Business point

Review the pros and cons of these methods for transferring farm assets.

Avenues for succession success

***Editor's note:** Kent Vickre and Chuck Cagley write a tax and finance column for each issue of Pioneer* GrowingPoint® *magazine. Vickre is state coordinator of the Iowa Farm Business Association. Cagley is state coordinator of Illinois Farm Business Farm Management. They address issues that influence agribusiness success.*

Several factors may prompt transition planning: retirement, estate planning or achieving personal goals. Regardless of the reason, the first and most important step in transition planning is to define the goals of each party and discuss the process with everyone involved. Too often this discussion doesn't happen until the wheels are already in motion.

A written transition plan will help define the expectations and financial needs of all parties. Since transferring the farm operation typically is a long-term process involving considerable assets, a documented plan clarifies details that can easily be forgotten over time.

Additionally, a written plan helps explain this transition to others such as future in-laws or off-farm heirs. Both the process and the actual written plan help ensure success.

Creating a plan is typically a balancing act between the financial needs of the retiree and payment ability of his successor. Most farm assets appreciate significantly in value, so tax management can be crucial. Let's discuss several traditional methods of transferring assets.

Selling the assets

The simplest transfer vehicle is to sell the asset, but this also tends to produce the least favorable tax consequence. Another disadvantage is the successor may be subject to related-party rules and Section 179 limits.

To help manage this income tax, review each asset classification and basis prior to selling. Because long-term capital gains and qualified dividend rates are currently low, the sale of these assets is more appealing. For 2007, the tax rates and considerations are:

- For taxpayers in the 10 percent or 15 percent tax brackets, 5 percent.
- For taxpayers in the higher brackets, 15 percent.
- Tax on unrecaptured Section 1250 gain is 25 percent.
- Long-term gain generally applies to assets held longer than one year.
- Qualified Dividend Income is generally for dividends held 60 days or more.

Remember, most taxable income on machinery is due to depreciation. This gain is subject to ordinary rates.

Installment sales

The primary advantages of installment sales are spreading the taxable gain over the life of the contract and immediate possession for the buyer. This method works best for assets with capital gain because only the capital gain can be deferred. All ordinary income (income due to depreciation of an asset) is subject to recapture.

For example, suppose you sell a tractor originally costing $100,000 with $0 remaining basis for $50,000 with the payment to be received over five years. The total sale amount of $50,000 would be taxable on the recipient's tax return in the *first* year.

Other installment sale disadvantages compared to traditional sales are:

- The seller remains a creditor of the buyer.
- The capital gains rates could increase.
- The sale could increase the amount of Social Security benefits included in income.

You might eliminate some of these tax disadvantages if the recipient elects out of installment sale reporting.

Gifts

Each individual is permitted to transfer $12,000 annually to any individual as a gift without tax implication. For assets, this limit applies to the fair market value (FMV); however, the asset basis remains unchanged.

For example, a husband and wife who jointly own the farm machinery may give equipment with a FMV of $48,000 to their son and his wife ($12,000 x 4). Any remaining basis on the machinery would be depreciated on the son and wife's Schedule F.

Note: If you're using this method, these gifts are included in the Medicare program's "look back" period.

Residence exclusion

When considering transferring the farm business, an often overlooked and unique asset is the principal residence. Retirees should consider taking advantage of the Section 121 exclusion. The exclusion allows a taxpayer to exclude $250,000 ($500,000 for a married couple) of gain from the sale of the personal residence provided certain conditions are met.

The IRS has specific rules concerning rental income, frequency of use, etc. In general, though, this exclusion is available for taxpayers who have owned and used the home as a primary residence for at least two out of the five years prior to sale (if they haven't claimed this exclusion in the previous two years).

Estate

Generally, assets transferred through your estate will receive a stepped up basis. Typically, you should use this method to transfer low-basis assets. For 2007, the federal estate tax limit is $2 million per individual or $4 million per couple (equivalent to about 800 acres of Iowa farmland at $5,000 per acre). This means you won't necessarily "lose the farm to estate taxes" when you die.

The major disadvantage comes if you die or through unseen future events or expenses. Additional safeguards can ensure these assets are available. Several common safeguard tools are long-term care and life insurance. As nursing home costs and retiree life expectancy increase, many look to long-term care insurance as a solution.

Several key considerations for this type of insurance are eligibility and affordability, which depend primarily on your age and health. Also consider whether the benefit adjusts for inflation and what qualifies you to start receiving benefits: Each policy has different terms.

Before purchasing any insurance, carefully evaluate the cost, probabilities and tax implications. It's important to compare the net present value of all outflows (taxes, insurance premiums, etc.) as expenses.

Start planning now

Remember, as the owner of your business, only you can decide what's best for you, your family and your operation. It helps to think of the transition plan as a process, not an event.

The sooner you start planning, the more options everyone will have to prepare for cash-flow needs and to minimize taxes. Be sure both generations understand and are committed to the process.

While this article highlights several of the most common vehicles used for transition planning, others are available. More-complex options such as trusts, buy/sell agreements, life estate, etc., may help you achieve your goals. Review your personal situation with your accountant or lawyer to design a plan that makes you comfortable.