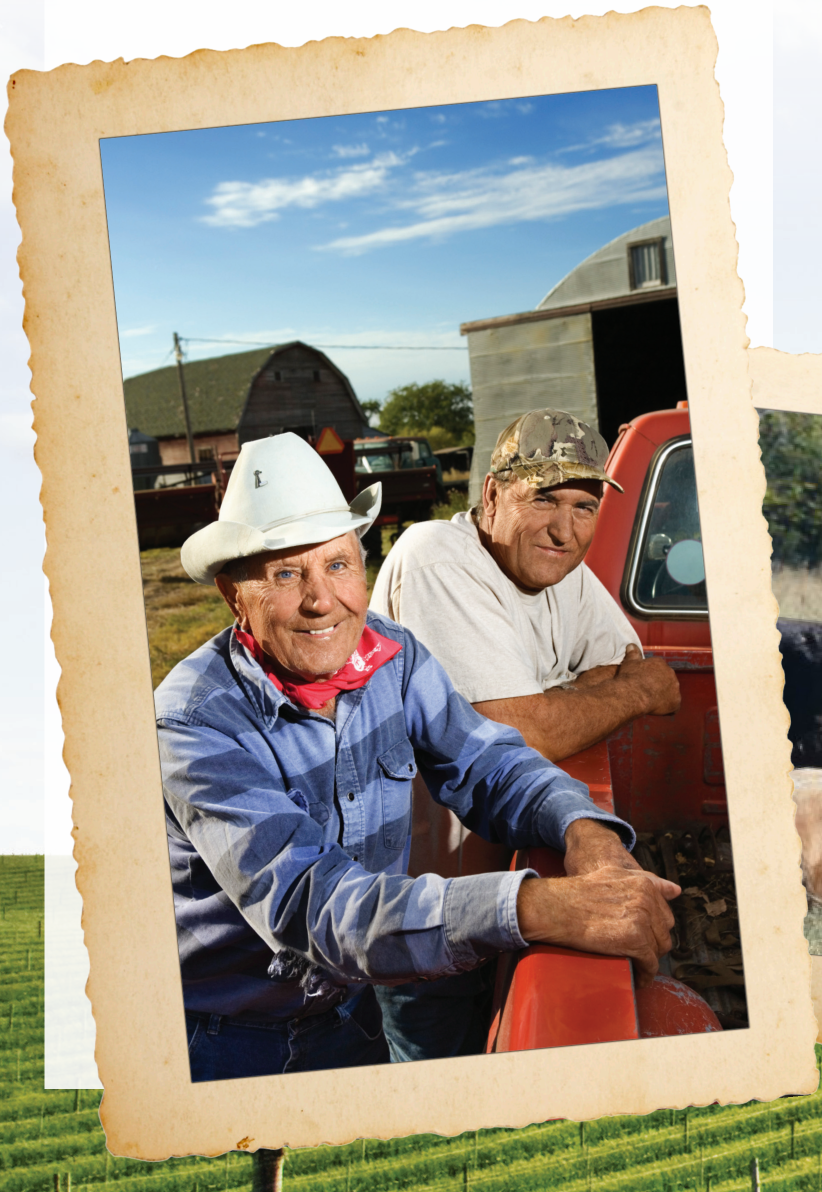
Farm Planning

FOR THE FUTURE: TRANSFERRING YOUR FARM TO A NEW OWNER

West Virginia AgrAbility Project

Transferring your farm to a new owner

The United States Department of Agriculture (USDA) estimates that over one quarter of the nation's farmers will retire during the next decade. Estate planning (preparing a plan for giving away your property, possessions, assets or money either before or after you die) can be hard for any family. It can be even tougher for farm families who wish to pass the farm onto younger generations. Farm transference planning is increasingly important for family farms because the majority of these farms do not have a formal succession plan.



A written transference plan acts as a guide for the transition process. The transference plan should include as many details as possible. The clearer and more detailed the plan is, the less chance there is for disagreement and conflict in the future.

