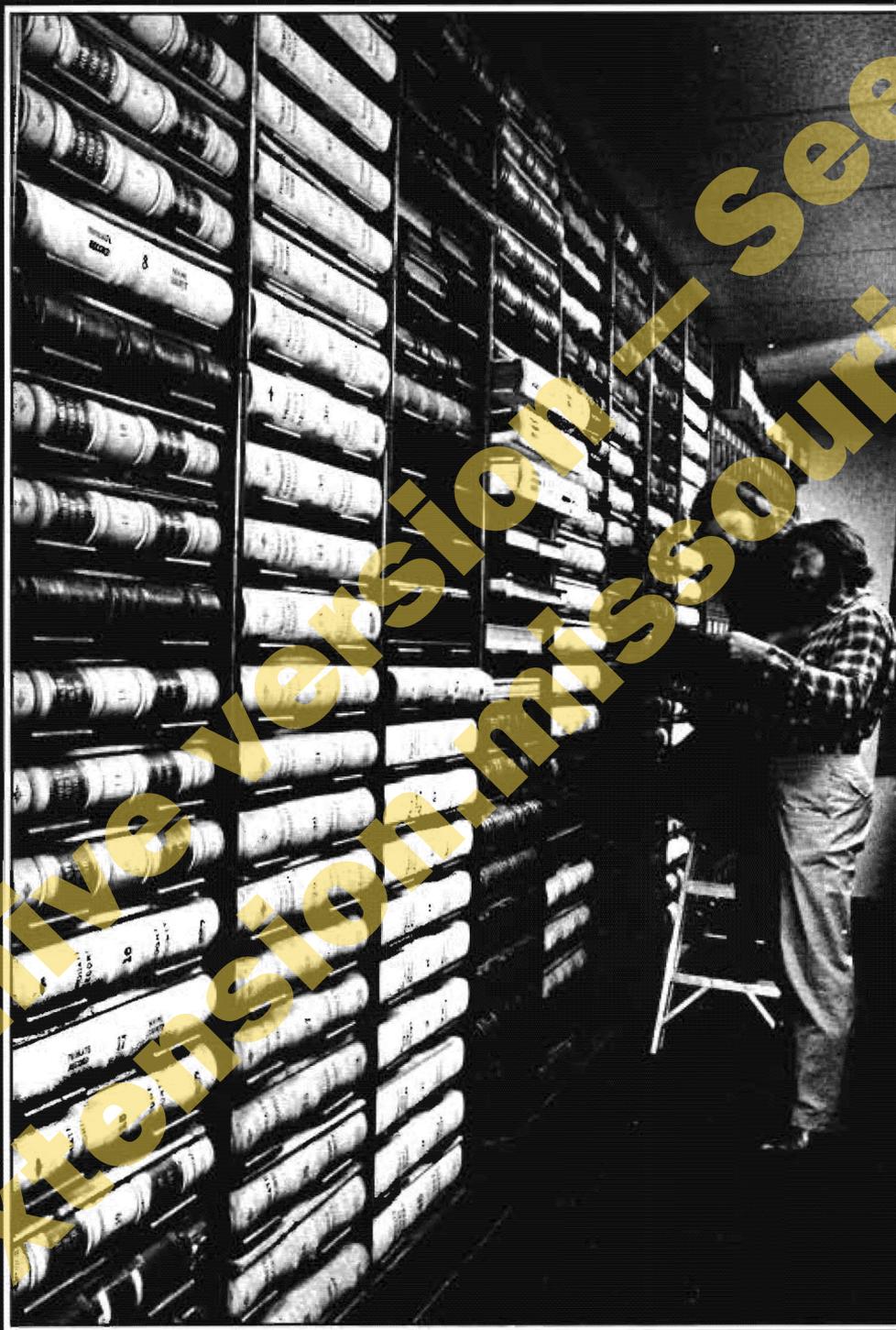


Getting Started In Farming:
So You Have Inherited a Farm



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So You Have Inherited a Farm



Most people who inherit farmland consider themselves fortunate. Land has potential for both current earnings and appreciation in value.

