Structuring Your Farm to Build and Preserve Wealth

Poppy Davis

Overview

Goal: Help you to develop a "balance sheet" mindset so you can manage your business to build and preserve real wealth, not just short-term profits.

Skill: Understand how the balance sheet and income statement work together to guide you as an owner/manager

Application: Critical business decisions that affect your short-term cash flow and long-term wealth

- *Choice of entity*
- *Relationship between business and land where business is conducted*
- *Aspiring farmers*
- *Retiring farmers*
- *Taxes, taxes, taxes!*

Overview - Who are you?

40 responses

8 people with 10+ years

7 people with 5-10 years

12 people with 0-1 years

13 people with 2-4 years

Opportunity to talk about aspiring and retiring farmer issues!

Overview - Who are you?

40 responses

Do you farm on the same property where you live? 72+%

Do you rent any of the land you farm? 32+%

Do you rent all of the land you farm? 22+%

Do you own a greenhouse or a cooling facility? 62+%

Opportunity to talk about taxes!

Overview - Topics

1. What makes a farm or ranch business a business?
2. Looking at a balance sheet and an income statement
3. Structuring for liability
4. Structuring for taxes
5. Mixed use property
6. The value of a tax loss
7. Aspiring farmers and retiring farmers

What makes a farm or ranch business a business?

What make a farm or ranch a business?

Profit motive

- *Annual cash profits*

or

- *Long term increase in net worth due to increase in value of assets*

Ideally you have both.

What make a farm or ranch a business?

- No profit motive = no business = a "hobby"
  - Income is subject to income tax but ***losses can not be used to offset earned income.***
  - Not eligible for many programs designed to assist farmers and ranchers.
  - May still be eligible for conservation programs designed to assist landowners.

The Actual Hobby loss Rule

Show a profit in 3 out of five years or else the burden of proof shifts and you must prove your **intent** to make a profit or defray costs of improving your investment in real property. (You start out with the presumption that you are in it for profit. After 5 years you lose the presumption and you have to be able to make the case to the IRS.)

What make a farm or ranch a business?

How do you show a profit motive?

Run your business like a business!

The hallmarks of this are:

- Ability to articulate a theory about how you are going to sell your product for a price greater than the cost of production, or at a price that makes a material contribution to your overall costs to maintain and improve the property.

  You don't need a formal written business plan, but you need a plan.

- A standard bookkeeping system appropriate to the scale of your operation.
- Regular review of profit and loss and increase or decrease in asset value and adjustments to your business plan to reflect lessons learned.
- Acquiring and continually updating the skill and knowledge needed to run your business.

What is a standard bookkeeping system?

- A check register?
- An Excel spread sheet with a list of your income items and expense items?

Maybe for a year or so. But only if you are really small and don’t really care.

What is a standard bookkeeping system?

- ✓ A “Double Entry” system
  - ❑ A chart of accounts with assets, liabilities, owner’s equity, income and expense
  - ❑ A system of recording two sides to every transaction
  - ❑ A system capable of producing:
    - ❑ a Balance Sheet (Assets – Liabilities = Equity)
    - ❑ an Income Statement (Profit – Loss = Net Income/Loss)

Looking at a balance sheet and an income statement

What are you managing for?

CREATING AND PRESERVING WEALTH

BALANCE SHEET:

ASSETS

minus LIABILITES

equals EQUITY

measured over the life of the business

Assets and Liabilities

ASSETS - have long term value

cash, land, buildings, equipment, trees, vines, breeding livestock

LIABILITIES - amounts owed to others

accounts payable, credit cards payable, wages and payroll taxes payable, mortgage payable, other loans payable, property taxes payable

Assets and Liability

LIABILITY is also a legal term.

- You are personally liable for your debts, and for any number of mistakes you might make.
- If you are a sole proprietor you are personally liable for any debts of your business and any mistakes made by you or your employees, and possibly your contractors and customers.
- Personally liable means that any of your **personal assets**, and any of the assets of your spouse may be used to pay the claim against you. This is also called "unlimited liability" because you – or your spouse – could have your wages garnished for life to settle a claim.

