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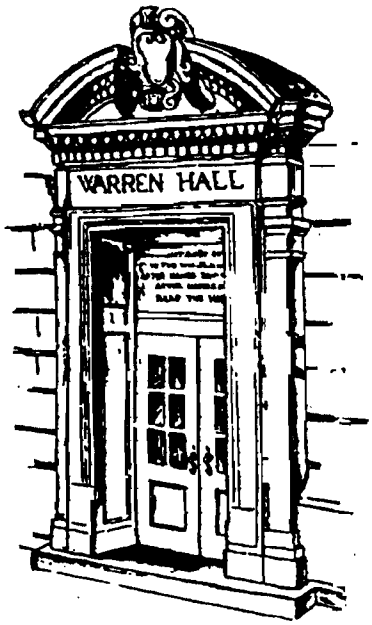


# Staff Paper

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## TAX TRAPS AND OPPORTUNITIES ASSOCIATED WITH FAMILY FARM TRANSFERS

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**Abstract**

Transferring farm property from the Senior to the Junior farm family generation with conventional methods such as sales and debt transfer can cause tax traps or burdens. The most serious tax traps and related problems occur when the farm business being transferred has high debt and is below optimum size and profitability.

Farm families should recognize the conditions that cause tax traps when farm property is transferred. Alternative planning and transfer strategies can be used to avoid serious tax traps and maximize after tax income.

# TAX TRAPS AND OPPORTUNITIES ASSOCIATED WITH FAMILY FARM TRANSFERS

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There is great concern about the future of the family farm. Fortunately, not all of the information we hear and read about the demise of the family farm is true. Urbanization and development are not consuming a major portion of prime farm land in the U.S. Big corporate farming is not a major threat to the family farm. It is not impossible for young people to acquire the management and ownership of a viable and competitive farm business today. For young people to become successful farm business owners it is difficult because there is more risk, more capital and planning is required, but it is not impossible.

## Opportunities Under Different Conditions

The opportunity for the junior generation to own and manage the family farm depends on more than the goals and desires of the family members. There are other conditions and constraints that contribute to the success of family farm transfers. Transferring farm ownership, under three different sets of conditions, is discussed below:

1. The farm is of adequate size and profitable enough for two or more families.
2. The farm must change to become more efficient and profitable.
3. The senior generation retires or exits farming.

## Adequate Farm Size and Profitability

Many transfer constraints and problems can be avoided when the farm business is of adequate size and level of profitability. Here is a basic description of a dairy farm that meets this definition:

- 100 or more cows and three tillable acres per cow.
- $800,000 or more of farm assets with $300,000 or less of farm debt. (Debt to asset ratio .375 or less.)
- $500,000 or more of farm equity (Sixty-two percent or more equity.)
- $60,000 available for personal/family expenditures.
- $40,000 available for debt service.

Following is a common farm family transfer scenario under these favorable conditions.

> Junior Farmer acquires an interest in the business but needs capital (financing) to do it. Buying one half of Senior Farmer's equity in cattle and equipment used to be common. Typically Senior Farmer would take Junior Farmer's note to finance the sale. A combination of acquisition methods including gifts and purchases are more common today.
>
> Under this scenario, Junior Farmer's debt would not cause a tax trap or major burden. Senior Farmer's taxable gain will be the difference between the sale price and the basis. Although the basis of many farm assets is low, tax management strategies can be used to minimize taxable gain.
>
> Family farm asset sales are often prices somewhat below fair market value (FMV), particularly for assets that produce ordinary income. Senior can avoid problems associated with depreciation recapture by allocating more of the sale price to capital gain assets and excluding machinery from farm installment sales.
>
> After a routine transfer of farm assets, if Junior and Senior Farmer failed to work and manage together a major financial and tax problem could occur. Profits and net worth decline, Junior Farmer leaves after paying little or none of what he owes Senior Farmer. Senior Farmer is left holding "the bag". The best remaining alternative may be to sell out. Senior Farmer's equity after sale expenses and taxes will be less than his equity if the transfer to Junior had been successful because:
>
> 1. Sale proceeds less expenses and basis will be taxable in year constructively received. It is likely that an installment sale is not an option at this time.
> 2. Debt may have increased more than assets.

