BREAKING BARRIERS

Why Estate Planning is Different for Farmers

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Top Producer SUMMIT

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Why Succession Planning is Different for Farmers

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Executive Women in Ag

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LinkedIn

Agenda

- How farmers are different
  - (what your lawyer might not get)
- Specific Strategies
- Farm kids need pre-nups
  - (and widowers too)
- What’s your basis?
- Retirement
- Common Mistakes

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How Are Farmers Different?
What Your Lawyer Needs to Know

- Strong emotional ties to the land (don’t want it sold)

- Different vocabulary (know what bushels are)

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How Are Farmers Different? What Your Lawyer Needs to Know

- Operating assets (machinery, equipment, semi trucks, bins, dryers, shops, barns) are different from land. They can and probably should be thought of and planned for differently.

- They farm their own land plus have other landlords. Your plan needs to address continued access to others' land.

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How Are Farmers Different?
What Your Lawyer Needs to Know

- They're fiercely private & notoriously understate their net worth.

- Tough to get an accurate PFS.

- They can't find their deeds – just call a title company

How Are Farmers Different? What Your Lawyer Needs to Know

- They don’t hate trusts
  - If farm assets “skip” a generation, they are not included in the next generation’s estate
  - Keep next gen under the estate tax exemption
  - Divorce and creditor protection. Next Gen doesn’t really own it, but has all the income off it. It’s still in your name, so it’s out of their marital estate

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How Are Farmers Different?
What Your Lawyer Needs to Know

- Team approach is crucial – CPA, CFP, insurance expert
  - Life insurance for liquidity needs – may (still) need an ILIT
  - Commercial liability and property coverage, umbrella?
  - Nuances about income tax savings available to farmers
    - Entity selection to reduce self employment taxes
    - Tax-Free Fringe Benefits
    - Commodity wages
    - Gifts of grain to children used to push income to lower tax bracket – be weary of new kiddy tax at trust & estates rates
    - Gifts of grain to charity to reduce income.

How Are Farmers Different?
What Your Lawyer Needs to Know

- Farmers tend to outgrow their advisors
- USDA and Farm Service Agency payments are tricky
- Follow Paul Neiffer's blog: http://www.farmcpatoday.com/

PLANNING FOR THE FAMILY FARM:

- “Fair” does **not** necessarily mean “equal” ownership among kids
- Equal tenants in common ownership may set the stage for a family feud
  - Partition actions can allow one tenant in common to trigger a court ordered auction, no matter how small an interest he owns

The Do Nothing Plan

- No, if you ignore this, it won't go away.
- Sweetheart Will: All to spouse… then he remarries, then what!?
- The kids will just work it out….um, no.

The Say Nothing Plan

- Planning in secrecy is a bad idea. Entitlement may be brewing at the next generation.
- Take a poll – not a vote -It's not a democracy.
- Once you decide what's fair – tell everyone – no surprises!
- "No Contest" clauses are a cop out
- "It's easier to talk to your kids about sex than about farmland transition" … said one Iowa farmer.

Threshold Issue

Is Co-Ownership at Next Generation Best?

- Should your children be in business together?
- Do you have a child in mind as a management successor?
- Can they get along well enough to split the cash rent?
- Could they get along if a professional farm manager was involved?

If not – pursue a different plan

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Ideas & Strategies – Divide it up

- ✓ Direct ownership of different tracts of land to different children, which they wholly own *instead of* co-owning the whole as TICs.
- ✓ Can still do this if land is owned by an Limited Liability Entity (“LLE”) by including instructions to dissolve LLE at death and distribute different ground to different children.
- ✓ May add a “hook” on the deeds subjecting sale of land to a right of first refusal in siblings, cousins, neighbor
- ✓ All land (or ownership in land-holding LLE) could go to farming child, identifying different assets for other beneficiaries.