Limited Liability

LIABILITY is also a legal term.

- If you incorporate your business then any judgments against the business can only be settled with the assets of the business. Liability of the business is limited to the balance sheet of the business.
- Your house, your spouse, and your future wages stay out of it.*
- You get to keep your land too if you structured your business properly and kept the land separate.* (More on this later).

** Unless you really done wrong.*

Liquidity

LIQUIDITY describes the relationship between assets and liabilities.

- If you have liquid assets (cash, accounts receivable, inventory you hope) then you can pay current debts (accounts payable) with your current assets. This is the goal.
- If you have poor liquidity you may have spent all of your cash on land and livestock and you have no cash to pay for hay, and you won't sell your livestock for at least six months. You may own assets worth more than your current debts but you still can not pay your current debts without taking out a loan for cash.

Liquidity and Wealth

For many farmers and ranchers, the richer you get the poorer you feel. You are constantly improving the value of your land and paying down long term debt, but you never have any more cash. That's called getting rich the old fashioned way.

Sometimes after a while the farm operation that was building wealth by operating at a profit starts operating at a loss. Then the temptation is to take some of the long term wealth the business created over the years and put it back into the business. That's how farmers go bankrupt and lose everything.

What are you managing for?

OPERATING PROFIT then Annual Income

INCOME STATEMENT:

OPERATING INCOME
minus OPERATING EXPENSE
= GROSS PROFIT/LOSS FROM OPERATIONS
minus OTHER EXPENSES
= NET INCOME
typically measured for a month, quarter or year

What are you managing for?

OPERATING PROFIT

If you can't come up with any scenarios where you have operating income greater than operating expenses then you do not have a viable business plan.

ANNUAL INCOME

If you have operating income greater than operating expenses but then you spend the rest of your cash paying down debt and buying assets and expanding your operation then you are going to be "cash poor" but you might be on the road to building real wealth.

