Transferring the Farm to the Next Generation

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TRANSFERRING THE FARM: A CASE STUDY
Key Players

Mom & Dad

- Son #1
- Daughter
- Son #2
Mom & Dad

- Both age 70 and in good health. Beginning to slow down a bit, turning over their duties to the son on the farm. Want the ability to “get away” from time to time and not be so tied down. Good yields and higher prices have had them paying more taxes than they are comfortable with.

- They have concerns regarding the best method to pass the farm to the next generation. They came in to discuss the best method to structure the farm for the future.
Son #1

- He is age 48 and lives on the farm. He came home to the farm upon graduation from WSU at age 22. He is married with 3 children: 1 in college and 2 in high school. He basically runs the day-to-day operations on the farm and has assumed the duties as Dad has slowed down. His son, the oldest child, is now at WSU and loves the farm. He plans to return to take over the operation at some point down the road.

- Although Son #1 is not an owner and is simply paid as a hired man, he helped “build” the farm. When he came back at age 22, the farm was less than half its present size and encumbered with a mortgage. He has existed on a minimum wage to assist in retiring the land debt.
Daughter

- She is 46 years old, married with 2 children and lives in Seattle. She has a great job, a great retirement, has a nice house, and is living the good life. She likes to come back to the farm a couple times a year and enjoy the slow pace and open country.
Son #2

Son #2 is age 44, married, and lives in California. He does not have much interest in the farm. He has trouble managing his finances, has a good job and a high income but not much to show for it. His wife is high maintenance and very controlling. This son is beginning to ask questions about what is going to happen with the farm.
# Balance Sheet

<table>
<thead>
<tr>
<th>Asset Type</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash / IRA / Savings</td>
<td>$ 1,000,000</td>
</tr>
<tr>
<td>Crops on Hand / Seeded summer fallow</td>
<td>500,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>750,000</td>
</tr>
<tr>
<td>Farm Lands</td>
<td>4,000,000</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>6,250,000</strong></td>
</tr>
<tr>
<td>Debt</td>
<td>0</td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td><strong>$ 6,250,000</strong></td>
</tr>
</tbody>
</table>
**Form 1040**  
Department of the Treasury — Internal Revenue Service  
U.S. Individual Income Tax Return  
2014  

**For the year Jan 1 - Dec 31, 2014, or other tax year beginning**  

**JOE FARMER**  
First name and initial  
Last name  
Social security number  
123-45-6789  

**MARY FARMER**  
First name and initial  
Last name  
Social security number  
987-65-4321  

**6546 SUNSET RIDGE RD**  
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).  

**ANYTOWN, WA 12345**  
Foreign country name  
Foreign province/state/country  
Foreign postal code  

**Presidential Election Campaign**  
Check here if you or your spouse if filing jointly, want $3 to go to the fund. Checking a box below will not change your tax or refund.  

**Filing Status**  
1. Single  
2. Married filing jointly (even if only one had income)  
3. Married filing separately. Enter spouse’s SSN above & full name here  
4. Head of household (with qualifying person) (See instructions.)  
5. Qualifying widow(er) with dependent child  

**Exemptions**  
6a. Yourself, if someone can claim you as a dependent, do not check box 6a  
6b. Spouse  
7. Total number of exemptions claimed  

**Income**  
7. Wages, salaries, tips, etc. Attach Form(s) W-2.  
8a. Taxable interest. Attach Schedule B if required  
8b. Tax-exempt interest. Do not include on line 8a.  
8c. Ordinary dividends. Attach Schedule B if required  
9a. Qualified dividends.  
9b. Taxable refunds, credits, or offsets of state and local income taxes  
10. Alimony received  
11. Business income or (loss). Attach Schedule C or C-EZ  
12. Capital gain or (loss). Attach Sch D if needed. If not, check box here  
13. Other gains or (losses). Attach Form 4797  
14. IRA distributions  
15a. Taxable amount  
15b. Pensions and annuities  
16a. Taxable amount  
16b. Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E  
18. Farm income or (loss). Attach Schedule F  
19. Unemployment compensation  
20a. Social security benefits  
20b. Taxable amount  
21. Other income  
22. Combine the amounts in the far right column for lines 7 through 21. This is your total income  
23. Adjusted Gross Income  
24. Educator expenses  
27. Deductible part of self-employment tax. Attach Schedule SE  
28. Self-employed SEP, SIMPLE, and qualified plans  
29. Self-employed health insurance deduction  
30. Penalty on early withdrawal of savings  
31a. Alimony paid  
31b. Recipient’s SSN.  
32. IRA deduction  
33. Student loan interest deduction  
34. Tuition and fees. Attach Form 8917  
35. Domestic production activities deduction. Attach Form 8804  
36. Add lines 23 through 35. This is your adjusted gross income  
37. Subtract line 36 from line 22. This is your net income  

