FARM SUCCESSION FOR REALISTS
LEGAL AND TAX TOOLS TO MAKE IT WORK

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AGENDA

- Taxation Considerations
- Legal Tools
- Examples

NOTE: The page numbers on slides coordinate to the page numbers for Estate and Succession Planning for the Farm.

Disclaimer

This presentation does not provide legal advice.

Any information is not intended to be a substitute for legal services from a competent professional.

Your situation is unique, and that influences the legal consequences of certain decisions.

"Yes, Peters, it is just legalese. It's all just legalese. We're a law firm."

Presentation title

TAX CONSIDERATIONS

20XX

TAX CONCEPT 1: BASIS

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Basis is generally the amount of your capital investment in property for tax purposes.

- Original Purchase Price + Capital Improvement Costs - Depreciation

When land is inherited, the basis "steps-up" (or down) to the current fair market value if it was included in the taxable estate.

When land is gifted, the basis stays the same as when the donor obtained the gift.

- If an item is sold after being gifted to you, there may be capital gains taxes.

Important for income tax purposes.

TAX CONCEPT 2: DEPRECIATION & RECAPTURE

Page 44-46

- Type of deduction that is allowed based on the useful life of a business asset.
  - Reduces ordinary income in year taken.
  - Decreases basis of asset.
    - = Original Purchase Price + Capital Improvement Costs – Depreciation
- When depreciated asset is **exchanged** or **sold**, the depreciation deductions are "repaid"
  - Taxed at ordinary income rate, not capital gains.
  - After the depreciation amount, if remaining gain, then taxed at capital gains rates.

TAX CONCEPT 3: UNIFIED GIFT AND ESTATE TAX CREDIT

- Each person has their own unified **gift and estate tax credit**.
  - "Credit" exempts from gift or estate taxes.
  - "Unified" because it is a single credit against both gift and estate taxes.
- This unified credit results in everyone have a standard exemption (basic exclusion amount) from estate and gift tax.
  - In 2025, basic exclusion is $13.99 million per person. $27.98mil/married couple.
  - In 2026, basic exclusion is $15 million per person. $30mil/married couple. *
- Only the value **that exceeds** the unified credit amount is taxed.

PORTABILITY

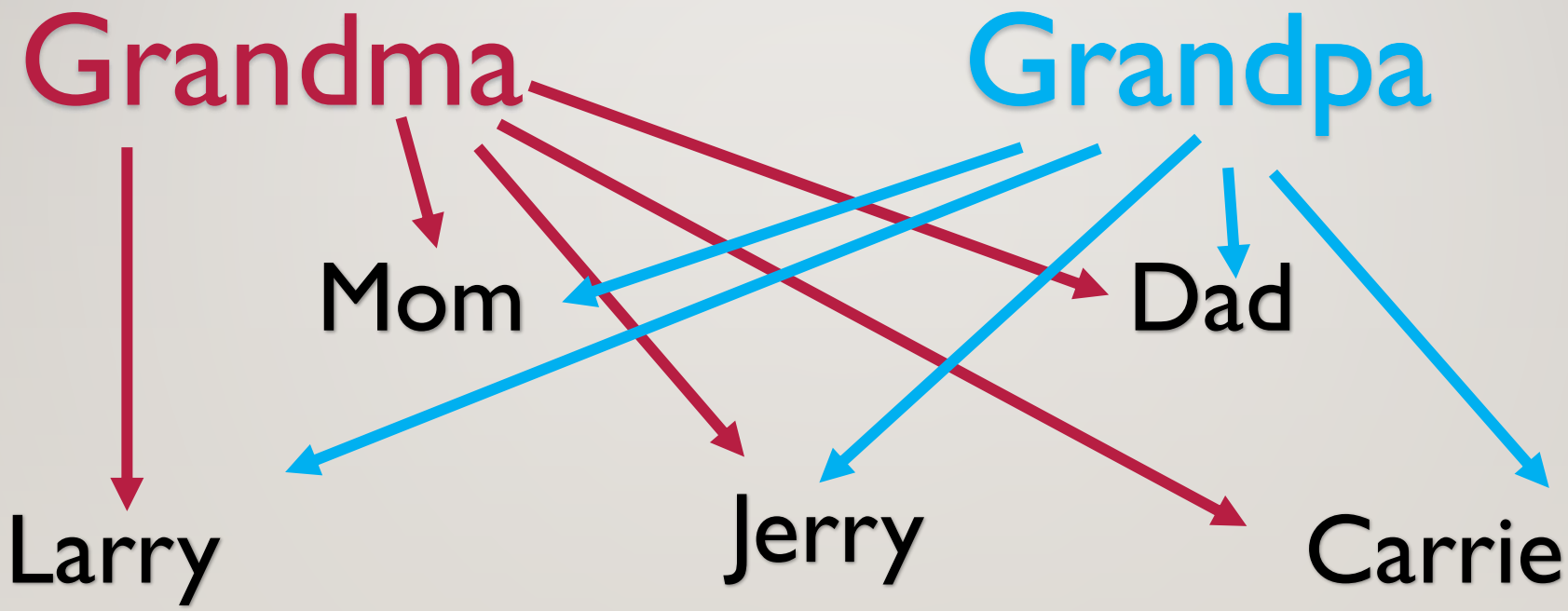
- Unused exclusion amount of spouse dying after 12/31/2010 may be used by surviving spouse.
- Only available if election made on timely filed estate tax return (Form 706) of predeceased spouse.
  - You file even if no tax is owed or no other reason to file.
- This means that spouses can currently share $27.22 million in assets with no estate tax.
- New procedure allows election to be made up to five years after death.

