Transitioning Your Farm to the Next Generation

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Today's Agenda

- Why is Planning Important?
- Succession Planning Objectives
- Succession Strategies
- Legal House in Order
  - Business Documents
  - Estate Planning Documents
- Transfer Tax Considerations
- Gifting Strategies for the Family Farm
- Signs of Successful Transition

What is Succession Planning, exactly?

"We all must exit at some point."

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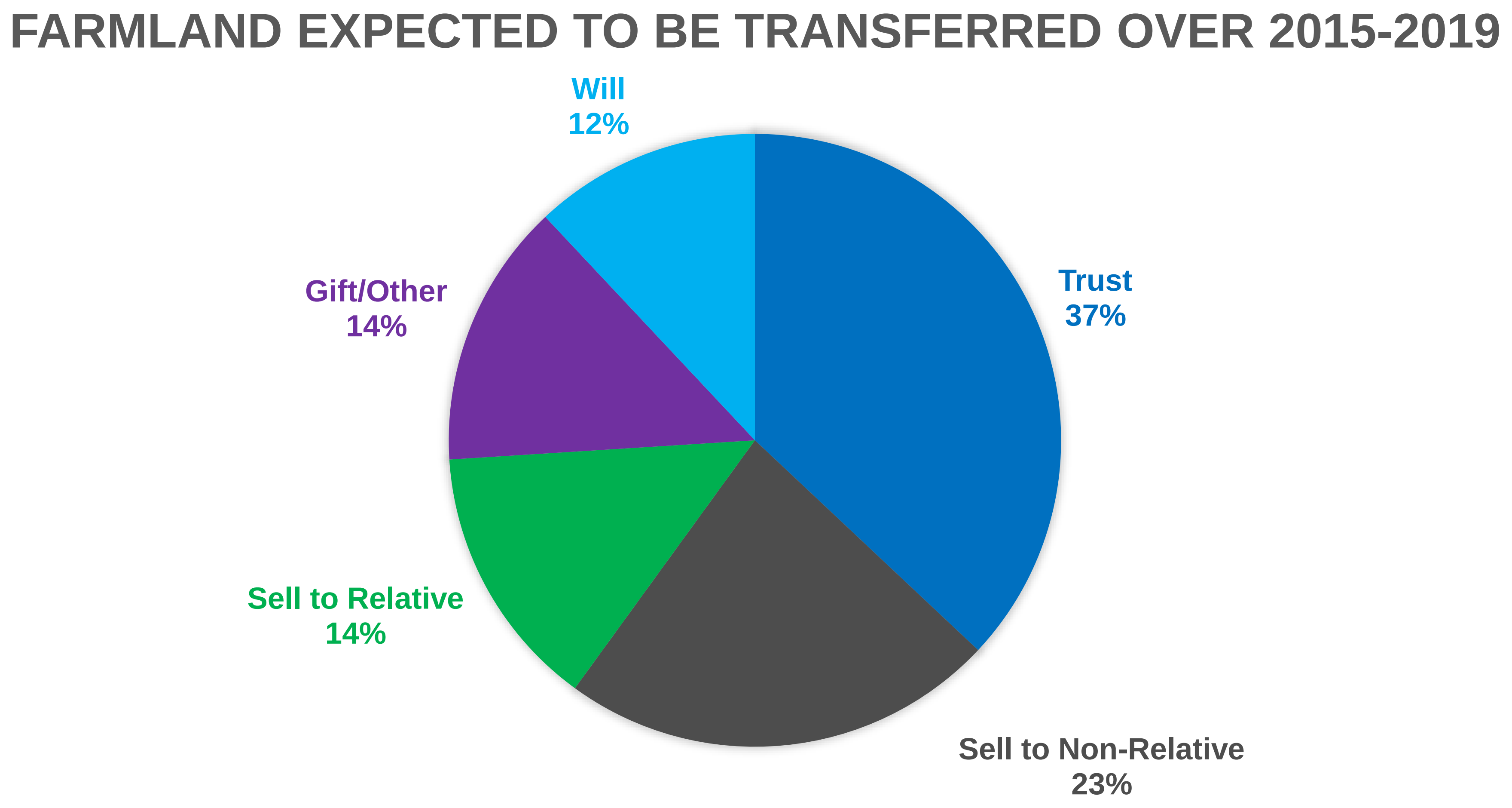
Survival of the Family Owned Farm

