Ready Set Retire

Farming: With an Operating Heir

Many farm couples are delighted that a child or another relative is involved in the farm operation and eventually wants to increase that involvement to take over the business. The couple has worked hard to build the business; it is nice to think that it will continue to thrive under an heir's management. One of their goals in retirement, then, is the transfer of the farming business to an operating heir who would inherit all or part of the operation.

It is in the best interests of both generations that the transfer be accomplished with a minimum of financial and emotional cost. The business probably represents the livelihood for both generations. But the transfer requires careful planning so the financial needs of the retiring couple are met and equitable distribution of assets to non-operating heirs is ensured. Many families literally have been torn apart in the process of transferring the farm from one generation to another.

Financial Security for the Couple during Retirement

For many farm couples the farm represents not only their current source of income, but the source of income needed for later years, as well. Between 56 and 70 percent of all assets held by farm families are in land, buildings, livestock, and machinery. For most families, it is not possible to make a gift of the farm to the heir. An outright gift would not result in sufficient annual income for the parents. The need is to transfer the farm to the operating heirs in such a way that the older generation is assured of sufficient income for the remaining years. One of the questions that must be carefully considered, as plans are made for the transfer of the farm property, is whether the business is large enough to support both the parents and the operating heirs.

A related question has to do with effects of the parent generation's retirement on the farm business. If the business is large enough to support both generations, it may be too large to be managed by the operating heirs. The retirement of the parents usually means a reduced labor supply and a reduced supply of operating capital. How does the business adjust? Hire labor? Borrow capital? Bring in a third generation? If downsized, the farm business may no longer be large enough to support both generations.

Equity for Non-operating Heirs

A more complex question than the economic issue is the treatment of non-operating heirs. If the non-farm assets are adequate to compensate the heirs who have left the farm, then the farm can be transferred to the operating heir quite easily. Most farm families do not find themselves in this situation. They need to ask if the farm should be transferred in equal shares to all of the heirs, operating and non-operating. Does the operating heir deserve compensation for the "sweat equity" contributed? Would some of the non-operating heirs like to be a part of the farming operation? If equal shares are transferred to all heirs, how will the income from the farm be divided? Will the operating heir receive a salary? Will the non-operating heirs receive rent? Would it be better to form a corporation that would pay wages to the operating heirs and dividends to all share holders, including the non-operating heirs? What is the responsibility of the operating heir to his or her siblings, and vice versa?

Unsatisfactory resolution of these and other intrafamilial issues in the property transfer have led to hurt feelings, and even lawsuits that pit one sibling against another. The only way to deal with the issues is to openly discuss all options with all family members before decisions are made and actions taken.

Arrangements for the Surviving Spouse

Most often, the surviving spouse is female; women have longer life expectancies than men, and tend to

IOWA STATE UNIVERSITY
University Extension

Pm-1167f Revised January 2002

marry men older than themselves. The couple should make plans together for the disposition of the property during retirement and for its disposition after the death of either spouse. Many a farm widow has found herself locked into the terms of a trust established before her husband's death that limits her options. Both partners need to consider living arrangements and property disposition after the death of either spouse before solidifying plans for retirement and for property transfer.

Alternative Ways To Transfer the Property

There are a number of ways that the real estate can be transferred to an operating heir or heirs. Some are discussed in this section. A more complete discussion, with excellent examples, can be found in North Central Regional Extension Publication 610F, *Planning Your Late Career, Retirement Mode Years* (cost publication).

It is important to remember two things. First, every situation is unique; what one family decides to do may not be appropriate for another family. Each family needs an individual plan tailored to its specific situation. Second, any of the alternatives discussed have fairly complex legal issues and implications. Time should be spent shopping for a good lawyer, one who specializes in the legal aspects of property transfer, and who has knowledge of income, gift, and estate tax implications. It is important that all parties involved in the transfer know and trust the attorney. Alternatively, each of the parties involved (the parents and the operating and non-operating heirs) should have their own attorney who is looking out for their interests.

Sell the Farm

Perhaps the most obvious way to transfer the farm at the time of retirement is to sell all or part of it to the operating heir. If the retiring couple owns the farm outright, the older generation could hold either a land contract or a private mortgage. The heir would agree to pay a specific amount each year for principal and interest payments. Retirement income would be guaranteed, and secured by the farm if the payments could not be met. If the farm is mortgaged, there might not be the opportunity for the older generation to hold a private mortgage or land contract. A discussion with the holder of the current mortgage could reveal several options—for instance, mortgage assumption by the operating heir.

