Transferring the Farm to the Next Generation



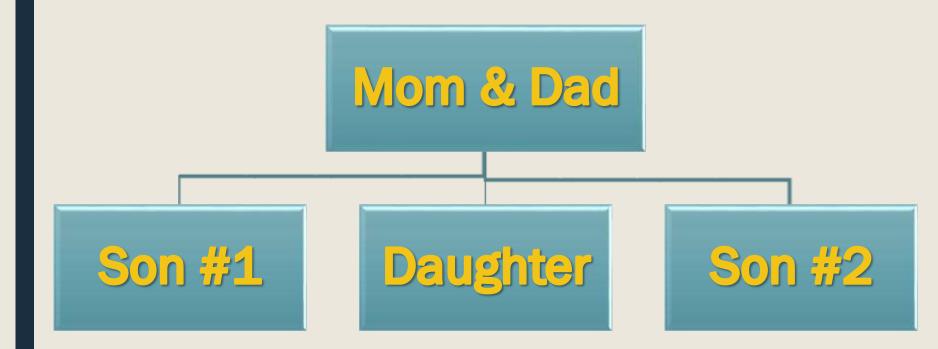
Todd King, C.P.A.

Leffel, Otis & Warwick, P.S.

Odessa, Washington

TRANSFERRING THE FARM: A CASE STUDY

Key Players



Mom & Dad

- Both age 70 and in good health. Beginning to slow down a bit, turning over their duties to the son on the farm. Want the ability to "get away" from time to time and not be so tied down. Good yields and higher prices have had them paying more taxes than they are comfortable with.
- They have concerns regarding the best method to pass the farm to the next generation. They came in to discuss the best method to structure the farm for the future.

Son #1

- He is age 48 and lives on the farm. He came home to the farm upon graduation from WSU at age 22. He is married with 3 children: 1 in college and 2 in high school. He basically runs the day-to-day operations on the farm and has assumed the duties as Dad has slowed down. His son, the oldest child, is now at WSU and loves the farm. He plans to return to take over the operation at some point down the road.
- Although Son #1 is not an owner and is simply paid as a hired man, he helped "build" the farm. When he came back at age 22, the farm was less than half its present size and encumbered with a mortgage. He has existed on a minimum wage to assist in retiring the land debt.

Daughter

She is 46 years old, married with 2 children and lives in Seattle. She has a great job, a great retirement, has a nice house, and is living the good life. She likes to come back to the farm a couple times a year and enjoy the slow pace and open country.

Son #2

■ Son #2 is age 44, married, and lives in California. He does not have much interest in the farm. He has trouble managing his finances, has a good job and a high income but not much to show for it. His wife is high maintenance and very controlling. This son is beginning to ask questions about what is going to happen with the farm.

Balance Sheet

Cash / IRA / Savings	\$ 1,000,000
Crops on Hand / Seeded summer fallow	500,000
Equipment	750,000
Farm Lands	4,000,000
Total Assets	6,250,000
Debt	0
Equity	\$ 6,250,000