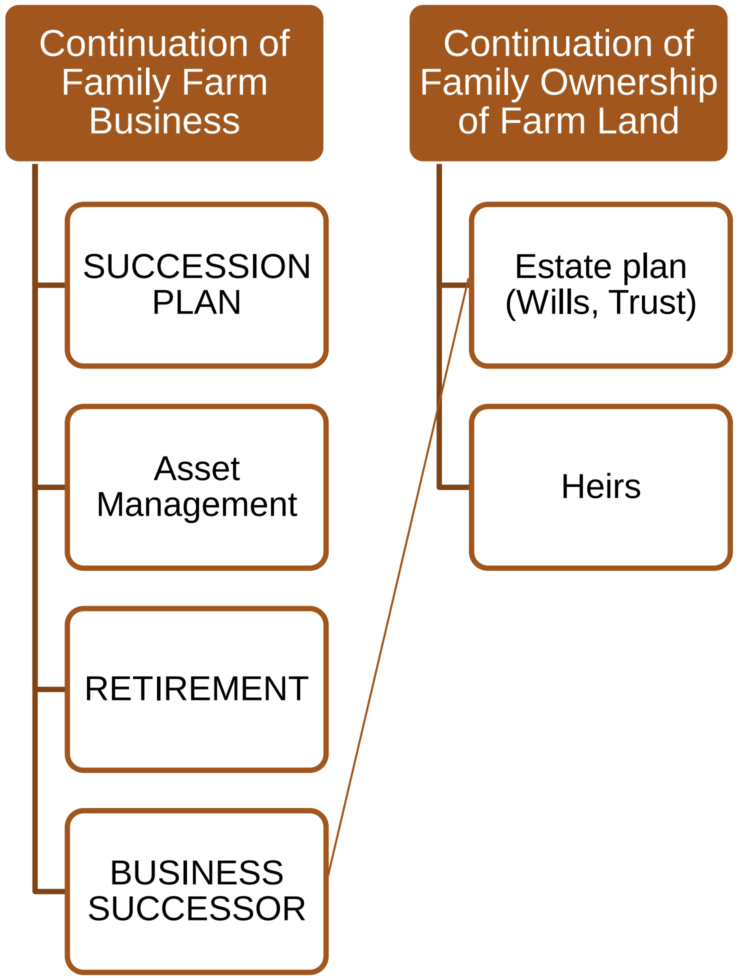
- Over **80%** of U.S. businesses are family owned
  – Generates over **60%** of country's GDP
  – Employs over **half** of the country's workforce
- Intention to pass the business to the next generation
  – **52%** intend to pass the business on to the next generation to own and run
  – **24%** intend to pass the business on to the next generation to own but not run
- Approximately **30%** of family-owned businesses survive past the first generation; **12%** past second.
  – When a business is sold to a *non-family member, 70% chance of success*

Sources: SBA; Family First Institute, Inc. – Global Data Points; PwC Family Business Survey 2012/2013; Harvard Business Review 2012

If You're Transferring Land…How Are You Going to Do It?



Isn't an Estate Plan Enough? Maybe…What is Your Priority?



