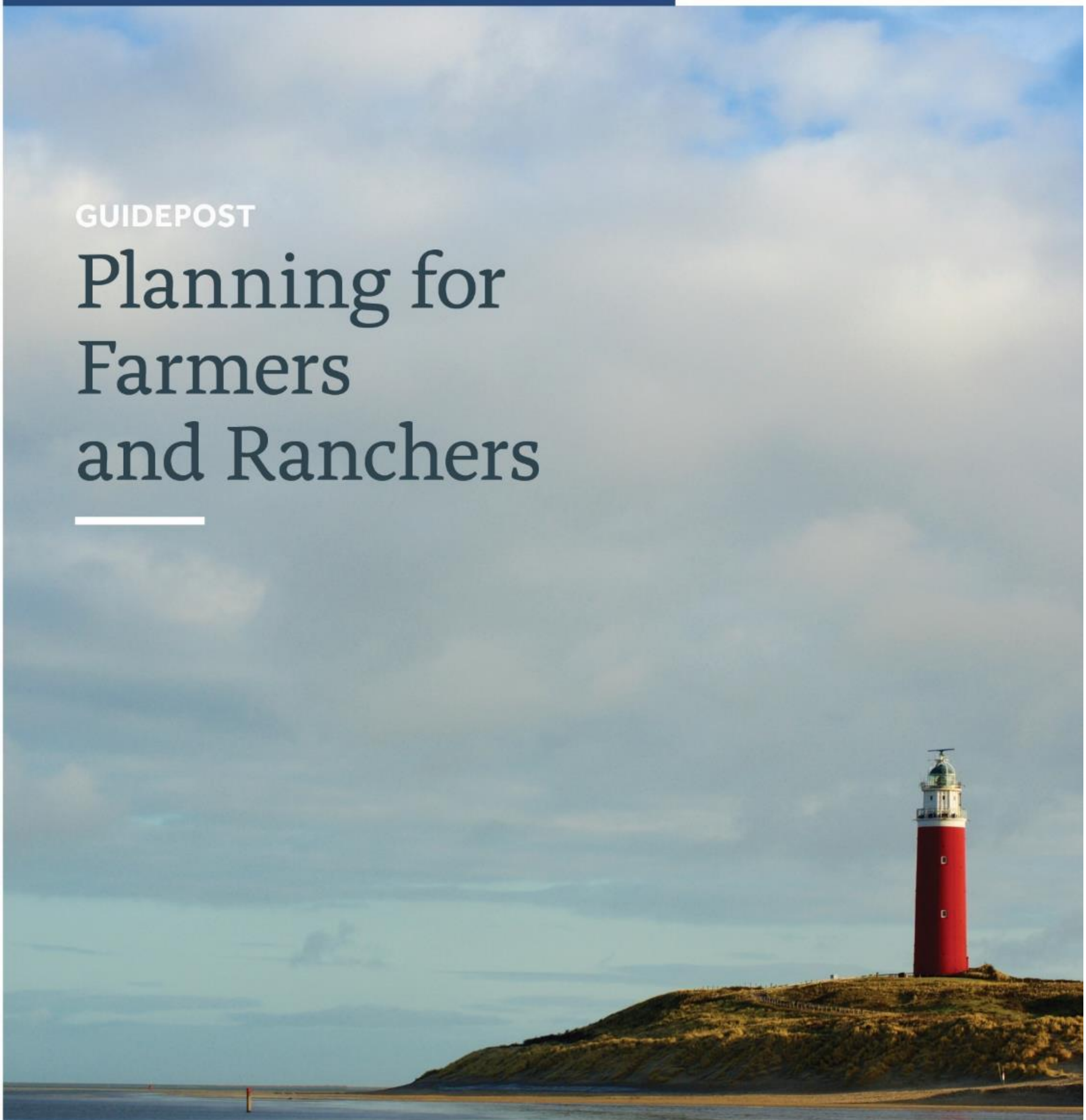
Wealth Coach of Kentucky

dba Larry E. Botts & Associates

GUIDEPOST

Planning for Farmers and Ranchers



Planning for Farmers and Ranchers

While farmers and ranchers confront the same problems as any business owner regarding succession planning, wealth preservation, and estate taxes, they also face many unique issues. Specific tax rules, regulations, and the nature of their industry requires a specialized focus and expertise when planning for such clients.