	: 31, 201	5. Individual Income 4, or other tax year beginning	, 2014, en	ding	, 20		See sep	arate instructions.		
Your first name and initial			Last	name		You	social sec	erity number		
JOE FARMER								123-45-6789		
If a joint return, spouse's	irat name	and initial	Last	rame		Spor	use's social	security number		
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6546 SUNSET		Myou have a P.O. box, see matruptions. GE RD			Apartmen	I no.		sure the SSN(s) ab on line 6c are corre		
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and the second of the second o	- 2	Theorem		- T	T Head of house			You Spouse person). (See		
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Check only one box		name here		5	Qualifying wid	ow(er) with i	depende	nt child		
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Exemptions		X Spouse	you as	_ sept. Str. , 00	THE STREET WEST UNI		-	on 6s and 6b No. of children		
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		Tax-exempt interest. Do not in			8 b		-	1		
Attach Form(s) W-2 here, Also		Ordinary dividends. Attach Sc Qualified dividends	nedule B if re	gured	96		. 9a			
attach Forms	1	Taxable refunds, credits, or of	feets of state	and local income		canatoons	10			
W-2G and 1099-R if tax was withheld.	-		19010 01 01900	at 14 10040 11 100110			11			
		Business income or (loss). At	tach Scheduk	a C or C-EZ		- <u></u>	12	1,000		
If you did not get a W-2.	13	Capital gain or (loss), Att Sch D if red	d. If not read, c	k here			13	12,75		
see instructions.	14	Other gains or (losses). Attac			EIBANASONNANA		14			
		IRA distributions	15a		Taxable amount		15b	T		
		Pensions and annuities		THE RESERVE AND ADDRESS OF THE PARTY OF THE	Taxable amount	N. L. J. J. F	16b			
		Rental real estate, royalties, p Farm income or (loss). Attach		a corporations, tri	uses, etc. Attach :	schedule E	18	100,00		
		Unemployment compensation					19	200,00		
WK		Social security benefits	20 a	10,200. b	Taxable amount		20b	8,67		
(3.0	21	Other income					21			
		Combine the amounts in the far right		7 through 21. This is			► 22	124,76		
Adjusted	23	Educator expenses. Certain business expenses of reservisi		Sets and for havin	23		_			
Gross	24	government officials, Attach Form 210		vaca, and ree-counts	24					
Income	25	Health savings account deduc	tion. Attach F	orm 8889	25					
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		IRA deduction			32					
		Student loan interest deduction			33					
		Tuition and fees. Attach Form			34					
		Domestic production activities deducti			35		-	(807,800)		
		Add lines 23 through 35					36	7,06		
	100.000	Subtract line 36 from line 22.1	This is union to	diasted areas in	CORNE		▶ 37	117.70		

