# Succession Planning: Introduction and Retirement

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# Problem

- Over half of U. S. adults do not have a will
- A USDA survey published in 2013 found that more than 58% of farm and ranch business owners listed inadequate succession planning as the biggest threat facing their business

# Reasons for lack of planning

- Don’t want to think about death
- Too busy
- Believe their estate is not large enough to require an estate plan
- Unsure of the elements of their plan
- Believe an estate plan is expensive and complicated

# Result of lack of planning

- Legal and family chaos
- Unnecessary emotional turmoil and family distress
- Inordinate conflicts and delays
- Significantly increased legal fees

# Estate Plan

- The documents to effect the succession plan
  - Advance Directive for Health Care
  - Power of Attorney
  - Will or trust
  - Business entity formation
    - Operating or partnership agreement
    - Buy-sell agreement
- May include tax planning
- Program 6/19

# Succession Planning

- Your plan or vision for the future of the farm and who will implement that plan
- Continuous process to transfer knowledge, skills, labor, management, control and ownership to the next generation
  - Handing over control to a child is difficult for some farmers
    - A business entity may be a solution (the last thing a parent wants is for a child to run the business into the ground, especially when that parent is depending on income)

# Succession Planning

- Questions to consider:
  - Is it practical to keep the farm in production
  - Is it important that the farm stay in the family
  - Will your children get along after you are gone
  - If one child is farming they need to be secure in their right to use the land
    - What do non-farming children receive
  - Who manages the farm, pays the taxes, etc.
  - Will the parents be able to maintain their quality of life after the transfer (retirement)

# Retirement Planning

- The best retirement planning is done early in your working life
  - The longer you have, the more options you have
  - Having a plan is more important than ever because today's retirees are living longer
    - A 65-year-old man is expected to live another 17.9 years to age 82.9
    - A 65-year-old woman is expected to live another 20.5 years to age 85.5

# Retirement Planning

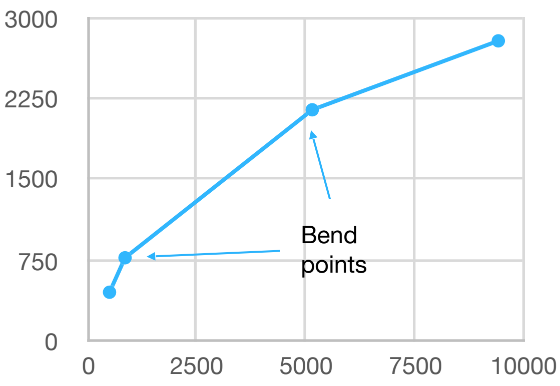
- Primary sources of income
  - Social security
  - Retirement plans (employer-sponsored, IRA’s, SEP’s, etc.)
  - Personal wealth

# How Income Affects Social Security

- The primary insurance amount (PIA) is the benefit a person would receive at their normal retirement age (neither reduced for early nor increased for delayed retirement)
  - PIA is the sum of three separate percentages of portions of average indexed monthly earnings (AIME)
  - AIME is the sum of the highest 35 years of indexed annual earnings divided by 420 (35 years times 12 months)
    - Indexed earnings are an individuals earnings prior to age 60 indexed for inflation using the consumer price index (CPI) for age 60
    - Earnings from age 60 to normal retirement age are not adjusted

# How Income Affects Social Security

- PIA is based on the AIME and is calculated as follows (for 2017):
  - 90% of the first $885 of AIME, plus
  - 32% of the AIME between $885 and $5,336, plus
  - 15% of the AIME above $5,336
  - maximum of $2,888



# How Income Affect Social Security

- For full benefits you must have at least 40 quarters of coverage
  - In 2017 you need $1,300 of earnings per quarter or $5,200 per year
  - Since a 35-year history is used, $0 years reduce your benefit
  - The maximum return is on the first $885 (for 2017); so, it is probably beneficial to have at least a minimal income each year

# Social Security Example

- Farmer Brown's net income from his cattle operation was $72,000
  - He could pay his wife $12,000 in wages and reduce his income to $60,000
    - Farmer Brown pays 7.65% in FICA or $848 on spouse's wages
    - Spouse pays 7.65% in FICA or $848 on the wages
  - Is this a bad economic decision?
  - No, if Farmer Brown had not paid his wife, he would have had an extra $12,000 in income and he would have had to pay the same FICA
  - The only question is whose account is it credited to, Farmer's or spouse's

# Social Security Example

- The Brown's could have AIME's as either
  - All to Farmer Brown
    - Farmer =$6,000
    - Spouse = $0
  - Wages to spouse
    - Farmer = $5,000
    - Spouse = $1,000

# Social Security Example

- The Brown's could have monthly benefits as either
  - All to Farmer Brown or
    - Farmer =$2,433 ($885 * 0.9 + $5,115 * 0.32)
    - Spouse = $0
  - Wages to spouse
    - Farmer = $2,113 ($885 * 0.9 + $4,115 * 0.32)
    - Spouse = $833 ($885 * 0.9 + $115 * 0.32)
    - Total = $2,946
- Result of paying wages
  - An additional $513 per month in retirement
- But wait, don't hang up, I have an even better deal

# Domestic Production Activities Deduction (DPAD)

- Under IRC §199, taxpayers can claim a deduction for a percentage of their net income from qualified domestic production activities
- DPAD equals the smaller of
  - 9% of taxable income derived from qualified production activities income
  - 9% of taxable income or
  - 50% of Form W-2 wages paid by the taxpayer

