific task. In some farms it might be prudent to create 3 or more different business entities. Options to consider when adding a new generation might include:

a. General Partnership

This is the simplest and least expensive way for two or more farmers to create a joint business. There is no double taxation, but each partner is personally liable for all partnership debts. It should be seen as a temporary (maximum 20 year) arrangement through which the younger generation "grows" into the business and the senior withdraws from it.

b. Limited Partnership

By the time senior partner is over 65 he or she should consider becoming a limited partner. That implies that senior no longer "actively participates" in the business, but continues to hold an investment interest in it. The investor's liability is normally "limited" to the value of the investment. But the managing partner(s) is personally liable for all partnership debts.

c. Corporation

This is a far more flexible vehicle. It facilitates the entry and exit at different times of siblings or

multiple generations. It is an entity by itself and continues beyond the death of any one shareholder. Shareholders are only liable to the amount of their investment in the corporation.

There may be double taxation - of the corporation and then on the shareholders for their returns (unless it is a subchapter S which chooses to be taxed as a partnership). It is more complex to form and requires that many rules be followed in its operation, accounting, and management.

d. Limited Liability Company

Consider an LLC if you want the flexibility and the protection from liability of a corporation, and the advantages of a partnership. It is relatively simple and inexpensive to create and use. A comprehensive discussion of this vehicle can be found at the Penn State/Dickinson Agricultural Law Research and Education Center web page <http://www.dsl.psu.edu/aglaw/aglaw.html> Go to Center Publications then under Agricultural business there is a document "Using a Limited Liability Company to Operate a Pennsylvania Farm Business." If you can not get it there, call your equal opportunity Extension office or 717-240-6500 and request a copy.

e. Sales

This is a very clear and simple way to transfer assets. In a family business it may be a very effective vehicle. But it will create a tax obligation for the seller and often a debt obligation for the buyer. Taxes and interest might bleed the business into a cash flow crisis.

Bargain-price sales are sometimes used, but both parties should be aware that, in the view of IRS, the value of the asset above the sale price has been transferred by gift.

f. Gifts

These can be very helpful to the next generation. But remember that the tax basis of the asset passes with the gift. You can gift up to \$11,000 a year to as many individuals as you please. You and your spouse could gift \$44,000 annually to each child and their spouse.

Any gifted amount greater than these values is deducted from your "lifetime exclusion" for Federal Gift Tax calculations. In 2002 this exclusion amount increased to \$1 million dollars. Now it is set to gradually increase to \$3.5 million in 2009. In 2010 the estate tax is repealed –

unlimited exclusion - but in 2011 the exclusion amount reverts back to \$1 million unless congress changes the law again (which is almost certain). These Estate Tax laws are now a moving target. Keep in touch with your accountant or CPA for regular updates.

g. Wills

This "default vehicle" will transfer all assets that you own at death. Until Estate Taxes are eliminated the basis of these assets will be stepped up to the valuation used to probate the estate. As long as stepped up basis is available, this is an appropriate way to transfer highly appreciated farm land. But a major problem occurs when a farming heir with two or more siblings has to purchase the major portion of the estate from the sisters to continue to farm.

Summary

This discussion has sketched out suggestions to follow in the process of transferring a farm business. Space and time have not allowed for much detail. Some options have not been mentioned.

Recent tax law changes make people think they don't need to worry about planning the transition of the farm. Making this assumption will be disastrous for thousands of family farms.

It is more important than ever that the junior generation start to build equity early. They also need to gain management skills which can only come with responsibility, authority, and experience. It is essential that a timetable be set for the sequential transfer of business; cattle and machinery; and structures and real estate. This will greatly increase the chances of the farm surviving to the next generation.

Seek professional advice

Your circumstances are different from every other farm situation. One recipe does not fit all. Research your options by searching, reading, and talking to others. Key people to consult are your accountant; income, estate and gift tax

advisor; banker; and management advisor. Dramatic changes in federal estate and gift tax law will be implemented over the coming years, and Congress will almost certainly make further changes to these laws before 2011. So stay tuned!

When you know what you want to do and how to do it, have your attorney draft the necessary documents. Afterwards, establish a regular schedule with your heirs and advisors to review your plan in the light of current laws and regulations. This final step is the best way to ensure that you achieve the goal that you set out when the planning process began.

If you need to discuss details, or a group would like a presentation on these matters, please do not hesitate to E-mail rfreund@psu.edu or call 717-240-6500.

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