Form 1040 (2014)	JOE AND MARY FARMER	23-45-6789	Page 2
acceptor a	38 Amount from line 37 (adjusted gross income)	38 11	7,700.
Tax and Credits	39 a Check		
Standard	b If your spouse iterrities on a separate return or you were a dual-status alien, check here. ► 39 b		5010±00±2
Deduction for —	40 Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40 1	4,800.
	41 Subtract line 40 from line 38.		2,900.
People who	42 Examptions. If line 38 is \$152,535 or less, multiply \$3,950 by the number on line 6d. Otherwise, see instru. 43 Taxable Income. Subtract line 42 from line 41.	42	7,900.
check any box on line 39a or	43 Taxable Income. Subtract line 42 from line 41. WKS II line 42 is more than line 41, enter -0.	43 9	5,000.
39b or who can	Tax (see instrs). Check if any from: a Form(s) 8814 c		
be claimed as a dependent, see	b Form 4972	44 1	4,194.
instructions	45 Alternative minimum tax (see instructions). Attach Form 6251	45	0.
 All others: 	46 Excess advance premium tax credit repayment. Attach Form 8962	46	
Single or Married filing	47 Add lines 44, 45 and 46	47	4,194.
separately.	48 Foreign tax credit. Attach Form 1116 if required		
\$6,200	49 Credit for child and dependent care expenses. Attach Form 241. 49		
Married filing	50 Education credits from Form 8863, line 19		
jointly or Qualifying	51 Retirement savings contributions credit. Attach Form 8880 51		
widow(er),	52 Child tax credit. Attach Schedule 8812, if required		
\$12,400	53 Residential energy credits: Attach Form 5695. 53		
Head of household	54 Other crs from Form: a 3800 b 8801 c 54		
household, \$9,100	55 Add lines 48 through 54. These are your total credits.	55	
	56 Subtract line 55 from line 47. If line 55 is more than line 47, enter -0-	56 1	4,194.
Other	57 Self-employment tax. Attach Schedule SE	57 1	4,130.
Taxes	58 Unreported social security and Medicare tax from Form: a 4137 b 8919	58	(
	59 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59	
	60 a Household employment taxes from Schedule H	60a	
	b First-time homebuyer credit repayment. Attach Form 5405 if required	60b	
	61 Health care: individual responsibility (see instructions) Full-year coverage X	61	
	62 Taxes from: a Form 8959 b Form 8960 c Instrs; enter code(s)	62	
	63 Add lines 55-52. This is your total tax	63 2	8,324.
Payments	64 Federal income tax withheld from Forms W-2 and 1099 64		
If you have a	65 2014 schmated tax payments and amount applied from 2013 return 65		
qualifying child attach	66a Earned income credit (EIC) NO 66a		
child, attach Schedule EIC.	b Nortarable combat pay election 66 b 67 Additional child tax credit Attach Schedule 8812 67		
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	31743 (0100 C T C M 1 7 T C C C C C C C C C C C C C C C C C C		
	69 Net premium tax credit. Attach Form 8962 69 70 Amount paid with request for extension to file. 70		
	70 Amount paid with request for extension to file	-	
	72 Credit for federal tax on fuels. Attach Form 4136 72	1	
	73 Credits from Form: a 209 b Reserved c Reserved d 73		
	RATE OF STATE OF STAT	74	0.
D-4	The state of the s	75	0.
Refund	75 If line 74 is more than line 63, subtract line 53 from line 74. This is the amount you overpaid 76a Amount of line 75 you want refunded to you. If Form 8888 is attached, check here	76a	
	▶ th Routing number Systematic Televines (Systematic Checking Sawings	708	
Direct deposit?	d Account number		
See instructions.	77 Amount of line 75 you want applied to your 2015 estimated tax 77		
Amount	78 Amount you own. Subtract line 74 from line 63. For details on how to pay, see instructions.	78 2	8,324.
You Owe	79 Estimated tax penalty (see instructions) 79		
Third Party	Do you want to allow another person to discuss this return with the RS (see instructions)? X Yes. Comp	niete below.	No
Designee		erconal identification	Ц.,,,
		treatests.	
Sign	Under parallises of payury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my an belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has an	owledge and v knowledge.	
Here Joint return?	Your signature Date Your occupation	Daytima phone number	
See instructions.	FARMER	0.000	
Кеер а сору	Topose's signature. It a joint return, both must sign. Date Spoulais occupation	If the IRS sent you an it	dantity Pro-
for your records.	0.110.100.00 (1.110.100.000.000.000.000.000.000.000.0	If the (RS sent you an it tection PMs, erest it here (see instra)	Taraca Maria
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Preparer Use Only	Firmia rame - LEFFEL OTIS & WARWICK, PS	The State of	
Coc only	Firms address PO BOX 129	 91-113843 	8
FO(40112), 12/29/14	DAVENPORT, WA 99122-0129	(509) 725-3	
		Form 1	040 (2014)

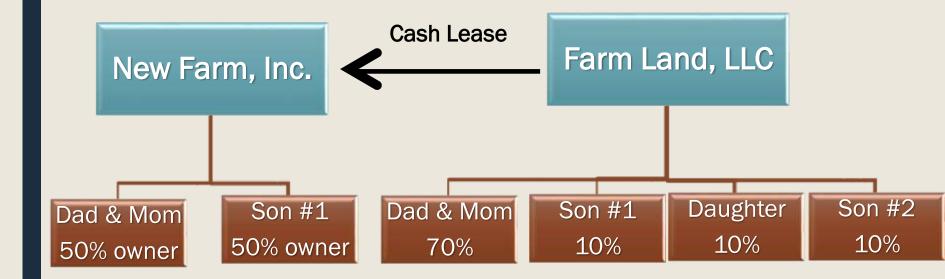
Goals Identified

- 1. They would like to see the tax bill to Uncle Sam decreased.
- 2. Estate/transition goals:
 - a) They would like the farm to stay in the family as a working farm!
 - b) They love all their children and want to be fair to them all.
 - c) They do not want to pay estate tax.
 - d) They want to reduce exposure to the possible impact of divorce, long term care or bankruptcy on the part of one of the owners.
 - e) They would like to reduce any threat to "off farm siblings."