Inheriting land may also cause some problems. You have decisions to make about how to handle the land. Like most other resources that are expected to be productive, land requires management.

What you do with inherited land will depend, in part, on the circumstances under which you obtained the land, your background, and your present situation. Often the person inheriting

land is a widow or child of a farmer, or the widow or child of a parent who had the land as an investment. In some instances, the land may have been inherited from a more distant relative, or even from a nonrelative.

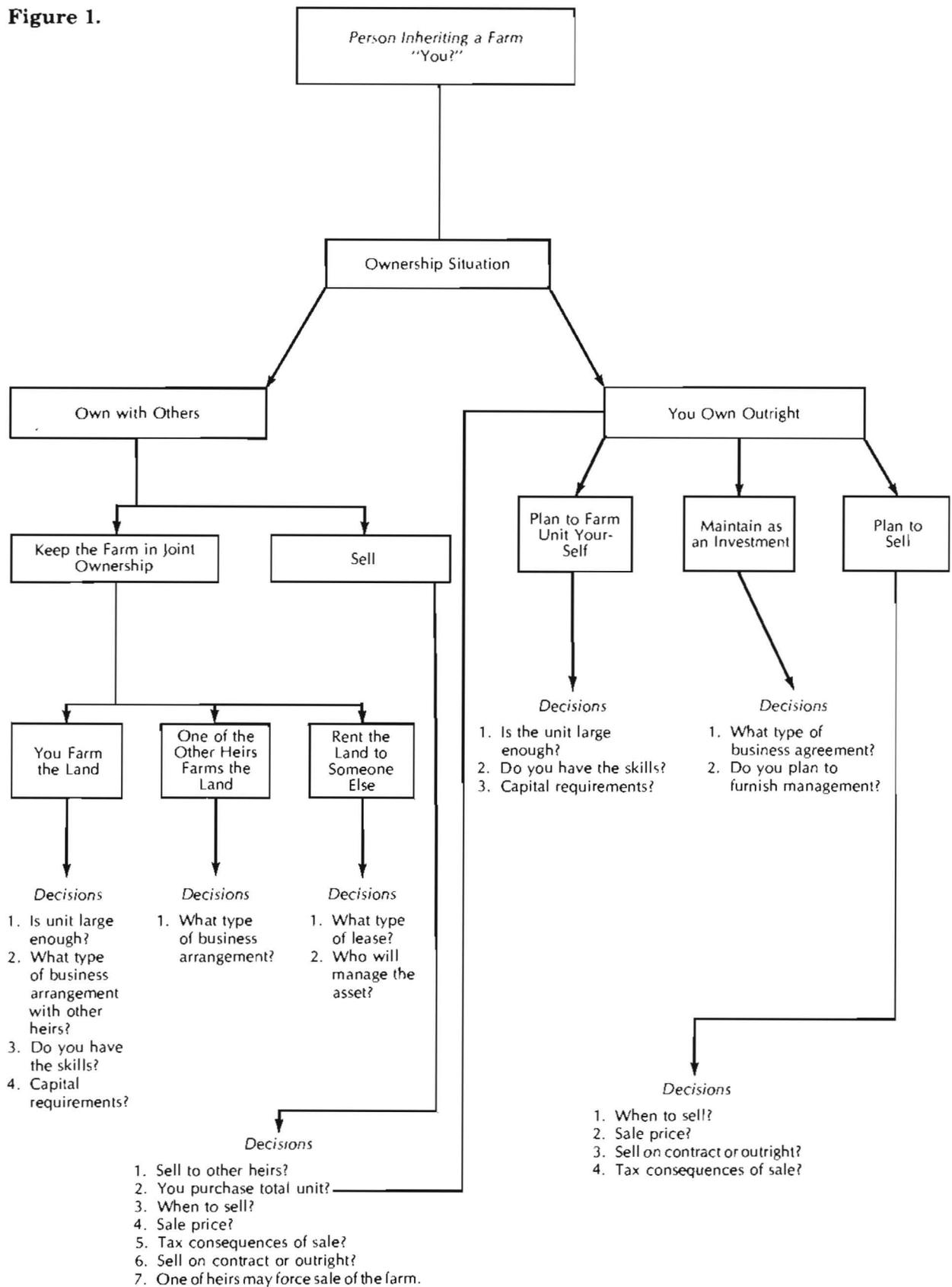
A widow inheriting land may not be interested in farming the land but she may wish to keep it as a source of income. A child with a farm background who inherits land may be interested in farming the land. Any debt remaining on the land tends to complicate decisions as to how to handle the unit and the alternatives available.