Oftentimes, owners of family farms assume the farm will be carried on by the next generation. Without a formal plan your farm may be at risk. If you die and do not have a transference plan or will, your farm will be transferred according to the law, not according to your wishes (see *Personal Planning for the Future: Dying without a Will in West Virginia Fact Sheet* in *Caring for Caregivers: Tools for Rural Caregivers* for more information or call **800-841-8436** to request a copy). The farm and the family may suffer if a farm is passed down without a clear idea of who will run it and how.

When and how should I talk about plans for farm transference?

There are a lot of questions that will need to be answered when you think about transferring your farm. Do younger generations or any family member want to carry on your farm business? Do the people to whom you are transferring the farm live close by or will they have to move to the farm? Who will be making the decisions about the farm transference process? Who will pay for which farm expenses, like insurance and tractor fuel, during the transition? Will you want to continue to work on the farm after the transfer is complete? These are all important questions that may take time to answer.

Since there is so much to think and talk about when planning for your farm's transference, it is important for conversations about the transfer to be often, ongoing, open and honest. Serious disagreements can come up during these discussions. If this happens, you may want to think about mediation. Mediators are professionals who are trained in keeping communication lines open between people who are in disagreement. There are a lot of different people who can help make your farm transfer go smoothly. Examples of people who may be of help are: attorneys, tax consultants, extension agents and insurance agents.

What is the first step in planning a farm's transference?

There are some basic questions that you will need to answer to get your plan started. How do you want your farm cared for when you are no longer around to manage it? To whom do you want to transfer your farm? Does this person want the same things for your farm as you do? Changes in farm management, growth and production should be discussed to help transfer your farm more smoothly.

Your goals for your farm and the steps to be taken to reach your goals are the core of your farm transference plan. An action plan is commonly used to assist farmers in making decisions about their goals and the steps needed to carry them out. Your action plan may include a time table of when you want to reach your goals and who is responsible for each step of the plan. For a checklist of steps common to farm transfer action plans= and for additional information on farm transference planning, visit Michigan State University Extension at **www.msu.edu/~steind/estate_planning.html.**

What do I need to think about if I want to pass my farm onto my children?

Not all farms are passed on outright at death. Some farm transfers happen over a period of time. Some farmers decide to do this so the new owner can take over the farm operation at a pace that he/she can afford. This arrangement gives the retiring farmer a steady income for a longer amount of time.

What do I need to think about if I want to pass my farm onto my children? (cont.)

The retiring farmer can also phase out of the farm business.

If you rely on your farm for income, a source of savings or as a retirement plan, formalizing your farm's business model may be part of planning for your farm's transfer. Established business models are not just for large companies. Established business models can protect your personal property and business from lawsuits. Business models also allow for flexibility and options. This may be important if your farm's transfer will involve more than one owner for a period of time. An example of this situation is when a parent and child jointly own their farm during the transfer process.

Common business models often used are the Limited Liability Corporation (LLC) and Limited Liability Partnership (LLP). A Limited Liability Corporation is a business model that offers limited personal liability. This means if a person wants to sue your farm, they can only be awarded assets that the farm owns. The person suing you cannot go after your personal assets, like your house. A Limited Liability Partnership is very similar in protecting your personal assets. The major difference between the two is the LLP requires more than one owner to establish the business. Both LLC and LLPs serve as "pass through" entities. This means that profits from the business are shown on the owners' individual tax returns. The business does not file separately.

Many farmers want to pass the farm onto their children because they either think their children want the farm, or the farm is the only thing the family has to pass down. What do you do if your children do not want the farm but you have nothing else for them to inherit? What if some of your children want the farm and some of them do not want to farm? This situation does not necessarily mean a dead end for your farm transference plan. You do have options. For example, if you have livestock, one option is to give some to your children over time. This option lets you give your children an asset that is not money or property. Another option is to buy life insurance and make your children who are not interested in the farm the beneficiaries (people who receive the benefits of the insurance policy, in this case money). A life insurance policy gives you an additional asset to pass on to your children. In this example, the children who want the farm will receive it in its entirety while your other children will inherit an asset of equivalent value to the farm.