GIFT TAX

- Currently, you can gift $19,000 per year to any one person without any using any of the unified credit.
  - Called the "annual gift tax exclusion"
  - Must file IRS Form 709 if your gift goes over the exclusion.
  - $19,000 per year in 2025.
- Other Exemptions:
  - Gift to Spouse (unlimited marital deduction)
  - Charities
  - Tuition or medical expenses (direct to provider/school).

ANNUAL GIFTING

$190,000/Year



BACK TO RETIREMENT PLANNING

SELL IT ALL!

- Selling it all in 1 year comes with significant tax consequences.
- Example of $7.5mil farming operation results in approximately $1.5mil owed in federal taxes.
  - $5.4 mil subject to capital gains.
  - $770,000 subject to income tax.
    - Primarily depreciation recapture.
- Iowa taxes approximately $370,200.*
- Net value (after taxes) $4.5mil.

Tax Attributes of Assets from 400-Acre Crop and Livestock Farm

Asset	FMV	Basis	Gain	Character
Raised dairy and breeding heifers (at least 24 months)	$75,000	0	$75,000	1231 Gain
Farmland	$4,800,000	$800,000	$4,000,000	1231 Gain
Purchased dairy and breeding heifers	$200,000	$50,000	$150,000	1245 Gain
Machinery	$600,000	$150,000	$450,000	1245 Gain
Poultry, hog or dairy barn	$250,000	0	$250,000	1245 Gain
Bins	$75,000	0	$75,000	1245 Gain
Multi-purpose building	$500,000	$100,000	$400,000	1250 Gain
Personal residence	$300,000	$100,000	$200,000	Excluded
Raised dairy and breeding (< 24 months)	$30,000	0	$30,000	Ordinary
Feed inventory	$50,000	0	$50,000	Ordinary/ SE Tax
Stored grain	$500,000	0	$500,000	Ordinary/ SE Tax
Supplies and fuel	$40,000	0	$40,000	Ordinary/ SE Tax
Livestock held for sale	$150,000	0	$150,000	Ordinary/ SE Tax
	$7,570,000		**$6,370,000**	

INSTALLMENT SALES

- Sell the assets and receive payment over a period of years.
  - Minimizes tax liability. Income tax on payments received in year received.
  - Seller is the bank.
    - Interest is required, IRS will assign % if you don't specify.
  - Buyer receives ownership of assets in Year 1.
- Depreciation recapture for Seller is due Year 1, even if not enough $ received.
- Buyer has full ownership of the assets during the repayment period.
  - Only if buyer misses a payment will Seller regain ownership according to procedures outlined in sales agreement.
- **Work with tax professional and attorney to complete**.
  - Must have written sales contract, promissory note, etc.

