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PLANNING FOR THE FUTURE OF YOUR FARM

Legal tools and strategies for farm transition and estate planning

THE OHIO STATE UNIVERSITY EXTENSION

USING LONG-TERM LEASES IN FARM TRANSITION PLANNING

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A common challenge in farm transition planning is dividing assets between farming heirs and non-farming heirs. In an ideal scenario, the farming heirs simply receive the farm assets and the non-farming heirs receive the non-farming assets. However, this approach is usually problematic for two reasons. First, since most of a farmer's wealth is usually made up of farm assets, leaving the farm assets to farming heirs can cause non-farming heirs to be treated unfairly. That is, non-farming heirs could receive less of an inheritance.[1] Second, even though they may not be involved in the farming operation, non-farming heirs might wish to inherit the family farmland for sentimental or business reasons.

These issues present a common dilemma for farmers with on-farm heirs and off-farm heirs. On the one hand, they might want to treat all of their heirs fairly. On the other hand, they might want to protect the farmland base for a farming heir. The use of a long-term lease (LTL) in the farm transition plan is one strategy to help overcome this dilemma. This publication will discuss how an LTL can be used in a farm transition plan and the advantages and disadvantages of this strategy.

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[1] What is considered "fair" treatment of heirs is highly subjective and can vary from family to family. Farm transition plans often provide certain benefits to the farming heirs, such as receiving a larger proportion of the assets or the right to purchase assets on favorable purchase terms.

WHAT IS A LONG-TERM LEASE?

Before discussing how to use an LTL, we need to understand what is meant by LTL. There is no precise definition for an LTL, but for the purposes of this discussion an LTL is a contract between the non-farming heir (as the Landowner) and the farming heir (as the Tenant) that allows the farming heir to lease farmland for an extended period in exchange for rental payments to the non-farming heir. An LTL usually has a term of at least five years and sometimes 40 years or more. An LTL provides stability for the farming heir, allowing for long-term planning and investment in the farming operation.

THE DILEMMA OF DIVIDING ASSETS

Let's further explore the dilemma facing many farmers. Consider the following example:

> Mom and Dad own a farming operation and farmland. They have two children, Andy and Chris. Andy is involved in the farming operation full-time and intends to continue the farm. Chris is not involved in the farming operation but enjoyed growing up on the farm and would like to inherit some of the land. Mom and Dad own \$1 million of farmland, \$500,000 of farm operating assets and \$500,000 of non-farming assets. Mom and Dad recognize Andy's contribution to growing the farm and think a 60/40 split between Andy and Chris is a fair inheritance allocation.

In this typical farm transition scenario, Mom and Dad face a dilemma. If they give Chris only non-farming assets, he will not receive the 40% of their total estate they believe is fair and he will not own any of the farmland. On the other hand, if Chris receives any of the farm assets, Andy's farming operation could be at risk due to Andy not having full control over the farm assets. For example, what if Chris receives some of the land, then leases it to the neighbor or gets into financial problems and is forced to sell the land?

HOW DOES AN LTL SOLVE THE DILEMMA?

An LTL can be designed and incorporated into a farm transition plan to allow non-farming heirs to inherit land without jeopardizing the land base for the farming heir. The LTL gives the farming heir the right to farm the land even though they do not own the land. Let's continue the previous example:

> Mom and Dad want Chris to inherit the Smith Farm and want Andy to be able to farm the land. Mom and Dad establish a trust with the following terms:
> *"Upon our deaths, my Trustee shall execute a 20-year cash lease for the Smith Farm with Andy. My Trustee shall distribute the Smith Farm to Chris subject to this lease. In the event Andy discontinues farming for any reason, Chris may terminate the lease."*

The LTL helps solve Mom and Dad's dilemma. Chris will get the Smith Farm to satisfy Mom and Dad's goal of Chris receiving 40% of their estate while also fulfilling Chris' wish to own farmland. Andy's farming operation is protected by attaching a 20-year lease to the Smith Farm. This strategy meets Mom and Dad's goals for Chris while also making sure all of the farmland will be available to Andy's farming operation.

SHOULD YOU USE A LONG-TERM LEASE?

An LTL is an important tool in the farm transition legal toolbox. However, an LTL is not for everyone and might not be an appropriate strategy for some farm transition plans. A careful analysis done on a case-by-case basis can determine if an LTL is appropriate for a particular plan. To help with this analysis, let's look at the advantages and disadvantages of LTLs.