A serious tax trap can occur when Senior Farmer transfers debt to the partnership. The assumption of Senior Farmer's debt by the partnership is common and reduces the assets that Junior Farmer must contribute to gain the desired level of equity. However, a contribution of liabilities which exceed the adjusted basis of assets contributed to the partnership plus the liabilities assumed, is treated as a taxable transaction.

The following example illustrates this tax trap:

> Senior Farmer contributes $190,000 of raised cattle and feed, and $10,000 of cash to help establish a 50/50 partnership with Junior Farmer. The partnership plans to lease the machinery and real estate from Senior Farmer. Senior Farmer also contributes $80,000 of debt. The basis of Senior Farmer's assets contributed is only $20,000 because raised cattle and feed have a zero basis.

| | |
|---|---|
| Adjusted basis of assets contributed by Senior Farmer | $10,000 |
| - Senior Farmer's liabilities assumed by partnership | (80,000) |
| + Senior Farmer's 50% share of partnership liabilities | 40,000 |
| Tax basis of Seniors Farmer partnership interest | ($30,000) |

Senior Farmer has a negative basis of $30,000 which must be returned to zero by reporting a gain of $30,000 for the year the partnership was formed. He should try to avoid this tax trap by:

1. Contributing assets that have more basis.
2. Contributing fewer liabilities to the partnership.
3. Increasing his share of the partnership.

The Farm Must Change

If the farm needs additional capacity and new technology to become profitable enough to support two or more families, the tax traps and management risks become larger. Expansion and new technology require substantial amounts of additional capital. The expansion program may begin before Junior Farmer makes a decision to return to the farm and it may continue and gain momentum when Junior Farmer returns.

To double herd-size and change from old to new dairy facilities requires an additional investment of $3,000 to $4,000 per cow depending upon the purchase of expansion cattle, companion equipment required, and the size of the expansion.

Dairy Farm A Example:

| | Before Expansion | After Expansion |
|---|---|---|
| Cows | 150 | 300 |
| Farm assets | $900,000 | $1.8 mil[1] |
| Farm assets/cow | $6,000 | $6,000 |
| Farm debt | $150,000 | ($1.15) mil[2] |
| Farm debt/cow | $1,000 | $3,833 |

[1]New facility for 300 cows, est. cost $800,000. Additional cows and equipment = $200,000. Total assets = $1million new -$100,000 lost capital +$900,000 = $1.8 million.

[2]$1million new capital +$150,000 = $1.15 million.

Assume the FMV of farm assets after expansion is $1.8 million. The debt to asset ratio is 0.63. Equity is $650,000, down $100,000. Equity will grow rapidly if the farm business is well managed and profitable. Equity could exceed $1 million in 6 to 8 years.

If the business is not well managed it will not be profitable. The equity may decrease, the family partners may disagree, Junior Farmer may leave and Senior Farmer will face a sale decision with major tax implications.

Here is a probable sale scenario following three troubled years:

The farm assets have dropped to $1.7 million and debt has increased to $1.2 million. Senior Farmer sells all assets in one year.

| | | |
|---|---|---|
| Gross sale price | $1,700,000 | |
| Sale expenses | -200,000 | |
| Net sale price | $1,500,000 | |
| Basis of assets | -800,000 | Est. Fed & NYS |
| Gain on sale | $700,000 | Income Tax |
| Ordinary gain | -200,000 | $70,000 |
| Capital gain | $500,000 | 180,000 |
| Est. tax on sale | | $250,000 |

| | |
|---|---|
| Net sale price | $1,500,000 |
| Less debt owed | -1,200,000 |
| Less tax liability | -250,000 |
| Net income from sale | $50,000 |

If the sale does not occur until most of the expansion facilities, equipment, and purchased cattle are depreciated (8 to 10 years). The basis will be much lower, ordinary and capital gain will be higher and the tax liability could be $500,000.

