

# Bringing the Next Generation into the Farming Operation

INAgLaw's 2023 Estate & Succession Planning for the Family Farm Workshop

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# How Do I Start?

- No “one size fits all” solution, and no, you cannot copy what your neighbor did.
- Accurate Personal Financial Statement is home base.
  - Fair market value, not cost basis or book value after depreciation, or low ball conservative estimate.
  - How are things titled – individual, joint, POD/TOD.
    - Need the deeds!
    - Who owns the ground under the bins?
  - Face value of life insurance, not cash value.
  - Current beneficiaries of retirement accounts, annuities, life insurance.



# Baseline Questions

- Who is the successor?
  - Don't jump the gun.
- What is “part of the operation?”
  - Transferring assets or bringing them into income?
  - If transferring assets, why?
  - Any “family friendly” discounts?
- What is the “operation” – machinery and equipment, bins, barns, shops... land?
- Will the operation support another family?



# Factors Influencing Answers

- Want others to benefit from your estate/wealth? (off farm heirs)
- When will you give up control?
- Your retirement income and goals.
- Taxes.... both income and death taxes.
- Farm Economics.
- Generational differences.



# Most Common “Mistakes”

- “I want to treat all my kids exactly the same.”
- “Fair” does not necessarily mean “equal” ownership among kids.
- Equal tenants in common ownership ~~may~~ **will** set the stage for a family feud. Partition actions can allow one tenant in common to trigger a court ordered auction, no matter how small an interest he or she owns.
- If your kids aren’t in business together during lifetime, don’t throw them into business together after death.



# Generational Differences – Broad Strokes

- Boomers (Bs) vs. Millennials (Ms)
- (Many) Bs didn't know the plan until dad died vs. Ms, who know everything about everything. It's on their phone.
- “Paying your dues” vs. the “checklist.”
- Bs want to communicate more than dad did, and the Ms want a checklist so they can check boxes ASAP.
- Ms more motivated to own assets – feel behind in building wealth.
- Some Bs still living in a house they don't own.



# Issues Created by Differences

- Pressure to transfer assets early.
  - Buying that back if it doesn't work out?
  - Even if it works, divorce concerns? (Prenup...)
- Avoiding the conversation.
  - “Every time I bring it up, they want to know what they're getting.”
- Difficult to articulate training – there's no farming checklist hanging in the shop.



# Creating the Plan – Step 1

- Starts with your estate plan.
  - Protect the successor if you (and your spouse) die young.
  - Use a Trust or LLC to hold the land that must be offered for lease to the successor, avoiding future partition actions.
  - Leave the “operating assets” to the successor, or give the successor the right to buy the machinery, equipment, bins, shops, sheds, etc. on terms YOU decide. Devil is in the details.
  - If willing, share the plan.



## Step 2

- Create a timeline (not set in stone) based on your set of facts.
  - Hope your estate plan isn't your succession plan.
  - When do you want to “slow down?”
  - Do you plan on giving up control?
  - What is the successor's timeline for getting control/assets?
  - Succession plans often take years, rarely on one day.



## Step 3

- Implement the plan as needed.
- Should you be pre-planning? Transitioning into an entity now?
  - Difficult to sell 10% of a sprayer.
  - Entity documents contemplate what happens at death, incapacity, divorce, bankruptcy, retirement, or simply “quitting.”
  - Even if assets are off the table for now, could farm “through” an entity to share income and expenses, and that entity can lease the assets. Not fun using multiple checks to pay for everything, and could make registering for program payments easier.



## Step 3, Continued

- Is land rent your retirement plan?
  - Stop buying land and pay off mortgages?
  - Successor can make future purchases.
- More retirement contributions?
- Pay down that operation line?
- Successor buy the new machinery and equipment as yours is “whittled” down?



## Step 4

- Revisit the plan.
- Everything, including tax laws, changes over time.
- Plan for today based on today's circumstances.
- Build as much flexibility as possible into the plan.
  - Sales and gifts are normally irrevocable.
- Again, no cookie cutter plan – even your goals may change.



# Let's Talk Taxes

- The income tax wave.
  - Prepaid inputs, Bonus/Section 179 depreciation, hold pay/delayed payment, and operating lines...
- Can't sell "hot assets" on installment. Ordinary income or recaptured depreciation upon sale.
- Risky delaying payment from the elevator for years...
- Transferring assets or "slowing down" is retirement to the IRS.
- If you sell 10%, congratulations, you're 10% retired!