There are different arrangements and options that can help everyone inherit what is in their best interest. Talk to your family about farm transference and estate planning no matter how uncomfortable or sensitive these topics are. You know when everyone understands and is in agreement when each family member has the same answer when asked about decisions.

What should I consider if I plan on selling my farm to a non-family member?

It may not always be possible to keep the farm family owned and operated. There are different ways to sell your farm.

- Farm land preservation easements keep land as farmland and cannot be sold to developers or abandoned. For more information contact, West Virginia Farmland Protection at **www.wvfarmlandprotection.org**, your local extension agent or local Natural Resources Conservation Service (NRCS) office.

- Ownership agreements, like a LLP or LLC, let future owners buy the farm little by little. For example, new owners can take on maintenance and upkeep expenses, like buying new machinery and paying for repairs. The selling farmer can then phase out of running the farm. The selling farmer will also enjoy a steady income from the new owner's payment installments.

- Sell the farm outright in its entirety.

Tax Considerations

Whether you are passing the farm down to younger generations or selling it, there are some tax issues to think about when planning your farm's transfer. If you are transferring the farm, you may want to think about the financial situation of both the retiring and beginning farmers. For example, it is common for the retiring farmer to want to spread the income from selling the farm over a long period of time.

The beginning farmer may not have the capital to buy the farm all at once. In this case, the selling farmer may face higher income taxes due to increased income from selling pieces of the farm. The beginning farmer may have to consider self-employment and property taxes. If you are selling the farm outright, the lump sum you may receive from the sale may be counted as income putting you in a very high tax bracket for the year in which you sold it.

Common taxes to think about whether you are transferring or selling your farm are estate taxes, gift taxes, generation skipping taxes, capital gains taxes and self employment income taxes.

Estate Taxes

Estate taxes are based on the value of a person's estate at the time of their death. A person's estate is everything the person owns including property, debt, farm equipment, and checking and savings accounts. People only have to pay this tax if what they own is worth more than the estate tax exemption at the time of their death. For example, the current estate tax exemption rate is five million dollars. If your estate is worth less than five million dollars, you do not have to pay estate taxes. If your estate is worth more, then you will have to pay estate taxes. The exemption rate changes from year to year. Although the estate tax exemption rate is usually in the millions, your estate (farm) may be closer to the exemption rate than you might think.

Estate Taxes (cont.)

For example, in 2004 the exemption rate was $1.5 million. The average value of a farm in WV is $373,435. This amount only accounts for an average West Virginia farm (170 acres) and agriculture buildings. If you add to this an average size home, two new vehicles, a farm truck, a tractor, a combine, an average amount of breeding stock, corn or other inventory in reserves, a savings account, and an investment property, the value of your estate may be close to the $1.5 million exemption rate. While the exemption is currently at $5 million, it could eventually be set at a lower amount.

A common problem for people whose estate's value is more than the exemption rate is the lack of 'liquid' money to pay the tax. In other words, the estate's value is held in its property and equipment, not money sitting in a bank account. The estate tax must be paid out of the value of the estate. Oftentimes the only option is to sell off a portion of your property or farm equipment in order to pay the tax. What is left of the estate is passed on as inheritance to your beneficiaries (people to whom you left your estate, in this case your farm).

You do have options to lower the value of your estate if you face this common problem:

- Spousal exemption. Money you give to your spouse does not count as part of your estate. You may be able to 'gift' everything to your spouse at the time of your death. However, this still leaves the problem of paying the tax when your surviving spouse dies.

- Charitable donation. Money you give to charity does not count as part of your estate.

- Educational and health insurance expenses. These also do not count as part of your estate and you can pay them indefinitely. For example, you can pay for each of your grandchildren to go to private school or, you could pay for health insurance for your entire family. However, you must pay the money directly to the school or insurance company. You cannot give money to companies in advance to be used as credit.