Farming and ranching operators may also have particularly strong convictions regarding long-established family enterprises that are heavily concentrated in real property. Many farms and ranches have been in the family for several generations, and a prevalent desire is to keep ownership of the land in the hands of family members: both those involved in operations as well as those who may not be involved. Of course, this generally gives rise to unique problems governing appropriate income apportionment, control, and estate equalization.

As a result, a comprehensive understanding of the relevant issues and techniques is crucial to the effective implementation of appropriate legal and tax strategies, ensuring the preservation of the farm or ranch for succeeding generations while bestowing long-term peace of mind on operators.

Challenges

Farm and ranching operations are especially vulnerable to poor economic conditions. Capital requirements are high and return on investment is sometimes low. Operators typically accumulate most of their equity through earnings and gradual increases in asset values from growth and inflation; net worth tends to result more from growth in the value of production assets rather than income accumulation. It is also critical for operators to maintain a debt-equity structure which assures survival through periods of adverse weather and market conditions.

Likewise, agriculture also is extremely sensitive to export markets. For example, high interest rates in the 1980s contributed to a strong dollar, which in turn contributed to a drop in U.S. farm exports. Farmers and ranchers were ultimately hurt by the decline in the price of agricultural products and real estate. Operators with excessive debt combined with high interest rates and low prices often did not survive during the era. For today's farmers and ranchers to survive, maintaining financial solvency is important. For a family enterprise to thrive for generations, establishing and maintaining an effective long-term plan is essential.

Details of the Industry

Attitudes and Outlooks

Many successful family farms and ranches are built over generations, creating a deep personal bond and sense of identity in the operation. Furthermore, the physical nature of the labor that goes into building a farm often creates a unique perspective by the operator, one that may place a strong emphasis on the character, stability, and integrity that farming or ranching signifies. The fruits of the many years of labor include self-respect, personal satisfaction and a tangible, permanent family legacy.

Nature of Work

Farming and ranching operations have become more complex in recent years. Farm output and income are strongly influenced by the weather, disease, fluctuations in prices of domestic farm products, and federal farm programs.

Both farmers and ranchers operate machinery and maintain equipment and facilities, and both track technological improvements in animal breeding and seeds and choose new or existing products. Farming and ranching can be hazardous work. Tractors and other machinery can cause serious injury, and operators must be constantly alert on the job. The proper operation of equipment and handling of chemicals are necessary to avoid accidents, safeguard health, and protect the environment.

Operators of small farms and ranches usually perform all tasks, physical and administrative. They keep records for management and tax purposes, service machinery, maintain buildings, and grow vegetables and raise animals. By contrast, operators of large farms and ranches have employees who help with the physical work. Farmers on crop farms usually work from sunrise to sunset during the planting and harvesting seasons. The rest of the year, they plan next season's crops, market their output, and repair machinery.

On livestock-producing farms and ranches, work goes on throughout the year. Animals, unless they are grazing, must be fed and watered every day, and dairy cows must be milked two or three times a day. Many livestock and dairy farmers monitor and attend to the health of their herds, which may include assisting in the birthing of animals.

Tailored Planning

Since each family farm or ranch is unique, no single approach to estate and business planning works for everyone. It is important to understand that the farm or ranch involves the interaction of people in the strong bonds of family, who are engaged in the business and who make decisions affecting the business.

It also is important that estate and succession planning adopt a long-term planning horizon and implement planning strategies in a timely and efficient manner to accomplish intended goals. Most farmers and ranchers desire that the operation continue when they are gone, though a few do not. When the operation will not be continued, the focus shifts to transferring, liquidating and distributing equity to the heirs while minimizing any loss in value.

Potential Planning Issues and Concerns

Since operating a farm or ranch is difficult, designing a strategy for the ultimate transition of the business upon the primary operator's demise can be confusing. There are a variety of issues and concerns related to estate and business planning that should be addressed, the most common of which are discussed below.

Farm Economics

Farm economics differ from that of most other businesses. An acre of farmland might cost $5,000 but have a rental value of only $200 per year, a 4% return. Compare this with residential and commercial real estate which typically have returns in the range of 8%-10%. This means that the current productivity of farmland is relatively low, and much of its value lies in the possibility of future appreciation. It also means that farming is extraordinarily capital-intensive. For example, a dairy operation typically requires about one acre of farmland to support one cow. Therefore, a typical 200-head dairy operation requires 200 acres of land with a value of approximately $2,000,000. This of course doesn't include the cost of the cows or a modern computerized milking parlor (which can cost $1,000,000).