# Let's Talk Taxes

- Where's the tax bill with your plan? (It's somewhere).
- Gifting versus selling versus inheriting. Often it's a combination.
  - Giving everything away solves your income tax problem...but most clients need retirement income. Your income tax problem becomes their income tax problem! (gift horse)
  - Selling doesn't solve your tax problem, but does give the successor a tax basis to depreciate, if they can come up with the cash.
  - IRS won't let you and your successor both eat cake...but if you wait long enough, there will be cake at your funeral...



# So what do we do?

- Unless you give everything away, we can't make your tax bill \$0.
- Identify what assets the successor needs, their value, and what income you need, then work backwards.
- Most plans are part gift and part sale. (farm economics)
- Then:
  - Delay taxes;
  - Control marginal income tax rate; and
  - Convert ordinary income to capital gains.

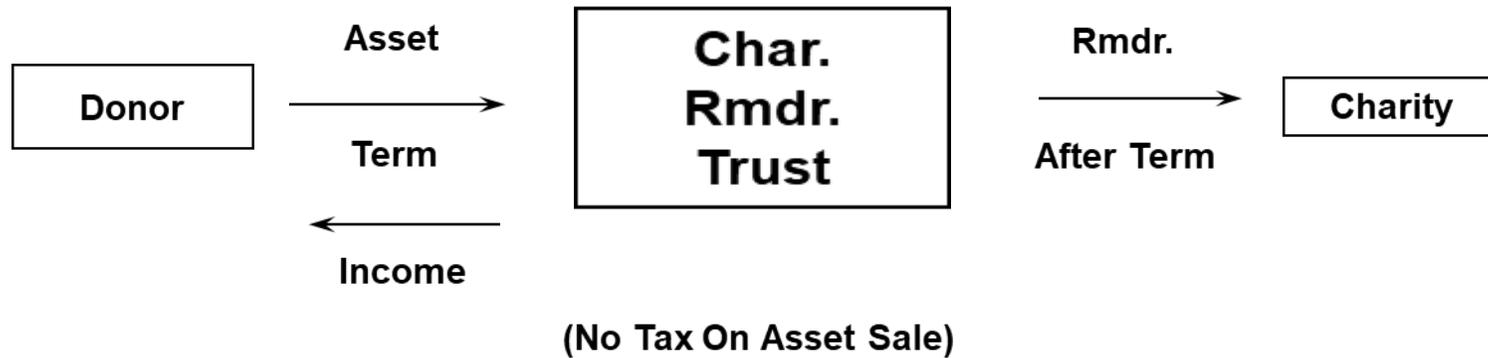


# Charitable Remainder Trusts

- For charitably inclined clients, or at least clients that like charity more than the IRS.
- Usually used for the final crop.
  - Successors don't need the final crop.
  - Farmer doesn't have next year's inputs to offset the income.
  - Can't be used for sales of machinery and equipment to related successor, but could be used with non-related successor.
  - "Lock in" a retirement income stream.



# CHARITABLE REMAINDER TRUSTS



# CHARITABLE REMAINDER TRUSTS

## Advantages

- Defer income up to a 20-year term.
  - Lower federal income tax rates.
  - No SE Soc. Sec. Tax.
- Commodity can be sold by Trust with no tax.
- Less federal tax; trades off with residual to charity.
  - 10% minimum net present value to charity.



# CRT EXAMPLE

- 10 year term, annual payout.
- \$500,000 funding.
- Annual payout @ year-end of \$57,150 (based on current IRS rates) taxed as it's received.
- Charitable remainder of \$50,000.
- If you die during the term, you can designate successor recipients of remaining payments.



# CASE STUDY: ACTIVE OPERATIONS TO SUCCESSOR

## Facts:

- John, age 65, operates as Schedule F proprietor.
  - Owns grain, machinery, and land.
  - Objectives: Retire in several years, liquidate grain, and sell machinery to Sam.
  - Est. grain value: \$800,000; machinery \$500,000.
- Sam, age 34, who may or may not be related, farms with John, but also files as proprietor.
  - Owns his share of grain, some machinery (total value \$200K).
  - Buying 160 acres on contract from neighbor.



