Part 2: The Legal Side of Farm Transition Planning

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Seven common mistakes farmers make when transition planning

1. Procrastination
2. Thinking joint property titles will do
3. Overlooking expenses at time of death
4. Assuming no federal estate taxes
5. Trying to be fair to all beneficiaries
6. Failing to consider disability as well as death
7. Avoiding communication
Today’s topics

Federal estate tax and tax strategies
Business entities: the LLC
LLC operating agreements
Buy-sell agreements
Leases
Transferring machinery and livestock
Wrap up
Federal estate taxes

- Net worth is used for federal estate tax liability.
- $11.7 million per person and $23.4 million per couple is exempt from federal estate tax.
- Portability rule allows using a couple’s combined exemption on second death.
- Strategies can reduce value of the estate to minimize estate tax risk.

<table>
<thead>
<tr>
<th>Year</th>
<th>Individual</th>
<th>Couple</th>
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<tbody>
<tr>
<td>2021</td>
<td>$11.7 M</td>
<td>$23.4 M</td>
</tr>
<tr>
<td>2022</td>
<td>$11.7 + inflation</td>
<td>$23.4 + inflation</td>
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<tr>
<td>2023</td>
<td>2022 + inflation</td>
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<td>2024</td>
<td>2023 + inflation</td>
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<tr>
<td>2025</td>
<td>2024 + inflation</td>
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<tr>
<td>2026</td>
<td>Back to $5,000,000 per person adjusted for inflation</td>
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Gifting

• A gift is essentially the transfer of an asset in exchange for nothing (or almost nothing)

• Gifts can include:
  • Land
  • Farm machinery
  • Livestock
  • Grain

• Gifts are subject to federal (and some state) gift taxes
  • No Gift Tax in Ohio
  • Check your State’s laws!

• Federal Gift Tax Exclusion
  • Lifetime Exclusion - $11.70 million (per person)
  • Annual Gift Tax Exclusion - $15,000 per gift-giving person, per gift recipient, per year
Why gift?

Gifting can:

• Reduce your tax burden
• Provide equity to the younger generation
• Reduce the size of your estate

Carry-over v. Step-up in Basis

• The recipient of a gift takes the gift giver’s basis in the asset (because the transfer is made during the donor’s life).
• An heir that inherits an asset through will or trust receives a step-up in basis (i.e. the FMV of the asset at the time it is inherited)
Should I gift?

It depends . . .

• Current estate value versus tax implications if the gift is ever sold by the donee.

• Under the current tax code, an inherited asset allows beneficiary to enjoy reduced tax implications.

Biden Step-up in Basis Repeal

• Biden campaigned to repeal the Step-up in Basis and increase the long-term capital gains tax – essentially beneficiary would have to pay taxes on inherited assets.

• BUT, there would be a logistical nightmare.

• HOWEVER, if Biden wanted to repeal the step-up in basis, he should do it sooner, rather than later:
  • Midterm elections
  • Specific details about Biden’s plan still unknown
Reducing the value of the estate

Valuation strategies

Special use valuation

- Section 2032A election allows estate to use agricultural use value rather than fair market value for land for federal estate tax purposes.
- Inflation adjusted maximum for 2032A reduction is $1.18 million.
- Requirements:
  - +25% of adjusted value of estate must be qualified real property.
  - And +50% of estate must be qualified real property.
  - Used as farm for 5 of 8 years prior or family member involved in business with deceased.
  - Passed down to qualified heir.
- Requires election at death and pre- and post-death planning.

Easement donation

- May donate an easement that restricts land to conservation purposes in Section 170(h) of IRS tax code—agricultural use is one purpose.
- Donation may arise upon or just after death, created by deceased or by member of family.
- Can claim estate tax exclusion of up to 40% of the encumbered value of land protected by an easement, capped at $500,000.
- But exclusion loses stepped-up basis on resale.
- And easement can also reduce the property value due to its restrictions.
Federal estate tax tools

The federal estate tax exemption is currently $11.7 million per person and $23.4 million per married couple, but those numbers may reduce to around $5 million per person and $10 million per couple in 2028 or sooner, depending on Congress. Although you can't know which amount will apply to your estate, you can work with your attorney, accountant, and others to minimize the risk of exceeding the federal estate tax exemption amount. Use these questions to help guide you.