GIFTING

- Avoids the tax consequence of a sale because no money is received.
- Basis carries over to new recipient.
  - Recipient cannot take depreciation if already fully depreciated.
  - Land considerations
- Gift tax
  - Usually no tax is owed, but amount will count against allowance for estate with regard to the Unified Credit.
  - Over annual exclusion, a gift tax form needs to be filed.

INSTALLMENT SALE + GIFT EXEMPTION

- Set up Installment Sale arrangement.
  - Sale Agreement, Promissory Note, etc.
- Each year Seller/Financer forgives payments in the amount of the annual gift tax exclusion.
  - CANNOT guarantee in sales contract or other written document that the forgiveness will happen every year. If so, the total amount will be considered a gift in year 1.
  - If Seller/Financer dies during repayment, then forgiveness will not happen.
- Can allow transaction to be completed quicker, but will lessen the amount of $ received by Seller.

RENTING

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- Instead of selling equipment, rent it to next generation.
  - Payments received subject to income and self-employment tax.
    - If equipment + land, then no self-employment.
  - Be realistic on timeline and if you will replace/upgrade as necessary.
- Land rental
  - Payments received subject to federal income, but not SE tax.
  - May not have to pay Iowa income tax.
  - Leases over 5+ years must be recorded. Maximum length is 20 years.
- Put it in writing and all parties sign.
  - Only lawyers benefit with oral contracts.

LEGAL TOOLS

OVERVIEW

- How you own an asset dictates how it is **managed during life** and the options to **transfer upon death**.
  - Step 1: How do you own your assets? Make an inventory.
- There are many different ways **to own an asset**:
  - Individually, co-ownership, life estate or remainder
  - OR business entity or trust owns the asset.

OWNERSHIP

CO-OWNERSHIP

JOINT TENANCY

- When one owner dies, their share goes to other owner(s).
  - Right of Survivorship
- Deceased owner's estate plan does not matter.
- No probate administration necessary with asset.

TENANTS IN COMMON

- When one co-owner dies, their share goes according to their estate plan.
  - Estate plan beneficiaries are now new co-owners.
- Probate administration is likely necessary when one owner dies.
- Default form of co-ownership.

TENANCY-IN-COMMON

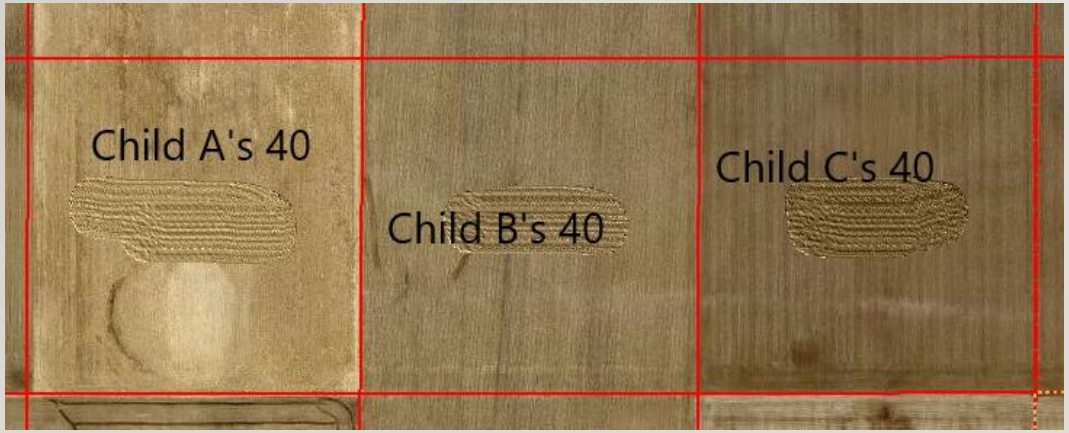
- Each owner has the legal right to possess the entire parcel.
  - If one owner exclusively possesses, may need to pay rent to others.
  - All owners responsible for their share of the property taxes.