Proposed Re-Organization

- Transfer equipment, summer fallow, and crops on hand to newly organized C-corporation
- Transfer farm land to new LLC

Proposed Re-Organization



What Have We Accomplished?

Income Taxes:

- Assumed expenses:
 - 1. Medical insurance, out of pocket medical, dental & optical for Dad, Mom & Son #1's family totals \$22,400 per year.
 - 2. Groceries for both families above total \$15,000.
 - 3. Utilities for both homes total \$7,500 per year.
 - 4. Insurance on homes, repairs to homes, purchases of appliances and furniture for both homes totals \$8,000 per year.

What Have We Accomplished?

New Corporation's tax calculation:

Beginning Net Income	\$ 100,000
Less Medical	(22,400)
Less Groceries	(15,000)
Less Utilities	(7,500)
Less Insurance, repairs, etc.	(8,000)
Subtotal	47,100
Paid out of corporation to LLC as rent	(47,100)
Net Taxable Income	<u>\$ 0</u>

For the year lan 1 . De		S. Individual Income 14, or other tax year beginning	, 2014, e		20 OVE No. 154	HOUSE THE		_	write or staple in the	_
Your first name and initial								See separate instructions our social ecority number		
JOE FARMER							123-	45-6	5789	
If a joint return, spouse's	first nam	e and intel	Line	trame			Броцья'я	oute's social security number		
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check here >			DISCOUNT OF THE PARTY OF THE PA	1				_	Add numbers on lines	
		Total number of exemptions of						7	above	
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		Tax-exempt interest. Do not i			86			00		3,343.
Attach Form(s)		Ordinary dividends. Attach Sc						9a		
W-2 here. Also		Qualified dividends			1					
attach Forms W-2G and 1099-R	10	Taxable refunds, credits, or or	ffsets of stat	e and local incom	e taxes		271301	10		
if tax was withheld.		Alimony received						11		
If you did not		Business income or (loss). At						12		A BEA
get a W-2,		Capital gain or (loss). Att Sch D if re				- 🗆	-	13	1	2,750.
see instructions.		Other gains or (losses). Attac IRA distributions			b Taxable amo		111111	15b		
		Pensions and annuities			b Taxable amo			16b		
		Rental real estate, royalties, p					e E	17	3	2,970.
		Farm income or (loss). Attach	A TOTAL STATE OF					18		and the content of
	19	Unemployment compensation	Verezen					19	9	1.000000
WK	ALCOHOL: 1	Social security benefits	20 a	10,200.	b Taxable amo	unt	111111	20b		8,670.
		Other income		77 79 7				21		7 700
Turner and	23	Combine the amounts in the far right Educator expenses	column for any	is / through 21, This)	5 your total incom	le		22	5	7,735.
Adjusted		Certain business expenses of reservis	ts, performing s	rtists, and fee-basis	23		_			
Gross		government officials. Attach Form 210	6 or 2106-EZ		24					
Income		Health savings account deduc		Form 8889	25					
		Moving expenses. Attach Form 3903. 26								
		7 Deductible part of self-employment tox. Attach Schedule SE. 27 8 Self-employed SEP, SIMPLE, and qualified plans. 28								
		Self-employed SEP, SIMPLE, and qualified plans. 28 Self-employed health insurance deduction. 29					_			
		Penalty on early withdrawal of savings 30					_			
		a Alimony paid b Recipient's SSN > 31a								
		IRA deduction			32					
		Student loan interest deduction			33					
		Tuition and fees. Attach Form			34					
		Domestic production activities deduct	on. Attach Form	8901	35			203		56
		Add lines 23 through 35						36		0.
	37	Subtract line 36 from line 22.	i nis is your	aujusted gross ii	ncome			37		7,735.

