

An Overview of Legal Issues in Farm Transfer

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Introduction

With the average age of farm operators climbing to 57.3 as of the 2007 Census of Agriculture, farm policy is focusing more heavily on the implication an "aging" farm population has on domestic agricultural production. Little discussed is the implication of the average age of the farmland *owner*, which is, at least in the author's experience, likely ten to fifteen years higher than the average operator age.

Farming is a business, and it is easier to enter and claim ones-self a farmer (by filing a Schedule F to their 1040 federal tax return), or quit farming and cease to acknowledge being in the business of agricultural production. Land ownership, on the other hand is harder to transfer due to a combination of financial security, emotional, tax implications, and general reluctance in decision-making.

The increasing operator age causes farm policy experts to focus on assisting younger operators get to the point where they can declare themselves in the business of farming. Their point: farmers are less than a decade from "retirement," when the farmer will stop farming, leading to a loss of farm skills and use of assets such as land and equipment.

The attorney's role in helping farming and farmland-owning families address issues of succession should be more than simply executing basic asset distribution documents. Rather, the attorney can serve a key role in helping the client understand their own values and goals, which will help the attorney better serve the client. Many farms we visit have legal documents in place, but do not really understand what these documents say or mean.

Succession Planning Overview

Succession Planning is a term generally used to describe a comprehensive approach to transferring working farm assets (e.g. land, animals, machinery), sometimes as a distinct going concern (farm operating business) to another, usually younger, person or persons who will continue to employ those assets to earn

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income. This planning is an intersection of estate planning (death-time transfers of property), transfer planning (life-time transfers of property), and business planning (determining how assets will produce income). Typical objectives in succession planning include:

1. Successfully bringing next generation into the business (access to assets)
2. Providing vocation for the next generation
3. Establishing a base for financially successful business in the future
4. Providing an exit strategy/plan for the parent generation
5. Providing a business succession (with estate plan) that is fair to all potential heirs of the family wealth

Helping the next generation get established in farming

As noted above, often the goal of the parent generation and that of an operator in the "successor" generation is to keep the farm producing income as it passes between generations. In other words, how can the parents use the family wealth to get the successor established during the transfer so that she has a better chance of success on her own. Typically, the next generation starts their business in three ways:

1. Next generation family member starts a farming enterprise on her own
2. Next generation family member uses, rents, leases, purchases or is gifted production assets from owners (e.g. parents) to start their own farming enterprise ("spin-off" model)
3. Next generation family member goes into business with established firm ("super-firm" model)

Whatever the model that is being pursued by the family and next generation, succession planning is an orderly transfer of:

1. **Income** from assets: owners decide how income produced by assets (farm production, rent, timber sales) is allocated among users.
2. **Management/control of assets**: owners decide who will manage property, and make decisions about how income will be produced from use of property
3. **Ownership of assets**: who holds title to assets, and when and how that might that be transferred

Transfer of Income from Business Assets

1. Generally, the farm firm or production assets must produce growth of 5-6% per year (given 3% inflation) to support another family²

² Guido van der Hoeven, Extension Specialist, NC State University

2. Senior generations income needs generally 80-100% of pre-retirement needs. Possible sources of retirement income include:

- a. Land rent - how much can farm operation afford?
- b. Machinery rent - how much can operation afford?
- c. Income from assets sold on installment
- d. Paid for labor performed
- e. Dividends or preferred payments
- f. Qualified retirement plans
- g. Social security - if built up over the career in farming
- h. Requires analysis of projected income vs. projected living expenses

Transfer of Leadership and Management

As a rule of thumb, the second generation should enter into management no later than their 6th year of farming.³ This is out of fairness to the next generation, to allow them some measure of commitment to move forward (as well as demonstrate to siblings that they are moving forward with a commitment to use the land as their livelihood). As a practical matter, it is needed to allow the next generation to acquire the skills necessary to generate the income from the property that the parents will need (and to build up their operational equity and borrowing power)

Transfer of Ownership: Federal and State Income and Estate Tax

Always in our outreach presentations and education workshops, we endeavor to address the technical issues that are plaguing the farm owner, indeed what he or she has come there to learn, while addressing the "soft" issues of communication. Often, Dad is there with his arms crossed, and as we go around the room, everyone introducing themselves and why they have come to the meeting, he will say "I want to learn the best way to avoid estate taxes." Taxes tend to occupy a large measure of the attention span offered to developing -- or at least learning about developing -- a plan to keep the farm in production after Dad and Mom have stepped away from its management. The present uncertainty about the future of estate and gift tax law -- federal and state -- undoubtedly makes planning, or committing to the recommendations of counsel, more difficult.

More difficult still is the helping the owner generation appreciate the process by which he or she reaches the decision to follow a legal strategy to minimize estate taxes. The farm owner wants answers, and can sometimes find the questions he must ask first himself, then his family, to be a source of frustration.