Ideas & Strategies – Divide it up

- ✓ Are there sufficient assets to pull this off?
  - Summer lake house
  - Winter beach condo
  - Securities accounts
- ✓ Could there be with life insurance benefits to provide liquidity to balance things out? You might <u>not</u> want to own the insurance yourself.
  - Irrevocable Life Insurance Trust (“ILIT”)
  - Direct ownership by children

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Let’s Talk Taxes

- Upon death, up to $11.4 million (as of 1/1/2019) will pass exempt from Federal Estate Tax. A married couple can pass $22.8 million.
- During lifetime, you may give away up to $11.4 million of your assets ($22.8 if married) exempt from Federal Gift Tax, which would reduce the amount of your exemption remaining at death.
- For estates or gifts in excess of this exemption, the maximum tax rate is 40%.

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Let's Talk Taxes, portability election

- A surviving spouse can make a portability election in order to "port" over any unused federal gift/estate tax exclusion amount from the first spouse, if he/she died on or after January 1, 2011.
  - "Deceased Spousal Unused Exclusion Amount" (DSUE) - I.R.C. § 2010(c)(5)(A)
- Election must be made by the estate of the first spouse to die, which requires filing of a Form 706 Federal Estate Tax Return, even if no tax is owed.
- Could be a $11.4M mistake is not elected-get it in writing if surviving spouse declines to elect.

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Let's Talk Taxes
Annual Exclusions & State Taxes

- Annual gift tax exclusion is $15,000 – to as many individuals as donor wishes, without reducing donor's $11.4 million estate tax exemption or triggering Gift Tax.

- State inheritance or estate taxes deserve special attention: Connecticut, District of Columbia, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, Oregon, Rhode Island, Vertmont, Washington, Iowa, Kentucky, Nebraska, and Pennsylvania.
  - *Indiana repealed 1/1/2013*

Let’s Talk Taxes, tick tock

- Tax Reform under Tax Cuts and Jobs Act of 2017 (“TCJA”), made major changes to succession planning for farmers.
- Temporary doubling of the transfer tax exemption is set to expire January 1, 2026, reverting back toward the 2017 levels; $5.6 million per person, $11.2 million per married couple.
- Now is the time to act.

Irrevocable Life Insurance Trust ("ILIT")

- ✓ Face Value of life insurance "counts" toward the $11.4M ($22.8M) estate tax exemption
- ✓ Transfer existing insurance to an ILIT – 3 year lookback for estate inclusion
- ✓ Apply for and own new insurance in ILIT – no risk of inclusion
- ✓ Don't be your own trustee (no control)
- ✓ Terms of ILIT should complement estate plan – facilitate loaning/buying assets from estate to inject liquidity to pay the estate tax

Strategies – First Right of Refusal

- ✓ During lifetime: Landowner can “sell” first right of refusal to a family member. It is important that consideration is given (ex: $100) to make the contract valid.
- ✓ Then the first right should be recorded in the chain of title.
- ✓ At death: deeds distributing different tracts of land to different heirs can include ROFR language
- ✓ The farm cannot be sold without first being offered to the holder of the first right.
- ✓ * Operators - ask all your Landlords for this!

Strategies – Right to Purchase

- ✓ At death: You can leave the farm (or interests in LLE that owns the farm) equally to all children
- ✓ Require the off-farm children to offer their interests for sale to the on-farm child, and giving the on-farm the option to purchase same.
- ✓ Certain kids don't ever have a right to own land, but get cash. Are you OK with this?
- ✓ Simple strategy - avoids problems in future generations when ownership is fractionalized among cousins.

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First Rights - the details

The document granting the first right must clearly identify:

- ✓ The purchase price
  - Match offer that's on the table
  - Appraisal – who selects? average?
  - "Sweetheart deal" – ok but TELL ALL
  - Entity buy-sell – is BIG tax liability included for a C corp, are valuation of interests include discounts?
    - Attach a sample!

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First Rights - the details

The document granting the first right must clearly identify:

- ✓ Payment terms
  - Cash – lump sum
  - % down with delivery of low-interest * Promissory Note for the balance due

Applicable Federal Rate, Long Term Inst., January, 2019 = 3.15%

WSJ Prime January 2019= 5.50%

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First Rights- Fund With Insurance?

- ✓ Life insurance owned by the right-holder on the life of the landowner would help provide liquidity to accomplish the purchase in a lump sum.
- ✓ May want to require amount of insurance proceeds received to be paid over as the down payment, with a promissory note for balance in excess of insurance amount.

