



## So you have inherited a farm . . .

**I**nheriting a farm can be both exciting and frustrating. Some people know exactly what they would like to do with the farm, but many do not. A number of questions and issues must be addressed before the final decisions are made.

### INTRODUCTION

Over the next several years the question of what to do with inherited farmland will become increasingly important. The average age of farmers continues to increase. More significantly, a recent Iowa survey showed that more than one-third of the farmland is owned by people age 65 or older.

Farmland prices have changed dramatically since the 1970s. At that time, land values were increasing at an unprecedented rate. They continued this climb until the early 1980s, at which point they began an unprec-

edented decline. Iowa land values dropped 67 percent from 1981 to 1986, the largest drop ever recorded in such a short period. Since then land prices again have begun an upward trend.

Today the agricultural land market is influenced by many factors. The single biggest factor is government payments to farmers. It is not known how long and at what level these payments will continue. This uncertainty clouds the picture of what to do with the inherited farm.

Individual circumstances also dictate the most prudent course of action. In some cases the land already may be farmed by the individual who inherited it, and the decision is relatively simple. In other cases, the land may be inherited by someone who knows little about modern agriculture and has no idea what to do with the farm.

Finally, the farm may be jointly inherited and the wishes of all parties influence what to do with the farm.

Regardless of the circumstances, it is important to think carefully about the farm before making decisions. This publication is designed to raise questions that need to be asked and to direct heirs to specific information that might suit their circumstances.

Before making any decisions, it is important to know the farm—in other words, know what you have inherited. In most cases this will determine the best course of action. The second major factor is whether the farm was inherited by one individual or a group. The more people involved with the inheritance, the more complicated the decisions.

This publication is an update of an earlier work with the same title. That publication, authored by E. G. Stoneberg, was written in the 1970s. (Stoneberg, E. G., *Getting Started in Farming: So You Have Inherited a Farm*, North Central Regional Extension Publication 85, University of Missouri-Columbia, undated). This update relies heavily on the previous work. Many of the ideas presented are similar because the basis for good farmland decision-making has not changed. Attribution is made in a general sense and will not be made throughout to avoid disrupting the flow of the publication.

What E. G. Stoneberg said in the original piece on inheriting farmland is as true today as it was then:

*Before making major decisions, appraise your situation. 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.*

## THE INHERITANCE

### Location

An old adage in real estate appraisal says that the three most important factors in determining the value of a parcel of real estate are location, location, location. Although an inherited farm involves many factors, the location is still the key to its value. The location determines the farm's current and best use and as well as its future use. For example,

land situated near an expanding metropolitan area has potentially greater value than similar land located elsewhere.

### Income

After location, the property's potential income is the most important indicator of value. Figuring the farm's potential income will help in estimating the value as well as provide information to help make the final decision of what to do with the farm.

The present use of the farm (or land) is determined by many factors. It is important not to assume that the current use is the best use for the land, especially under new ownership. The current use of the land is a good starting point in estimating the potential income from the land, however.

It also is important to be aware of any contracts, leases, zoning regulations, or other easements connected with the farm. Such arrangements limit the potential uses of the property.

Estimating the potential income is not a simple matter. The inherent productivity of the soil will help in estimating the expected yield for different crops and cropping systems. Iowa State University Extension can provide estimated production costs and potential yields. The USDA's Natural Resources Conservation Service can provide advice on the most appropriate uses for the land, given its natural limitations. NRCS also can help develop a soil conservation plan if necessary.

Income from livestock can play an important role in determining the potential income from the property. For example, land that is in permanent pasture or hay will be used primarily for beef, sheep, or dairy cattle. In this case, animal income will determine the value of the land. Animals also can play an important role in determining the value of the land if there are extensive livestock facilities on the property. The age and condition of these facilities will determine their relative value and the contribution they can make to the value of the property.

Several government and private organizations offer programs that can affect the income from a farm, depending on the type of farm and its location. The Farm Service Agency can provide information about the current government programs and the farm's eligibility for these programs. In addition, several resource conservation groups, such as the American Farmland Trust, the Nature Conservancy, and Ducks Unlimited, offer programs that might affect the farm.

### Value

To learn the true value of a farm, a full appraisal is needed. However, there are other means available for estimates. Whether or not these are appropriate depends on the desired degree of accuracy.

In estimating the value of the farm, the heir must consider any buildings and improvements. In some cases, these buildings can add considerable value to the property and significantly influence how

it will be used. A dwelling on the property also can influence the property's use. In any case, the condition of these buildings, dwellings, or improvements should be known. In some cases, old dilapidated facilities actually may decrease the value of the farm.

In many cases, the farm will have sentimental value. This becomes much harder to quantify, but it will still enter into the decision. However, one heir's sentimental value will not be the same as that of others.