Generally, we describe the three ways that one can dispose of real or personal property. With each, we declare that each transfer has a tax consequence, unless the taxing authority -- local, state (commonwealth), federal -- has passed a

³ Id.

law granting it an exclusion (which is itself merely a deferral to where the liquidation of the property, if it still has value, will trigger a tax consequence at a later time). Below are the three categories we discuss:

1. Transfer of property by gift: transferor transfers evidence of ownership (deed, title) to transferee. This transfer is subject to lifetime gift tax exemption under current federal law of \$1,000,000, and annual gift tax exemption of \$13,000 (which can be combined with a co-owner spouse into a \$26,000 annual gift exclusion). However, the transferee "inherits" basis of transferor, which if inherited or purchased long ago, can be relatively low compared to today's values. When that property is liquidated, a tax will be owed on the gain (the difference in the sale price and the inherited basis).

2. Transfer of property by sale: transferor receives something of value for transfer of ownership. Note that, as described above, the income from the sale may be subject to capital gains tax paid by the transferor. Below-market sales may be considered partial gifts in some circumstances. For the sale of personal property that has been subject to depreciation, there is a possible recapture of depreciation taken on property that sells for higher than its depreciated value.

3. Transfer of property by inheritance: in many cases, this will be a transfer by the first-to-die of a married couple, and property passes to heirs on the death of the second spouse. The "disadvantage" of transferring property through the estate is the possible tax on the value of that property above the applicable exemption (\$3.5 million in 2009, but sure to change before Congress adjourns this year). However, couples can take advantage of a credit shelter trust in their will to take advantage of the maximum estate tax exclusion. An advantage is that the transferred property (land) gets a step-up in basis under current law, whereby the property is appraised as of the date of death, and that appraisal becomes the new basis for the heirs. Should they liquidate it, their capital gain on income from the sale will be much lower. The great disadvantage is that transferee who is using the land for income production (farming) loses control of the asset if it is inherited by others in co-tenancy.

Production and land use transition

To achieve the growth from farm assets required to allow the next generation to share in their income, most farms will have to add new production/marketing to their business mix.

1. **Liability** - generally, higher returns mean higher risk. A lot of these production/marketing models bring the producer closer to the customer, which can increase the incidence of liability (ie. agritourism customers come to the farm). Farmers continually ask "which is the best" form of business entity for them, which of course is a balance of their short-term operational goals and long term transfer goals. Because many new ventures are operationally small to the point where an

owner in a business entity is at risk of personal liability (and thus personal asset exposure) due to hands-on management and decisions, making sure the operation is adequately insured (to protect potentially exposed assets) is of greater importance.

2. **Zoning** - changes to the operation, particularly in agritourism (ie. inviting the public to the farm) will have to meet local zoning requirements if in a zoning jurisdiction. For example, what do local zoning ordinances say about parking lot sizes and road front stands in agricultural zoning areas. Some uses may be interpreted as commercial and prohibited.

3. **Health Regulations** - operational changes that add-value to raw products will likely be covered by local health regulations. Constructed facilities on the farm that prepare products for public consumption will likely require permitting of local health officials.

4. **Insurance** - as noted above, insurance plays a key role in operational transition. Attorneys must make sure that the client understands the limits of a sophisticated business entity in terms of defending assets against injury claims, particularly that insurance will cover the necessary costs of defending such actions. The attorney should endeavor to have the client understand that operational changes, particularly those that add value to raw products or bring customers closer to the farm (direct selling, agritourism, etc.) will require a frank conversation with their insurance carrier to see if their new production model will be covered, or what additional insurance is required.

Farm Family Dynamics: Pennsylvania Study⁴

John Becker, JD, Professor of Agricultural Economics and Law at Pennsylvania State University, conducted a study of farm families in that state and made the following classification of farm families' experience with succession planning:

1. **Extensive Experience:** families have developed a transfer plan, and are executing elements of it. Characteristics: of these families were a) respective roles worked out: successor identified, other heirs understand asset distribution scheme, b) clarity in decision-making process (all successors and heirs understand how decisions are made), and c) clarity on need for moving forward with the plan: family members understand implications of not acting on the plan (e.g. loss of gift exemptions, estate reduction)

2. **Moderate Experience:** families have held meetings, discussions with family, are starting to meet with professionals. Sticking points in the progress for

⁴ Becker, Kaplan and Nussbaum, *Family Farm Succession Planning: Balancing Professional Responsibility with Client Needs for Help with Family Relationship Issues*, San Joaquin Agricultural Law Review, Vol. 16, No. 1, 2006-7.

these families were a) decisions about division of family wealth, b) specific roles of each family member, and c) differences in the sense of urgency between the senior (owner) and the successor generations. Another major sticking point for some families in this category was lack of a clear successor.

3. Limited Experience: families gathering information, passive education in comfortable environments (cattlemen's meeting, extension office), but are making little progress in decision-making.

Mr. Becker's study advises the following conclusions on how attorneys serving farm operating/owning families in their succession planning can help with crucial intra-family communication issues:

1. Identify the client and firmly establish the role the attorney will play for the client. This will reduce dependence of extended family members on the attorney who may indeed not represent their interests.