Initial Decisions

As the accompanying chart shows, your decisions will take place along two different paths, depending on whether the farm was willed entirely to you or to you and others. If you own the farm with others, your alternatives likely will be more limited. Regardless of whether you own the farm outright or with others there are several things you will need to consider.

Before making major decisions, appraise your situation. Each inheritance situation is different. The first step in making a sound decision (the right one for you) is a systematic, careful appraisal. This evaluation should include three major parts: you, the real estate inherited, and the current economic conditions.

Figure 1.



Appraisal of Yourself



Analyze yourself and your situation thoroughly before making a final decision. Do you want to farm the land yourself? This may depend on family goals, your family's attitude toward rural living, your age, your health, and the composition of your family.

Your financial position, including your present net worth and present income, will also be an important consideration. Inheriting land may bring about a major change in your financial situation, including taxes. Thus, an evaluation of the impact this may have on current and future financial decisions would be in order. The need to make wise investment and expenditure decisions may be as great as ever.

Your current occupation, including how well you like it, the possibilities for future income and

advancement, and the challenges it offers are all key considerations on how to handle the inherited land. Your knowledge about the complexities of today's commercial farm operations is also important. Modern agriculture requires use of many technologies that are quite complex.

Farming today requires a large amount of capital. Do you have this capital, or can you borrow ample capital to operate the farm business? Inadequate operating capital may limit income potential from the unit. Perhaps the decision of whether or not to farm the land yourself can be made better at a later time. If you cannot farm the land now, you can always rent it and consider the possibility in the future. Normally, land rented to someone else is leased on a year-to-year basis.

Appraisal of the Real Estate

An evaluation of the real estate inherited is certainly in order. The size of the tract may influence future decisions. The size will determine whether the unit is adequate for a full-time farm business. The location may be very important. Location and closeness to other tracts will determine the feasibility for blending in with a present farming operation, or other businesses.

The productive characteristics of the land will be a key determinate as to its future use. Is the land suited for cultivation? What is its production potential? The facilities on the real estate, including the dwelling, may influence whether or not the family should consider this as a future

living site. You may wish to live there while working off the farm. Farming may be a part-time business adjusted to labor available. Or the land may be leased to a neighbor.

If the land is presently leased, it may not be available until the lease expires. In some states a farm lease extends on the same basis for another year unless proper notification of termination is given. If the decision is to continue leasing the land, then there may be a question of whether to continue with a tenant to farm productive land. There may be a problem in selecting which would be the best tenant. More detailed methods of leasing the land will be discussed later.

Appraisal of Current Economic Conditions

Current and future prospects for agricultural income may influence your decision on how to handle inherited land. The farm estate market also may influence your decision of whether or not to sell the land or when to sell. If the land has future potential for development and nonagricultural uses this may have an impact on your decision.

Landowners find that current cash returns from land are low when compared with the returns from other investments. One of the reasons present owners keep land as an investment is the gain in value that has taken place. Land values in the corn belt states more than tripled from 1968 to

1978. Many economists predict that land values will continue to increase over a five or ten year period but not as rapidly as they did for 1968 to 1978. Economists also expect that cash returns from land will remain relatively low based on the current land values. Owners with interest and principal payments on borrowed money associated with land may face problems with low cash earnings and high interest rates. Sometimes a piece of land has potential for nonfarm development; this could also have an impact on how the unit should be handled, both in the short and long run.