The size of the farm also influences the decision of what to do with it. Not only does the size determine the value of the inheritance, but it determines the feasibility of earning a living from the farm. In many cases, the farm is left to someone who is already farming the land. Regardless, the size of the farm is an important consideration.



Photo courtesy of USDA Natural Resources Conservation Service

## **Taxes**

Estate and inheritance taxes at both the state and federal level are important considerations. Minimizing these taxes can increase the value of the inheritance, but simply minimizing the taxes may not produce the best use, given individual circumstances.

The size of the estate, how the assets were owned or leased, and what is done with the property determine the amount of the taxes. If a high proportion of the inheritance is in land, it might be necessary to sell some of the assets or borrow money just to settle the estate.

In some cases, the inheritance may come under "special use" valuation. In this situation, there may be restrictions on how long the property may be farmed in order to maintain that special use valuation.

In some special cases, the property can be sold and the proceeds reinvested without triggering tax consequences.

If the farm is held as an investment, who farms it and whether or not material participation occurs can be important in determining the amount of inheritance tax.

It is not possible to examine all of the details and circumstances of taxes in this publication. Farmland heirs should seek sound legal advice regarding the inheritance to determine which of the special provisions it qualifies for and what restrictions there are on the use of the property. In some cases, it will be better to pay the taxes, but in other cases, it will be better to alter the uses or disposition of the farm in order to lessen the tax burden.

If taxes are owed, the new owner should be able to borrow funds to pay them by using the property as collateral.

Whether a farm is inherited by an individual or a group, there are three basic options available to each heir: farm the land, keep the land as an investment, or sell the farm.

## **OPTIONS FOR THE FARM** **Farming the Land**

Farming the land is a complex decision that will involve a number of considerations. One of the first questions is whether or not the heir has the necessary skills and resources.

If the heir already is farming, then the question becomes one of how the farm fits within his or her current operation. In these circumstances, heirs may opt to add the land to what they are currently farming and farm it as one unit, or they may sell one of the farms and consolidate around the other farm. That decision rests on a number of factors. How close is the inherited property to the current property? Will the size of the new operation generate an adequate income? Will the heir be able to manage it? Will it require new or different machinery? These and many other questions must be answered prior to making the decision about farming the inherited property or combining it with an existing operation.

If the heir is not currently farming but would like to start, there are numerous family decisions regarding the change in lifestyle that farming would entail. It might be easy to get caught up in the allure of farming or being on the land, but this is a decision that requires careful consideration.

The key factor is generating an income that will allow the heir and his or her family to live in the lifestyle to which they are accustomed or aspire. Will a farming operation provide that level of income? For new farmers there is a learning curve or start-up time. One of the considerations is the opportunity for off-farm employment to help during the start-up time. Off-farm income also can be used to supplement expected farm income so family income is satisfactory.



Photo courtesy of USDA Natural Resources Conservation Service

Once the heir has decided to farm the land, he or she must decide whether to raise crops, livestock, or both. Iowa State University Extension offers many publications explaining which crops can be grown across the state as well as estimates of the crops' production costs. This information can be used to estimate the potential income from the inherited farm. The choice of crop and livestock enterprises is sometimes complementary. For example, one option is to raise crops that will be fed to livestock.

Production agriculture involves more than just owning the land. It also includes labor, capital, and management. The amount of capital required in production agriculture varies by the system chosen. Many of the systems in use today rely heavily on purchased inputs and therefore require a significant amount of capital. Other systems rely more heavily on labor, management, or marketing skills.

Regardless of the system, there will be machinery requirements. Modern farming machinery can be expensive and requires skill to operate it safely. Owning the machinery is one option. Today, many farmers use leasing or custom hire as a means of machinery management. This is especially beneficial for the higher priced, seldom-used pieces of equipment.

Management is a key skill needed to run a profitable farming operation. Many of the skills are similar to other businesses, but other aspects, such as certain risk management techniques, are unique to farming.

The decision whether or not to farm inherited land is not one to be made lightly, and each situation is different. The major consideration is the estimated income that can be generated from the farm and whether or not that is sufficient for the heir. Additionally, reserves should be available to help get the farm started under new management.

## **Holding the Land**

Holding the land as an investment is another option for heirs. Those who opt to hold the land can choose from several different ways to handle the farm, each of which involves different amounts of time and effort.

Some people enjoy being active in running the farm and others prefer not to be involved.

## **Leasing**

Leasing land to others is a viable and common option today. In Iowa, a recent estimate showed that more than 60 percent of the land is leased. A number of lease arrangements are available. In general, they fall into the categories of cash rent or crop share. In a cash situation, the tenant bears the risk, whereas in a crop share arrangement, the production and price risk are shared.