Source: Dr. John Baker
Iowa Beginning Farmer Center

Multiple Issues to Address Before Exit

No-Plan Plan

1. Work

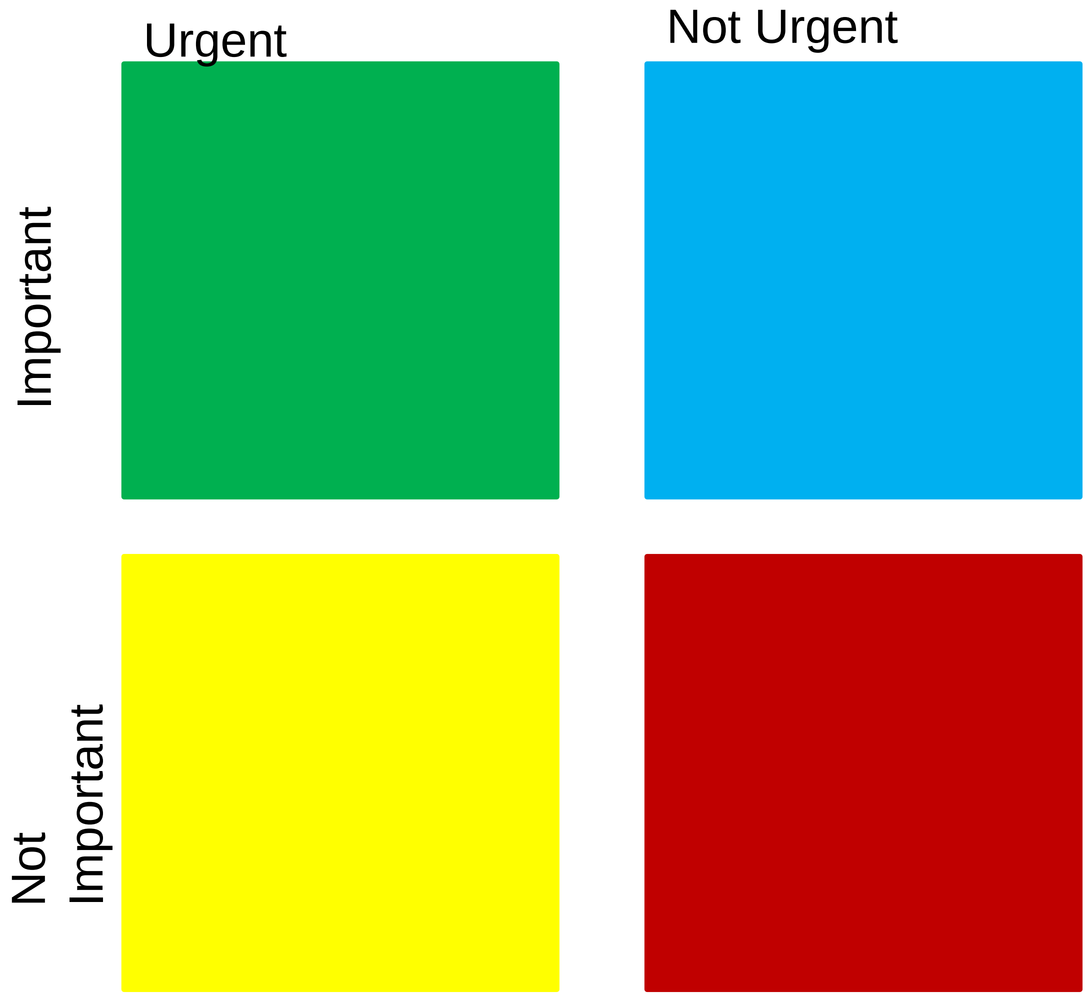
2. Die

Average Farmer and Succession Planning

- Average age of U.S. Producer – 59 years old (2017 Census of Agriculture)
  - 66% of primary farm producers are 65 years old +
  - Only 17% of U.S. farmers surveyed said they **planned to retire 5 years later**
    - Of those, **53% have no succession plan**
    - Of the 47% who do have a succession plan, **only 19% have a successor that is currently working on the farm**
- 40% percent of the nation's agricultural land – 370 million acres – is owned or operated by seniors

Sources: 2017 Census of Agriculture; National 2014 Tenure, Ownership, and Transition of Agricultural Land Survey

Why so little planning? Eisenhower Matrix



- Uncomfortable – can lead to family conflict, talking about money, giving up control
- Overwhelming – complex tax and legal considerations, financial strain, time commitment, no good solutions seem obvious
- Expensive -- $$$ for advisors.
  - Consider mediation services to get started!

Goal of Farm Succession Planning

The goal of farm succession planning is to have as little disruption to the farm (and family) as possible in the event of an owner’s incapacity or death.

Common Disasters

- Sibling rivalry or other difficult family dynamics (in-laws)
- Loss of farm for lack of liquidity
- Lack of developed talent to take over farm (or talent leaves)

Common Disasters, pt. 2

- Lack of formalized plan to transfer ownership to heirs or other successors
- Loss of farm to estate taxes
- Sudden event puts farm in a bind
    - Forced to make reactive choices

Hit by a Bus

Best Case Scenario:

1. There is a succession strategy in place
2. There is a qualified and willing successor
3. There is an estate plan in place to manage assets
4. There is a business transition strategy in place

Result: Seamless transition

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Worst Case Scenario:

1. There is no plan in place
2. There is no willing and qualified successor
3. There is no liquidity

Result: *The farm crashes*

Objectives of Succession Planning

- Secure the future of the farm and employees
- Make the transfer of business efficient
- Transfer the business at the least cost (Income, Estate and Transfer Taxes)
- Provide income for 1st Gen., post-retirement
- Keep the business in the family
  - Training children to run business
  - Protecting business from divorce
- Treat children fairly (as opposed to equally)
- Protect your Legacy

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Succession Strategies

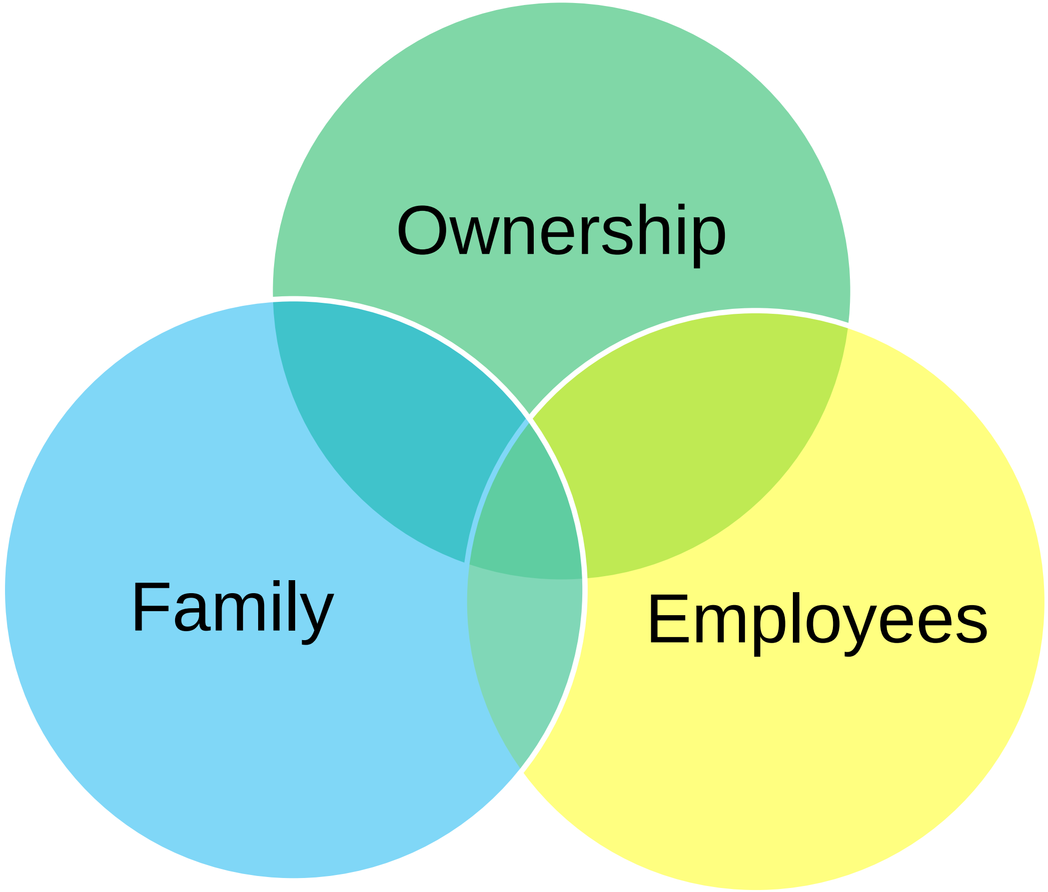
Strategy 1	**Strategy 2**	**Strategy 3**
Pass to Relative	Develop Internal Person	Hire Outside Person

Succession Strategies

"A clearly communicated plan . . . signals that the Company is here to stay."