# CASE STUDY: ACTIVE OPERATIONS TO SUCCESSOR

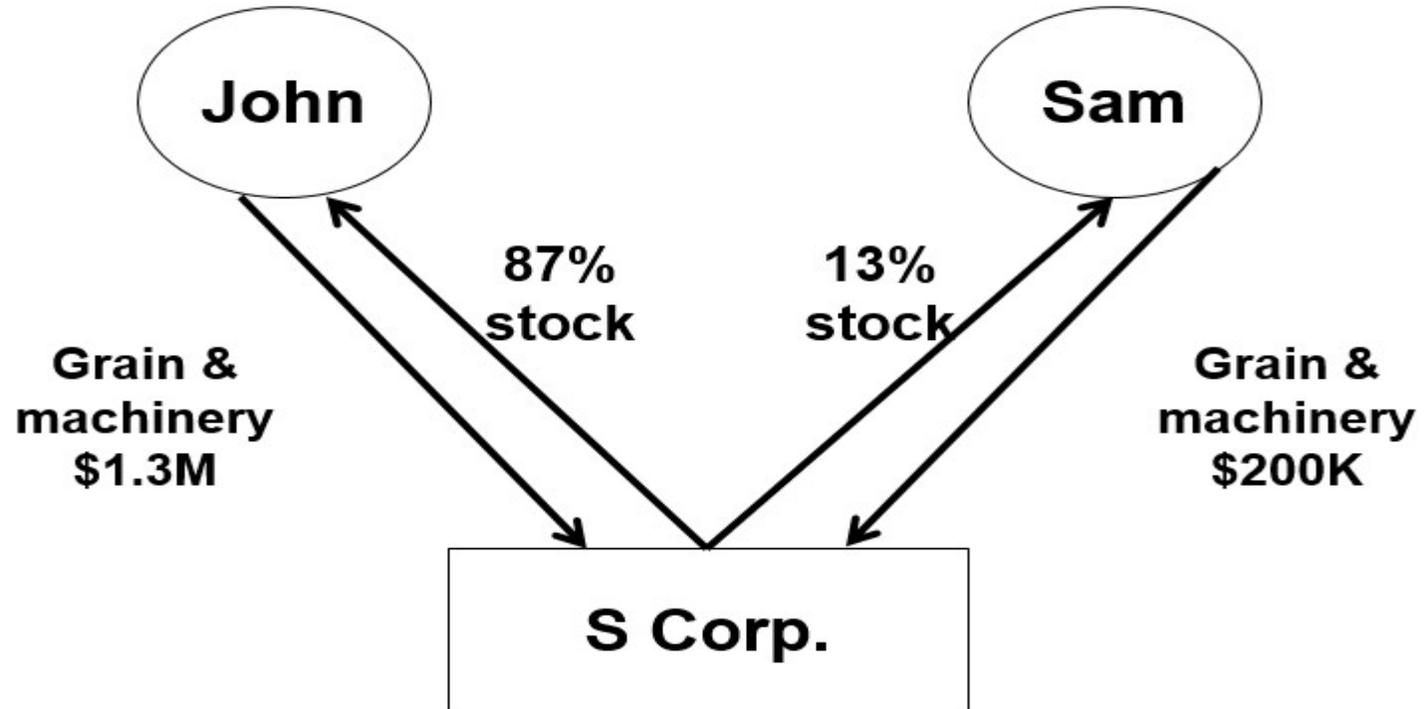
## Plan A: Liquidate grain/lease & sell machinery to Sam

<u>Asset</u>	Federal Income & SE Taxes		<u>Total</u>
	<u>Income Tax</u> (35% blended)	<u>Soc. Sec. Tax</u> (9% blended)	
\$800K grain	\$280K	\$72K	\$352K
<u>\$500K machinery</u>	<u>\$175K</u>	<u>\$ -</u>	<u>\$175K</u>
\$1.3M	<u>\$455K</u>	<u>\$72K</u>	<u>\$527K</u>
		Combined Tax	41%