Government Programs

Farm and ranch subsidies have a significant influence on agricultural production in the global and local economy. Farm subsidy supporters argue that subsidizing agricultural products helps ensure farmers have a constant stable income, and that certain vital commodities will always be available through domestic production, ensuring U.S. independence, security and economic health. Most subsidies are aimed at grain farmers; however, producers of most U.S. agricultural commodities do not receive regular subsidies from the federal government.

The Agricultural Act of 2014 (2014 Farm Bill) was signed into law on February 7, 2014. This bill came on the heels of much legal wrangling and stalemate after the prior farm bill expired in 2012. It authorizes spending of $956 billion over 10 years, however roughly 80% of the budget is devoted to the federal food stamp program known as SNAP (Supplemental Nutrition Assistance Program).[1] Its provisions affecting nutrition and agriculture are in effect for the traditional 5-year period of prior farm bills, but had not yet been renewed in 2018. The bill eliminates direct payments to farmers in lieu of insurance that pays out when revenues or crop prices drop. Different crops are eligible for different programs, and ranchers are eligible for immediate assistance for livestock losses due to natural disasters.

---

1 H.R. 2642; Pub.L. 113-79

In spite of the passage of the 2014 Farm Bill, the current political environment regarding the future of farm subsidies is uncertain. Many farmers, in fact, may believe that subsidy programs will be less prevalent in the future, and should not therefore drive the estate and succession planning process.

A decision to modify the current business structure or establish an LLC, partnership, or corporation can also affect agricultural subsidies. The type of organization established, amount of farmland under management and number of owners within the organization can all impact eligibility for subsidy payments. As a result, the creation and modification of estate and business plans should always be cognizant of the extent to which eligibility for certain programs may be impacted.

Lack of Liquidity and Diversification

Due to the unique nature of farming and ranching, operators tend to put all income and profits back into the operation in the form of illiquid assets such as farmland and equipment. At an operator's death or at the transition of the operation, problems can be caused due to a lack of assets easily convertible into cash.

Operating Loans

Operating loans may be used to purchase items needed for a successful farm operation. These items include livestock, farm equipment, feed, seed, fuel, farm chemicals, repairs, insurance, and other operating expenses. Loans for annual operating expenses (seasonal loans) are normally repaid within one year. Loans for equipment and livestock purchases are scheduled for repayment over longer periods. Some loans are obtained through private credit and some through government programs.

These loans can be substantial based upon the time of year. Yearly operating loan balances can be very high in the spring and completely paid off by December. This can cause a problem depending on the time of year operators become disabled or die. A loss of the key operator can be devastating at any time and especially during the time that an operating loan exists. The need to recognize the loss of an operator in the succession plan is crucial.

Depreciation Recapture

Certain farm related property can be depreciated. Property subject to depreciation that is subsequently sold or exchanged can be subject to recapture. When real property in a farm or ranch is sold at a gain and accelerated depreciation has been previously claimed, the owner may be required to pay tax at ordinary rates to the extent of the excess accelerated depreciation.

Succession of Planning for Active and Non-Active Children

One of the most sensitive issues for parents within the operation is balancing the interests of the children who work in the operation against the interests of the non-participating children. More so than in most businesses, children establish their "right" to the farm or ranch through sweat equity. Working on the farm or ranch is not for everyone—some children would rather pursue other career opportunities. When there are active children involved in the operation, farm and ranch operators will sometimes gift or assist an active child to acquire their own ownership interest in a portion of the land, livestock or equipment. It is rare, however, for a non-active child to acquire an ownership interest in these assets since current operators realize that non-active ownership can sometimes stifle farming operations. This is especially a problem in the typical situation in which the farm or ranch is the only significant asset in the family. Will the non-active children feel slighted, or will they feel lucky that they are free from the rigors of farming/ranching life? If the farm or ranch represents the family heritage, how can a non-active child feel a part of that heritage?