Source: PwC Family Business Survey 2012/2013

Identify Roles – Now, and Later



Who is Entitled to What?

- Owners: Return on investment
- Employees: Fair compensation for Time
- Family: Love and respect

Source: Wesley Tucker

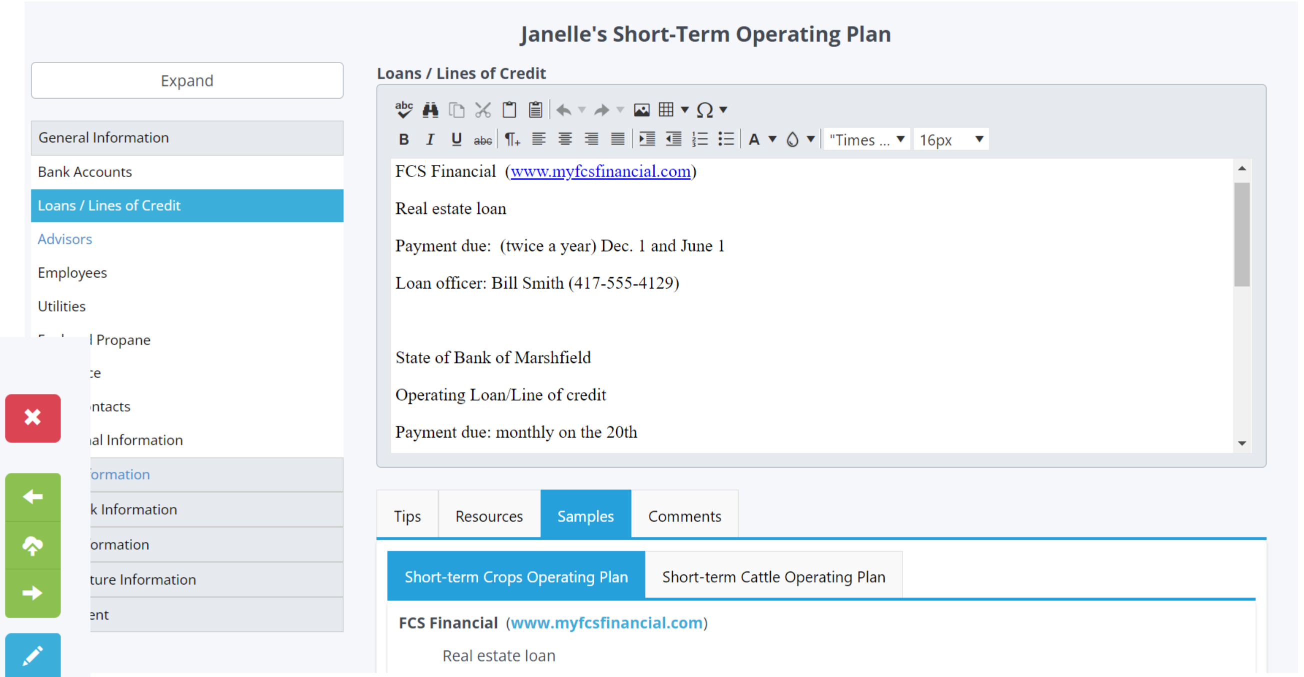
Succession Strategies – Create a Roadmap

