

Income Tax Management for Ag Producers

NDSU Extension Service

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Income Tax Management for Ag Producers—NDSU Extension

What we will cover today:

1. Tax Management Ideas Upon Retirement
2. Estate Planning Ideas
3. Transition Planning
4. Communication

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Business Transfer or Asset Transfer?

Both are Journey's—not a 2 hour meeting!

Business Transfer

- ✓ Transition to the next generation
- ✓ Communication is vital
- ✓ What are the goals for all stakeholders
- ✓ Financial Viability
- ✓ Succession Plan
- ✓ Tax Control Plan
- ✓ Retirement Plan
- ✓ Estate Plan
- ✓ 5 to 10 years.

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Asset Transfer

- ✓ No Transition to the next generation
- ✓ Tax Control Plan
- ✓ Retirement Plan
- ✓ Estate Plan
- ✓ Time frame hinges on the process used to transfer assets- is asset protection a priority?
- ✓ Communication is important
- ✓ 2 to 5 years



Retirement Planning – Tax Management

Tax Management Ideas:

- Filling up the lower brackets
- Maybe defer into future years—do you trust your elevator?
- Use of a retirement plan such as a 401(k) or defined benefit plan.
- Perhaps leasing machinery to family or neighbors rather than selling for cash.
- Charitable Remainder Trusts (machinery and grain).

Retirement Planning—Tax Management

Start filling up those lower brackets a few years before retiring. Cannot kick the can down the road forever!

Defer, Defer, Defer: how sound is the elevator or cattle buyer?

Where are tax rates going with the new administration and all of the new debt?

Is there a plan to reduce the tax bill before the auction?

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Retirement Planning-Tax Management

Retirement Plans – 401(k)

- ✓ *If age 50 or older; 2020 maximum annual contribution of \$62,000/year/person if age 50 or older.*
- ✓ *Not obligated to make contributions each year & cancel at any time. Sometimes used in conjunction with a Pension.*
- ✓ *Consider a “Safe-Harbored” plan if there are employees.*
- ✓ *Not required to withdraw income until age 72*
- ✓ *At age 72 withdrawal is about 4% of total balance*
- ✓ *Leave to children (non-farming?) at death*

There's no requirement that 401(k) money be invested in the stock and bond markets!

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Retirement Planning-Tax Management

Defined Benefit Pension (tax reduction-not tax avoidance)

- ✓ *Contributions can be high---\$150,000+ per year*
- ✓ *Must have plan in place for 3 years (pensions can run on a fiscal year—idea; use up two pension years in one tax year)*
- ✓ *Contribution amount based on net income, age, gender & mortality, interest rates and other factors. Each year contributions must be calculated by an actuary*
- ✓ *Work well with profitable operations that have low or no debt, owners in late 50's early 60's, losing tax deductions, corporations, no employees . They require a lot of cash!*
- ✓ *Another way to equalize the estate.*

There's no requirement that pension money be invested in the stock and bond markets!

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Retirement Planning-Tax Management

Charitable Remainder Trusts

- ✓ Used most often with a machinery sale but can be used with grain and land as well
- ✓ Assets transferred to trust first and sold tax free by the trust
- ✓ Most often used to enhance retirement income—customer is usually charitably inclined, also
- ✓ Charitable Annuity Trust—Payments are fixed (cannot add assets)
- ✓ Charitable Uni-Trust-Payments vary (can add assets)
- ✓ Annually, must withdraw a minimum of 5% of original value and can take up to 50% of original value (5% to 8% most common)
- ✓ Charity must receive at least 10% of original value
- ✓ Trust cannot last longer than 20 years

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Retirement Planning-Tax Management

“Operating/Tax” Lease for equipment, bins or buildings:

- ✓ Avoids the up-front tax on the sale of depreciated assets if sold on a contract over time—i.e. “Installment Sale”
- ✓ Lessors (Parents/Owners) retain ownership of the equipment
- ✓ Payments deductible to the Lessee (operator)
- ✓ Leases usually for 3 to 10 years with a 15% or 20% buyout
- ✓ Build the lease to accommodate trades and upgrades
- ✓ If a building or bin site—sell the land on a contract with same duration as the lease
- ✓ IRS rules need to be reviewed

Your Legacy

Estate Planning

Planning for Death and Disability

“If its not in writing, it does not exist”

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Components of a Well-Structured Estate Plan

A documented plan for the land. Do you want your will or trust to contain language granting a farming child the right to buy and rent land? Co-owned land becoming problematic.

A documented plan for the farm site. This is especially important if a farming child has paid for improvements to the site (like a bin or shop).

A documented plan for machinery and equipment. If you are gifting machinery make sure the gift is documented and both the grantor and grantee have the same documentation.

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Estate Planning

What is the plan?

- If there is a successor(s) then we are transferring a business via the estate plan
- If we are not transitioning and there is/are no successor(s) we are transferring assets to the survivor and ultimately to family

Estate Planning

Is the Goal to be Fair or Equal?