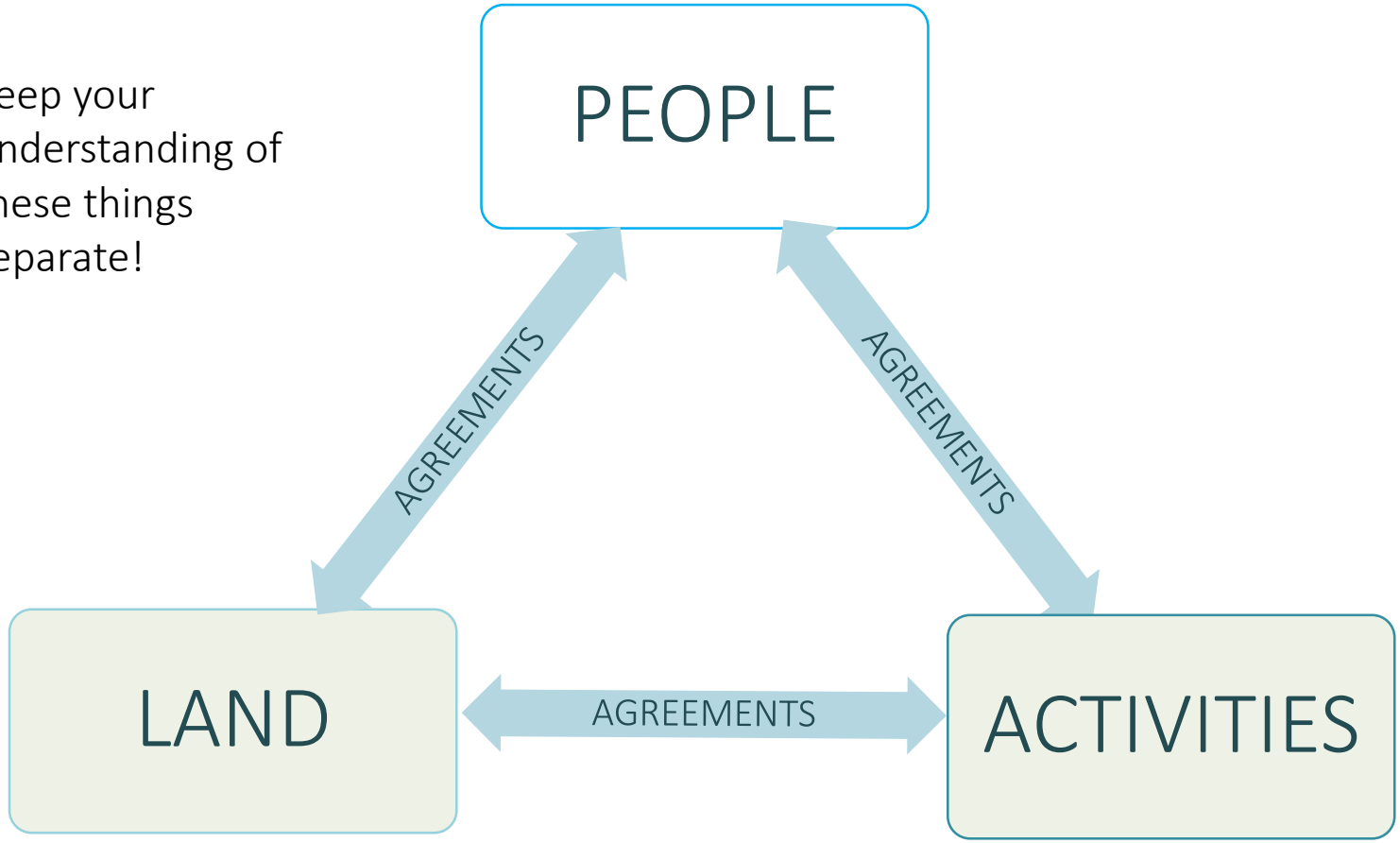
Cash flow

For many farms and ranches annual income is just that – annual. But the bills come monthly. This creates a cash flow problem usually solved with farm credit.

An alternative is a business plan that "smoothes" income over more months.

How do I form a farm or (or other business) with other owners?

Keep your understanding of these things separate!



Structuring for liability

How do I form a farm or (or other business) with other owners?

A "General Partnership" is the default for a business

"If you don't have a plan, the State has one for you." Janie Hipp

- A general partnership may form as soon as you and someone else work together sharing expenses in pursuit of shared profits.
- General partners share each other's unlimited liability. That means your spouse could have wages garnished for life because of something your partner does.

YIKES! How can I get out of the partnership I formed inadvertently?

- If you have contributed unequal amounts and have only been in association in the last year maybe the partner who contributed less is actually an employee?

  You would owe back wages and payroll taxes to your "partner" but it would end the partnership problem.

- Incorporate!

How do I form a farm or (or other business) with other owners?

- Incorporate
  - Cost of attorney fees to incorporate
  - Time and effort to hammer out an agreement
  - **In CA – there is a minimum franchise tax**
  - Additional cost and effort to file a corporation tax return
  - Balance Sheet accounting generally required

How do I form a farm or (or other business) with other owners?

- S-Corp or Limited Liability Company - Which one?
  - Probably an S-corp for tax reasons.
  - There are some limitations on forming or maintaining an S-corporation, so you and your co-owners need to make the decision in consultation with a **knowledgeable** CPA, or an attorney **with a tax practice.**

You may have been told an LLC because people think that owning a farm or ranch business is the same as owning farm or ranch land and you should not put land in an S-corp. This is only half wrong.

- ❑ Own the land separately, perhaps in an LLC. (Don't put land in an S-corp.)
- ❑ Put the business in an S-corp, it saves on income taxes (more later).
- ❑ Have the S-corp pay rent to the land owner (you, you & co-owners, or the LLC) to maintain the separate ownership status of the land protecting it from any claims against the business.