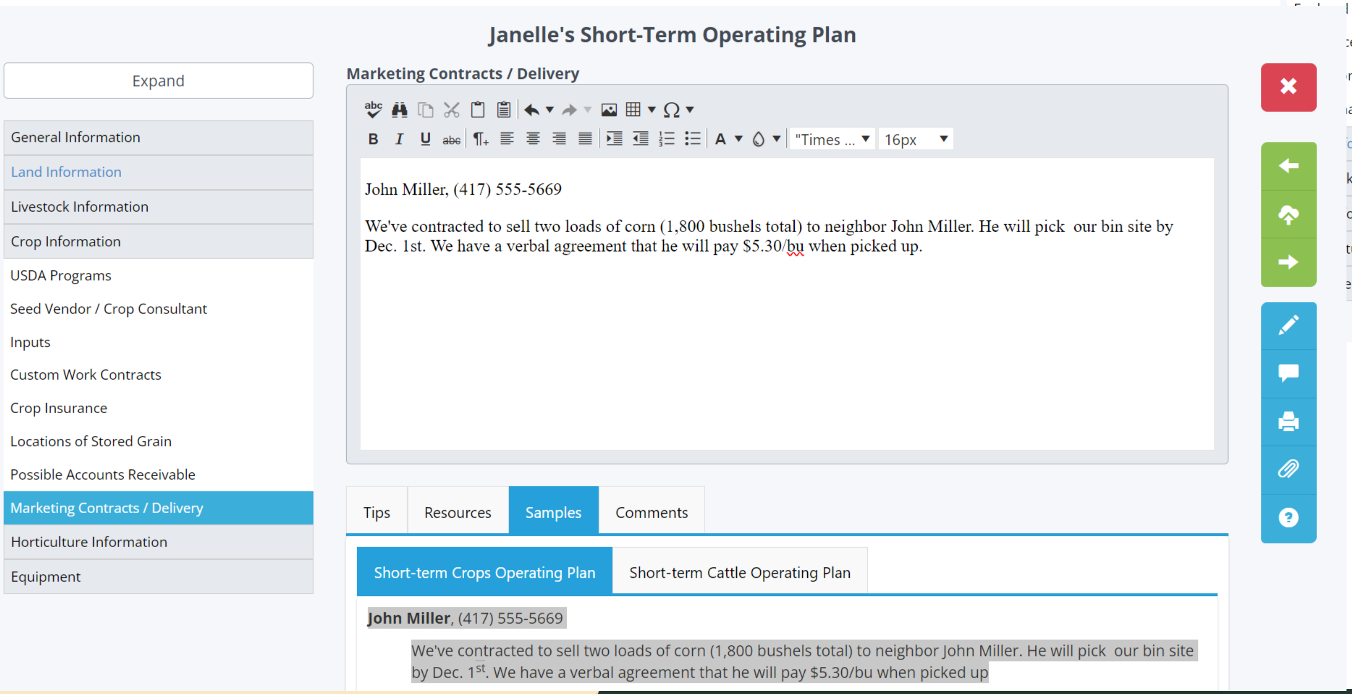
2025	2027	2029	2031	2043
1. Seek Experience Away From Home	2. Work for a Trial Period on Farm	3. Begin Taking On Some Ownership and Management Duties	4. Accept **Advanced** Ownership and Management Duties	5. Become the Majority Manager and Owner

Source: Wesley Tucker, Missouri University Extension

Short-Term Operating Plan

- Agplan.umn.edu





Workbook from: Landforgood.org/how/transitioning-farmers

TABLE OF CONTENTS

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YOUR CURRENT SITUATION • WORKSHEET #1

Describe your farm business. What are the enterprises? What is the overall financial picture? (When you get deeper into your planning, you'll collect more detailed financial information.)

What type of entity is your business (for example, sole proprietorship or LLC)? And how is the real estate held?

How would you assess the health of the operation? Is it a viable business? What are the threats and stressors?

Continued...

1

Assess Current Situation

THE FIRST STEP IS TO TAKE STOCK.

It is harder to know where you want to go if you don't know where you are. This step involves gathering information and answering key questions. It is good practice to keep your relevant documents and records in a file.

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DOCUMENT CHECKLIST • WORKSHEET #3

HAVE IT ✓		WHERE IS IT?
	Will (☐ Updated in the last five years)	
	Power of Attorney for finances	
	Power of Attorney for health care	
	Health care proxy/living will	
	Health records, other vital health information & providers	
	Birth, death, marriage, divorce certificates/decrees	
	Current LLC/corporation/other operating agreement(s)	
	Property deeds including legal property description	
	Current tax returns	
	Contracts, leases, promissory notes & other signed agreements (including employment)	
	Loan documents (you owe & owed to you)	
	Title to vehicles, farm equipment etc.	
	Payroll & business personnel documents	
	Financial statements/reports, including personal investments, retirement, etc.	
	Trust documents	
	Insurance policies (life, health, vehicle, other)	
	Bank statements & account information	
	Easement documents	
	Other:	
	Other:	
	Other:	

It will be really helpful to know where these documents are located.

Make sure they are up to date when the time comes to meet with your advisors.

You may not need every document listed here.

"The best gift my parents ever gave me was a binder of all their important documents compiled."

– LFG Farm Succession School participant

2

Land for Good

Clarify Vision, Values & Goals

YOUR VALUES WILL GUIDE AND INFLUENCE YOUR GOALS.

Every good plan is built on a set of values. What is important to you, your family, your farm and your land? What drives your decisions and preferences? Your transition goals emerge from your big-picture vision. What do you want to happen to the farm and the land? What do you want your legacy to be?

3

Involve Family & Advisors

GET THE PEACE OF MIND YOU AND YOUR FAMILY DESERVE.

It is probably no surprise that family can be one of the biggest challenges in succession planning. Spouses, siblings, parents, and children do not always see things the same way, nor have the same goals. Some topics may be never discussed openly – for example challenges with in-laws, mental health concerns, or disgruntled employees. Family matters can derail the planning process. But they don't have to.

Some farmers benefit from bringing on a neutral person as a coach or facilitator. You may want a trusted friend, clergy member, Extension educator, agricultural mediation professional, or paid consultant to support the process. They can guide family meetings, help resolve conflicts and point out accomplishments. They may also coordinate your advisor team and help keep you on track with your planning benchmarks.

4

Implement Your Plan

LEARN HOW TO MOVE FORWARD FROM HERE.

Most farmers benefit from a supportive team of advisors throughout the planning process and at key points when implementing the transfer. You likely won't need all the advisors in this list. Your attorney and other advisors will be more efficient if you have gathered background information and clarified your goals in advance.