- Give money/property away while you are alive. You can give up to $13,000 per recipient (person who receives the money) away each year as a gift without this money counting towards your estate. For example, you could give $13,000 per year to each of your grandchildren without it counting towards your estate when you die.

Gift Taxes

Gift taxes are taxes a person pays when he/she gives money away as a gift. Gift taxes are closely related to estate taxes. Money you 'gift' to people is counted as part of your estate if the gift amount is over $13,000 (the gift tax exemption rate). You can give away up to $13,000 per person per year without having to pay gift taxes. If you 'gift' more than $13,000 you may or may not have to pay gift taxes depending on current laws and regulations. However, if you do not have to pay gift taxes, your gift will be counted as part of your estate's value.

Capital Gains Taxes

Capital gains tax is a tax charged when you sell a non-inventory item, such as a building or property, for more than its original purchase price. Property, such as land, is included under this tax because it is not regular business income. It is a one-time sale.

When a person sells land, he/she will pay a capital gains tax. The tax rate is based on the difference between what the person originally paid for the land and the price for which it sold. The tax can also be affected by the land's original price; the current selling price; improvements made to the land; and any depreciation to the value of the land. When land is involved, the capital gains tax is referred to as income tax basis. Since the basis is specific to the land being sold, the tax rate is adjusted to reflect any improvements made to the land and/or its depreciation.

The original income tax basis is only used if land is purchased and later sold to someone else. If the land is passed through inheritance, you do not pay taxes based on the land's original basis. Instead, you pay a tax based on the Fair Market Value (FMV). This value is assigned to an asset that passes through someone's estate (what someone passes on as inheritance). How much you pay in taxes according to the FMV depends on what the FMV is on the day the person passing the asset dies. Taxes based on FMV are the same as capital gains taxes and have the same tax rate. The difference is taxes based on FMV are paid on a lower amount of money than capital gains taxes. This gives many landowners an incentive to keep the value of their property low when they want to pass it onto a younger generation.