There are two potential problems with planning to sell the farm to the operating heir. First, the younger family may not be able to afford the purchase. They may not have sufficient capital or credit base for even a modest down payment; other debt obligations may mean that they could not meet the annual payment schedule. Second, the income tax obligation for the parents from the outright sale of the farm property may make another alternative more desirable.

Look closely at the income tax issues surrounding the sale of a farm business. Assume that the entire farm business is sold, including the dwelling, the machinery, the livestock, and the land. Under the cash basis method of accounting, farmers will have income that has not yet been recognized. Thus, over a period of years, they accumulate considerable assets on which income taxes have not been paid. Under these conditions, if the farm business is liquidated in a given year, there is ordinary farm income from the sale of crops and livestock, income from the sale of the machinery (part of which will be ordinary income), and gains from the sale of breeding stock (if the holding period is met) and the sale of land.

Careful planning is needed to reduce the income tax obligation of the parents. The installment sale method, in which part of the payments are deferred until future years, can help ease the tax burden. This method treats a part of each payment received as the recovery of cost and a part as profit. If the sale value greatly exceeds the tax basis, however, even an installment sale may trigger a large tax burden. An alternative is to sell outright a little each year, although this approach may be impractical.

The farm residence is an asset that, although located on the farm, is not entirely a farm business asset. Consequently, its sale usually is treated as the sale of a principal residence by the Internal Revenue Service, except for parts of the residence (such as an office in the home) used for business purposes. When the farm is sold, a portion of the selling price and a portion of the cost basis are allocated to the residence, including its yard and outbuildings not used for business purposes. Since up to $500,000 of gain for a couple filing jointly ($250,00 for single person) is not taxable on the sale of a principal residence, the sale will probably not produce any taxable income.

Lease the Farm

A second alternative is to lease the farm to the operating heir on a cash or share basis. In most cases, the sale is either deferred for a period of time, while the heir builds sufficient capital for the sale, or the property is passed to all heirs, operating and non-operating, at the time of death. If leasing is deemed the most desirable, both generations should take care to distinguish the leasing arrangement from either an employer-employee relationship or a partnership.

The advantage of a leasing arrangement is that the operating heir can have many of the benefits of farming before capital or credit base has been developed. If the transfer of property is deferred until the estate is settled after the death of one or both parents, and there are non-operating heirs, a potential disadvantage is that the operating heir may not be able to buy the shares of the non-operating heirs, thus forcing the sale of all or part of the property. Or, the operating heir may be unable to pay the costs of the estate settlement, usually considerably higher when the second spouse dies than when the first spouse dies. The "unlimited marital deduction," which permits the surviving spouse to inherit all or part of the estate of the deceased spouse without federal estate tax obligations, is extremely advantageous in planning for the transfer of property. In larger estates, however, it may not be an advantage to make full use of the unlimited marital deduction. Careful estate planning on the part of the parent generation can help limit estate tax obligations and can provide assets to be used to pay the estate tax obligations at the death of the second spouse.

If the parent generation wants to ensure that the farm business continues after their death, they need to indicate that the farm business should not be sold by the non-operating heirs when the last spouse dies. Several options for such protection are available. They include the purchase of additional assets to be liquidated at the time of death, the purchase of life insurance, or financial gifts prior to death.

Joint Tenancy Between Generations

One of the least desirable devices used for transferring an interest in the farm is for the ownership of the farm to be held in joint tenancy by the retiring generation and the potential heir. A share of the ownership is given or sold to the heir, and the legal property records are changed to that effect. The advantage of this alternative is its simplicity and familiarity, and its low cost, particularly if the share in the property is a gift.

The disadvantage in using joint tenancy between generations is that all joint tenants are subject to each other's desires and interests in the use of the property. If a father and son are joint tenants, the death of either results in the property being transferred to the surviving joint tenant, leaving the deceased's spouse and other heirs with no ownership share in the farm. The heirs of the deceased may have inadequate income.

Exchanging the Farm for a Life Annuity

An annuity is a promise to pay a specific amount of money over a specified time period. One method of using an annuity to transfer the farm property to an operating heir is to deed the farm to the heir in exchange for a promise to pay the retiring couple a joint and survivor annuity. In its simplest form, an annuity is a transfer in which the specified payment period is the lifetime of the annuitant (the seller). Under this arrangement, the parents could transfer ownership of the farm for a specific annual amount of income. If the parents die earlier than expected, the heir receives the farm for only a fraction of its value. If the parents live longer than expected, the cost of the farm to the heirs becomes greater.