**BAA For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions.**
**Form 1040 (2014)**

### Tax and Credits

#### Standard Deduction for

- People who check any box on line 39a or 39b who can be claimed as a dependent, see instructions.
- Single or Married filing separately, $6,300
- Married filing jointly or Qualifying widow(er), $12,600
- Head of household, $9,100

#### Other Taxes

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>48</td>
<td>Foreign tax credit</td>
<td>48</td>
</tr>
<tr>
<td>49</td>
<td>Credit for child and dependent care expenses</td>
<td>49</td>
</tr>
<tr>
<td>50</td>
<td>Education credits from Form 8863, line 19</td>
<td>50</td>
</tr>
<tr>
<td>51</td>
<td>Retirement savings contributions credit from Form 8889</td>
<td>51</td>
</tr>
<tr>
<td>52</td>
<td>Child tax credit</td>
<td>52</td>
</tr>
<tr>
<td>53</td>
<td>Residential energy credits</td>
<td>53</td>
</tr>
<tr>
<td>54</td>
<td>Other credits from Form 8814</td>
<td>54</td>
</tr>
<tr>
<td>55</td>
<td>Add lines 44 through 54. These are your total credits</td>
<td>55</td>
</tr>
<tr>
<td>56</td>
<td>Subtract line 55 from line 47. If line 55 is more than line 47, enter 0.</td>
<td>56</td>
</tr>
<tr>
<td>57</td>
<td>Self-employment tax</td>
<td>57</td>
</tr>
<tr>
<td>58</td>
<td>Unreimbursed social security and Medicare tax from Form 8917</td>
<td>58</td>
</tr>
<tr>
<td>59</td>
<td>Additional tax on IRA, other qualified retirement plans, etc. from Form 5323 if required</td>
<td>59</td>
</tr>
<tr>
<td>60</td>
<td>Household employment taxes from Schedule H</td>
<td>60</td>
</tr>
<tr>
<td>61</td>
<td>First-time homebuyer credit repayment from Form 8812</td>
<td>61</td>
</tr>
<tr>
<td>62</td>
<td>Health care: individual responsibility (see instructions) Full-year coverage</td>
<td>62</td>
</tr>
<tr>
<td>63</td>
<td>Add lines 62 and 63. This is your total tax</td>
<td>63</td>
</tr>
</tbody>
</table>

#### Payments

- Federal income tax withheld from Forms W-2 and 1099 | 64 |
- 2014 estimated tax payments and amount applied from 2013 return | 65 |
- Earned income credit (EIC) | 66a |
- Net taxable combat pay election | 66b |
- Additional child tax credit | 67 |
- American opportunity credit from Form 8883, line 8 | 68 |
- Net premium tax credit | 69 |
- Amount paid with request for extension to file | 70 |
- Excess social security and tier 1 FRTA tax withheld | 71 |
- Credit for federal tax on fuels | 72 |
- Credits from Form 8962 | 73 |

#### Refund

- If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you overpaid | 74 |
- Amount of line 75 you want refunded to you, if Form 8888 is attached, check here | 76a |
- Routing number | 76b |
- Type | 76c |
- Account number | 76d |
- Amount of line 77 you want applied to your 2015 estimated tax | 77 |

#### Amount You Owe

- Amount you own. Subtract line 74 from line 63. For details on how to pay, see instructions | 78 |
- Estimated tax penalty (see instructions) | 79 |