EXAMPLE Page 8

Rolly owns 120 acres when he dies with 3 living children. His will simply states that his assets will be "distributed equally" among the three children.

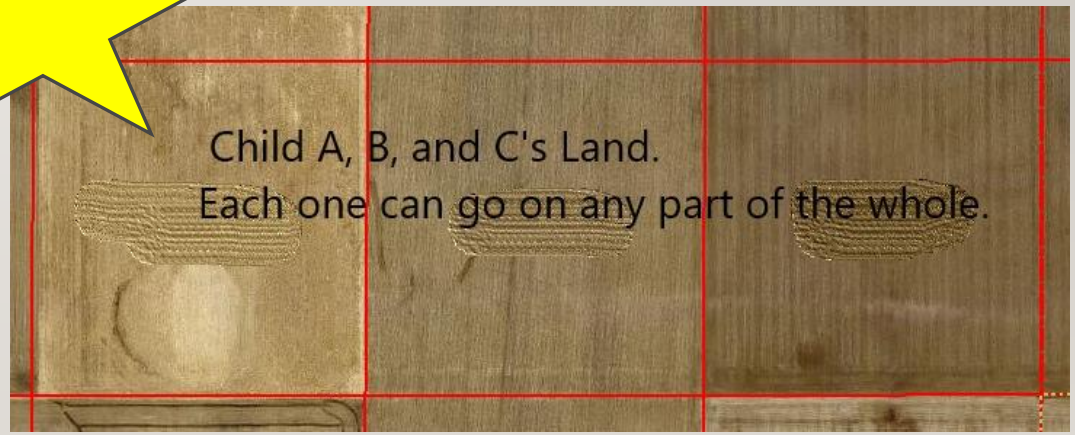
Which picture describes the ownership of the 120 acres?

A



or

B




TENACY IN COMMON
JOINT TENANCY
imgflip.com
JAKE-CLARK.TUMBLR

EXAMPLE

Rebecca and Robert are married. Their home is titled in joint tenancy.

- Robert's Will: House goes to Tina, daughter from previous marriage.
- Rebecca's Will: House goes to charity.

1. Robert dies first. What happens to the home when he dies?

   A: Rebecca becomes owner. No payment to Tina.

2. Rebecca then dies. What happens to the home?

   A: It goes to the charity listed in Rebecca's will.

3. Rebecca dies, then Robert. What happens to the home?

   A: It goes to Tina.

4. Robert and Rebecca are siblings. What changes?

   A: Nothing.

EXAMPLE

Rebecca and Robert are married. Their home is titled in tenancy in common.

- Robert's Will: House goes to Tina, daughter from previous marriage.
- Rebecca's Will: House goes to Vallory.

1. Robert dies first. What happens to the home when he dies?

   A: Rebecca and Tina are co-owners. Rebecca likely owes rent to Tina.