The advantages of a life annuity agreement between the generations is that the transfer of the property may reduce future estate taxes substantially and income taxes may be reduced. A potential disadvantage of private or "family" annuities is that the lifetime income of the annuitants is essentially unsecured. If the younger family finds that it cannot meet one or more of the periodic payments, the older generation may have little recourse except, of course, a lawsuit.

Some of the disadvantages of a private annuity may be overcome through the purchase of a commercial life annuity. The buyer of the farm would pay the cost of the annuity to an insurance company; the company in turn would assume the obligation for making periodic payments to the persons named in the annuity contract. The company would either make payments on a "life annuity" contract, a guaranteed income for life with no payments due at or after death, or under a "cash refund life annuity." The cash refund annuity guarantees periodic payments for the lifetime of the annuitant with an additional lump sum payment at death equal to the excess, if any, of the purchase price over the sum of the payments.

Life Estate

Another method of ensuring the future ownership of the farm by operating heirs is to transfer ownership through a gift of the farm while the parents retain lifetime use and income as a life estate. This plan might also include a lease of the farm to the heir on a cash or share basis during the parents' lifetime. This method can be successful if the value of the property in which the parents retain the life estate is relatively modest. Tax problems arise when the value is relatively high, because the value of the property is still included in the parents' estate. Estate taxes may be excessive, as the full value of the property may be included in the parents' estate for the death tax purposes.

Partnership Between Generations

In a partnership, a portion of the farm capital could be transferred by sale or gift to the operating heir at the start of the partnership and during the years that the partnership is operated. When the parents reach retirement age, their remaining share of the capital could be transferred to the heir by sale or gift. If the transfer is accomplished through a sale of the property, the parent generation would have the revenue from the sale to invest for their retirement income. A gift of the share would leave the parent generation without income from the farm business or from investment from the sale of the farm business in retirement.

An alternative is to convert the partnership from a general to a limited partnership, to give the heir complete managerial responsibility and to limit the involvement and liability of the parent generation. Retirement income for the parent generation would come from a share of the profits. One of the potential disadvantages of the general partnership arrangement after retirement is that income from a partnership (farm or nonfarm) may reduce social security benefits for individuals under age 65 if it is considered "earned income." If the parent generation is a "limited partner," income from the partnership generally will not be counted as earned income for social security purposes. However, a limited partner does not have any voice in the management of the farm. The general partner may endanger the asset by borrowing, which the limited partner has no control over.

Corporate Ownership

Incorporating the farm converts ownership from interests in land, machinery, livestock, and crops to readily transferable stock certificates representing ownership in the entire business. The heir could be hired to manage and operate the business. Income in retirement is received through dividends. Alternatively, income could be received through the sale of stock in the corporation to the operating heir. A disadvantage of incorporation is the double taxation that occurs when appreciated farm assets, such as land, are sold. One tax is paid at the corporate level and a second tax when the proceeds are distributed to shareholders.

Creating a Trust

A trust is an arrangement whereby the management control and legal title to property are placed with a trustee who manages or operates the property for the benefit of other persons, the beneficiaries. A trust can be created during life (an inter-vivos trust) or can be set up by will (a testamentary trust). In either case, the trust can continue after the death of the decedent.

There are many variations of the basic trust idea. Its flexibility can permit substantial discretion by the trustees. For example, they can be granted power to redistribute the trust principal at a future date, to allocate income among family members, to distribute the principal to the beneficiaries in times of need, and to make similar arrangements that can adjust to future changes in family needs or the economic climate. A trust may be used to guarantee income for the retiring farmer and spouse as beneficiaries while including the heir in the management of the farm operation.

For Further Reading

Harl, Neil. *Planning for Tomorrow: Estate Planning*. Iowa State University Extension publication (Pm-993), available at your county Extension office. Cost publication.

Harl, Neil. *Farm Estate and Business Planning*. 14th ed. St Louis, MO: Doanne Publishing, 1999.

Thomas, Kenneth H. *Planning the Late Career, Retirement Mode Years* (NCR-610F). Ames, IA: Midwest Plan Service, 2001. Cost publication.

File: Economics 1-5

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Issued in furtherance of Cooperative Extension work, Acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture. Stanley R. Johnson, director, Cooperative Extension Service, Iowa State University of Science and Technology, Ames, Iowa.