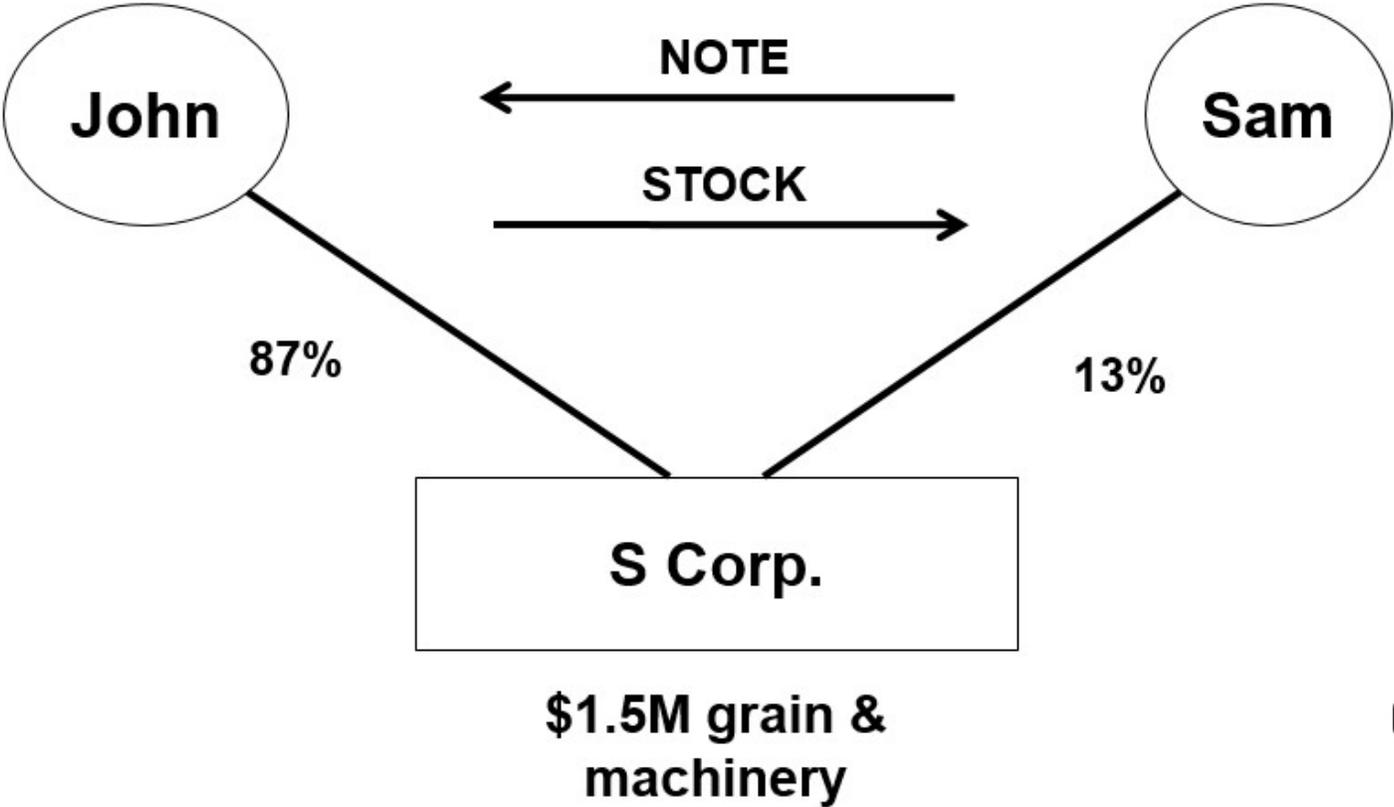


# CASE STUDY: ACTIVE OPERATIONS TO SUCCESSOR

## Plan B: USE AN ENTITY TO TRANSITION OPERATING ASSETS



# CASE STUDY: ACTIVE OPERATIONS TO SUCCESSOR



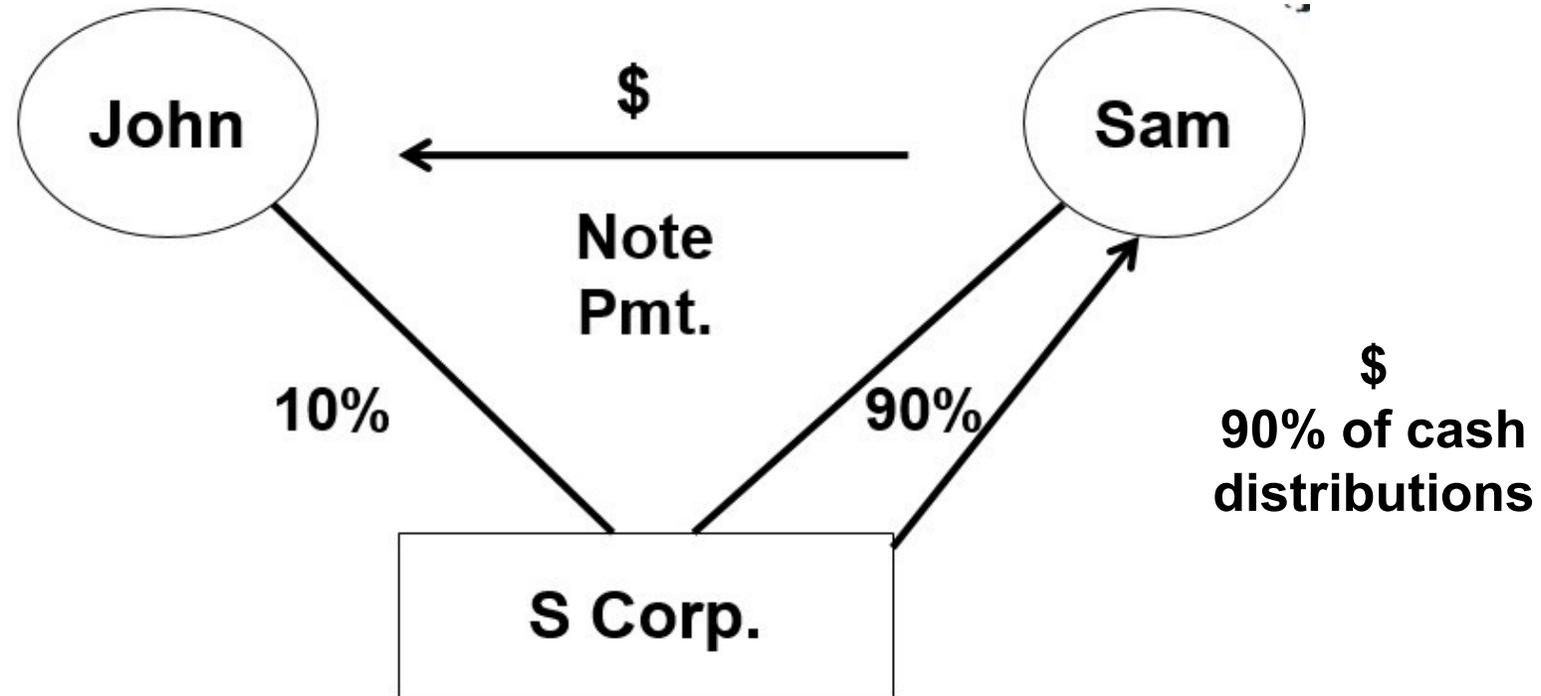
# CASE STUDY: ACTIVE OPERATIONS TO SUCCESSOR

## Strategies with corporate entity:

- Capital gain & no SE tax to John on stock sale.
  - Cuts effective tax rate from 40% to 20%.
  - Spread gain over term of note (e.g., 10 yrs.).
- Sell stock in minority increments with discounts.
- Consider reorganizing into voting & non-voting shares.
  - John can dispose of most stock, but retain control if desired.



# CASE STUDY: ACTIVE OPERATIONS TO SUCCESSOR



# CASE STUDY: ACTIVE OPERATIONS TO SUCCESSOR

	<u>Plan A Sale</u>	<u>Plan B (Entity)</u>
Value of grain/machinery	\$1,300K	\$1,300K
Less stock discount (25%)		(300K)
Less tax cost: A @ 40%	(520K)	
B @ 20%		<u>(200K)</u>
Net to John after taxes	<u>\$780K</u>	<u>\$800K</u>



# CASE STUDY: SUMMARY

- Entity sells John's grain, but offsets income with ongoing farm input expenses & prepaids.
- Sam does not get fresh depreciation on machinery, but:
  - Bought stock at a discount,
  - Sam gets favorable long-term financing from John, and
  - Sam has cash method farm expenses to continue tax deferral.
- S corp. distinguishes salaries vs. rent vs. owner distributions.



