Estate and Transition Planning Potpourri

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Overview

Estate and succession planning is very important to many farm and ranch families. Keeping the land in the family is a key component to estate plans and providing a legacy that keeps the family tied together is critical – not only financially, but also emotionally and spiritually. I have a farming friend who is fifth generation on the same farm and in the same farm home. I am pleased that my great nephews and great niece (along with their parents) occupy the home that I grew up in on the homeplace in Indiana.

That all brings me to today's article. Each brief topic relates to tax and estate planning in one way or another.

Farmland in an IRA?

Farmland can be owned in an IRA, but should it? What if you want to continue farming the land? What are the issues with holding farmland inside an IRA?

Many farmers who want to buy land and hold it in an IRA or retirement account also want to farm the land. Also, in many situations the purchase is financed. The problem with farming or financing land held in an IRA is that it will likely cause the IRA to be fully taxable.

Many actions are prohibited when land is owned by an IRA. For starters you or anyone closely related to you can't farm the land. You can't even personally do any work on the land such as mowing grass waterways or painting a barn or doing any maintenance. Also, rent should be based on fair market value. If you borrow funds to buy the land, you can't personally guarantee the debt. If you do finance the purchase, part of your rental income will be subject to income tax and the IRA will need to file an income tax return.

You'll also need to find an IRA custodian to handle the transaction and the ongoing ownership of the land – and pay fees. The land will have to be appraised every year, and once you turn 73, you may need to partially distribute the land annually.

Do you still want to own land in an IRA?

Gifting Property with Debt

Succession planning can be complicated. It's even more difficult when property that is transferred to the next generation is not debt-free.

Gifting property as part of a succession plan generally does not cause any income tax issues. The donor's tax basis simply carries over to the donee. But if the gifted property doesn't have a cost basis and there is debt against it, income tax is triggered. For instance, let's say that Dad has a fully depreciated tractor that still has $100,000 debt on it. If he gifts the tractor to his daughter, he will have to pay tax on $100,000 of gain. It's treated as a sale. While Dad could continue to owe the debt, he would need to make sure he has the income to pay it.

The same situation can result with farm partnership interests. There are many zero-basis farm assets held in a partnership such as grain inventories, pre-paid inputs as well as machinery and equipment. But the partnership might have debt. So, a gift of a partnership capital account triggers tax on the amount of the negative capital account. Death, with a step-up in basis, solves this problem and wipes out the negative capital account that can then be gifted to the next generation.

Debt on farm assets makes succession planning more difficult to avoid negative tax consequences.

Transitioning the Farm or Ranch Business

How do you plan to transition the management of your farm or ranch? It's a big issue – the business of production agriculture has gotten more complex over the years. How will the next generation handle it? What should you be considering when it comes to transition planning?

When thinking about transitioning the farm or ranch business, what are your options if you don't have anyone in the next generation of your family to pass the business to? You could just sell everything off. Or you might be able to work with a neighbor or younger farmer in the area to take over the business while you transition to retirement. If you have employees, are any of them good managers that might be interested in taking over? Some states have beginning farmer programs that might be an option.

If you do have heirs interested in managing the business, do they understand what they don't know? Will they ask for help? That can be a sign of a potentially good manager.

Also, you must be ready to step aside from managing the business. This is a hard one for many farmers and ranchers. Do you have a vision for what you want to do if you retire from running the operation? Maybe you have a "bucket list" of things to accomplish.

Transitioning the farm or ranch is a process. But, thinking and planning now can mean long-term success for the next generation. It's rarely too early to start.

Using a 401(k) for Start-Up Capital

The capital intensiveness of farming can be a significant drawback to starting in farming on a full-time basis. But you just might have a substantial asset that you could tap to create the necessary working capital.

If you have a 401(k)-retirement account, you might be able to use the funds to start a farming business. To do this, you will need to create a C corporation to establish a 401(k) plan and then roll over your current 401(k) at the old employer into the new 401k) plan. The new plan will then buy shares in the corporation and become an owner. The money put into the corporation will then become the working capital that the corporation can use to buy equipment, plant crops, acquire land and livestock as well as other assets.

There is no limit on how much stock the 401(k) can buy. This means that unlike borrowing money from a 401(k) which is limited to $50,000 or cashing in the plan and paying taxes and a 10 percent penalty on the funds received, you can put a significant amount of capital into the farm business in a tax-efficient manner.

But don't be overly aggressive with the strategy. IRS has noted abuses. Don't think you can set up a corporation simply to buy a motor home, for example. This will most likely get disallowed on audit. But if you use the cash to create a farming entity and will be actively farming, there should be no issue with using your 401(k) to fund it.

Conclusion

Estate and business planning is part of your legacy plan. Make sure to stay on top of it to preserve your farming/ranching legacy for your heirs. Don't delay. How much sand is in the top of your hourglass?