Separate Land and Operations

- ✓ Treat assets differently during lifetime to make them easier to pass at death
- ✓ Survey and split off operations from bare land: machinery, equipment, trucks, bins, dryer, shop, barns, pasture
- ✓ Direct who gets these assets through lifetime sales or gifts or at death

Separate Land and Operations

- ✓ Include operations in share of farm successor child - either "off the top," or so farm kid gets less of other stuff
- ✓ Offer operations for sale to non-related successor
- ✓ Hold land in trust to be available to a farm successor until retirement, then distribute to grandchildren?
- ✓ Have land in entity, which all kids inherit with rules attached, keeping land available to successor

Landholding Entity ideas

- Entity can (should) be structured with voting and non-voting interests
- Lifetime gifting or a coordinated estate plan provides control of land to farming successor through voting interests
- Off-farm heirs can receive non-voting interests
- “Fair” does not necessarily mean “equal” ownership among kids

Decision Making in the Landholding Entity

- The holder of the voting interests controls the entity unless you provide otherwise
- Include specific details:
  - Must the land be offered to lease to a certain tenant? If so on what terms?
  - Can interests be owned by “non-blood” relatives? Transfer restrictions are crucial! Think about a put option.
  - If a buy-back happens because of a default, do “good owners” get to pay “bad owners” a discounted price?

Decision Making in the Landholding Entity

- Non-voting owners need not be excluded from all management
- Define “Big” decisions that may require majority, supermajority or unanimous approval of all non-voting interests, so everyone feels involved

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Examples of "Big" Decisions In a Landholding Entity

- ✓ Sell land
- ✓ Mortgage Land
- ✓ Drastically change use of land
- ✓ Setting cash rent rates if one owner is the tenant (checks and balances) (include provision for alternative method to set rent if/<u>when</u> can't agree)
- ✓ CAFO, Wind Farm, other "hot button" issues…

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Who’s Your Successor?

If you don't have a successor, do you want to find one, or is a machinery auction your plan for retirement or after death, with spouse and kids splitting the net after taxes?

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Sale to Non Related Successor

- Through estate plan, at death an option to buy machinery, or “operating” assets could be given to non related successor, for ex: long time employee, young farmer who won’t be inheriting an operation.
- During lifetime, sell operating assets to identified successor, perhaps using corporation and selling stock.
- Hand picked successor gets a chance to buy operating assets, perhaps at a discounted price, or installment over time.

Sale to Non Related Successor

- Kids become landlords, with stream of income

- Take steps to insure successor to operations has access to farm land, outline formula to set lease terms, and consider giving successor operator ROFR over land.

Use of Corporate Entity to Transition Operating Assets to Next Generation - With Successor

Forming a Farm Corporation

- Clean cut-off: End all farm income and expense activity of farm proprietorship checking account; start corporate checking account activity next day.
- Prepare bill of sale to transfer to corporation
  - Unsold inventory (grain, livestock)
  - Accounts receivable (sold, but deferred pmt.)
  - Other assets (breeding stock, M&E)
  - Never land!

Case Study: Active Operations to Successor

<u>Facts:</u>

- John, age 65, operates as Schedule F proprietor
  - Owns grain, machinery, and land
  - Objectives: Retire in several years, liquidate grain, and sell machinery to Sam (might be his son, but could be unrelated)
  - Est. grain value: $800,000; machinery $500,000
- Sam, age 34, *<u>who may or may not be related</u>*, farms with John, but also files as proprietor
  - Owns his share of grain, some machinery (total value $200K)
  - Buying 160 acres on contract from neighbor

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Case Study: Active Operations to Successor

Plan A: Liquidate grain/lease & sell machinery to Sam

Asset	Federal tax Income Tax (35% blended)*	Soc. Sec. Tax (9% blended)	Total
$800K grain	$280K	$72K	$352K
$500K machinery	$175K	$ -	$175K
$1.3M	$455K	$72K	$527K