1. Advantages of LTLs

- **Protects land base for farming heir.** An LTL can ensure land is available to the farming heir even if the land is inherited by another family member. Recorded leases typically remain on and "run with the land," so the farming heir is protected even if the land is transferred in the future.
- **Provides income to off-farm heir.** The lease requires the farming heir to pay rent to the non-farming heir. Lease payments are a steady, secure income stream for the non-farming heir.
- **Helps cash flow of farming heir.** As anyone who has recently purchased farmland knows, farmland often has negative cash flow. That is, the debt payments on farmland are usually greater than the income from the land. Leases allow the farming heir to farm the land without the large capital outlay required to buy farmland. Also, the lease payment is a fully deductible expense for the farming heir.
- **Provides certainty.** An LTL allows the farming heir to plan for the future with more certainty. The farming heir can make long-term business and financial plans, which is crucial in agriculture when crop cycles and investments span several years. For the non-farming heir, an LTL guarantees a consistent stream of income, usually with favorable tax treatment.[2]

2. Disadvantages of LTLs

- **Limited options for non-farming heir.** While the non-farming heir will own the land, they have little control over it. The lease intentionally limits the non-farming heir's ability to control the land in favor of allowing the farming heir to use the land for their farming operation. Even though the non-farming heir's name is on the deed, they do not have the same control a typical owner would have over property.

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[2] For income tax purposes, the income from a cash rent lease is considered passive income and thus not subject to Self-Employment taxes. The classification of passive income depends on the terms and conditions of the lease and the role of the landowner in the leasing situation.

- **The land is largely unmarketable while LTL is in effect**. An LTL can makes farmland less marketable. Buyers might not be willing to purchase farmland that has an LTL in place. In fact, the person most likely to be interested in purchasing farmland subject to an LTL is the farming heir. A non-farming heir who wants to sell the farmland they inherited could be disappointed if an LTL limits the land's marketability.
- **Does not contribute to farming heir's equity.** The lease payments the farming heir makes to the non-farming heir does not build land equity for the farming heir. If those same payments were being made to purchase the farm, the farming heir would be creating equity. The farming heir could be frustrated that they are paying for the use of family land without ever receiving the benefit of equity in the land.
- **Farming heir does not have full control.** Similar to the first disadvantage discussed above, the farming heir does not have full control over the leased land. They may be reluctant to make capital improvements to the land such as drainage tile, grain bins and buildings. Leasing land does not allow the farming heir the same opportunities to grow and expand their farming operation as owning the land offers.

WHAT ABOUT THE EVER-CHANGING RENTAL VALUE?

The farmland cash rent market is always changing and factors like commodity prices, input costs and government programs can have significant effects on cash lease rates. Fixing the lease rate for the duration of an LTL will almost assuredly result in the lease rate eventually being unfair to one of the parties. A mechanism to adjust the lease rate can address this issue. A typical provision could allow either party to request the lease rate to be adjusted every few years. If the parties cannot agree on the adjusted lease rate, the lease rate could be established by government or university lease rate data or determined by an independent third-party, such as an appraiser. The following is an example of a lease rate adjustment provision that could be included in an LTL:

> *"Every third year of the lease, either Tenant or Landowner may request a renegotiation of the lease rate. Upon such request, the parties shall attempt to reach a mutually agreeable lease rate. If the parties are unable to agree upon a lease rate, a mutually agreeable third-party shall be hired to determine the fair market cash rent value of the property. The costs of hiring the third-party shall be divided equally between the Tenant and Landowner."*

DISCOUNTING THE LEASE RATE

An LTL can include a discount on the lease rate. The discount is commonly included to prevent the farming heir tenant from having to compete with the highest cash rents. The parents might want the farming heir to pay a fair rent for the land but not necessarily the top rent. For example, let's say Mom and Dad do not want the farming heir to have to compete against high cash rents established in the area. They feel 80% of cash rent provides a fair rental rate to both the farming heir and non-farming heir. The following is an example of a provision that could be included in an LTL:

> *"The lease rate shall be 80% of the fair market cash lease rate for similarly situated farmland. For example, if the fair market cash lease rate for similar farmland is $250/acre, the lease rate shall be $200/acre."*

CONSULT WITH YOUR LEGAL PROFESSIONAL

An LTL can be a valuable tool in the farm transition toolbox by allowing farmland to be transferred to non-farming heirs while keeping the land base available to the farming heir. However, an LTL is not for everyone. As with any strategy, there are both advantages and disadvantages that should be weighed when deciding if an LTL is the appropriate strategy for any given situation. Due to the long-term nature of an LTL, it should be drafted in consultation with legal counsel to be sure that the lease meets the expectations of both parties and has adequate protection for changes in lease rates.

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