### Third Party Designee

- Do you want to allow another person to discuss this return with the IRS (see instructions)? □ Yes. Complete below □ No

#### Sign

- Joint return? See instructions
- Direct deposit? See instructions. Direct deposit | □ Yes. Complete below □ No
- Amount you owe. Subtract line 74 from line 63. For details on how to pay, see instructions. | □ Yes. Complete below □ No

### Paid Preparer

- **LEFFER OTIS & WARMICK, PS**
- PO BOX 129
- DAVENPORT, WA 99122-0129

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Form 1040 (2014)
Goals Identified

1. They would like to see the tax bill to Uncle Sam decreased.

2. Estate/transition goals:
   a) They would like the farm to stay in the family as a working farm!
   b) They love all their children and want to be fair to them all.
   c) They do not want to pay estate tax.
   d) They want to reduce exposure to the possible impact of divorce, long term care or bankruptcy on the part of one of the owners.
   e) They would like to reduce any threat to “off farm siblings.”
Proposed Re-Organization

- Transfer equipment, summer fallow, and crops on hand to newly organized C-corporation
- Transfer farm land to new LLC
Proposed Re-Organization

New Farm, Inc.
- Dad & Mom: 50% owner
- Son #1: 50% owner

Farm Land, LLC
- Dad & Mom: 70%
- Son #1: 10%
- Daughter: 10%
- Son #2: 10%

Cash Lease
What Have We Accomplished?

- Income Taxes:
  - Assumed expenses:
    1. Medical insurance, out of pocket medical, dental & optical for Dad, Mom & Son #1’s family totals $22,400 per year.
    2. Groceries for both families above total $15,000.
    3. Utilities for both homes total $7,500 per year.
    4. Insurance on homes, repairs to homes, purchases of appliances and furniture for both homes totals $8,000 per year.
What Have We Accomplished?

- New Corporation’s tax calculation:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Net Income</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less Medical</td>
<td>(22,400)</td>
</tr>
<tr>
<td>Less Groceries</td>
<td>(15,000)</td>
</tr>
<tr>
<td>Less Utilities</td>
<td>(7,500)</td>
</tr>
<tr>
<td>Less Insurance, repairs, etc.</td>
<td>(8,000)</td>
</tr>
<tr>
<td>Subtotal</td>
<td>47,100</td>
</tr>
<tr>
<td>Paid out of corporation to LLC as rent</td>
<td>(47,100)</td>
</tr>
<tr>
<td>Net Taxable Income</td>
<td>$0</td>
</tr>
</tbody>
</table>
After re-org: Self-employment farming income replaced by 70% share of land rent from LLC

Note: Three children will each be taxed on his/her 10% share of land rent from LLC
Self-employment tax is eliminated.

Tax before re-org: $28,324
Tax after re-org: $2,434
Tax savings to Mom & Dad: $25,890!!
Other Benefits

- Operating farm is carved off separate for the son on the farm to run on his own, at some point.

- Land is in LLC, subject to various LLC agreements. The kids share in ownership but cannot “sell the ranch to the highest bidder.”
  - We can get cash as needed to Dad and Mom through cash lease and farm wages.
  - Farm will already be paying fringe benefits to them.
  - Dad and Mom will still control LLC and even the corporation, if they wish.
HOW DO FARM INTERESTS BECOME FRACTURED?
Basin Farms LLC
Landholding LLC
1,000 acres irrigated land
Dad & Mom Farmer

Child #1
- Grandchild #1
- Grandchild #2
- Grandchild #3

Child #2
- Grandchild #4
- Grandchild #5
- Grandchild #6

Child #3
- Grandchild #7
- Grandchild #8
- Grandchild #9

Child #4
- Grandchild #10
- Grandchild #11
- Grandchild #12
How Do Farms Become Fractured?

1) 1. Mom & Dad start the farm (2)

2) They have four children (4)

3) Each of them has 3 children (12 grandchildren)
Is This Good or Bad?