“I want to be equal but fair”. Hmm???

- ✓ Usually, Equal is unfair to the farming children. Need some kind of recognition for sweat equity and contribution the farming child(ren) makes to the farm. Remember, this is their livelihood.
- ✓ Equal means the estate is split up in equal shares. A \$4 million farm; 4 kids (1 farming) means each child has \$1 million in their name at parent's death. **Is this a good idea?**
- ✓ Fair means the farming child might get the machinery, the bin site and shop and is **“favorably treated”** with land, while non farming children receive fewer farm assets (less land) more non-farm assets, maybe life insurance or just land rent or sale proceeds. Very case specific.

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Business Transfer—Estate Plan

- ✓ Have you “tested” your estate plan—run your balance sheet through your will or trust using today’s values and debt and see if the plan is viable?
- ✓ How often is the estate plan reviewed—best to review every 3 to 5 years when transitioning. Every 5 to 10 if not.
- ✓ Have you talked to your family about your estate plan?

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Estate Planning

Documents you will need:

1. Will or Trust--depends on privacy concerns and probate
2. Durable Power of Attorney
3. Health Care Directive

What should I be thinking about:

- ✓ Who represents you and makes decisions for you?
- ✓ How are assets distributed—what about grandkids?
- ✓ How will debt be handled in my estate plan?
- ✓ **Business transfer** (keeping the farm going) if there is a successor or **asset transfer** (no need to keep the farm going) if no successor

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Estate Planning – Managing Your Land While Alive

Land Transfer Ideas While Alive

Entity Owned (Most common is a LLLP or Limited Liability Limited Partnership);

- *Keeps land together-“Land Legacy”*
- *Can protect land plus a **Buy Sell Agreement** can restrict who owns*
- *Heirs inherit an ownership in the entity vs. inheriting land*
- *With the correct set up, Farmers stay in control (LLLP) when transferred via the estate plan*

Life Estate

- *Allows parents to transfer land to child and legally retain income rights. Good way to transfer equity a child who needs to buy land.*
- *No probate and possible protection from a nursing home (ND/SD)*

Revocable Living Trust

- *Land can remain in Trust or transfer to children*
- *No probate*

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Estate Planning- Transferring Your Land via a Will or Trust

Land Transfer Ideas Through your Will or Trust

⇒ Equal

- 5 kids : each inherit a 1/5 ownership in the land
- Ownership can fractionalize over time (1/5 heir w/3 kids = 1/15 for grandkids)
- *Problematic when 1 or 2 want to sell and the others don't. And how does the farmer tap into the equity if needed?*

⇒ Specific

- Each child inherits whole parcels— Who gets the one with the water?!
- Land could leave the family
- Consider an Option or Right of Refusal for the farmer to rent and/or buy land

⇒ Farmland Trust that will own only the land

- Land goes into a Trust at first or second passing
- Why – to protect land, time for farmer to buy, equal distribution of rents or sale proceeds, irresponsible heirs, children not in agreement

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Estate Planning – Machinery

Usually left to the farming child



Any machinery owned at death receives a step up in basis to market value.

Another idea:

Can be left to all children to “equalize” the estate:

- *Farming heir is typically given an option to buy from the estate at a reduced price (50% of value?) with proceeds distributed equally to all family members.*
- *If the discount is steep enough, proceeds often only to non-farmers.*

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Estate Planning – Farm Site

- ✓ If farm site has infrastructure (bins, shop, etc.) then typically left to the farming child.
- ✓ If the personal residence can be separated and a farming child will not live there, then the personal residence is an idea for non-farmers.
- ✓ If a farming child has erected bins, a grain handling system or other out-buildings and does not own the land underneath, it's important that they own the land at some point:
 - *Important for lenders*



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Estate Planning-Is Asset Protection a Concern?

Yes—protection from...?

- ✓ Nursing Home
- ✓ Marital or Financial challenges with children
- ✓ Second Marriage
- ✓ Health Concerns
- ✓ Disabled Family Member

Tools and Solutions

- Insure, Sell, Gift, Self-Pay (60-month look-back)
- Trusts to retain assets, parents retain assets, pre-nup or post-nup for children
- Pre-nup, QTIP Trust in Wills
- Health Care Directive, Irrevocable Trust, Guardianship or Conservator
- Special Needs Trust, Disinherit

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Transition Plan – Next Generation

Time is your friend in Transition Planning

- Time to give the younger producer a chance to get used to running things and making decisions.
- Time to give the senior producer a chance to get used to giving up control.
- “Rule of 25”—When should farming children start building equity? Very case specific.

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Business Transfer Goals

They may be different!