Structuring for taxes

PASSTHROUGH ENTITIES

Partnerships, Corporations electing "S-CORP" taxation, LLCs electing to file as partnerships

ENTITY – 1065 or 1120

Entity REPORTS but does not PAY.

NET TAXABLE INCOME reported to IRS and to owners on a K-1 (like a W-2)

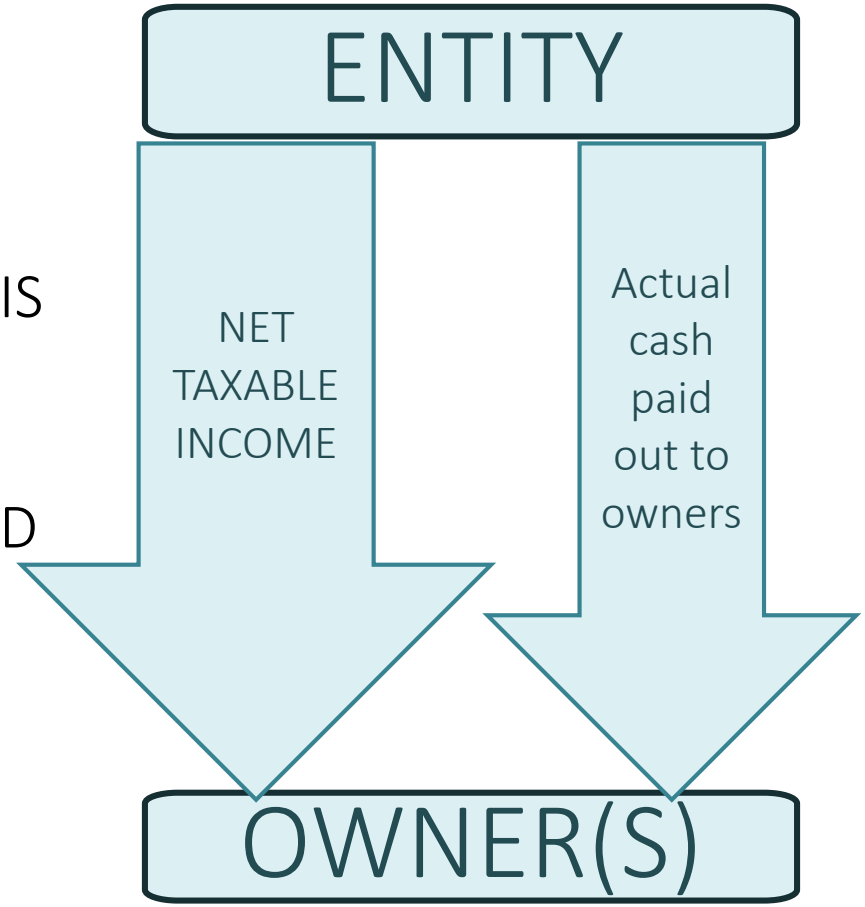
OWNER(S) 1040

Owner REPORTS **and PAYS**

PASSTHROUGH ENTITY

PARTNERSHIPS, S-CORPS, electing LLCs

NET TAXABLE INCOME IS NOT THE SAME AS CASH PAID TO THE OWNER.



Owners may owe taxes on business income but have used that cash to buy assets or pay down debt and thus not have taken home enough cash to pay the tax. Avoid this by doing year-end tax-planning with your CPA.

A NOTE ON PARTNERSHIPS

For tax purposes, profits and losses may only flow to owners in the same percentages as their actual ownership.

Actual ownership percentages are determined by what each partner actually contributed – NOT by what the partners say they want or where they say they are going to end up when the get around to it.

If you say you are 50/50 and report your taxes as if you are 50/50 but you are actually 70/30 you have under and over reported taxes to the partners.

Buying into a partnership with "sweat equity" may involve paying wages to the sweating partner.