BUILDING YOUR TEAM • WORKSHEET #10

Who is on Your Advising Team?

TYPE OF ADVISOR	NAME (if identified)	PLAN TO OBTAIN (if needed)
Attorney *(real estate, estate planning, tax, elder care)*		
Financial advisor		
Farm business management consultant		
Accountant/tax planner		
Land use planner *(NRCS, landscape design, etc.)*		
Land trust/conservation organization		
Lender		
Facilitator/succession coach		
Mediator		
Insurance agent		
Realtor		
Appraiser (land, business)		
Health care planning specialist		
Other		
Other		

Continued...

Family vs. Business Matters

Family business (emotion-oriented)	Business family (results-oriented)
Emotion-based	Task-based
Mission to nurture offspring	Mission to produce goods & services
Equality	Competency
Unconditional acceptance	Acceptance based on performance
Relationships are permanent	Relationships are contractual
Power tied to generation/birth order	Power based on authority & influence

Who to Include in Your Succession Plan?

Lawyers

Estate planning

Corporate

Financial Planner

Accountant (CPA)

Insurance Agent

Successor(s)

Legal House in Order: Business Documents

Business Documents

- Bylaws
- Shareholder or Operating Agreement
- Board meetings and minutes
- Permits and licenses

Planning Note: Lack of legal organization can delay or derail transactions and stymie confidence of successors.

Ex: Sale of Business … Need Letters of Authority

Uncapping of Property Taxes

- Qualified Agricultural Property Exemption

The percentage of a parcel that is devoted to agricultural use is calculated based on the portion of the parcel's **total acreage,** including any area(s) covered by an easement or right-of-way for road or drain purposes, that is devoted to agricultural use, **not** the portion of the parcel's **tillable acreage** that is devoted to agricultural use.

Example: A 15-acre parcel is classified residential. Of the parcel's 15 acres, 4 acres are tillable and are devoted to an agricultural use. The remaining 11 acres are not devoted to an agricultural use. The parcel is not eligible for the qualified agricultural property exemption since the parcel is not classified agricultural and only 26.7 percent of the parcel is devoted to a defined agricultural use, even though 100.0 percent of the tillable acreage of the parcel is devoted to a defined agricultural use.

What is the Qualified Agricultural Exemption?

MCL 211.7ee provides for an exemption from certain local school operating taxes, typically up to 18 mills, for parcels that meet the qualified agricultural property definition.

> (1) Qualified agricultural property is exempt from the tax levied by a local school district for school operating purposes to the extent provided under section 1211 of the revised school code, 1976 PA 451, MCL 380.1211, according to the provisions of this section.

Qualified Agricultural Property is further defined in MCL 211.7dd as:

> (d) "Qualified agricultural property" means unoccupied property and related buildings classified as agricultural, or other unoccupied property and related buildings located on that property devoted primarily to agricultural use as defined in section 36101 of the natural resources and environmental protection act, 1994 PA 451, MCL 324.36101.

A parcel is qualified agricultural property through one of two ways:

1. Classification of the parcel as agricultural on the current assessment roll **or**
2. Devotion of more than 50% of the acreage of the parcel to agricultural use (described below) as defined by MCL 324.36101.

In addition to the up to 18 mill exemption, a transfer of qualified agricultural property is not considered a transfer of ownership if both of the following are true:

1. The property remains qualified agricultural property after the transfer **AND**
2. The new owner files Form 3676 with the assessor and the register of deeds. This form, available in the appendix, is an affidavit attesting that qualified agricultural property shall remain qualified agricultural property.

How does Property Qualify for the Exemption?

In order to qualify for the exemption, owners of parcels that are not classified agricultural must file an affidavit, Form 2599, claiming the exemption with the local assessor by May 1.

An assessor will use the status of the land on May 1st in making their determination for qualification. In situations where the land may not be actively farmed on May 1, the parcel may still be eligible for the exemption. For example, the land may be intentionally left fallow or the growing season for a crop in some parts of the State may begin after May 1, etc.

Uncapping of Property Taxes - Residential Property

Transfer of Ownership Definitions

What is a transfer of ownership?

Central to the concept of transfer of ownership is a **change in the beneficial use** of the property. Michigan statute defines "transfer of ownership" generally as the conveyance of title to or a present interest in property, including the beneficial use of the property, the value of which is substantially equal to the value of the fee interest. MCL 211.27a(6)(a)-(j) provides a variety of examples of what constitutes a transfer of ownership for taxable value uncapping purposes. If a transfer of property (or ownership interest) meets one of these definitions and does not fall under one of the exceptions or exemptions noted in the law, that transfer is a transfer of ownership. Transfer of ownership definitions and transfer of ownership exceptions are contained in MCL 211.27a(6)(a)-(j) (*See appendix*). Transfer of ownership exemptions are contained in MCL 211.27a(7)(a)-(x). (*See appendix*)

Is a conveyance of property which constitutes a distribution from a trust a transfer of ownership?