After re-org: Self-employment farming income replaced by 70% share of land rent from LLC

Note: Three children will each be taxed on his/her 10% share of land rent from LLC

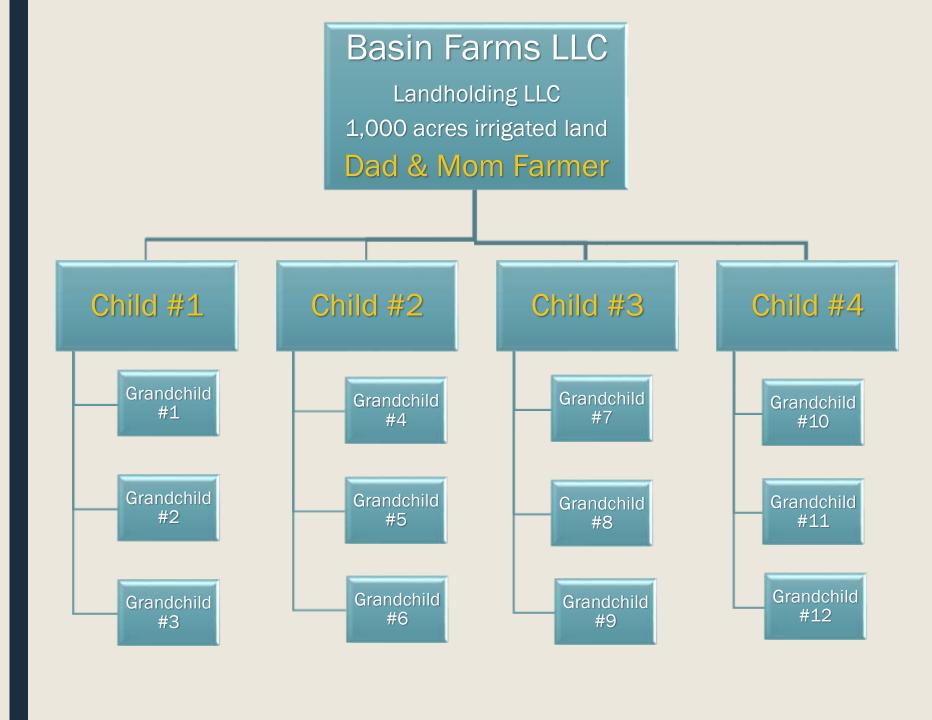
Form 1040 (2014)	JOE AND MARY FARMER	123-45-6789 Page 2
	38 Amount from line 37 (adjusted gross income)	57,735.
Tax and Credits	39 a Check XYou were born before January 2, 1950, Blind. Tetal box	MATERIAL CONTROL OF THE CONTROL OF T
	if. X Spouse was born before January 2, 1950, Blind checked	400 DAG
Standard	b If your spouse itemizes on a separate return or you were a dual-status alien, check here	▶ 39h
Deduction for -	40 Itemized deductions (from Schedule A) or your standard deduction (see left margin) 41 Subtract line 40 from line 38	40 14,800. 41 42,935.
People who	42 Exemptions, If line 38 is \$152.505 or less, multiply \$3.950 by the number on line 6d. Otherwise, see	
check any box	43 Taxable income. Subtact line 42 from line 41. WKS If line 42 is more than line 41, enter 4.	Assettation bits and a control of the control of th
on line 39a or		43 35,035.
39b or who can be claimed as a	44 Tax (see instrs). Check if any from: a Form(s) 8814 c	
dependent, see	b Form 4972	44 2,434. 45 0.
All others:	Alternative minimum tax (see instructions), Attach Form 6251. Excess advance premium tax credit repayment, Attach Form 8962.	45 0.
Single or	47 Add lines 44, 45 and 46	► 47 2,434.
Married filing	48 Foreign tax credit. Attach Form 1116 if required. 48	6,707.
separately, \$6,200	49 Credit for child and dependent care expenses. Attach Form 2441 49	
Married filing	50 Education credits from Form 8963, line 19 50	
jointly or	51 Retirement savings contributions credit. Attach Form 8880 51	Self-
Qualifying widow(er),	52 Child tax credit. Attach Schedule 8812, if required 52	Jeii-
\$12,460	53 Residential energy credits. Attach Form 5695 53	employment
Head of	54 Other crs from Form: a 3800 b 8801 c 54	
household, \$9,100	55 Add lines 48 through 54. These are your total credits:	tax is
-	56 Subtract line 55 from line 47. If line 55 is more than line 47, enter -0-	F 56 2 434
Other	57 Self-employment tax. Attach Schedule SE	eliminated
Taxes	58 Unireported social security and Medicare tax from Form: a 4137 b 8919	58
	59 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59
	60 a Household employment taxes from Schedule H	60a