41% Combined Tax

**rates not updated after Trump Tax Cuts and Jobs Act of 2017*

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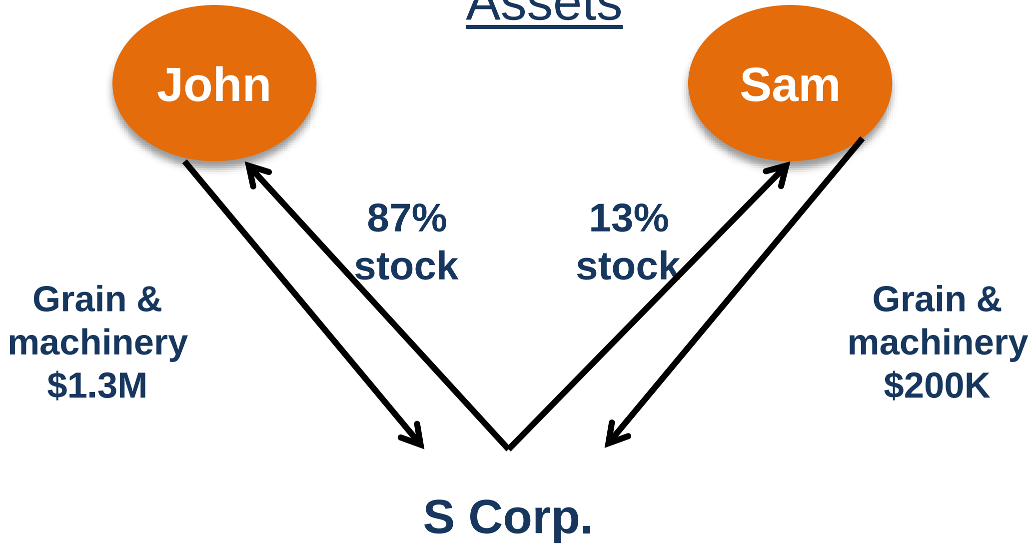
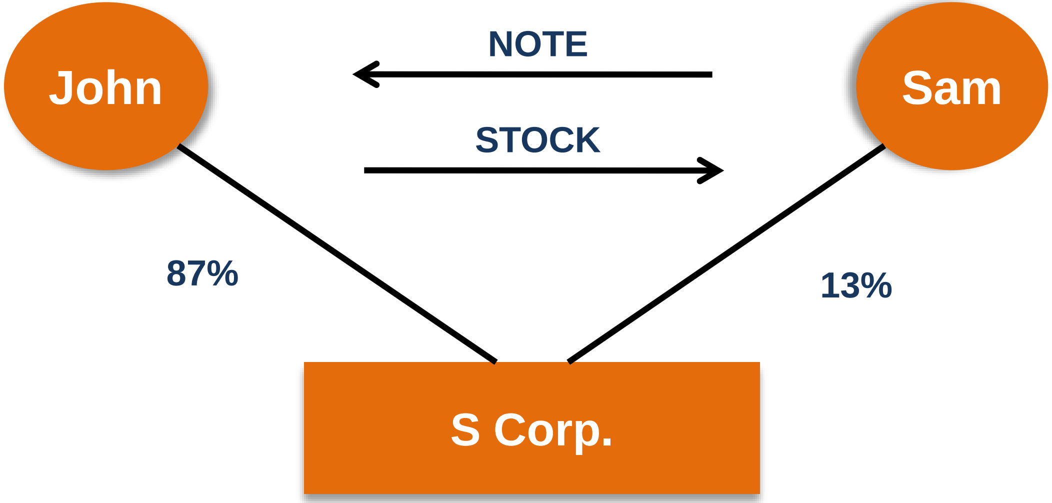
Case Study:
Active Operations to Successor

Plan B: Use an Entity to Transition Operating Assets



Case Study:
Active Operations to Successor



$1.5M grain & machinery

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Case Study: Active Operations to Successor

Strategies with corporate entity:

- Capital gain & no self employment tax to John on stock sale
  - Cuts effective tax rate from 41% to 20% (or 15% or 0%)
  - Spread gain over term of note (e.g., 10 yrs.)

- Sell stock in minority increments with discounts

- Consider reorganizing into voting & non-voting shares
  - John can dispose of most stock, but retain control if desired.