Yes. However, there are two exceptions when a distribution from a trust is not a transfer of ownership. A conveyance of property which is a distribution from a trust is not a transfer of ownership if the distributee is also the sole present beneficiary of the trust or the spouse of the sole present beneficiary or both. *See MCL 211.27a(6)(d)(i).*

Beginning December 31, 2014, a distribution of residential real property to a distributee who is the trust's settlor or the settlor's spouse's mother, father, brother, sister, son, daughter, adopted son, adopted daughter, grandson, or granddaughter and the residential real property is not used for any commercial purpose following the conveyance is not a transfer of ownership. *See MCL 211.27a(6)(d)(ii).*

Note: Not all transfers of property from trusts are distributions from the trusts. A transfer of property from a trust to someone other than a beneficiary (or contingent beneficiary) of that trust is **not** a distribution from that trust. It is simply a transfer of property from a legal entity (the trust) to a person and the transfer should be considered in that context.

Step-Up In Basis on Death

What Is the Step-Up In Basis?

The step-up basis is a provision in federal tax law. It determines how assets are valued for calculating capital gains taxes when a person passes away, leaves these assets to heirs, and those assets are sold.

So, for example, imagine a person passes away and leaves their home to their children through their will.

When the children inherit the property, the home's cost basis changes. ("Cost basis" is the amount for which an item is originally purchased.) The home's cost basis is adjusted – or "stepped up" – from what it was valued at when the parent originally purchased the home to its fair market value on the date the parent died.

In this case, suppose the original cost of the home 30 years ago was $100,000, and the "stepped up" basis in 2022 (date of death) is $300,000.

If the children then sell the home for $500,000, the resulting capital gains liability is calculated by subtracting the stepped-up basis from the sale price. This determines the children's taxable gain ($500,000 – $300,000 = $200,000 gain). The effect is that the capital gain between the original purchase of the home and the children's receipt of it is eliminated.

In other words, without the step-up in basis, the children who inherited the property would have had a considerably higher taxable gain after the sale ($500,000 – $100,000 = $400,000 gain). As a result, they would then have potentially had to pay more in capital gains tax.

Legal House in Order: Estate Plan

Control of Business Upon Incapacity or Death

- Are the necessary documents in place to name an individual to act on your behalf?
  - Incapacity:
    - Agent in Durable Power of Attorney
  - Death
    - Personal Representative in Will
    - Trustee in Trust
- Is the designee capable of running the business?

Coordination of Planning

- Coordinating Business Succession Plan with Estate Plan
  - Fiduciaries during estate/trust administration
  - Distribution of business (or control of business) to active family members
  - Stock or membership interests transferred to trust
- A lack of coordination can have devastating effects on your business and family

Coordination of Planning

- Having one or more entities involved makes it easier to transition the family farm to the next generation.
  - Easier to control voting rights among owners and to otherwise provide for management of the farm.
  - Ability to separate ownership from management by having voting and non-voting interests.
  - May make it easier to treat farm and non-farm children equally by virtue of giving non-voting interests to non-farm children.
  - To provide liquidity and to ensure an exit strategy for owners.

Buy-Sell Agreements

- The organizational documents (Buy/Sell Agreement) for the entity(ies) may define triggering events which are specifically agreed upon events giving rise to an optional or mandatory sale.
- Each event raises the central questions:
  - Should the affected owner keep his/her interests?
  - Should the remaining owner(s) have an optional or mandatory call right?
  - Should the departing owner have an optional put right?

Lifetime Transfer Restriction

- Absent a valid transfer restriction, any owner could transfer his or her interest to a third party at any time for any amount of consideration.

- A lifetime transfer restriction is triggered if any owner transfers his or her interests either voluntarily or involuntarily during his or her lifetime.

- <u>Usually the non-transferring owner(s) receives an option to purchase interests of a transferring owner (a right of first refusal)</u>.

Death

- Are the heirs of the decedent are allowed to become, or do they want to become, successor owners?
- Does the decedent require liquidity in his/her estate?
- The entity and/or the remaining owner(s) may have either an optional or mandatory right to purchase the shares of the deceased owner.
- The agreement may give the decedent's estate a put option. A put option is appropriate where the remaining owners are willing to accept the decedent's heirs as owners or buy them out.

Incapacity

- Incapacity may or may not be a trigger depending on owner expectations regarding each other's involvement in the business.
- Furthermore, depending on a particular owner's involvement in the business, incapacity may provide for an optional or mandatory buyout of an owner's interest in the entity.

Transfer Tax Consideration

- No Michigan Estate or Gift Tax
- Federal Estate and Gift Tax 2018-2025:
  - BEA of $13,990,000 per person (2025)
  - Assets transferred in excess of BEA taxed at top rate of 40%
  - Portability of unused exemption between spouses
  - $19,000 annual gift tax exclusion
- 2026 and Beyond:
  - Estimated ~ $7,000,000 (absent new legislation)
    - $5,000,000 exemption, plus COLA from 2010

Transfer Tax: 2025 Planning Opportunity Before Sunset

If the drop in exemption could impact your estate, complete gifts and sales of farm to members of your family or to trusts for the benefit of family members before 2026.

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Strategies to Reduce Estate Tax Issues

- Primary Gifting Strategies:
  - Irrevocable Trusts
    - Grantor Retained Annuity Trust
    - Sale to a Defective Trust
  - Limited Liability Company/Family Limited Partnership
    - Voting/Non-voting shares
    - Manager
    - Discounts
- Solutions to Liquidity Issues:
  - Life Insurance

Disagreement and Divorce

- How will the owners resolve disagreements?
- Will a family member (mom or dad?) resolve disagreement? A third party?
- Protection against divorce and attachment by creditors is also important.