1. Are you keeping up with your estate's current value? Talk with your attorney if your net worth is near the exemption level, and pay attention to events that affect your net worth such as:
   - Increasing in inheritance
   - Stock market fluctuations
   - Selling or buying property
   - Increasing land values in your area
   - Marriage or divorce
   - Other income or assets
   - Selling or leasing mineral rights, solar rights, and similar resources

2. Do you want an estate strategy? Rely on your attorney and accountant to help you decide if you should develop a gifting plan. Remember, a recipient may lose the stepped-up basis of a gift received during your lifetime as opposed to after your death. Note your thoughts on gifting in this chart.

<table>
<thead>
<tr>
<th>Gifting recipient</th>
<th>Type of gift</th>
<th>Is loss of step-up basis a concern?</th>
<th>Amount of gift per year</th>
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</tbody>
</table>

3. Could Section 2032A special use valuation apply to your situation? Estates that qualify for special use valuation may be reduced in value for federal estate tax purposes if all criteria exist, but making the special use election is a complex decision. Talk to your attorney and accountant to discuss planning for a special use election if land in the estate qualifies according to the criteria:
   - Land was used as a farm for 5 or 8 years prior to death, or a family member was involved in the business with the deceased.
   - Land will be passed down to a qualified heir.
   - At least 25% of the adjusted value of the state is qualified real property and 50% or more of the total estate is qualified real property.

4. Are you interested in donating a permanent agricultural or conservation easement? Doing so can ensure protection of the land in perpetuity and can reduce the value of the estate for federal tax purposes, but has implications for stepped-up basis on resale. Talk to your attorney and accountant to determine how an easement donation could fit into your scenario.
Business entities as farm transition tools—the LLC

Poll question:

What type(s) of business entity do you have in your operation?

- Sole proprietor
- Partnership
- Limited Liability Company
- Corporation
- Cooperative
- Other
- Not sure
Formal entities such as Limited Liability Company, Corporation, and Partnerships are separate persons in the eyes of the law.

- Unlike a sole proprietorship, which is the same as the individual.

These entities have internal and enforceable “rules:”

- Operating agreement
- Bylaws
- Partnership agreement

These rules can help accomplish farm transition goals

The LLC is the most flexible
LLC operating agreement “rules”
Ownership

- Who are owners (members)
- Percentages of ownership
- Who can be a “permitted owner” in the future
  - Limit to blood relatives or identified successors?
- Transfer of ownership to non-permitted owner
- How to get out of ownership

Examples:
Allow permitted owners to buy back ownership from deceased owner’s spouse at 25% discount to be paid over 25 years.

Can withdraw from ownership if other owners buy out share or approve replacement owner.
**LLC operating agreement “rules”**

**Management**

• Who makes management decisions
• How to determine successor managers
• Voting requirements for certain decisions
• Limits to authority of managers

**Examples**

Identified successor increases management responsibilities over time.

Permission of all owners required for selling land.

Must lease land to farming heir.
Using LLCs for holding land

• Keeps the land base together rather than dividing among heirs, selling, etc.
• Heirs can receive income from the LLC but can be prevented from subdividing or selling the land.
• Ownership can be adjusted according to other factors such as equity, other farm assets, non-farm assets.
Goal: maintain the operation’s land base

- Children are owners of the LLC.
  - Non-farm children hold higher ownership because farm child received operation assets.
- LLC must lease land to farming child, with rules for rental rate.
- LLC pays property taxes and insurance, divides rental proceeds among members according to ownership.
- Farming child can buy out LLC ownership interests on pre-determined terms, over time.
Using LLCs to bring in the next generation

• Place the operating assets in a separate operating entity.
  • This makes it more affordable for next generation to buy or work into an ownership interest in the operating entity.