Making a Decision



Once you have evaluated the situation you are ready to make some decisions on how to handle the inherited land. Your decision may be influenced by whether you own the land yourself, or whether it is owned by others. Chart 1 will help identify the key decisions you face depending on your situation. Consider all the relevant alternatives and select your preference within the limitations you face or set.

If you inherit the farm along with others, you and the others have first to decide whether to keep the farm or sell it and divide the income. If you and the heirs decide to keep the farm a decision will have to be made whether you or one of the others will farm the land or whether it will be rented.

If you own the farm outright, your first decision is whether to farm the unit yourself, rent it and hold it as an investment, or sell.

Then, depending on which of these courses you took, the next set of decisions have to be made. If you decided to farm the place: 1. Is it large enough or will you need more land to support you and your family? 2. Do you have the skills? 3. Do you have enough capital or can you find enough?

If you inherited the farm yourself and decided to sell it, you have to decide when to sell in view of your financial and tax situation, what the sale price will be, and whether to sell on contract or outright.

If you inherited the farm with others and you are going to farm it, you need to decide—

1. Is the unit large enough to support you and your family and yield some income to the other heirs (partners)?
2. What types of business arrangements could be

made with the other heirs? What alternatives are available?

3. Do you have the skills needed to manage a farm? Or do you have part of them and feel you can learn the rest quick enough with the aid of such agencies as the Agricultural Extension Service.
4. Can you meet the capital requirements? If one of the others is going to manage the farm, your decision, along with the others, is what type of arrangement. If you and the other heirs decide to keep the land as an investment, you have two decisions to agree upon—what type of lease and who will manage the asset?

If you and the other heirs decided to sell, you have these decisions to make among you:

1. Sell to one of the other heirs?
2. Can and should your purchase the total unit from the others? If you do, you enter the position of sole owner and move over to the other column in the chart and go through those decision steps.
3. When will you sell? It may be a difficult decision to compromise on if you are in different tax situations and age brackets.
4. What is a logical sale price agreeable to all heirs?
5. What will be the tax consequences for the different heirs?
6. Should you sell on contract or outright?
7. Is one of the heirs likely to force the sale of the farm?

You may wish to hold the land now with the option of selling at a later date. The following discussion will examine several alternatives in more detail on how to handle the inherited land.

Farming the Land Yourself

Whether or not you farm the land yourself will depend upon your individual situation. If you are farming and inherit land that is nearby, you may wish to add this land to your present unit. Another possibility may be to sell either the land presently owned or the inherited land and use the proceeds to expand the other as a base unit. If the inheritance involves land presently farmed, the decision may simply be to continue as before. If the land inherited is some distance away, the decision may be whether to move to the inherited land, sell it, or maintain it for investment income.

The decisions over what to do with the land are much more difficult if you are not now farming. In order to farm, you would have to change your occupation. In this case, before deciding to farm the inherited land you would need to evaluate the income potential of the farm relative to needs and goals of you and your family. If the income potential appears inadequate, you need to find out if additional land or other resources are available for purchase or lease to increase the income potential.

Whether or not adequate housing is available

on the land may be an important consideration also. Farming today requires many technical skills. Do you have the technical skills, or can you secure the skills essential to success?

Your health and ability to do physical labor should not be ignored when deciding whether or not to farm. Although many jobs on the farm are partly or fully mechanized there are still many tasks which require physical labor. Can you meet these requirements? Much of the time a farmer works outside where he is fully exposed to the weather. Many farm activities are performed whether it is hot, cold, wet, dry, comfortable or uncomfortable.

Even though you have the land resources available, it takes a considerable amount of capital in the form of machinery, equipment, and supplies such as seed, fertilizer, chemicals, and fuel to farm today. Many operators must borrow funds for at least part of these expenses. You should discuss your situation with potential lenders before making a final commitment. Will you be able to borrow the capital needed for operating expenses and purchasing machinery and equipment?¹

¹Additional information on farming the land yourself is available in other publications in this series.