Consult a ***knowledgeable*** *CPA or an attorney* ***with a tax practice.***

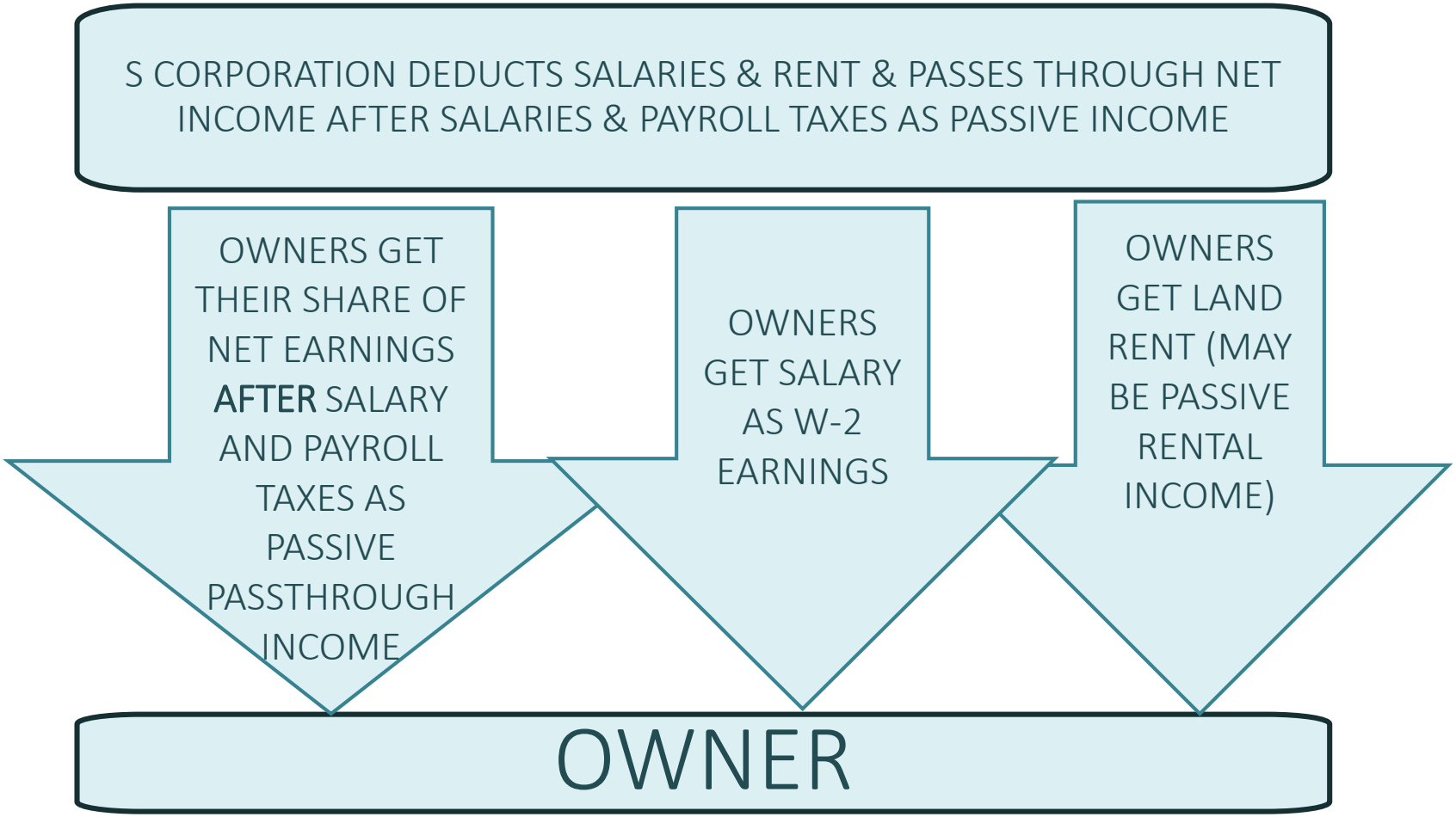
“C” CORPORATIONS

CORPORATE TAX IS PAID ON NET EARNINGS

AFTER-TAX CASH IS PAID TO OWNERS AS TAXABLE DIVIDEND INCOME

OWNER PAYS TAXES ON DIVIDENDS

“S” CORPORATIONS



NOT-FOR-PROFIT (EXEMPT) CORPORATION

NON-PROFIT FILES A 990

INCOME RELATED TO THE ORGANIZATION'S EXEMPT PURPOSE IS EXEMPT FROM TAXATION

NET INCOME FROM AN UNRELATED BUSINESS ACTIVITY IS TAXED AT REGULAR CORPORATE RATED

ANY ONE WHO AUTHORIZES OR RECEIVES AN IMPROPER PAYMET IS SUBJECT TO A 125% PENALTY.

Mixed use property

Home Place on the Farm

The document that forms the basis for allocating purchase price between personal and business is the farm appraisal.

A farm appraisal is done by an expert in farm appraisals and breaks out the different depreciable assets and also breaks out the land assets according to the relative value of the soils.

If there are permanent crops on the land those will also be separately stated as different assets depending on age, variety, yield potential etc. You need a farm appraiser with expertise in valuing permanent crops if there are permanent crops on the land.

Home Place on the Farm

Step 1: Identify Personal and Business Assets

Step One: Use the appraisal to define the assets and to calculate the ratio of personal and business use.							
Per Appraisal page 1		**Total**	**By Asset**		**Personal**	**Farm**	**Total**
Purchase Price		300,000					
Value of House			155,000		155,000		155,000
Value of Barn			20,000			20,000	20,000
Value of Ag Well and Improvements			8,000			8,000	8,000
Value of Apple Trees			7,000			7,000	7,000
Value of Land			110,000				
		300,000	300,000				

Home Place on the Farm

Step 2: Calculate Ratio of Business to Personal Assets

Land Value Allocation	**From Appraisal page 3-4**					
	acres	value/acre	Value			
Acres of prime farmland	15	5,000	75,000		75,000	75,000