Older Generation Farmer

- ✓ *Successful transition-how is this defined?*
- ✓ *Income security*
- ✓ *Tax Control*
- ✓ *Identity, self-worth and sense of "purpose"*
- ✓ *Farming and non-farming heirs, "equal or fair"?*
- ✓ *Access to Medical Care*
- ✓ *Maybe head south for the winter*

Younger Generation Farmer

- ✓ *Successful transition-how is this defined?*
- ✓ *What about the Will ? Do I have to share my life's work?*
- ✓ *Decision making transfer-when?*
- ✓ *Growth plans & attitude toward debt*
- ✓ *How long will I have to rent assets?*
- ✓ *Work-family balance*

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Business Transfer—Financial Viability

How many families can the farm support?

- ✓ What is the senior farmers debt?
- ✓ What are the family living figures for senior and younger generation?
- ✓ Is an off farm job necessary for the next generation?
- ✓ How much owned vs. rented land?
 - ✓ Will the younger generation need to buy non-family land that is being rented? If this is a “**strong maybe**” or an “**I’m pretty sure**” what do the parents wills say about family land at their death? Will the next generation have to buy both family and non-family land? Can the farm afford it?

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Business Transfer—Succession Plan

Are the parents ready for a business partner?

- What is the plan to transfer management
 - Is the next generation involved in all aspects of management?
- What is the plan to transfer assets?
 - Sell (what can the farm afford?)
 - Gift-most often with machinery at first, land later on (life estate)
 - Rent (often with land-this is the parents retirement income)
 - Lease (great for machinery, bin sites, shop)
- Have you written down the transition plan and are all family members aware of the process?

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Business Transfer—Retirement Plan

How do you define “Retirement” in a transition plan?

- When will management transfer?
- What are the sources of retirement income?
- What are family living costs and debt?
- Has a tax planning strategy been discussed?
- Are you ready for this?

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Transition Tools

Machinery:

- ✓ Gift individual pieces each year and have next generation make the trade and pay the boot
- ✓ In the year of retirement, set up an Operating Lease
- ✓ For larger operations (multi-owners) when not everyone has a successor, maybe an S-Corp with a stock redemption plan
- ✓ If machinery is in an entity and the entity will stay in place, sell or gift the entity over time. If farming child won't take over the entity, maybe a machinery lease?
- ✓ Gift all or most of the machinery and increase cash rents

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Transition Tools

Bin Site and Buildings:

- ✓ Operating lease for depreciated assets and contract for deed for the land
- ✓ Outright gift
- ✓ Sell, but usually a big tax bill (hear again, consider a lease)
- ✓ Retain as retirement income
- ✓ In larger multi-owner operations could be placed into an S-Corp with a stock redemption plan

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Transition Tools

Cattle and Grain

- ✓ Grain is usually sold and a tax plan is set up to control taxes (deferring, retirement plan) unless debt reduction is important.
- ✓ Cattle; a contract works best for raised cattle (contracts rarely exceed 7 years)
- ✓ Cattle; Purchased cattle (most often bulls) are usually sold for cash

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Transition Tools

Land

- ✓ Usually retained by parents and passed through the estate unless a protection plan is needed
- ✓ Life Estate; transfer land to children and parents retain income rights
- ✓ Land Entity; usually a plan to protect, keep the land together and allow farmers to stay in control
- ✓ Contract for deed for retirement income but also assures the younger producer that they will own the land and allows the family to determine the terms (Bargain sales, AFR interest rates).
- ✓ Cash sale; we are seeing more of this with parents who want to retire with higher levels of debt. *Sell the higher basis land if possible.*
- ✓ Always discuss “Rights of Refusals” and “Options”

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Transition—Two Entity Idea

Operating Entity - (Sole Prop, General Partnership, LLC, Corp.)

- ✓ Owns Grain/Livestock
- ✓ Owns machinery, grain handling and other buildings
- ✓ Checkbook for the operation
- ✓ This entity is 100% transitioned to the next generation of farmer(s)

Land Entity - (LLLP—General Partners control, Limited Partners no control)

- ✓ Owns some or all of the land—a way to keep the land together
- ✓ Limited interests **left equally to all children** with farming children set up to manage and control the entity by leaving the General Interests to them via the estate plan
- ✓ Buy Sell Agreement states who can own, how to value and how to transfer
- ✓ Can help control estate taxes

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What Does Not Work

- Last minute “Plans” —
- “My kids will work it out – they get along great”
- Purchasing land from siblings when you are 60+
- High Debt & High Family Living and a desire to transition or retire
- Wanting to feed too many mouths
- *Poor Communication within the family*
- Last minute changes to the estate plan
- Not talking to your professionals

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Review and Communicate

- Make sure your plan is updated regularly
- Make sure your plan is COMMUNICATED
 - Have an open dialogue with your family – both farming, and non-farming children
 - Uncommunicated and thus un-met **expectations** will create chaos or harsh feelings within the family.

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Success!

What makes a good plan great?

- ✓ **Time** to think, plan and adjust
- ✓ Open, honest and ongoing
Communication
- ✓ *Having a good **Team** to help you*

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Thank you for Attending!

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