	b First-time homebuyer credit repayment. Attach Form 5405 if required	60b
	61 Health care, individual responsibility (see instructions). Full-year coverage. X	61
	62 Taxes from: a Form 8959 b Form 8960 c Instrs, enter code(s)	62
	63 Add lines 56-62. This is your total tax	2,434.
Payments	64 Federal income tax withheld from Forms W-2 and 1099	
If you have a qualifying	65 2014 estimated tax payments and amount applied from 2013 return 65 66a Earned income credit (EIC) NO 66a	
child, attach	66a Earned income credit (EIC) NO 66a b Nortsaable contat pay election 66 b	
Schedule EIC	67 Additional child tax credit. Attach Schedule 8812 67	Tax before
	68 American opportunity credit from Form 8863, line 8 68	
	69 Net premium tax credit. Attach Form 8962. 69	re-org: \$28,324
	70 Amount paid with request for extension to file 70	
	71 Excess social security and tier 1 RRTA tax withheld	
	72 Credit for federal tax on fuels, Attach Form 4136 72	Tax after
	73 Cradits from Form: a 2439 b Reserved c Reserved d 73	
Contract Contract	74 Add ins 64, 65, 66a, & 67-73. These are your total pmts.	re-org: \$2,434
Refund	75 If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you overpaid	75
	76a Amount of line 75 you want refunded to you. If Form 8888 is attached, check he	76a
ACCUPATION A	▶ b Routing number. C Type: Checking	Savings Tax savings to
Direct deposit? See instructions.	d Account number	
	77 Amount of line 75 you want applied to your 2015 estimated tax 77 78 Amount you owe. Subtract line 74 from line 63. For details an how to pay, see instructions.	Mom & Dad:
Amount You Owe	79 Estimated tax penalty (see instructions) 79	\$25,890!!
Third Party Designee		Yes, Complete below. No
Designee	Designed a (509) 725	-3251 Note: PN
Sign	Under penalties of dejuty, I declare that I have examined this return and accompanying schedules and statements, and to	the best of my knowledge and
Here	pellef, they are true, correct, and complete. Declaration of pregarer (other than taupayer) is based on all information of which Your signature. Oate	In prepare has any knowledge. Daysine phone number
See instructions.	FARMER	161(6505/2016)
Кеер а сору	Spouse's oignature. If a joint return, both must sign. Date Spouse's cocupation	If the IRS sert you an identity Pro- tection PIN, writer
for your records.		Incoon PTN, enter in here (ase incorp)
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Other Benefits