Acres of marginal farmland	7	3,000	21,000		21,000	21,000
Acres of Homesite	2	5,500	11,000	11,000		11,000
Acres of access and unfarmable	1	3,000	3,000	240	2,760	3,000
Total Acres	25		110,000			
				166,240	133,760	300,000
				55%	45%	100%

Home Place on the Farm

Step 3: Set up business assets for tax depreciation

Step two: Set the farm assets up to track tax basis and depreciation for the landowner						
Farmland (23 acres)	non-depreciable		110,000			
Barn	20 year GDS		20,000			
Ag Well and Improvements	15 years GDS		8,000			
Apple Trees (1 acre)	10 years GDS		7,000			

Home Place on the Farm

Step 4: Use the ratio to allocate expenses between personal and business

Step three: Determine which expenses will be allocated between Schedule A and Schedule E (for farm rental) or schedule F (for a farm sole-proprietor)							
Things to include:							
Mortgage interest							
Property taxes							
Property insurance							
Things to consider depending on actual use and layout:							
Road maintenance							
Utilities							
Septic							

Aspiring farmers and retiring farmers

Aspiring farmers – there are opportunities for you here!

Beginning farmers - the best time to plan for retirement is NOW!

Retiring farmers – hope this helps!

Don't worry if I lose you – we won't be here long and then I will talk about what to do if you have never filed farm taxes before.

What are the typical challenges a plan needs to address?

For the farm business and the farm land

- Liquidity
- Structure
- Estate valuation

For the family

- Actual equity
- Perceived equity
- Practicability

What are the typical challenges a plan needs to address?

For the farm business and the farm land

Liquidity

- Income for retiring farmers
- Income for incoming farmer

Key challenges:

- *How to get cash out of existing farm or ranch business?*
- *How to get cash out of the land?*

What are the typical challenges a plan needs to address?