Resolution of this question is fundamental to the continuation of the operation but is limited by the basic economics of farming. The following factors must be weighed:

- Existing assets and cash flow available for both funding the legacy in the operation and providing for the non-active heirs;
- Dedication and ability of the successor;
- Parents' viewpoint regarding contribution equity of the successor and proportion of operation that should be attributed to the successor as a result;

- Desire by non-active heirs for continuity of the operation or preference for liquidation of their share;
- Ability and willingness of successor(s) and non-active heirs to work together in harmony; and
- Parents' viewpoint on continuity of the operation versus equality of inheritances for the heirs.

An additional matter to consider is the feasibility and reasonable opportunity given to non-active heirs to become active. Did these children have a chance to work in the family enterprise, or was that chance thwarted or at least hindered by the fact that an older sibling was provided the opportunity, and once accepted, foreclosed that opportunity to other heirs?

Retirement for the Senior Generation

Any plan to pass the farm or ranch to the next generation should allow for a secure retirement for the senior generation. Frequently operators don't have sufficient cash flow during their working years to accumulate liquid savings or otherwise save enough on a tax-deferred basis for retirement. Similarly, it is not usually possible to put in place a non-qualified deferred compensation plan when the junior generation is taking over, since there is not sufficient dependable cash flow when multiple families are reliant on the income from the operation.

Special Tax Preference Planning

The family farm and ranch has long had a special place in the American imagination and a special place in the tax code. Three important tax preferences can facilitate keeping the operation in the family: conservation easements, special use valuation, and alternative valuation date.

Conservation Easements

Farm and ranch land is frequently subject to development pressure which can dramatically increase the fair market value of the land and corresponding property taxes. Placing a conservation easement on the land permanently restricts the use of the land for agricultural purposes. This will reduce the current value of the land and associated real estate taxes and reduce future appreciation.

Special Use Valuation

The purpose of Internal Revenue Code §2032A (Section 2032A) is to allow farmland to *be valued as farmland*. Section 2032A permits farmland to be valued at its productive value in farming, rather than farmland's fair market value (if sold for its highest and best use). When valuing farmland at a lower cost, a significant amount of estate tax can be saved. In select situations, it is the difference between a farm remaining in the family or being sold to raise the cash necessary to pay estate taxes.

Special land use Section 2032A is generally misunderstood. It is widely perceived as easy, uncomplicated, and the primary method of solving farm estate planning problems. Unfortunately, that perception often is based on a lack of accurate information concerning the complexities of how Section 2032A works, and of its true advantages and disadvantages. First, it is critical that the decedent have materially participated in the farm or closely held business to use special-use valuation. The law also requires that property inherited by special-use valuation be used for a qualified purpose by a qualifying heir for a minimum of 10 years. A qualified use means: (1) the property is used as a farm for farming purposes; or (2) in a trade or business other than farming. The term trade or business applies only to an active business such as manufacturing, mercantile or service enterprise, or to the raising of agricultural or horticultural commodities.

If such tests regarding the material participation and qualified use of a qualified family member are not maintained, additional estate tax and penalties may apply.

Alternative Valuation Date

The purpose of alternate valuation is to reduce the tax liability if the total value of the estate's property has decreased since the date of the decedent's death. Alternative valuation applies to all the property in the estate. It cannot be used for only part of the property, as is the case with special-use valuation. However, the personal representative may choose alternate valuation and use special-use valuation also for qualified real property. The choice must be made on the first estate tax return filed for the estate.

Liquidity, Taxes, and Estate Administration

An overriding concern for preservation of the farm operation upon the death of the senior operator is protection from fragmentation (forced sale) through the following:

- Excessive estate taxes;
- Excessive debt service cost;
- Operational competence of the legatee; or
- Division of the estate among family members.

Asset liquidity within the estate or liquidity that can be created at death may be a necessary component of the plan.

Many wills and living trusts contain tax formulas that may create unanticipated and unwanted results, especially in situations where the estate is not subject to estate tax. As the law continuously changes, operators need to review the impact of the new law upon their existing documents.

Wealth Coach of Kentucky
dba Larry E. Botts & Associates

Larry Botts, CAP®, ChFC®, CLU®, MSFS, RICP®

Wealth Coach Of Kentucky (dba Larry Botts & Associates)

651 Perimeter Drive, Suite 200
Lexington, KY 40517
☎ Phone: (859)268-1987
lbotts@ft.newyorklife.com
http://www.wealthcoachofkentucky.com