- This can present challenges when dividing up the estate
- One farmer and 11 landlords?
  - Fair is not always equal and equal is not always fair
- What options are available?
  - Leave farmland to farmer and other assets to non-farmer
    - Likely not enough assets to make and equitable split
  - Leave farm equally to children and let them figure it out
    - More likely to fight it out than figure it out
  - Build in a buy-out at an affordable price
Example of an “Affordable Price”

<table>
<thead>
<tr>
<th>Description</th>
<th>Per Acre</th>
</tr>
</thead>
<tbody>
<tr>
<td>Safe “affordable” rental rate</td>
<td>$400</td>
</tr>
<tr>
<td>Less: Property taxes</td>
<td>(30)</td>
</tr>
<tr>
<td>Less: Average cost for updates*</td>
<td>(50)</td>
</tr>
<tr>
<td>*pumps, panels, mainline &amp; pivots</td>
<td></td>
</tr>
<tr>
<td>Less: Insurance</td>
<td>(5)</td>
</tr>
<tr>
<td>Available for land payment</td>
<td>$315</td>
</tr>
</tbody>
</table>
Other Considerations

- How much could I pay for land if:
  - I pay it off in 20 years
  - 5.75% interest
  - Payment of $315 per acre?
    - ANSWER: $3,687.51

- Most farmland would bring considerably more if sold outright

- How important is it for the land to stay in the family?

- Is it fair to encumber the land with a buy-sell agreement that restricts it to being sold to a family member at less than the Fair Market Value?
EVALUATING A POTENTIAL BORROWER
Primary Source Of Repayment: From Operating Profits

- Budgets are used to project repayment ability
- Also project peak borrowing needs
- Real benefit of the budget is the "forced thought process"
- Bankers like to see 10% margin on budgets
Secondary Source of Repayment: Collateral or Guarantees

- Look to net assets, equity, working capital, debt-assets ratio, etc.
- If the primary source of repayment fails, how will the bank get paid?
- Many farmers think, "I have a ton of equity, why do they not want to lend me money"?
  - Bankers no longer make "equity loans"
  - The 80's taught bankers that it was no fun forcing a farmer to sell his farm to repay a loan gone bad.
Other tools

- FSA guarantees
  - Reimburse lending institution for 90% of any loss sustained
  - Lenders may continue banking a marginal credit if they know the guarantee is in place
  - FSA guarantees may require additional fees and paperwork
    - May be worth it to reassure lender to "stick with you"

- Personal guarantee by family member
  - Family member be careful!
Other considerations

- History of the borrower
  - Why do they need the money?
  - Are they always “a day late and a dollar short”?
- Are they good managers?
  - Nothing wrong with financing growth or downturn in economy
    - No one wants to finance a mis-managed operation
- Confidence in the person
  - Are the borrowers “good people”?
  - Marginal ethics and a marginal loan do not often make for a good relationship
Other considerations (continued)

■ Does the borrower have good records?
  – Do they know where they are and why they are there?
  – Do they have a realistic picture
    ■ Where they will be in the future
    ■ How they are going to get there?

■ Communication with the banker
  – Good communication is reassuring to bankers
  – Surprises erode the confidence of bankers
  – Bankers are in essence partners in your operation

■ Willingness to make difficult changes if necessary
  – Is borrower willing to “tighten their belt”?
  – Can they say no to large spending decisions?
  – Can they and their spouse limit personal spending?
NEW TAX BILL – CHANGES RELEVANT TO FARMERS
Section 179 Depreciation

- Section 179 permanently extended at $500,000 level
  - Both new & used equipment
  - Phased out at $2 million worth of purchases
  - Indexed for inflation
Bonus Depreciation

- Rates will change
  - Stays at 50% through 2017
  - Goes to 40% in 2018
  - Goes to 30% in 2019
  - Goes away in 2020

- Applies to new property only

- Applies to farm buildings
Other Issues

- Five year built-in gain period is made permanent

- Penalties
  - Penalty for failure to file informational return is now at the rate of $500 per missed form
  - Penalty is increased to $1,000 per form if it is intentional

- Small asset expensing increases from $500 to $2,500