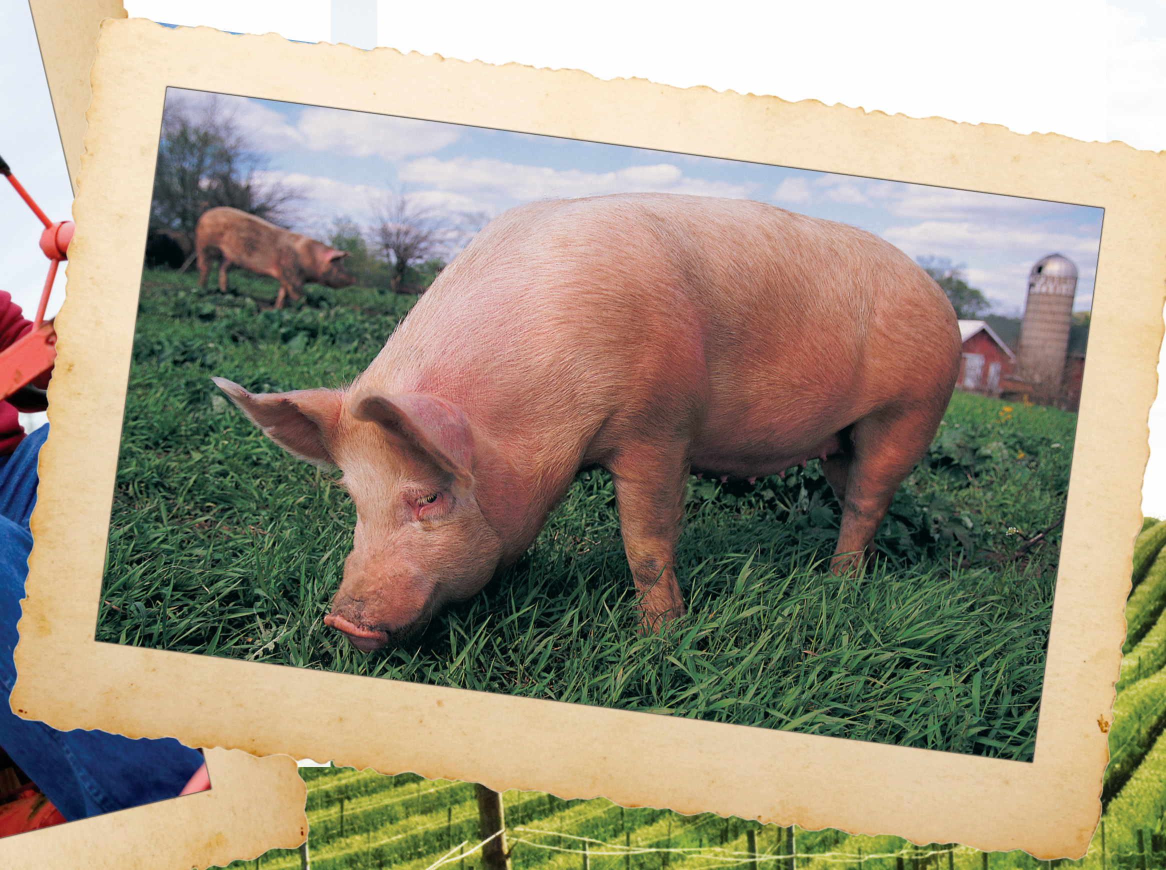
An example will better explain the difference between the tax rates for an income tax basis, i.e., capital gains tax, and FMV. A retiring farmer has land he bought for $40,000. His income tax basis for that land is $40,000 because that is what he paid for it. The land is now worth $100,000. The farmer wants to pass the land on to his child while he is still alive. The child decides to sell the land for the current market price $100,000. Since the land's value increased from $40,000 to $100,000, the child has to pay capital gains tax on the difference, $60,000. The income tax basis rate is set at 15 percent. The son has to pay $9,000 in taxes.

Capital Gains Taxes (cont.)

Instead of giving the land to the child while the farmer is alive, the child receives the land as inheritance. When the child inherits the land it is worth $100,000. That is its FMV. If the child sells the land now for $100,000, the current market price, he will not pay any capital gains tax. This is because the selling price and the FMV are the same price. The child does not have to pay capital gains tax because the land was passed on as inheritance and is not considered an increase in income. However, this may not be the best situation in all cases. Depending on your situation, this specific example could trigger problems with estate taxes or other tax issues.

Home Exemption

Oftentimes, people ‘parcel out’ (separate out) their home and the surrounding personal (non-farm use) land when selling their farm because they can enjoy additional tax exemptions. If you are single, you are eligible for up to $250,000 in tax exemptions for your house. If you are married, your tax exemption increases to $500,000. You qualify for these exemptions if you own the house and have lived in it for two of the previous five years. This exemption applies to your home only, not to any land or buildings used as part of your farm business. Also, the sale price of the home and any land for personal use must be identified separately from the farm’s sale price. This is to clearly note the amount that is not taxed. If the home price is combined with the farm price, you cannot claim a home exemption. You will then pay the same tax rate for everything.



Income Averaging

"Income averaging" is an income tax policy that allows farmers who have a high income in the current tax year to spread it equally over the past three federal income tax years. This allows farmers to be in a lower tax bracket. More importantly, it lets farmers pay taxes at an average rate instead of one large lump sum. This can also greatly lower income taxes for retiring farmers.

For example, if you sell your farm all at once you will typically get a higher selling price. However, you may end up with less money from the sale after paying the higher tax rate that comes with getting the farm's selling price all at once. You can avoid this by selling your farm over several years (installment method) with a lower purchasing price. Although the income averaging policy is available for qualifying farmers, planning ahead is encouraged to avoid significant income tax increases.