# QUESTIONS ?



# Portability Election Is Crucial

- A surviving spouse can make a portability election in order to “port” over any unused federal estate tax exclusion (called “Deceased Spousal Unused Exclusion Amount” (DSUE)) from the first spouse.
- Election must be made after the death of the first spouse, which requires filing of a Form 706 Federal Estate Tax Return within five years of death, even though no tax is owed.
- IT’S NOT AUTOMATIC!
- Only available since 2011; Many advisors not aware of importance.
- Could be a multi million dollar mistake if not elected!
- Advisors should get it in writing if surviving spouse declines to elect.



## Example if Portability Election is Not Made

- Jed and Jane are farmers, with a net worth of \$12M, and one son who farms.
- Jed dies in Jan. 2023, with all assets jointly owned, so they automatically pass to Jane by operation of law.
- Jane's CPA and Lawyer say there's nothing to do. No estate tax is due at Jed's death because of the 100% marital deduction. Plus the exemption is \$12.92M per person this year, no problem...
- Jane dies in Feb. 2028 after the estate tax exemption has sunset to \$7M.
- Son owes \$2M in Estate Tax (\$12M net worth, less \$7M exemption = \$5M taxable estate x 40% estate tax)



# Example if Portability Election is Properly Made

- Same facts: net worth of \$12M, Jed dies in Jan. 2023, with assets jointly owned.
- Jane's CPA and Lawyer help her file a Form 706 to elect portability of Jed's \$12.92M DSUE, using the shortcuts that are available such as skipping appraisals and valuations and estimating date of death value to the near quarter million dollars.
- Jane dies in Feb. 2028 when the estate tax exemption has sunset to \$7M.
- Jane's available exemption is \$19.92M (Jed's \$12.92M + her \$7M)
- Son owes \$0 in Estate Tax.



# Portability Timing & Lessons

- Be aware, the Form 706 is “due” 9 months from date of death, and can be extended automatically with Form 4768 for another 6 months. Old rules provided an extra 2 years from date of death under Rev. Proc. 2017-34
- **NEW** Final deadline, **5 years from date of death** by invoking Rev. Proc. 2022-32.
- **If your spouse died within the last 5 years, file a Form 706 and elect portability.**
- **If one of your parents died within the last 5 years, help the survivor file a Form 706 .**
- **If you know someone who’s spouse died within the last 5 years –tell them!**



# Cannot collect and hold DSUE; Can collect and use DSUE

- If DSUE is ported to husband when Wife#1 dies, and husband remarries, the husband cannot collect DSUE on Wife #2's death.
- Husband can use Wife #1' s DSUE to shelter lifetime gifts to children, and then be able collect DSUE on second wife's death.
- Ex: Husband and Wife #1 worth \$20M,
- Wife #1 dies in 2023, husband collects Wife #1's \$12.92M DSUE .
- Husband gifts \$12.92M worth of farm to children using Wife #1's DSUE.
- Husband marries Wife #2, who then dies after 2026.
- Husband collects Wife #2's \$7M DSUE (It helps if Wife #2 is poor).
- Husband has Wife #2's \$7M DSUE, plus his own \$7M+ exemption= \$14M, plenty to cover \$7.08M worth of remaining assets.



# Dealing With Land Trapped in a Corporation



# C CORP. WITH LAND INSIDE: NO SUCCESSOR

- Liquidate grain/livestock inventory and M&E as a C corp.
  - Use C corp. lower tax rates – 21%
  - Possible offsetting deductions for past underpaid services to employee-shareholders?
- Convert to S corporate status after disposition of all operating assets
  - S corp. holds land only; becomes landlord entity.
  - Net rent income flows through to corp. owners.
  - But S corp. must be “active” (crop share rents) or pay out its prior C corp. earnings as a dividend.



# C CORP. WITH LAND INSIDE: NO SUCCESSOR

- Be mindful of Built In Gains (“BIG”) recognition period.
  - 5 years (used to be 10).
- After death of owner, stock gets step-up in basis.
- Heirs sell land.
  - Creates additional gain to add to stock basis.
- Heirs then liquidate in year of sale.
- Result equals no capital gains tax due (or even a small loss).