2. Rebecca then dies. What happens to the home?

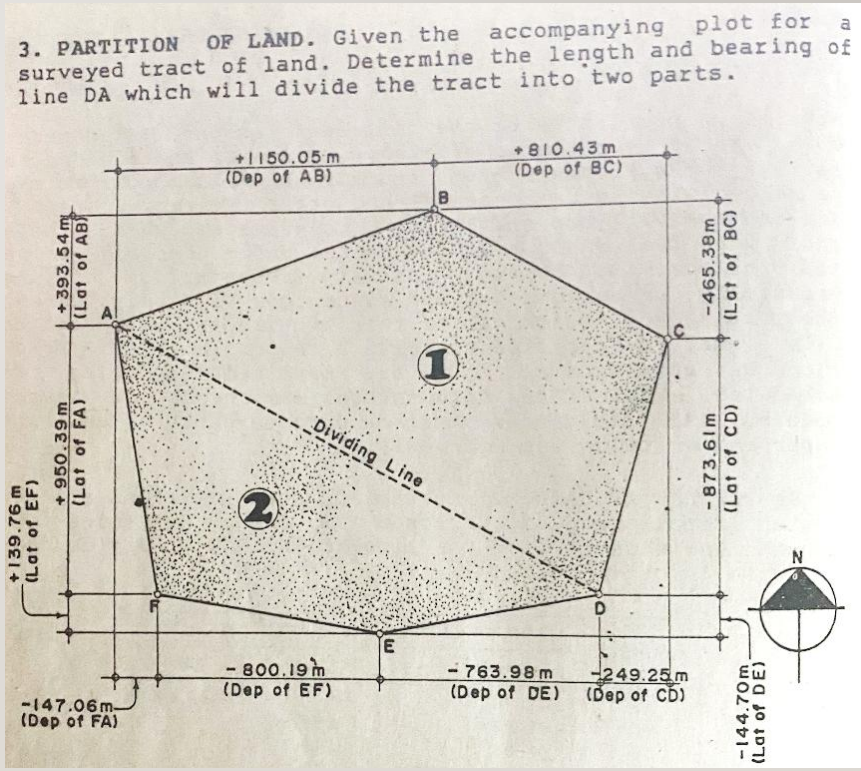
   A: Tina and Vallory are co-owners. *

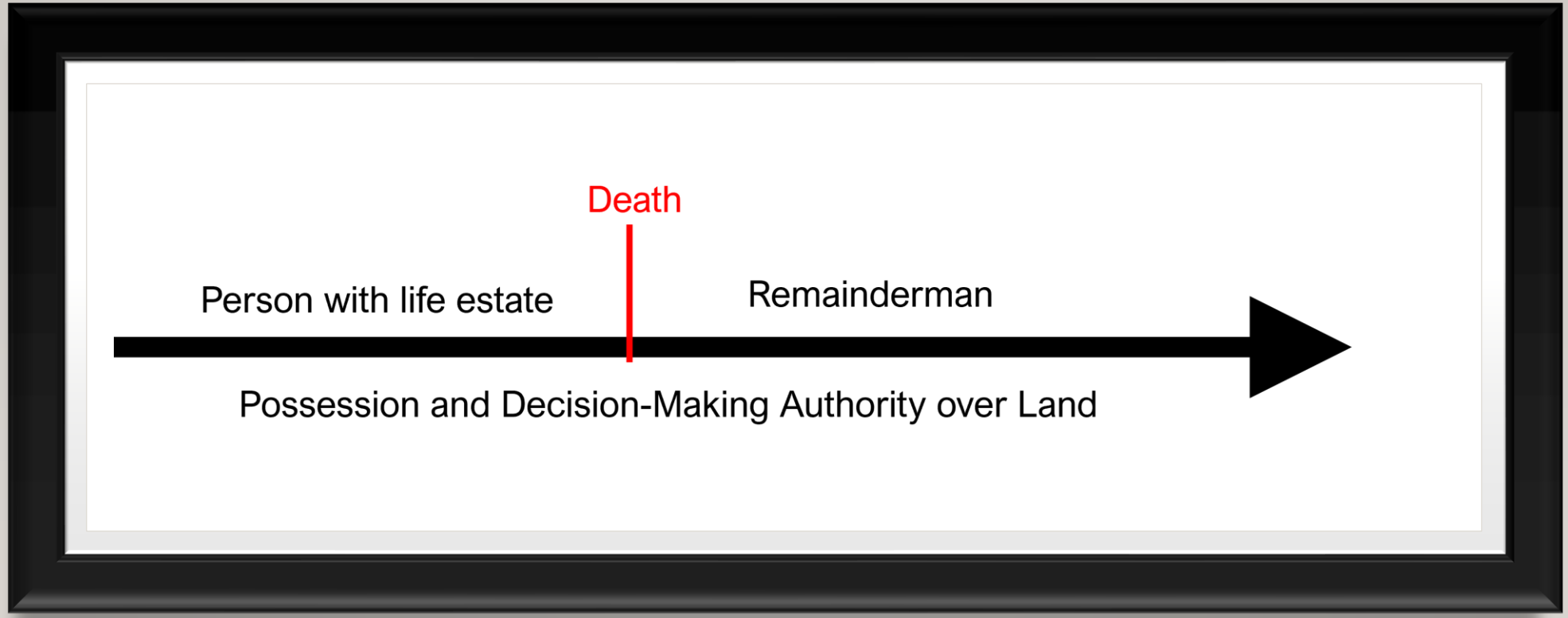
3. Rebecca dies, then Robert. What happens to the home?