Keeping the Farm as an Investment



Many people who inherit farmland elect to keep it for investment income and potential gain in value. Often the land is the home or family farm and also has some sentimental value to the new owners. If the land is to be kept for investment income, several factors should be considered. Current cash income from land is usually low compared to the potential cash return from other investments. Thus, if a relatively high current income is needed or desired, land investments may not be as attractive as other investments. One advantage of owning agricultural land during the past decade has been its rapid appreciation in value.

The most common method of getting a return from land that is not being farmed by the owner is by leasing it to a tenant. The tenant may live on the farm or he may be a nearby farmer who has the capacity to farm additional land. The size of the unit and whether or not it includes a satisfactory dwelling may have some influence on how land rental is handled.

The most common types of leases in the Midwest are crop share, cash rent, and livestock share leases.²

The most widely used is the **crop share lease**. Under this type of agreement the landlord receives a share of the crop as a return for use of the land. The landowner also normally shares in certain production expenses such as seed, fertilizer, and chemicals. The owner shares in the risk because the yield and the price received determine the gross income. The return or income varies from year to year. The management ability of the tenant will have an important impact on the level of yields obtained, which influences income.

Under a **cash lease** the tenant pays a stipulated amount for the use of the land, buildings, and facilities. Rental may be determined on a rate per acre plus a rental for buildings, facilities, or it may be a lump sum for the entire unit. Where the agreement provides for a fixed amount of cash rent, the landlord has a known return since the cash rent is not influenced by yields and prices. Poor yields or prices may have some impact on the tenant's ability to pay the cash

rent, however. There are also many different types of variable cash leases in use whereby the cash rent may depend upon yields or prices or both. The returns to the landowner are variable, much like they are under the crop share lease, but the owner does not normally share in the production expenses.

Under a **livestock share lease** the landlord shares in income from both crops and livestock. He also shares in a higher proportion of the expenses. The livestock lease is best suited for an owner who has good knowledge about modern agriculture and is willing to take the risk associated with both livestock and crop production.

Rental terms vary somewhat by areas because of several factors. The productive capacity of the land due to weather and soil type affects production costs per unit. Cash rental rates are closely associated with yield potential and price expectations. The final terms of the agreement are the result of bargaining between landlord and tenant. Local custom also influences leasing terms.

Custom farming may also be used by the owner. Under this arrangement the owner custom hires somebody to do the farming, either on a total operation basis or on an individual operation basis. The owner then has a variable income depending upon the yields, prices, and production costs. This method of handling land works best for the person who has good knowledge of modern agriculture and who can maintain a close association with the production on the farm. The risks are greater than under some of the other leasing agreements, but the rewards can also be higher under favorable conditions.

Anyone owning land should be aware that land requires management. An owner who is not in a position to supply the necessary management, or who does not have the knowledge needed to make wise management decisions about the use of land, may wish to consider hiring professional management. Normally, managers receive a percentage of the landlord's gross income. Thus, in good years the manager receives a higher return than in poor years. This provides an incentive for the manager to produce top returns.

²Additional information is available in North Central Regional Publication 43, *Taxmanship in Buying or Selling a Farm*.

Estate and Inheritance Taxes

Federal estate taxes and state inheritance taxes are involved in settling an estate. The amount of these taxes will depend on the size of the estate, how the assets were owned, and how they are transferred to the heirs. If all or a high proportion of the assets of the estate are in land, there may be a problem in raising the cash needed to close or settle the estate. It may be necessary to sell some of the assets or to borrow money using these assets as collateral to meet the cash needs.

Managing a farm through a professional manager may create some difficulties in estate planning. Material participation in the farmer's operation is required before a land inheritor can take advantage of the special use valuation. This may be an important consideration if the land is to be transferred to an heir who will farm the land. But it is likely to be an even greater consideration if the land is transferred to an heir who will not be farming the land but who plans to materially participate in the farm business.