Purchase Price and Payment Terms

- How will the interest be valued?
  - Book value?
  - Appraisal?
  - Some other formula?
  - Agreed value? Probably most common with an appraisal as a back-up if agreed value is not kept current.
- What are the payment terms?
  - Life insurance to fund upon death?
  - Cash down payment with balance payable pursuant to a note.

Life Insurance

- Provides income replacement for family
- Provides necessary funds to pay off (or reduce) debt level
- Provides liquidity to pay costs of estate/trust administration (including estate taxes) without having to sell farm assets
- Can help equalize distributions to descendants or to provide assets to non-farm descendants

Using Entities for the Family Farm

- Generally, want to separate the farming operation from the farm land.
  - Farming operation should be in an entity with limited liability to the owners/members. Usually an LLC, especially because you can choose desired tax treatment. The "operating entity."
  - Land ownership should be in an LLC. This allows for division of ownership to be transferred more easily to descendants and potentially allows some savings on self-employment taxes. The "land entity."
  - Separate non-farm business(es) into separate entity(ies)

Other Issues to Consider

- Tax advantage of annual gifting. For 2025, the annual gift exclusion is $19,000. If the farm operation or land is in a closely held entity, the gifts can receive discounts of up to 35%, so can actually gift more.
- Loan funds to farm children. Once you are at a certain estate level, it makes sense to loan funds to children to purchase farm land or other investments.
- Have child purchase new assets directly. Pride of ownership is created.
- Sell assets to farm children during lifetime. Capital gains is an issue though.

Typical Farm Structure

Haggadone Farms

- No entity, just a sole proprietorship. Own all tractors, machinery and equipment utilized in the farm in individual name.
- Own all farmland as tenants by the entireties with spouse.
- Disadvantages: unlimited personal liability, difficult to plan for the next generation, unable to minimize self-employment taxes, etc.

Better Farm Structure

Haggadone Farms, LLC

- This entity owns all of the tractors, machinery and equipment utilized in the farm.
- This entity could be disregarded for tax purposes or could elect to be an S Corp to reduce taxes.
- The "Operating Entity"

Land

- Land continues to be owned by husband and wife as tenants by the entireties.

  (Consider ladybird deed)
- Trust becomes owner on $1^{st}/2^{nd}$ death, and provides for distribution of real estate after death of husband and wife.

Best Farm Structure (Ex. 1)

- **Haggadone Farms, LLC**
  - This entity owns all of the tractors, machinery and equipment utilized in the farm.
  - This entity could be disregarded for tax purposes or could elect to be an S Corp to reduce taxes.
  - The “Operating Entity”

- **Haggadone Land, LLC**
  - This entity owns the agricultural land and leases the land to the Operating Entity.
  - This entity could be disregarded for tax purposes or taxed as a partnership.
  - The “Land Entity”

Best Farm Structure (Ex. 2)

Haggadone Farms, LLC

- This entity owns all of the tractors, machinery and equipment utilized in the farm.
- This entity could be disregarded for tax purposes or could elect to be an S Corp to reduce taxes.
- The "Operating Entity"

Haggadone Land, LLC

- This entity owns the agricultural land and leases the land to the Operating Entity.
- This entity could be disregarded for tax purposes or taxed as a partnership.
- The "Land Entity"

Haggadone Housing, LLC

- This entity owns the migrant housing used in the farm.
- This entity could be disregarded for tax purposes or taxed as a partnership.
- Own assets or businesses that pose liability risk to larger farm enterprise (trucking, excavating, spraying).

Important Decisions to Make

- If you have farm and non-farm children, how will your assets be distributed?
  - Fair is not always equal and equal is not always fair
- Will all of the farm assets be distributed to the farm children?
- Do you have sufficient non-farm assets so that non-farm children are treated equally?

Distribution Options

- Scenario 1: Farm and Significant Non-Farm Assets
  - Distribute operating entity to farm children with non-farm children receiving other assets (investment accounts, home in Florida, etc.). Land entity can be used to equalize distributions or provide farm children the option to buy the "excess" assets from non-farm children.
  - Consider investing in life insurance to equalize assets to non-farm children.
- Scenario 2: Mostly Farm Assets
  - Distribute operating entity to farm children with land entity distributed to farm and non-farm children. Non-farm children receive rental income from farm land with option in favor of farm children to buy out the non-farm children.

Distribution Option

- Assets
  - Land
  - Farm Operation
  - Home
  - Savings & Other Assets
  - Life Insurance

- Land, LLC — Land & Debt
  - To Non-Farm Children with option to buy?
- Operating, LLC — Equipment, Crops & Debt
  - To Farm Children
- Home
  - To Farm Children or to all?
- Savings & Other Assets
  - To Non-Farm Children?
- Life Insurance
  - To Non-Farm Children?

Signs of a Successful Transition:

Family/Employees/Customers are Happy!

Signs of a Successful Transition

- Succession or sale completed
- Seamless for those involved and those affected
- Mutually beneficial – financially and psychologically – to all participants
- Respect for farm’s history
  - Preservation of positive culture and values
  - Honoring legacy of founder(s)
  - Optimism for new leadership

Questions?

Your legacy matters. Let’s plan for it together.

For more information about Varnum’s succession planning services, visit www.varnumlaw.com or contact:

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