Cash renting is one of the least demanding options for the owner. This arrangement involves finding a tenant, paying taxes, and a few other minor ownership duties. The most important decision is determining the fair level of cash rent. In a crop-share lease, the tenant and landlord split some of the expenses and the yield. The exact division is a matter of negotiation. There are many variations of this type of lease arrangement, including a flexible lease, which can be a combination of both the cash and crop-share features.

The best rental arrangement is an individual matter. In some cases, there may be other factors outside the rented property to consider,

such as snow removal, property upkeep, and maintenance. ISU Extension offers publications that provide estimates of the current cash rent and information on how to establish the division between yield and costs.

## **Custom Farming**

Custom farming is another option that has become more popular in recent years. In this arrangement the owner contracts for all the field work to be performed. Some custom arrangements also include storage and hauling. In either case, the owner of the land makes the decisions about the crop, inputs, and marketing, but hires others to perform the actual work.

## **Hiring a Professional Manager**

Another option for those who want to keep the farm as an investment is to hire a professional farm manager. While each arrangement varies, in most cases the owner makes no business decisions but hires a professional farm manager to run the farm. The owner simply receives a check and the farm management firm receives a percent of the gross income.

The return to land as an investment is generally thought of in two components. The first is the yearly cash return, which varies according to the use of the land and the type of lease arrangement. It is subject to weather and other production risks as well as price risks. In the past the annual cash return to land has varied considerably, but it usually averages 5 to 8 percent after property taxes and before income taxes.

The second component to the return to land is the increase in value or capital gains. Land generally increases in value 2 to 3 percent per year, although land values have fluctuated widely in the past few decades. For example, in Iowa land values almost doubled from \$218 per acre in 1950 to \$419 in 1970. During the 1970s, however, land values increased almost fivefold, rising from \$419 per acre to \$2,066 in 1980. Then, during the 1980s, farmland lost almost 60 percent of its value, falling from \$2,066 per acre to \$1,214 in 1990. The 1990s have shown a recovery to \$1,781 per acre in 1999.

Land as an investment offers portfolio diversification. In addition, it offers investors a tangible asset.

## **Selling the Land**

The final option is simply to sell the farm. This option is especially appealing to those who want the proceeds of the inheritance for other uses.

There are many considerations in the decision to sell the property. Tax consequences from the sale depend on several factors: the amount of the sale, the income tax basis of the property, and, in some cases, the method of sale. Selling the property under contract can spread out the reportable gain over several years, lowering the tax burden but postponing the use of the funds for other purposes.



Photo courtesy of USDA Natural Resources Conservation Service

Those who decide to sell the land must consider the method of sale. Most use a licensed real estate broker. However, in some cases, heirs sell the land either to someone who knows the land or through classified advertisements.

It is possible to divide a large property into smaller tracts for auction. For instance, heirs may decide to sell the building site and keep the cropland.

Another method of selling the farm is to hold a land auction. It is uncertain which method produces the highest price. One option for those who hold land auctions is to set a minimum price. If the auction produces a higher price the land is sold, but if the minimum price is not met the owner can reassess the sale method or his or her expectations.

Many heirs who decide to sell the land do not know a good selling price. The land market is not well-defined as are other more frequently traded commodities. Farmland heirs should obtain

a professional appraisal to help establish the value of the land and assist in setting the right selling price. It also is important to remember that an heir's sentimentality for the farm is not translated into value for someone else.

#### **Cash Sale**

A cash sale is one way to sell the inherited property. A cash sale immediately produces the proceeds from the sale for other uses. It also minimizes the risk to the seller. However, a cash sale also reduces the number of potential buyers because most buyers will need some type of financing. Fewer buyers could mean a lower selling price.

#### **Contract Sale**

A contract sale is another option, in which the buyer provides a down payment and then makes payments on the land. The advantage to the buyer is the need for less money up front. The seller's advantages include the option of reporting the gain on an installment basis and lowering the overall tax consequences.

A contract sale does expose the seller to the risk of default from the buyer. However, the increased risk means the seller usually can receive higher interest. Additionally, offering a favorable contract will increase the number of potential buyers and provide the opportunity for a better price.

#### **Trade**

Trading the property is another option that may be appealing in some circumstances. This is especially true for an heir who is already farming but in another area. By trading the property to someone who owns or can buy property closer to their existing farm, the heir can avoid taxes that could be generated from the sale. Trading farmland for other rental property is another possibility.

#### **Gift**

Giving the property to a non-profit organization as a gift is another alternative to selling it. This usually occurs when the property has unique wildlife or scenic value and is desirable to organizations such as the Nature Conservancy, Ducks Unlimited, or Pheasants Forever. This option also allows heirs to avoid tax consequences.

#### HOW THE FARM HAS BEEN INHERITED

##### **Alone**

Inheriting the farm alone is the easiest of the two scenarios. In this case, any decisions will be based upon the individual heir's circumstances without dealing with others' expectations and desires.