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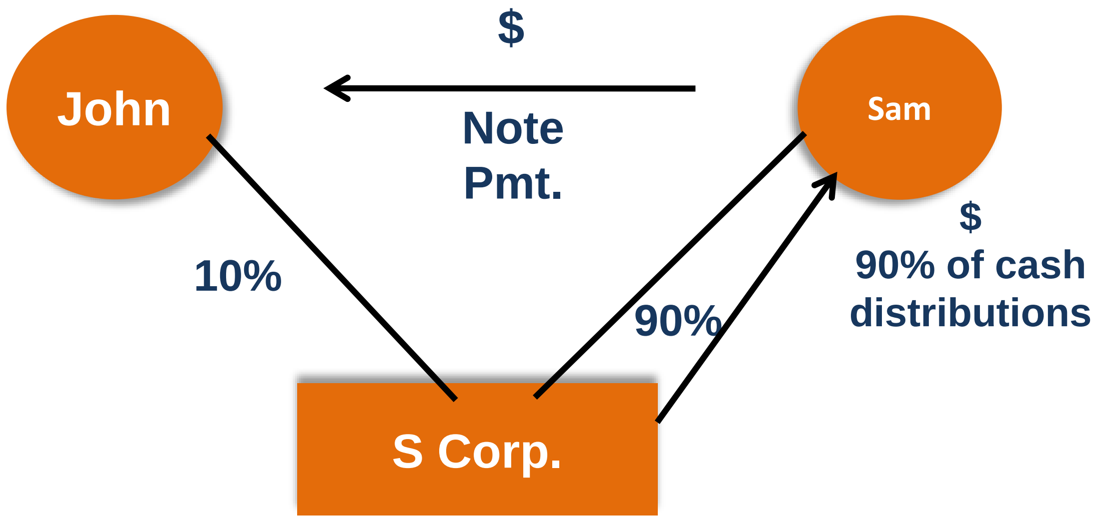
Case Study:
Active Operations to Successor



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Case Study: Summary

- Entity sells John’s grain, but offsets income with ongoing farm input expenses & prepaids
- Sam does not get fresh depreciation on machinery
  - Bought nondeductible stock, but at a discount
  - Sam gets favorable long-term financing from John
- Helps with “Fair” – if Sam is related, siblings can see that he bought in. Transition of Operations is complete during lifetime.

TRUSTS

- ✓ If you have young children you need a trust.
- ✓ Trusts help grown children with dependency problems, trouble handing money, bad marriages, or if you just don't want children to receive inheritance in a large lump sum.
- ✓ Beneficiaries receive distributions of the Trust's income and perhaps principal on terms you set.
- ✓ Provides control of ultimate ownership where one child doesn't have children.

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Ideas & Strategies – Dynasty Trusts

- ✓ Keep the farm in trust (with some seed money) for your children's lifetimes – They never truly own it but receive its income. Provides asset protection.
- ✓ Prevent land from being included in children's gross estate for tax purposes.
  - ✓ (allocation of GST tax exemption – tricky).
- ✓ You pick the trustee who'll have control, and you dictate continued management or sale of the farm in the trust agreement.
- ✓ Address cash rent if Trustee or a Beneficiary will be farming!

You control ultimate disposition

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What about your spouse?

- ✓ Those in a second (or third…) marriage with children from a first marriage can use a marital trust to preserve assets for children while providing lifetime support to surviving spouse.
- ✓ Provides protection ~~if~~ when spouse remarries.
- ✓ Unlimited marital deduction for gift and estate tax is powerful.
- ✓ Strike the proper balance between spouse & children.

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DIVORCE PROTECTION

- ✓ Trusts and Entity documents can only provide so much divorce protection, depending on a lot of factors, including how much control the beneficiary has.
- ✓ Ultimate discretion is given to the judge in the divorce proceeding.
- ✓ Other owners may have to buy back interests to keep from an ex
- ✓ Spouses have right to elect assets at death, which can be waived in a Prenup.
- ✓ Best protection is a Premarital Agreement.

Prenup. Prenup. Prenup. Prenup. Prenup. Prenup.

Dust it off every 5 years

- Plan for now, based on today’s circumstances.
- Original plan should allow as much flexibility as possible.
- Review when there’s a change in the laws, or a change in circumstances. Adjust if necessary
- No “one size fits all” solution

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Questions?