   A: Tina and Vallory are co-owners.

PARTITION

- When co-owners cannot get along, court solution is termination of the co-ownership structure.
  - Called partition action.
  - Judge will determine whether to sell or physically divide land, following procedure determined by statutes and case law.
    - Heirs' Property – procedure to help buy out when land was received from relative. Alternative is sale of property on open market or auction.
    - Any owner can bring partition action.
- When a trust or business entity owns the land, partition is not available to beneficiary/business owners.




Death
Person with life estate
Remainderman
Possession and Decision-Making Authority over Land

LIFE ESTATE

Pages 26 and 61

OTHER OWNERS

BUSINESS ENTITY/COMPANY

- Business is a separate entity.
  - Additional responsibilities when using the asset.
- Managers/Officer manage according to entity documents/default state law.
- Shareholders/unit holders may have some management over the asset.

TRUST

- Trust is a separate entity, like a business.
- Trustee manages according to trust document/default state law.
- Beneficiaries have little to no management over the asset.

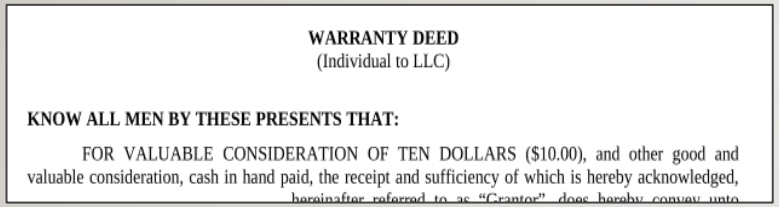
COMMON PLANS FOR SUCCESSION

"One day, son, this farmland will be yours to sell to a tech company building a data center."

Cartoon by Lynn Hsu

2 ENTITY STRUCTURE

Pages 63-64



WARRANTY DEED
(Individual to LLC)

KNOW ALL MEN BY THESE PRESENTS THAT:

FOR VALUABLE CONSIDERATION OF TEN DOLLARS ($10.00), and other good and valuable consideration, cash in hand paid, the receipt and sufficiency of which is hereby acknowledged, hereinafter referred to as "Grantor", does hereby convey unto

Land Holding Entity

- Entity is the owner of the farmland.
  - Usually, homestead residence is not included.
- Usually, LLC
  - Taxation choice important. Chapter 11.
- Protects land from partition action while giving others revenue stream.

- **Operating Entity**
  - Entity type and taxation will be dependent on family and financial specifics.
  - Usually holds the equipment, inventory, and vehicles of farm operation.

WHY NOT ONE ENTITY?

- Liability
  - Likelihood of accident in operating entity can put land at risk.
- Farm Management
  - Off-farm owners have more ability to interfere with daily farming decisions.
- Taxation*
  - Depending on situation, can maximize various tax benefits by separating entities.
- Drawback to 2+ entities – More paperwork, additional tax forms, more need to keep things organized and formalized.