The Tax Reform Act of 1976 provided some alternative methods of valuing farmland under certain conditions. For estates of people dying after December 31, 1976, the law provides that the executor may elect to value real property devoted to farming or other closely held businesses at its

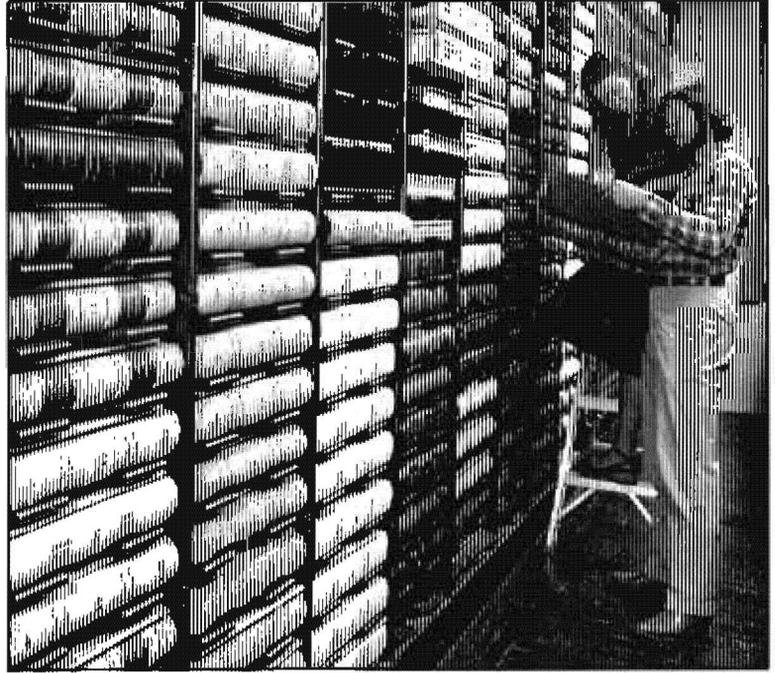
"current use" or "special value" rather than at fair market value. One qualifying requirement is that during five or more years in the eight-year period ending with the decedent's death the real property must have been owned by the decedent or a member of his family and held for qualified use.

Also, the decedent or a member of the decedent's family must have participated materially in the operation of the farm or other business. If the property is disposed of within 15 years after the death of the decedent to nonfamily members or ceases to be used for farming or other closely held business purposes, the tax benefits are recaptured. Full recapture occurs within the first 10 years with a phase out between 10 and 15 years.

There are other requirements to qualify for current use value. The details are too lengthy to discuss fully in this publication. If you inherit land which qualifies for current use valuation you'll want to explore this in more detail. It can also be an important consideration in estate planning for someone who owns land.

There are many factors to consider when settling an estate. The heirs should obtain the necessary legal assistance to help with the decisions and actions of estate settlement.

Land Ownership Decisions



There are many short-run, intermediate-term, and long-run decisions concerning owning and managing land resources. Short-run decisions are usually involved in making production decisions on an annual basis. These may include decisions about what crops to grow and the level and type of production technologies to use. Such decisions will be influenced by yield and price expectations, probable production costs, and land use capabilities.

Intermediate and longer term decisions often involve land use patterns, including cropping programs, terracing, contouring, and conservation practices. Making improvements such as tiling, clearing the land, drainage, and construction of buildings or facilities also become very important decisions. Implementing these decisions frequently involves sizable current expenditures. Often decisions involving capital expenditures will be

influenced by the objectives of the investor or the owner, the probable effect on future income, the current cash flow position of the owner. The tax implications of these investments may influence whether they are made and when.

If you are using a professional farm manager to manage the land he will develop some short- and long-run plans. When these suggestions involve capital expenditures, you as owner will have the final decision. Your financial position may be the determining factor in whether or not these investments will be made and when. The Cooperative Extension Service and other organizations in your state have helpful publications. Knowledge of current agricultural programs that apply is available at the ASCS office in the county in which your farm is located. Some information will also be available through the County Extension Office.