Inheriting the farm as an individual still leaves the same basic options and alternatives: whether to sell the farm, keep it as an investment, or farm the land.

If the heir currently is farming, deciding what to do with the inherited farm is simply a matter of deciding how the farm fits within the current operation and goals. The farm operation can be consolidated by selling the inherited farm and buying one closer to home without triggering tax liabilities.

If the heir currently is not farming, the earlier discussed pitfalls and considerations apply. Heirs must remember not to let the romantic notion of farming cloud their considerations and to estimate the expected income from all sources.

If the heir keeps the land as an investment, he or she must decide how much time and energy to devote to it. Depending on how it is handled, land ownership can involve considerably more time than conventional assets. Farmland heirs also must determine how much and which type of risk they are willing to bear.

Individual tax consequences probably will guide the decisions about selling the land. Many alternatives exist and should be considered carefully. In addition, options exist to postpone or eliminate the tax burden, depending on how the property is sold.

### **With Others**

Inheriting a farm with other people complicates the decisions. Each heir has different goals and needs. However, blindly pursuing what is in one heir's best interest can lower the returns to everyone. Heirs should think as a group and strive for compromises. Open communication is essential.

Ideally, the individual who left the farm to the heirs has made all the considerations for fairness. However, in some cases an equitable distribution was the guiding force. In these cases, fairness becomes an individual consideration.

A complication arises if the farm is currently operated by one of the heirs. It is important to remember that the decisions made by the non-farming heirs can substantially influence the ability of the farming heir to continue. If the heirs want to sell, the farming heir may not have the capital or be in a position to take over the entire farm alone. This may be true if one of the heirs wants to start farming but the others do not.

If the decision is to keep the farm as an investment property, the heirs must agree on how to do so. In many cases, it is easier for a professional farm manager to handle the investment to avoid complications. Regardless of the method chosen, some means of decision-making must be established. One heir must not be able to influence the return to the investment without the consent of the others.

The sale of a farm with multiple heirs should meet the goals and needs of the heirs and minimize the collective tax liability. If the heirs are in different financial positions, it might be possible to make arrangements to maximize the return from the entire inheritance but not necessarily in one party's best interest.

Again, communication is the key. Groups of heirs must communicate their needs and desires. They must listen to the others and try to work toward mutually beneficial compromises. The options of farming, keeping, or selling remain the same. However, multiple heirs must consider the whole inheritance, not just the individual pieces.

### **CONCLUSION**

Inheriting a farm can be very exciting and rewarding. More than likely the inheritance will hold some sentimental value.

Inheriting the farm alone or with others changes the complexity of the alternatives, but it does not change the basics of the decision. The first step is to accurately assess the inheritance. This determines the options and helps evaluate the alternatives.

An accurate professional appraisal will determine the size of the inheritance. The current use will help determine the potential income from the farm. ISU Extension and other organizations can help with the decisions about the options and alternatives for the inherited farm.

Farmland heirs have three choices of what to do with an inherited farm: farm the land, keep it as an investment, or sell it. A number of options are available within each of these three alternatives.

Heirs must remember that there can be significant differences in the tax consequences of the various options. Legal counsel should be obtained before deciding what to do with an inherited farm.

### References

Every state has a Cooperative Extension Service with many helpful publications for the first-time landowner. The publications usually are divided into topics such as buildings, crops, livestock, machinery, management, marketing, pesticides, soil, sustainable agriculture, and weeds. In addition, the federal government offers publications through the

USDA's Farm Service Agency, Economic Research Service, Natural Resources Conservation Service, and National Agricultural Statistics Service. The state departments of agriculture, local conservation agencies, and soil and water districts also are sources of information to aid in making decisions.

The following list of publications from Iowa State University Extension and the North Central Region is a sampling of management publications available.

*Estimated Costs of Crop Production*, FM 1712, ISU Extension publication, updated annually.

*Estimated Costs of Pasture and Hay Production*, AG 96, ISU Extension publication, updated periodically.

*Livestock Enterprise Budgets*, FM 1815, ISU Extension publication, updated annually.

*Iowa Land Values*, FM 1825, ISU Extension publication, updated annually.

*Iowa Cash Rental Rates*, FM 1851, ISU Extension publication, updated annually.

*Variable Cash Leases*, FM 1724, ISU Extension publication, updated periodically.

*Iowa Farm Costs and Returns*, FM 1789, ISU Extension publication, updated annually.

*Cash Farm Lease*, NCR 76, NCR publication, updated periodically.

*Livestock Share Rental Arrangement*, NCR 107, NCR publication, updated periodically.

*Crop Share*, NCR 77, NCR publication, updated periodically.

File: Economics 1-5 [A]

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