Conservation Easements

A conservation easement is another tax policy to consider when planning for retirement. Conservation easements guarantee that farmland remains in production. This may be an option for farmers who do not have anyone to pass their farm onto but still want their land to stay in production. These easements allow an older farmer to receive full market value for their land but still sell it to a beginning farmer. The easement may also reduce the farm's property taxes.

A retiring farmer may also donate an easement to a land trust instead of selling it. If this donation meets federal tax code requirements the value may be a tax deduction. This lets the farmer sell the farm at a lower price, i.e., the price at which a land trust can afford but still receive the net income equal to its market price. A farmer's third option is to sell the farm to a land group at a reduced rate. In this case your tax deduction is the difference between its full market price and the purchasing price.

Generation Skipping Transfer Tax

The generation skipping transfer tax applies when property is transferred from its owner to a related person who is two or more generations younger, or to someone who is more than 37.5 years younger than the owner. In this case, the person receiving the transfer is usually a grandchild, but does not have to be. Any person, other than the spouse of the former owner, can be the recipient of a generation skipping transfer. The purpose of this tax is to make sure taxes are not avoided by transferring property through a third party, like a trust. For more information on trusts, *Personal Planning for the Future: Establishing a Trust for a Person with Disabilities* Fact Sheet in *Caring for Caregivers: Tools for Rural Caregivers* call **800-841-8436** to request a copy.

Generation Skipping Transfer Tax (cont.)

Property can be transferred directly or indirectly. In the case of generation skipping transfers, a direct transfer is when a person gives money or property to another person who is two or more generations younger, outright while still alive or at death. In these cases, the transferor (owner transferring their land) will be responsible for paying the generation skipping tax.

An indirect generation skipping transfer is when money or property skips over a generation to a younger generation. If this happens, it is usually caused by an older generation dying before using the assets they inherited. For example, a grandchild is left with the remaining amount of money from his/her parent's inheritance because their parent died before spending all of it. In this case, property/money is transferred to the next generation, thus skipping a generation.

Self employment Taxes

Self employment taxes are taxes that people who are self employed pay to Medicare and Social Security. People who do not work for themselves pay these taxes too. Employers withhold money from their employees' paychecks to pay these taxes. You must pay taxes to Social Security and Medicare on any amount that you make annually that is over $400. These taxes are separate from income taxes.

Resources

For a checklist of steps common to farm transfer action plans, and for additional information on farm transference planning, visit Michigan State University Extension at **www.msu.edu/~steind/estate_planning.html**. The University of Minnesota also offers a wide variety of informational fact sheets available at **http://www.cffm.umn.edu/Publications/pubs/FarmMgtTopics/TransferringTheFarmSeries.pdf**.

The Small Farm Center, under the WVU Extension Service, was founded in 2009 and strives to increase the farmer's bottom line by helping him or her retain more of the dollar spent on food in his or her community. Information specific to farm transfer in West Virginia is available through the Small Farm Center at **http://smallfarmcenter.ext.wvu.edu/** or call **304-293-2642**.

For the most current information on estate and gift taxes, visit the IRS website at **www.irs.gov/businesses/small/article/0,,id=164871,00.html**. Because tax laws change frequently and may have both positive and negative impacts on your operation, it is important to contact an attorney or tax professional to ensure you make the choices that will be most beneficial to your situation.

For more information on conservation easements, visit the West Virginia Farmland Protection website at **www.wvfarmlandprotection.org**. There are 14 local districts dealing with farmland protection. Many counties have their own farmland protection board. You can also call your local NRCS or Extension Office for more information.

The West Virginia Land Trust is a non-profit organization started in 1995 for the purpose of protecting rural and wild lands in West Virginia. Information is available on their website about easements, why they are important and information for land owners. Visit **www.wvlandtrust.org** or call **304-346-7788**.

For more information on self employment tax visit the IRS website at **www.irs.gov/businesses/small/article/0,,id=98846,00.html**. This is general information. Everyone's situation is different and the information may apply differently to your particular situation. You may want to ask your attorney or tax professional about how these taxes apply to your particular situation.

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