Income tax liability is within $50,000 of net sale proceeds after debt owed in the sale of dairy farm A above. If an additional $150,000 of depreciation occurs before the sale, the basis would drop to $650,000, and tax liability would exceed net sale proceeds after debt payments. Here are strategies to avoid this high tax low net sales proceeds tax trap:

1. Invest in farm assets that add high amounts of FMV.
2. Plan (budget) capital expansion projects carefully, accurately and build in for extra needs.
3. Have a proven management team in place. Goals must be similar and management styles compatible.
4. Use recommended farm business and financial management reports to audit and evaluate the business regularly.
5. Recognize problems early, identify alternative solutions including sale of farm assets, take action before equity disappears.
6. Manage sale to maximize after tax income.

Funding Senior Farmer's Retirement

It is almost impossible for Senior Farmer to convert all of his/her farm business equity to retirement assets when the exit decision is made. Senior Farmer must recognize this as a reality and plan accordingly. Here are two major contributing factors:

1. Deferred taxes are often overlooked when calculating equity. A limited number of NY farmers currently include deferred taxes as a farm liability on their balance sheets. Following is a condensed balance sheet including deferred taxes that illustrates the impact deferred taxes have on farm net worth.

Condensed Balance Sheet Including Deferred Taxes
December 31, 1993
25 New York Dairy Farms, 1993

| Assets | | Liabilities & Net Worth | |
|---|---|---|---|
| Total Current Assets | $88,137 | Current debts & payables | $49,095 |
| | | Current deferred taxes | 28,723 |
| | | Total Current Liabilities | $77,818 |
| Total Inter. Assets | $312,057 | Intermediate debts & leases | $96,341 |
| | | Intermediate deferred taxes | 91,463 |
| | | Total Inter. Liabilities | $187,804 |
| Total Long Term Assets | $326,514 | Long term debts & leases | $77,496 |
| | | Long term deferred taxes | 51,632 |
| | | Total Long Term Liabilities | $129,128 |
| Total Farm Assets | $726,708 | Total Liab. w/o def. taxes | $222,932 |
| | | Total Farm Liabilities | $394,750 |
| | | Farm Net Worth w/o taxes | $503,776 |
| | | Farm Net Worth with taxes | $331,959 |
| | | Debt/asset ratio w/o taxes | 0.31 |
| | | Debt/asset ratio w/ taxes | 0.54 |
| Total Nonfarm Assets | $57,102 | Total Nonfarm Liabilities | $12,807 |
| Total Assets | $783,810 | Total Liabilities | $407,557 |
| | | Total Net Worth | $376,253 |

Deferred taxes are listed as current, intermediate and long term farm liabilities and nonfarm liabilities. On twenty five moderate-sized dairy farm (107 cows) total farm deferred taxes averaged $171,818 per farm and 24 percent of total farm.

Deferred taxes represent an estimate of the taxes that would be due if the farm were sold at year end fair market values. Tax liability accuracy is dependent on the reliability of the market values and the tax basis data provided.

2. If a junior generation wants to purchase the farm business, he/she may not be able to pay FMV prices. A moderate size farm with a relatively low debt load can provide a comfortable net farm income for the owner's family. When the same farm is sold to a new owner who has little to no capital, debt increases dramatically, cash flow becomes tight, needed improvements are postponed, labor and management resources are stretched and farm profitability declines.

Here are some partial solutions to the deferred tax and selling below FMV problems:

1. Recommend (require) accounting procedures, statements and balance sheets that include deferred taxes and reliable measures of farm profitability and growth.
2. Transfer ownership to the junior generation over a period of time. Start well before retirement. Complete it with a good estate plan.
3. Avoid putting all net income back into the farm business if farm growth is not a primary goal. Diversify investments before retirement.
4. Use tax management techniques and strategies to postpone taxable income.

Conclusions

Many family farms are still a viable production and management unit. Successful transfers of viable family farms from one generation to the next is important if opportunities for growth and profitability are maintained. The formula for success includes an understanding of potential tax traps that occur when farm assets are sold or transferred to the Junior generation or to farm partnerships. Recognition and understanding of tax traps and the implication of related tax management strategies will enhance the transfer and viability of the family farm.

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