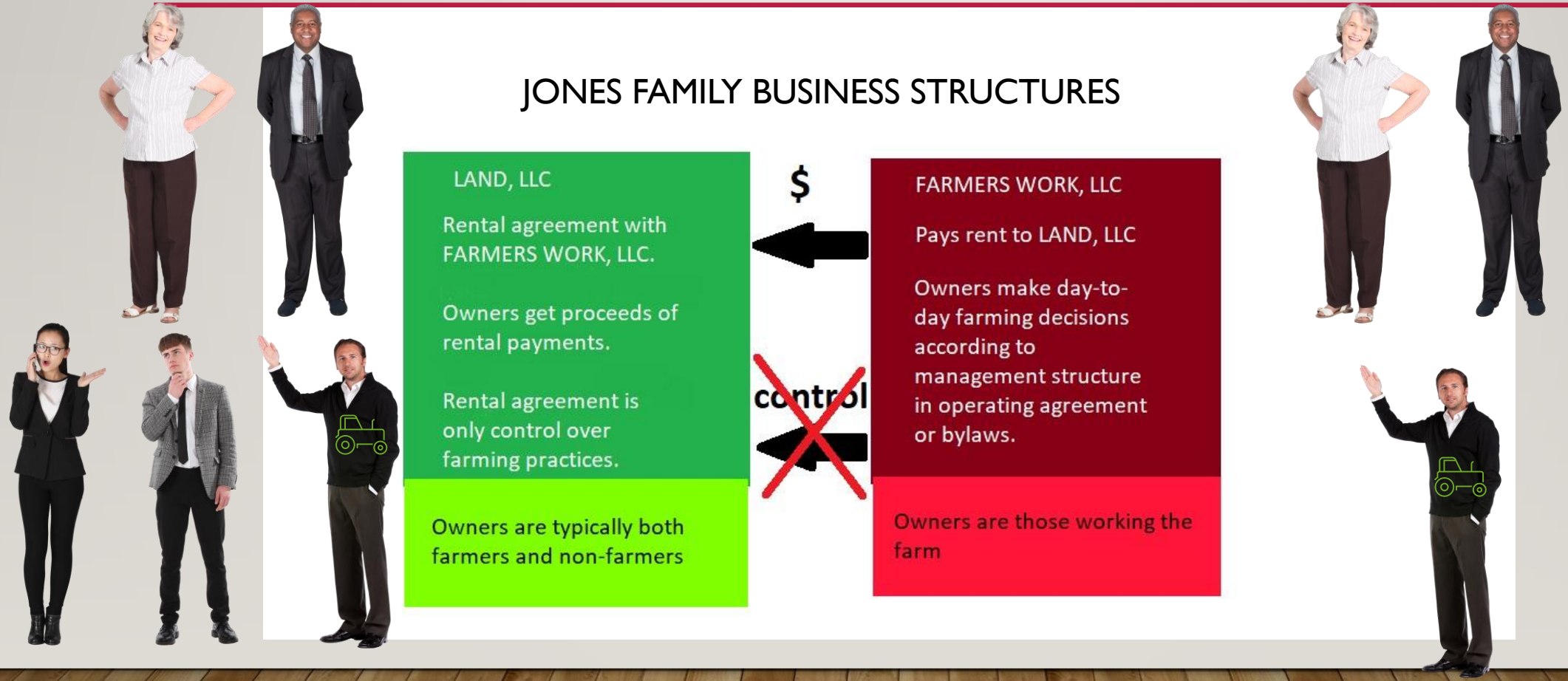
TYING ENTITIES TOGETHER

Operating entity rents the property from the land-holding entity.

Only farmers have ownership in operating entity, others have ownership in land-holding entity.

TYING ENTITIES TOGETHER

Results in off-farm heirs receiving some equity from family land, but little control over farming activities.