• Put on-farm heirs in the operating entity and off-farm heirs in a non-operating entity, like a land holding entity.
  • This keeps heirs that aren’t involved in the day-to-day out of its operations.
Goals: bring in next generation, balance assets between on/off farm heirs
A multiple entity solution

Operating Entity LLC
$500,000 Grain

- Farming heirs
  inherit

- Machinery/Trucking LLC
  $500,000

- Leases
  - Income to older generation
during lifetime

- Land LLC
  $1,000,000

- Off-farm heirs
  inherit
Other tools to incorporate in a farm transition plan

Considerations

• Valuation of the interest
• Discounting for minority interests
• Timing of the sale
• Financing
• Tax implications

Buy-sell agreement

• Sets rules for buying business ownership in event of an owner’s death, disability, divorce, or disassociation, whether voluntary or involuntary.

• Owners negotiate the terms of the transfer prior to the event.

• Knowing terms beforehand creates stability for the operation and allows successors to prepare for the sale.

• Life insurance and other accounts can play a role in funding the sale.
Leases

• Pre-established long-term leases can ensure stability for farming heir.
• Terms can be pre-negotiated.
• Leases can continue or arise after death, enable transition to next generation.
• Can provide income for older generation, non-farming heirs.
• Can also address machinery and livestock.
## Business entities and tools to use with them

Business entities and tools that go with them can be useful mechanisms for accomplishing your farm transition. Consider your farming operation, the assets involved with it, the people engaged in it, and your potential heirs. What “rules” might you need? How could separate business entities, “rules” for the entities, and tools such as buy-sell agreements and leases be helpful to you? Gather your ideas here.

<table>
<thead>
<tr>
<th>Entity 1</th>
<th></th>
<th>Entity 2</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>What's its purpose?</strong></td>
<td></td>
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<td></td>
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<tr>
<td></td>
<td><strong>Who are or will be the owners?</strong></td>
<td></td>
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<tr>
<td><strong>What assets are in it?</strong></td>
<td><strong>Are or will be owned by?</strong></td>
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<tr>
<td><strong>How could it use leases?</strong></td>
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Worksheet: Business entities and tools to use with them
Challenges with transferring machinery and livestock

Often the most challenging assets to transfer.

Important question: what is your goal for the machinery/livestock?

• Do you need income from it?
• Do you want to get it out of your name now?
• Do you want to keep control until after death?
## Transfer options for machinery/livestock

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<tr>
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<th>Advantages</th>
<th>Disadvantages</th>
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<td>Sell outright</td>
<td>Generates income at one time.</td>
<td>All recapture of depreciation is ordinary income tax.</td>
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<td>Spread income over several years.</td>
<td>All recapture tax due in year of sale.</td>
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<td>Gifting</td>
<td>No tax. Easy to make gift.</td>
<td>No income produced.</td>
</tr>
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<td></td>
<td></td>
<td>No stepped-up basis.</td>
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<td>Inheritance</td>
<td>No tax (assuming no estate tax).</td>
<td>Must own till death.</td>
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<td></td>
<td>Receive stepped up basis--can depreciate fair market value.</td>
<td>No income from sale.</td>
</tr>
<tr>
<td>Lease-to-own</td>
<td>Generates income over time. Retains ownership until bought out.</td>
<td>Retains liability with ownership.</td>
</tr>
<tr>
<td></td>
<td>Spreads income taxes over term of lease, usually 7—10 years.</td>
<td>More recordkeeping required.</td>
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Transferring machinery and livestock

Machinery and livestock are often the most challenging assets to transfer to the next generation. An important step in developing a plan for these assets is to define your goals and needs. These questions can be helpful:

- Do you need income from your machinery and/or livestock?
- If so, do you want one lump-sum payment or income spread over a period of time?
- Do you want to keep using the machinery and/or livestock to some degree?
- Do you want to get it out of your name now, and no longer be responsible for maintaining and insuring these assets?
- Do you prefer instead to maintain all control of your machinery or livestock until your death?
- Do you want your machinery or livestock to benefit your heirs? If so, how?

Considering your goals, review the following advantages and disadvantages to different strategies for transferring your machinery and/or livestock. Talk to your attorney about options that might help you accomplish your goals.

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<td>Delays taxes on purchase until end.</td>
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Planning for the Future of Your Farm

Q & A period

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