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# Ready Set Retire

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## Farming: Without an Operating Heir

Joe and Peggy Green have three children. Their oldest, Kate, completed her B.S. degree at State University, married a chemical engineer, and moved to the East Coast when her husband got a job there. Her two children, both teenagers, have romantic notions about life on a Midwestern farm and enjoy visiting their grandparents each summer, but neither Kate, her husband, nor either of her children, has any desire to return to farming.

The Green's second child, Pete, completed a B.S. in forestry at State U. and has worked for the U.S. Forest Service, first in Oregon and then in Montana, since his graduation. He likes his work very much, and particularly likes the climate and scenery that surround him in his daily work. Neither of his two daughters from his first marriage nor he and his second wife have any interest in returning to the family farm.

The Green's third son, Jack, born eight years after his older brother, took a job after high school in a local service industry. He always talked about farming with his dad, but he quickly rose to plant supervisor, married a woman not interested in farming, and moved to a community about 50 miles from his parents' farm. Like their cousins, his children

look forward to visits to their grandparents' farm but have little interest in returning to the farm.

Although they wish that one of their children was interested in returning to share in the farming operation so that the farm could be transferred to that child, none of their three children nor any of their grandchildren wants to be involved. The Greens' plans to meet retirement goals will center on a single consideration: ensuring sufficient income for their retirement years, including income and property arrangements for the surviving spouse.

### Alternatives for Retirement Without an Operating Heir

In general, there are five major alternatives available to retiring farmers who have no heirs interested in taking over the farm operation. The alternative chosen depends primarily on the amount of leisure time desired and the amount of work the retiring farmer wants to do.

#### Operate the Farm

The couple could continue to operate the farm on a full-time or part-time basis. This option is often chosen by couples who truly enjoy the kind of work that farming entails and want to remain on the farm as long as they can. Operations could be scaled back

to reflect the needs and desires of the couple. If the couple enjoys livestock farming the most, then they could keep the cattle and crop and hay land necessary for winter feeding, but sell the remaining land. They also could specialize in crops that minimize some of the back-breaking labor.

Potential disadvantages of continuing farm operations, even on a limited scale, are first, the couple is not really retired. They still may be tied to twice-daily feedings, the vagaries of the weather (making hay when the sun shines, for instance), and the general uncertainties of farming. A second disadvantage is that income from the farm operation, because it is income earned through current productive efforts, may reduce social security benefits for individuals under age 65. (See *Ready, Set, Retire—Farming: Social Security Issues*, Pm 1167h.)

#### Lease the Farm

A second alternative is to live on the farmstead but rent the land. This alternative could be combined with the first alternative, with the couple continuing part of the farm operation and renting the remainder of the land. Renting all or part of the land works best when a sizeable portion of the land is tillable and the farm buildings do not contain specialized equipment or facilities.

Several different lease arrangements are available. A **cash lease** specifies that the tenant pay the land owners a set amount of money for the use of the land for a fixed period. In general, the land owners furnish the farm, pay the taxes and assessments, and may be required to keep certain things in good condition, like a storage building or fences. The tenant supplies the labor and working capital. The advantage to the land owners is that the return is fixed and secure and does not count as earned income for either income tax or social security purposes. A disadvantage to the land owners is that, although the risk is low, so may be the returns on the investment in the farm. There also may be some risk of nonpayment of rent by the tenant.

A **crop share lease** specifies that the land owners will receive a portion of the crop as payment for the rental of the land. Usually the lease specifies that they share in the production costs, although arrangements in which they do not are possible. A crop share lease also may require land owners to supply part of the operating capital and to market the grain unless a professional farm manager is employed. Like farm operation, a crop share lease holds the possibility of higher returns than a straight cash lease if the crop year is a good one. There is also the potential for much lower returns in bad crop years, of course.

The most important decision that the land owners can make in a crop share lease arrangement is the selection of the tenant. Even with an excellent tenant, the land owners probably will want to be involved in decisions made about the crop land, because their annual earnings are tied in part to those decisions. It also may mean that the rental income will be counted as earned income for social

security purposes if the lease is a **material participation share lease**. Nonmaterial participation share leases should produce rent, not earned income, with the amount not subject to social security taxes. (See Ready, Set, Retire—Farming: Social Security Issues, PM-1167h.) A variation on the crop share lease is the **crop share/cash lease** in which the hay and pasture land is rented for cash and the tillable land is leased on a crop share basis.

A couple considering some type of leasing arrangement should obtain a copy of FM-1564, *Improving Your Farm Lease Contract* (cost publication), from the local extension office. Various leasing arrangements are detailed with a discussion of issues important to each arrangement. In addition, blank farm lease forms are available. Ask for PM 1538, *Iowa Farm Lease* (cost publication).

## Custom Farming

A third alternative is to continue to operate the farm, but hire machinery work done for crops on a custom basis. Under this method, the land owners hire someone who does custom work, often a neighbor, to plant, till, and harvest the crop for a fixed fee. The land owners supply all the capital, market the crops, and receive the income. This option tends to have all the risks of farming, with the additional risk of competing for an individual's services at a time when those services are in great demand. Involvement in the day-to-day decisions is also high, but involvement in the physical labor is minimized. Profit potential is high for those who wish to remain active in management. Publication FM-1823, *Custom Farming: An Alternative to Leasing*, discusses details of farm operation through custom farming.