FARM TRUST

- Common name for when a trust controls the land, and the Grantor has died.
  - Primary asset is farmland.
  - Sometimes equipment, machinery, implements are included.
  - Usually established in a will or an "article trust" within a bigger trust.
- Placing farmland into a trust can accomplish some transition goals.
  - Ensures certain individual has access to farmland at favorable terms.
  - Non-farming beneficiaries can receive income from the land.
    - Cannot partition the land.
  - Trustee is the decision maker.

FARM TRUST

- Potential drawbacks
  - Taxation – retained income (not given to beneficiaries) is at high tax rate.
  - Irrevocable trust = no step-up in basis.
  - Termination or beneficiary buy-out is arduous.
  - Trustee has all management authority.
    - Fiduciary responsibilities may become an issue if trustee is farmer leasing to themselves.

MANAGEMENT TRANSFER

LEGAL TOOLS

PURCHASE OPTION

- Allows an individual to decide if and when they want to purchase the asset.
- Things you need to decide:
  - Person
  - Price Determination
    - "Fair Market Value" can be argued over.
    - Set method and detail process for valuation.
  - Timing!
  - Payment Terms
    - Can have entity/trust "be the bank."
    - Entity/trust would have mortgage until repayment.

EXAMPLE

Lewis has 2 daughters – Kelly and Penelope. Kelly farms with Lewis; Penelope does not.

Lewis wants Kelly to own the land, but also wants to ensure Penelope receives some financial benefit from the land.

Lewis places the farmland into a testamentary farm trust. Penelope and Kelly are the income beneficiaries. The trust also gives Kelly the right to purchase Penelope's share at a discounted rate. Trust expressly states that funds from the sale will be given to Penelope.

What happens if Kelly decides to purchase the land?

Penelope receives the money, Kelly owns the land individually, trust will dissolve.

RIGHT OF FIRST REFUSAL

- Before asset is sold to third party, individual will have opportunity to buy.
  - Owner of asset (trust, LLC, other owners) decide when they want to sell.
- Things you need to decide:
  - Trustee/Management will control when sale occurs.
  - Person
  - Timeframe for Decision.
  - Price
    - Can have discount for right holder.
  - Payment Terms

RENTAL RIGHT

- Used when there is specific individual you want trust to first offer the right to rent.
  - Usually conditioned on "while actively farming."
- You need to decide:
  - Method for determining rental rate
    - Allow for agree otherwise but best practice to set a default method.
    - Can link to ISU rental survey (or other publication) with discount.
  - Second Choice
  - Deadlines

EXAMPLE

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Julio is a third-generation farmer with 3 kids. 2 of his children do not want to farm, but his daughter Juanita does.

Julio places the farmland into an LLC as part of his succession plan. Each child will receive 1/3 of the LLC when Julio passes.

In the LLC operating agreement, it says that Juanita has the right to rent the farmland. It also specifies the method for determining the rental rate, and that it would take unanimous consent of the members to change these two provisions.

EXAMPLE

In the LLC operating agreement, it says that Juanita has the right to rent the farmland. It also specifies the method for determining the rental rate, and that it would take unanimous consent of the members to change these two provisions.

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Why write this provision?
Gives Juanita assurance she can rent the family land.

Why unanimous consent to change the 2 provisions?
Without it, the two other siblings could vote to rent to someone else.

FARMING PRACTICES

- Provisions that control how the land will be managed.
  - If in trust, statement that the land must be used for "agricultural production."
- Can put more specific directives within:
  - Must have cover crops
  - Organic
  - CAFOs
- Think about potential future business opportunities
  - Wind farm
  - Solar

EXAMPLE

Henrietta converted 360-acres to certified organic for corn and soy. She strongly believes that this is best for the land. She places the land into her revocable trust as part of her estate plan.

What happens to the trust when Henrietta passes?
It becomes irrevocable.

What can happen if the trust does not acknowledge her wishes about organic farming?
Trustee could decide to farm the ground conventionally.

How could she prevent that from happening?
Place a clause in the trust that requires organic farm ground to remain organic.


INFORMATION