Selling the Land

If you have a need for the capital elsewhere, or feel you can achieve a higher return from other investments, your likely choice is to sell. Since current returns from land are quite low, many other investment alternatives will normally provide a higher annual current return. A decision to sell land, however, has many implications. Not the least of these is potential income tax consequences. The tax liability created by the sale will depend upon several factors, including the dollar amount of the sale, the income tax basis of the property, and possibly the method of sale. If this is a substantial gain in the property, it is possible to sell it under contract and spread out the reportable gain over several years (if this is desirable).³

If the decision is to sell the land, several alternatives are still available. If the money is needed elsewhere for investment, living expenses, or other purposes such as buying a house, a cash sale may be the most desirable. In this situation the buyer arranges his own financing, usually through a mortgage on the land. The advantage to the seller is that he or she receives the money and can use the proceeds. Also, there is minimum risk in this type of sale. Not many people are able to pay cash for land without some type of financing, so a cash sale may limit the potential number of buyers and, thus, reduce the selling price.

Today many real estate sales are handled as contract sales. This may have certain advantages both to the buyer and seller. For the seller, it gives

the option of reporting on an installment basis any gains from the sale as the principal payments are received. In addition, the seller may leave some of the equity in the land and receive a favorable interest return from this equity. A contract sale with a low down payment may attract more potential buyers and may result in a higher price for the land. This is a method that parents may use to transfer land to children earlier than would otherwise be possible. The best method of handling the sale or transfer of land depends on the objectives of the parties involved and the individual circumstances.

A person wishing to reduce or postpone taxable income that would be generated from a sale may consider trading property, which permits carrying the basis of the old property over to the new property without having a reportable taxable gain. It is possible to trade farmland for other rental property.

Another problem people face in selling land is determining what the sale price should be. A price below the market usually results in a quick sale. On the other hand, too high a price may result in no sale or long delays. It may be desirable to get a professional appraisal of the property before deciding whether or not to sell. The appraisal can provide a basis for pricing the property if a decision to sell is reached. There is no well-defined market for land, unlike for other commodities that are more frequently traded. Prices of land vary considerably depending on location, productive capacity, soil type, and many other factors.

³Additional information is available in North Central Regional Publications No. 43, "Taxmanship in Buying and Selling a Farm" and No. 56, "Long Term Installment Land Contracts." These publications are available from the Cooperative Extension Service in your state.

Inheriting Part of a Farm



Inheriting a farm may add to one's net worth, but at the same time may create some financial problems connected with the inheritance. The son who takes over the family farm may inherit part of it with brothers and sisters or other relatives. The other heirs may decide that they would like to have their money rather than own land. This may create some severe problems for the son on the farm if he is forced to buy out the heirs at a time when he is in poor financial position. He may need to borrow a considerable amount of money to pay off the other heirs. With current low returns on land and high interest rates this may create cash flow problems for the buyer. An untimely forced purchase may put him in a severe financial bind.

Thus, although inheriting the land and purchasing the shares of the other heirs may fulfill his long-run goal of owning the family farm, it may create some very serious short- or intermediate-term financial problems. It may force him to quit farming or to give up the home farm because he cannot meet the purchase requirements. Thus, the farm may end up being sold to someone outside of the family.

In some instances, a son or daughter who inherits a farm also inherits a sizable debt associated with it. Here again, serious cash flow problems in meeting the debt payments on the land and potential federal estate taxes and state inheritance taxes may be involved. In such cases, persons inheriting the farm may end up with far more debt than they had before. Although their

net worth may be higher, the amount of debt they face and the cash flow requirements may create some difficult problems.

Another problem that an heir may face is that he or she may have only inherited part of the unit. This individual may have been farming two parcels of family-owned land that made up a good economic unit. At the death of the parents, part of the total unit goes to other heirs by inheritance. The other heirs may decide to farm the land themselves, sell it, or rent it to some other person. Thus, the person who has been farming the land may find himself with an inadequate unit because he only inherited part of the land base he was farming and has no way of obtaining control of land going to other heirs.

It is also possible for the person inheriting a farm to end up in a much stronger financial position with the potential for a considerably higher income than before the inheritance. These persons have the option to make expenditures or investments they would not have been able to make before. They may wish to use money from selling the inherited land to establish a business (of their own), purchase a house, reduce debt, or make investments to increase current or future income. The final decision will depend on the individual situation and the values and goals of those involved. It is normally best to make these decisions in a business framework rather than let emotions dominate the decision.

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