2. Work with other professionals to help facilitate dialogue in the family. The attorney can seek to partner with mental health professionals or community educators who specialize in family relations.

3. Be flexible when working with farm families, recognizing that families react to participatory decision-making in different -- positive or negative -- ways.

4. Be patient with the problems families are facing in confronting the planning process.

Working with Outside Advisors

The attorney's role in helping to coordinate the best advice for farm operator and land-owning clients is certainly a challenge. Attorneys should be prepared to work with other advisers from outside their local or traditional referral pattern. A key question is protecting client confidentiality (considered in the ethics presentation of the Rural Lands and Agribusiness Update).

Advisers and their roles include:

1. **Attorney:** advise of legal and tax implications of asset transfer (role as counselor?)
2. **Accountant:** advise of tax implications of asset transfer (offering legal advice? e.g. directing toward self-help formation of Corp. or LLC)
3. **Business consultants:** coaches in family business transfer, technical advice on farm production transition (e.g. cooperative extension)
4. **Counselors:** formal or informal, for-profit or non-profit
5. **Financial planner:** expert advice on income needs, diversifying returns on working liquid capital

6. **Insurance agent:** role of insurance as asset replacement in business transfer and estate planning. Role as estate planner?
7. **Lender:** financing of production transition/asset purchase by next generation
8. **Mediator:** coordinate and develop structure family communication, reaching consensus on values and goals

Talking to Farm Families About Succession: The Five D's

When talking with farm operator and owner audiences across Virginia, one of our major challenges is orienting them to accept that things happen in life that can disrupt their vision of what they want the future to be. The purpose of the illustration is to suggest that these events are entirely foreseeable, and that their decisions on the use of succession planning tools (wills, trusts, business entities, insurance products, business plans, etc.) can help their operation survive or ownership of their land in the family continue. We call these the 5 D's: Death, Divorce, Disagreement, Disaster, and Disability. For example, we ask the audience to (either on paper or in their minds, as time allows), sketch their vision for what they want to see happen with their family lands. We then call for them to name something beginning with "D" that poses a risk to that vision. For each, we can name quickly how these foreseeable events can disrupt farm property income flow, farm property control, farm property ownership.

A Suggested Process

As noted above, farm succession is the intersection of several disciplines spread across a timeline of ever changing lives. On top of that, if a family is involved in farm production, it is also governed by the relentless march of the seasons. Many families who otherwise want to retain wealth or, for emotional and/or farm economic reasons, are daunted by the enormous task at hand. Lack of basic understanding of legal principles of property ownership and transfer -- and the popular specter of taxes -- likely causes hesitation in moving forward. Other causes of hesitation -- in the author's experience -- can include lack of cash resources for professional advice, unwillingness to embrace the inevitability of death, or perhaps most often, uncertainty about expectations of the rest of the family regarding the farm asset wealth, and how those expectations can strain family relationships.

To help families attack these uncertainties, we advocate a three-step process in our general outreach on planning to keep farm land in agriculture. Though each step may contain a thousand tasks and many decisions along the way, breaking them down to three broad questions may prove useful. These are:

1. What do you want?

What is the client's (and their family's) vision for the future? The attorney's role in some evaluation will greatly improve the service to the client. Exploring the development of family communication structures may be hard to manage on a project or hourly-billing matter, but directing clients to resources for developing a

vision for the future, or a clear articulation of what the clients wants to happen, will a) help the attorney understand the limits in application of legal tools, and b) help the client understand why the documents they have say what they do. Even before engaging a family coach or mediator, there are resources on the web (e.g. ncftn.org's *Planning the Future of Your Farm* workbook) that can help your client structure value assessment and goal setting exercises for their family.

2. **What do you need?**

We propose a real assessment of family members' needs to bring the vision into further focus, or to help the family understand why they are having trouble with coming to a consensus on a shared vision. For the parent generation, starting this step can be as simple as a) identifying what they want to do in their "retirement", and b) completing a worksheet of anticipated expenses (including health care) and comparing those with their sources of income. The successor generation, both farm operator and "off-farm" heirs, must come up with what their needs and expectations are from the parents potential estate (the family wealth). The farm operator must provide what income is needed to make his or her use of the assets viable to support his or her own family. Likewise, the off-farm heirs will have needs in their own lives that, though none of the kids (on- or off-farm) are owed anything by their parents, are nonetheless relevant to the parent's notions of fairness and equality in the division of their estate (farm and non-farm) assets.

3. **What do you have?**

We explain to farm audiences that this can be considered "the easy part," though it is time-consuming. By easy part, we mean what do you currently have at your disposal: legal tools, financial tools, assets, abilities of the next generation to take over. This question however embraces more than a survey and appraisal of business assets in terms of their ownership and value, though that is crucial. This is itself a process of determining ownership of property, but is also an assessment of community resources that support a farms ability to operate in an ever changing environment.