## Sell the Farm

The fourth option is to sell the farm and move to a dwelling in a nearby community or in another part of the country. The proceeds from the sale are invested to ensure retirement income (See Ready, Set, Retire—Farming: Investment Planning, Pm-1167i). Although many couples are reluctant to part with a farm where they have spent many years, it is sometimes the best alternative. In particular, farms with specialized equipment and facilities, such as a dairy operation or a confinement hog operation, may be difficult to rent and obtain a reasonable return on the investment. Such farms may be difficult to sell, also, but the potential for return may be greater with a sale than with leasing.

If the farm business is to be sold, careful planning needs to take place to minimize the income tax obligations of the couple when the farm is sold, as well as the estate tax obligations when the first spouse dies and when the second spouse dies. Because both income tax law and estate tax law are complex, an attorney or other tax adviser should be retained for advice throughout the process.

Consider 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, the sale of the machinery (part of which will be ordinary income), the sale of breeding stock,

and the sale of the land. If the sale price is higher than the cost basis, tax on the capital gains will be due. At the least, it may be desirable to sell the machinery one year, the breeding stock the next year, and the land the third year.

Selling the land on a land contract, essentially an installment sale, has the effect of deferring part of the payments until future years. If the land is sold on contract, a part of each payment is treated as the recovery of cost and a part as profit.

The dramatic decrease in land values during the 1980s pointed out the risk in contract sales, as many buyers could not continue payments and forfeited property back to original owners. The couple will need to weigh the tax advantages of a sale on contract against the advantages of receiving the entire purchase price of the farm for reinvestment.

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 like the sale of the 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. A \$500,000 in capital gains on sale of the residence can be excluded from taxation for married filing jointly taxpayers (\$250,000 for single taxpayers).

## **Transition/Sale to a Young Farmer**

The fifth option is a combination of the second and fourth alternatives. If one of your goals is to see your

operation continue, you may wish to bring a younger person into the business over a number of years. If this arrangement proves successful, you may wish to facilitate a purchase transfer upon death by the use of estate planning options such as buy-sell agreements combined with a life insurance trust, enabling the younger person to purchase farm assets without incurring prohibitive debts. Iowa State University Extension provides assistance to match beginning farmers with retiring farm families who have no on-farm heirs through the "Farm-On" program. For more information on the "Farm-On" program call 1-800-447-1985.

In most farm transition situations, the process usually starts with an employer/employee relationship for one to two years to help transfer experience to the younger farmer. Then, leasing arrangements can be implemented to start the transition of management experience to the younger farmer. Leasing works well with younger people who lack experience and capital resources, and gives retiring farmers an income stream through rental payments that help preserve a secure retirement.

These leasing arrangements usually start with short or intermediate term assets such as machinery and breeding livestock, followed by longer term leases of land. If the younger person is leasing an entire line of machinery, disagreements can be avoided if that same person is responsible for all fuel and repair expenses. If a machine is used by both the owner and the lessee, lease payments can be calculated by the acre or by the hours of use. Iowa State University Extension publication, *Iowa Farm Custom Rate Survey* (FM-1698) can be used to estimate rental rates. In transferring breeding livestock, a rollover approach is a

popular alternative. In this arrangement, the retiring farmer continues to own the breeding herd, but the offspring is owned jointly with the beginning farmer. When the original breeding animals are sold, the older farmer receives the income from the cull sale. The raised replacements are then owned jointly. Iowa State University Extension publication PM-1573, *Two Generation Dairy Cow Leasing* (cost publication), contains examples. An installment sale of a breeding herd may be possible with careful tax planning. For sales between closely related parties, resale within two years triggers gain for the original seller.

The leasing of machinery should be linked with the leasing of land to obtain the maximum tax benefit. When transferring land, the retiring farmer must consider additional tax implications, because the transfer of long-term assets may also be influenced by estate planning goals. The key in moving the farm to a younger farmer is to remember that although it takes time, it is a workable option in retirement planning, and it has the added benefit of seeing your operation benefiting another generation.

## **Estate Planning**

Regardless of which option is pursued, there will be two estates to consider—the estate of the first spouse and the estate of the second spouse. The "unlimited marital deduction" that 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. Careful estate planning on the part of the parent generation can help limit estate tax obligations or can provide assets to be used to pay the estate tax obligations at the date of the death of the second spouse.

## 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.

Harl, Neil. *Agricultural Law* (vols. 5,6). New York, NY: Matthew Bender and Co., 1996.

Harl, Neil. *Agricultural Law Manual* (Chapters 5, 6). Eugene, OR: Agricultural Law Press, 1996.

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

## For More information

Iowa State University Extension has other publications in the Ready, Set, Retire series. Ask for your copy of:

*Ready, Set, Retire: Farming Special Considerations* (Pm-1167e)

*Ready, Set, Retire: Farming with an Operating Heir* (PM-1167f)

*Ready, Set, Retire: Farming Social Security Issues* (Pm-1167 h)

*Ready, Set, Retire: Farming Investment Planning* (Pm-1167i)

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