Ready Set Retire

Farming: Without an Operating Heir

Joe and Peggy Green have three children. Their oldest, Kate, completed her B.S. degree at State University, married a chemical engineer, and moved to the East Coast when her husband got a job there. Her two children, both teenagers, have romantic notions about life on a midwestern farm and enjoy visiting their grandparents each summer, but neither Kate, her husband, nor either of her children, has any desire to return to farming.

The Green's second child, Pete, completed a B.S. in forestry at State U. and has worked for the U.S. Forest Service, first in Oregon and then in Montana, since his graduation. He likes his work very much, and particularly likes the climate and scenery that surround him in his daily work. Neither of his two daughters from his first marriage nor he and his second wife have any interest in returning to the family farm.

The Green's third son, Jack, born eight years after his older brother, took a job after high school in a local service industry. He always talked about farming with his dad, but he quickly rose to plant supervisor, married a woman not interested in farming, and moved to a community about 50 miles from his parents' farm. Like their cousins, his children look forward to visits to their grandparents' farm, but have little interest in returning to the farm.

Although they wish that one of their children was interested in returning to share in the farming operation, so that the farm could be transferred to that child, none of their three children nor any of their grandchildren wants to be involved. The Greens' plans to meet retirement goals will center on a single consideration: ensuring sufficient income for their retirement years, including income and property arrangements for the surviving spouse.

Alternatives for Retirement Without an Operating Heir

In general, there are four major alternatives available to retiring farmers who have no heirs interested in taking over the farm operation. The alternative chosen depends primarily on the amount of leisure time desired and the amount of work the retiring farmer wants to do.

Operate the Farm

The couple could continue to operate the farm on a full-time or part-time basis. This option is often chosen by couples who truly enjoy the kind of work that farming entails and want to remain on the farm as long as they can. Operations could be scaled back to reflect the needs and desires of the couple. If the couple enjoys livestock farming the most, then they could keep the cattle and crop and hay land necessary for winter feeding, but sell the remaining land. They also could specialize in crops that minimize some of the back-breaking labor.

Potential disadvantages of continuing farm operations, even on a limited scale are, first, the couple is not really retired. They still may be tied to twice-daily feedings, the vagaries of the weather (making hay when the sun shines, for instance), and the general uncertainties of farming. A second disadvantage is that income from the farm operation, because it is income earned through current productive efforts, may reduce social security benefits. (See *Ready, Set, Retire—Farming: Social Security Issues*, Pm-1167h.)

Lease the Farm

A second alternative is to live on the farmstead but rent the land. This alternative could be combined with the first alternative, with the couple continuing part of the farm operation and renting the remainder of the land. Renting all or part of the land works best when a sizeable portion of the land is tillable and the farm buildings do not contain specialized equipment or facilities.

Several different lease arrangements are available. A **cash lease** specifies that the tenant pay the land owners a set amount of money for the use of the land for a fixed period of time. In general, the land owners furnish the farm, pay the taxes and assessments, and may be required to keep certain things in good condition, like a storage building or the

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fences. The tenant supplies the labor and working capital. The advantage to the land owners is that the return is fixed and secure and does not count as earned income for either income tax or social security purposes. A disadvantage to the land owners is that, although the risk is low, so may be the returns on the investment in the farm. There also may be some risk of nonpayment of rent by the tenant.

A **crop share lease** specifies that the land owners will receive a portion of the crop as payment for the rental of the land. Usually the lease specifies that they share in the production costs, although arrangements in which they do not are possible. A crop share lease also may require land owners to supply part of the operating capital and to market the grain unless a professional farm manager is employed. Like farm operation, a crop share lease holds the possibility of higher returns than a straight cash lease if the crop year is a good one. There is also the potential for much lower returns in bad crop years, of course.

The most important decision that the land owners can make in a crop share lease arrangement is the selection of the tenant. Even with an excellent tenant, the land owners probably will want to be involved in decisions made about the crop land, because their annual earnings are tied in part to those decisions. It also may mean that the rental income will be counted as earned income for social security purposes. (See *Ready, Set, Retire—Farming: Social Security Issues,* Pm-1167h). A variation on the crop share lease is the **crop share cash lease** in which the hay and pasture land is rented for cash and the tillable land is leased on a crop share basis.