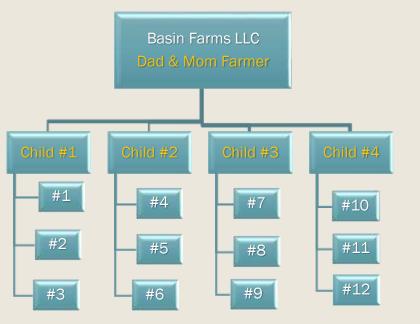
- Operating farm is carved off separate for the son on the farm to run on his own, at some point.
- Land is in LLC, subject to various LLC agreements. The kids share in ownership but cannot "sell the ranch to the highest bidder."
 - We can get cash as needed to Dad and Mom through cash lease and farm wages.
 - Farm will already be paying fringe benefits to them.
 - Dad and Mom will still control LLC and even the corporation, if they wish.

HOW DO FARM INTERESTS BECOME FRACTURED?





How Do Farms Become Fractured?



- 1) 1. Mom & Dad start the farm (2)
- 2) They have four children (4)
- 3) Each of them has 3 children (12 grandchildren)

Is This Good or Bad?



- This can present challenges when dividing up the estate
- One farmer and 11 landlords?
 - Fair is not always equal and equal is not always fair
- What options are available?
 - Leave farmland to farmer and other assets to non-farmer
 - Likely not enough assets to make and equitable split
 - Leave farm equally to children and let them figure it out
 - More likely to fight it out than figure it out
 - Build in a buy-out at an affordable price

Example of an "Affordable Price"

	Per Acre
Safe "affordable" rental rate	\$400
Less: Property taxes	(30)
Less: Average cost for updates*	(50)
*pumps, panels, mainline & pivots	
Less: Insurance	<u>(5)</u>
Available for land payment	<u>\$315</u>

Other Considerations

- How much could I pay for land if:
 - I pay it off in 20 years
 - 5.75% interest
 - Payment of \$315 per acre?
 - *ANSWER:* \$3,687.51
- Most farmland would bring considerably more if sold outright
- How important is it for the land to stay in the family?
- Is it fair to encumber the land with a buy-sell agreement that restricts it to being sold to a family member at less than the Fair Market Value?

EVALUATING A POTENTIAL BORROWER



Primary Source Of Repayment: From Operating Profits

- Budgets are used to project repayment ability
- Also project peak borrowing needs
- Real benefit of the budget is the "forced thought process"
- Bankers like to see 10% margin on budgets

Secondary Source of Repayment: Collateral or Guarantees

- Look to net assets, equity, working capital, debt-assets ratio, etc.
- If the primary source of repayment fails, how will the bank get paid?
- Many famers think, "I have a ton of equity, why do they not want to lend me money"?
 - Bankers no longer make "equity loans"
 - The 80's taught bankers that it was no fun forcing a farmer to sell his farm to repay a loan gone bad.

Other tools

- FSA guarantees
 - Reimburse lending institution for 90% of any loss sustained
 - Lenders may continue banking a marginal credit if they know the guarantee is in place
 - FSA guarantees may require additional fees and paperwork
 - May be worth it to reassure lender to "stick with you"
- Personal guarantee by family member
 - Family member be careful!

Other considerations

- History of the borrower
 - Why do they need the money?
 - Are they always "a day late and a dollar short"?
- Are they good managers?
 - Nothing wrong with financing growth or downturn in economy
 - No one wants to finance a mis-managed operation
- Confidence in the person
 - Are the borrowers "good people"?
 - Marginal ethics and a marginal loan do not often make for a good relationship

Other considerations (continued)

- Does the borrower have good records?
 - Do they know where they are and why they are there?
 - Do they have a realistic picture
 - Where they will be in the future
 - How they are going to get there?
- Communication with the banker
 - Good communication is reassuring to bankers
 - Surprises erode the confidence of bankers
 - Bankers are in essence partners in your operation
- Willingness to make difficult changes if necessary
 - Is borrower willing to "tighten their belt"?
 - Can they say no to large spending decisions?
 - Can they and their spouse limit personal spending?

NEW TAX BILL – CHANGES RELEVANT TO FARMERS



Section 179 Depreciation

- Section 179 permanently extended at \$500,000 level
 - Both new & used equipment
 - Phased out at \$2 million worth of purchases
 - Indexed for inflation

Bonus Depreciation

- Rates will change
 - Stays at 50% through 2017
 - Goes to 40% in 2018
 - Goes to 30% in 2019
 - Goes away in 2020
- Applies to new property only
- Applies to farm buildings

Other Issues

- Five year built-in gain period is made permanent
- Penalties
 - Penalty for failure to file informational return is now at the rate of \$500 per missed form
 - Penalty is increased to \$1,000 per form if it is intentional
- Small asset expensing increases from \$500 to \$2,500