# DPAD example

- Farmer Brown had $60,000 of income from his cattle operation
- He paid his wife $12,000 in W-2 wages
- His DPAD deduction is the lesser of
  - $5,400 (9% of $60,000) or
  - $6,000 (50% of W-2 wages of $12,000)
- If Farmer Brown’s marginal income tax rate is 15% he would save
  - $810 in income taxes (15% of $5,400) each year

# Long-term care insurance

- If you are self-employed, you may deduct, within limits, your long-term care premiums (not as Schedule A itemized deduction, but as Schedule F)
  - This could save you 15 or 25% based on your marginal tax rate

# Retirement Plans

- The second source of income is from retirement plans (contributions from earned income that reduce taxable income)
  - IRA (individual retirement account)
    - For individuals
    - Contribution limit is $5,500 with phase-out
  - SEP IRA (simplified employee pension)
    - Employer or sole proprietor
    - Contribution limit is 25% of gross income up to $53,000
  - SIMPLE IRA (savings incentive match plan for employees)
    - Contribution limit is $12,500 plus 3% employer contribution

# Personal Assets

- The third source of income is from personal assets you have accumulated
  - Savings and investments
  - Farm

# Farm

- Do you sell the farm or give it to your children?
  - To be able to gift the farm land and equipment to your children you will need to have assets that can provide retirement income and, probably, long-term care insurance to finance end-of-life care
    - How and when to transfer the farm will be covered in the estate planning program on 6/19
  - The other option is to sell the farm to one or more family members or someone outside the family

# Selling the Farm

- Many farmers invest everything they can into their farm and equipment and it is their largest asset and their retirement plan
  - At retirement the land and equipment have to be sold and the money reinvested into an income-producing asset
  - Selling assets for more than their basis generates taxable income
  - To compound the problem, if all the assets are sold in one year the farmer may find himself in a higher income tax bracket

# Example

- John and Mary Farmer
  - Mary is a substitute teacher and earned $8,712 in 2015
  - John had a net farm income of $60,539
  - With deductions and exemptions they would normally pay $5,359 of income tax and $8,554 of FICA for a total tax liability of $13,913
  - John has been farming for 30 years and has the assets listed on the next slide

| Asset Description | Market Value | Cost Basis | Accumulated Depreciation | Adjusted Basis | Gain/Loss | § 1245 Re-capture | § 1231 Gain |
|---|---|---|---|---|---|---|---|
| Purchased breeding livestock | 25,000 | 27,500 | 20,250 | 7,250 | 17,750 | 17,750 | |
| Machinery & equipment | 425,000 | 525,000 | 435,525 | 89,475 | 335,525 | 335,525 | |
| Single-purpose structures | 100,250 | 125,000 | 88,750 | 36,250 | 64,000 | 64,000 | |
| Total depreciable assets | 550,250 | 677,500 | 544,525 | 132,975 | 417,275 | 417,275 | |
| Raised breeding livestock | 175,000 | 0 | 0 | 0 | 175,000 | | 175,000 |
| Farm & pasture land | 535,750 | 125,500 | 0 | 125,500 | 410,250 | | 410,250 |
| Total land &livestock | 710,750 | 125,500 | 0 | 125,500 | 585,250 | | 585,250 |
| Total assets | 1,261,000 | 803,000 | 544,525 | 258,475 | 1,002,525 | 417,275 | 585,250 |

# Section 1245

- Gains from disposition of depreciable property
  - The amount by which the fair market value of property exceeds its adjusted basis shall be treated as ordinary income
  - The income has to be claimed in the year of disposition even if the assets are sold under an installment method
  - If the $1,261,000 of assets are sold in one year the marginal tax rate would be 39.6%
    - That means that their capital gains rate is 20%

| Category | No Sale | With Sale | Percent |
|---|---|---|---|
| Mary's wages | 8,712 | 8,712 | |
| Farm income | 60,539 | 60,539 | |
| Depreciation recapture | | 417,275 | 486,526 |
| Capital gain | | 585,250 | 585,250 |
| Gross income | 69,251 | 1,071,776 | |
| ½ of SE tax | 4,277 | 4,277 | |
| AGI | 64,974 | 1,067,499 | |
| Standard deduction | 15,100 | 15,100 | |
| Exemption | 8,000 | 0 | |
| Taxable income | 41,874 | 1,052,399 | |
| Tax on ordinary income | 5,359 | 130,907 | 26.9% |
| Tax on capital gain | | 117,050 | 20.0% |
| Alt. min. tax | | 415 | |
| SE tax | 8,554 | 8,554 | |
| Total tax | 13,913 | 256,926 | |

# Taxes owed (2015)

- Tax return calculated using Drake 2015 Tax Software
  - Taxes without the sale: $13,913
  - Taxes with the sale: $256,926
  - Additional taxes because of the sale: $243,013

# Strategies to reduce income taxes

- Spread sale over multiple years to lower annual income and thus the marginal tax rate
  - Land can be sold on an installment sale
  - Problem with 1245 property
    - Contribute assets to a limited partnership
    - Lease the equipment
- You should consult a tax professional and financial planner before making your decisions

# Conclusion

- Do you have a successor to manage the farm
  - Are you developing that individual
- Have you acquired the right type and amount of assets to retire comfortably