A couple considering some type of leasing arrangement should obtain a copy of FM-1564, *Improving Your Farm Lease Agreement,* from the local extension office. Various leasing arrangements are detailed, with a discussion of issues important to each arrangement.

Custom Farming

A third alternative is to continue to operate the farm, but hire machinery work done for crops on a custom basis. Under this option, the land owners would hire someone who does custom work, often a neighbor, to plant, till, and harvest the crop for a fixed fee. The land owners supply all the capital, market the crops, and receive the income. This option tends to have all the risks of farming, with the additional risk of competing for an individual's services at a time when those services are in great demand. Involvement in the day-to-day decisions is also high, but involvement in the physical labor is minimized. Publication FM-1823, *Custom Farming: An Alternative to Leasing,* discusses details of farm operation through custom farming.

Sell the Farm

The fourth option is to sell the farm and move to a dwelling somewhere else, in a nearby community or in another part of the country. The proceeds from the sale are invested to ensure retirement income (see *Ready, Set, Retire—Farming: Investment Planning,* Pm-1167i). Although many couples are reluctant to part with a farm where they have spent many years, it is sometimes the best alternative. In particular, farms with specialized equipment and facilities, such as a dairy operation or a confinement hog operation, may be difficult to rent and obtain a reasonable return on the investment. Such farms may be difficult to sell, also, but the potential for return may be greater with a sale than with leasing.

If the farm business is to be sold, careful planning needs to take place to minimize the income tax obligations of the couple when the farm is sold, as well as the estate tax obligations when the first spouse dies and when the second spouse dies. Because both income tax law and estate tax law are complex, an attorney should be retained for advice throughout the process.

Consider the income tax issues surrounding the sale of a farm business. Assume that the entire farm business is sold, including the dwelling, the machinery, the livestock, and the land. Under the cash basis method of accounting, farmers will have income that has not yet been recognized. Thus, over a period of years, they accumulate considerable assets on which income taxes have not been paid. Under these conditions, if the farm business is liquidated in a given year, there is ordinary farm income from the sale of crops and livestock, the sale of the machinery (part of which will be ordinary income), the sale of breeding stock (if the holding period is met), and the sale of the land. Under the 1986 Tax Reform Act, capital gains are treated as ordinary income. In addition, there may be investment credit to be paid. At the least, it may be desirable to sell the machinery one year, the breeding stock the next year, and the land the third year.

Selling the land on a land contract, essentially an installment sale, has the effect of deferring part of the payments until future years. If the land is sold on contract, a part of each payment received is treated as the recovery of cost and a part as profit.

The dramatic decrease in land values during the early 1980s pointed out the risk in contract sales, as many buyers could not continue payments and forfeited property back to original owners. The couple will need to weigh the tax advantages of a sale on contract against the advantages of receiving the entire purchase price of the farm for reinvestment.

The farm residence is an asset that, although located on the farm, is not normally a farm business asset. Consequently, its sale usually is treated like the sale of the principal residence by the Internal Revenue Service. When the farm is sold, a portion of the selling price and a portion of the cost basis are allocated to the residence, including its yard and outbuildings related to the house, such as a garage. If a capital gain is realized on the sale of the residence, the gain is postponed if a different residence of equal or greater value is purchased within 24 months of the sale of the farm residence. An individual who is at least 55 years old may exclude from gross income all or part of the capital gain on the sale of the principal residence if that exclusion has never been taken before. The first $125,000 of the gain can be excluded.

Estate Planning

Regardless of which option is pursued, there will be two estates to consider—the estate of the first spouse and the estate of the second spouse. The "unlimited marital deduction" that permits the surviving spouse to inherit all or part of the estate of the deceased spouse without federal estate tax obligations (there may be state tax obligations, however) is extremely advantageous in planning for the transfer of property. Careful estate planning on the part of the parent generation can help limit estate tax obligations or can provide assets to be used to pay the estate tax obligations at the death of the second spouse. See North Central Regional Extension Publication 193, *Farm Estate and Transfer Planning: A Management Perspective*, for a thorough discussion of estate planning for estates that differ in estimated values.

For Further Reading

Looney, J. W. *Estate Planning for Farmers.* 3rd. ed. St. Louis, Mo.: Doane Agricultural Service, 1979.

Polson, Jim G. *Handbook of Farm and Ranch Estate Planning.* Englewood Cliffs, N.J.: 1982.

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