For the farm business and the farm land

Structure

- Existing farm business
- Incoming farm business
- Separation of personal assets from farm business (or lack of separation)

Key challenges:

- *Separating the land from the business if this is not already the case*
- *Bringing a new farmer into an existing business*
- *Starting a new farm or ranch business*
- *Winding down an existing farm or ranch business*

What are the typical challenges a plan needs to address?

Remember Estate Tax is generally on a taxable estate in excess of 5.5M

Key is reducing the value of the total estate through special valuations

Farm or ranch business – business valuation

With discounts for fractional ownership interests (IRC § 2704 – rules in flux but some discount will continue)

Example: Ranchers H&W each own 50% of ranch business. They each transfer 10% to children B&G. If H or W passes his or her estate will own 40% of the business and that interest will be discounted because it is a fractional and minority interest.

What are the typical challenges a plan needs to address?

Special Valuation IRC § 2032A

Allowed if 50 percent or more of the gross estate is attributed to real or personal property used by the decedent or a member of the decedent's family for **farming/ranching/timber** for an aggregate of 5 years in the 8 years ending on the date of the decedent's death.

Allows for a valuation based on income producing potential rather than speculative / development value.

What are the typical challenges a plan needs to address?

Key challenges:

- *Reducing the estate during the owner's lifetime*
  - ✓ *fractional ownership of business*
  - ✓ *fractional ownership of the land*

- *Getting the right appraisal by a knowledgeable ag appraiser*

- *MAINTAINING the special use or family business valuation requires ongoing "material participation" for ten years*

Material Participation

Material Participation – To maintain the special use valuation the heirs must show material participation by satisfying ***any one*** of several tests including:

1. **Participated in the activity for more than 500 hours.**
2. Participation was substantially all the participation in the activity of all individuals for the tax year.
3. **Participated in the activity for more than 100 hours during the tax year, and at least as much as any other individual (including individuals who did not own any interest in the activity) for the year.**
4. Materially participated in the activity for any 5 (whether or not consecutive) of the 10 immediately preceding tax years.
5. **Participated in the activity on a regular, continuous, and substantial basis during the year – facts & circumstances test.**

Material Participation

Retired or disabled farmer and surviving spouse of a farmer.

A retired or disabled farmer is treated as materially participating in a farming activity if s/he materially participated for 5 or more of the 8 years before retirement or disability.

A surviving spouse of a farmer is treated as materially participating under similar rules.

2032 A Planning opportunities

Requires the property to be actively used in farming/ranching/timber by a family member who materially participates.

This does not mean only family - a non-family member also materially participating ore even having the main role in farming and management.

In fact…bringing in someone else to keep the farm going might be what allows the family to utilize the 2032A valuation.

2032 A Planning opportunities

Example:

Farmer R does not want the responsibility of the whole operation but wants to stay involved.

Heirs want to keep the land and want to keep the land in farming but do not want to farm full time.

Farmer Y wants to farm but can not afford to buy land, can only afford to buy into a business.

2032 A Planning opportunities

Solution:

- ❑Farmer Y buys into established farm operation.
- ❑Farmer R phases out activity but maintains material participation.
- ❑When Farmer R passes her heirs elect 2032A valuation and continue material participation.
- ❑Farmer Y continues operating the ranching business with the heirs.
- ❑The heirs own the land and partial interest in the ranch business.
- ❑Heirs as landowners get rents from the ranch business and as business owners they get their share of profit or loss.

How do I do my 2016 taxes?

Tax organizer available on the California FarmLink website.

- Use it then go to a preparer
- Use it then sit down with TurboTax, HR Block online, etc.

I am really not farming yet, but I am incurring expenses. Can I ever deduct those?

Yes. In the first year you begin operations with the intent to make a profit you can begin to amortize your start up costs – so keep track of them, even if they add up over several years.

Why should I do my 2016 taxes if I know I didn’t make money?

1. If you acquired a new property you want to get the assets recorded as business assets so you can depreciate them and recover their cost as business expenses.

2. Tax losses are good! They offset earned income dollar for dollar and you can re-invest that savings back into your business.

Questions?

Thank you!

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