WHAT'S IT WORTH IF YOU STAY ON THE FARM

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Abstract

The aging farm population, the need for replacement farmers for those who are or will retire, beginning farmer schemes and farm family business succession planning have been and continue to be issues that are receiving a great deal of attention over the last several years. An example is the current United States Farm Bill that contains approximately eighteen million US dollars to fund grants awarded through the Beginning Farmer/Rancher Development Program. Other examples of the interest in new farmers and farm family business succession include the FARMTRANSFER international research project. FARMTRANSFERS is a collaboration between Iowa State University, Ames, Iowa USA, Exeter University, Exeter, Devon, UK and the University of Plymouth, Plymouth, Devon, UK. A postal survey is employed to determine whether or not a successor has been of identified; demographic information on the owner/operator and the successor; the transfer of decision making authority to the successor and the timing thereof; and, the estate plan of the owner. Another example of interest in beginning farmers, farm entry opportunities and farm succession is the International Farm Transition Network (IFTN) that was established in 1990 and has grown to twenty member organizations throughout the United States and Canada. The IFTN members provide a variety of services including educational seminars on farm business succession planning.

Historically farm succession seminars have focused on issues such as business entities, financing the purchase of the farm and estate planning. Recently the emphasis has begun to shift to the intersection of the individuals' priorities and goals with the selection of the business entities and estate plans.

One area of particular difficulty for parent/owners is the division of assets by the estate plan. In a 2006 FARMTRANSFERS survey of Iowa farmers who had an estate plan responded the best plan was to divide the land equally among all heirs regardless of participation in the farm business. This distribution often results in the demise of the farm business as the successor cannot afford to buy out the other heirs. How then should the contribution of the one farm be valued and how should it be credited?

Keywords: Succession, Inheritance, Contribution, Wealth, Heir, Successor

Introduction

"I've spent my entire life paying off my uncles. Now I'll spend the rest of my life paying off my brothers." This statement was made by a Devon, UK famer. In reply to a question about the estate plan for the farm the farmer's father replied that he would divide it equally among his three sons, two of whom were not currently on the farm and had not worked on the farm since they were children. Clearly the on farm heir did not feel that an equal division of assets was equitable.

The first consideration for the owner generation is to identify farm business property and personal property. For most business owners this distinction is not difficult as most business owners do not live on their business property. Farmers do live in and on their business property making the distinction between the two difficult. After all, the older generation owns it all. While it may be admirable to divide family heirlooms equally among family members so as to provide each heir with a “piece” of family history it is not admirable to risk the success of the succession plan by dividing the farm business assets equally.

Farm business succession planning should not begin upon the death of the owner. It must start when the owners decide they want to move the farm business to the next generation. Given that the majority of the wealth of a farm business resides in the land and, as such, is a non liquid asset it is difficult to give farm assets to the successor and equalize the legacy give to non business heirs with liquid assets. If the successor has to “liquefy” the parents bequests to the non business heirs land may need to be sold to generate the need cash. Another option is to borrow sufficient funds to equalizing bequest. Either of these strategies increase the risk faced by the successor. In the first instance, the sale of land, the farm may no longer have a large enough land base to be profitable. In the second instance the farm may not be able to service the debt or the debt may inhibit the ability of the farm to grow and prosper. If the land is divided among the heirs he parents are forcing the successor to be in business with individual with whom the successor may not want to be in business.

In a 2006 survey of Iowa farmers who had a farm business successor and who had an estate plan state that the distribution of farm assets was to divide them equally among all heirs without regard to whether or not the heir had worked in the farm family business. The respondents indicated that an equal distribution was the “fairest” way to divide the assets. What is not considered in an equal distribution is the value that the successor, the in-business heir, has contributed to the wealth of the business.

When the asset value of farms and farm land experienced low appreciation the division of assets equally did not present a problem in designing an estate plan that was consistent with passing the farm family business to a successor. The relatively stable asset values and the high profit margins in farming allowed the successor to purchase the assets from the non farming heirs without burdening the farm business with unmanageable debt. The value of farm assets, primarily land, remained stable from the end of WWII until the decade of the 1970’s when land values began to rise rapidly. Concurrent with the rise in the value of farm business assets, primarily land, the profit margins in farming began to decline.

As on Iowa farmer stated, “No farmer every bought an acre of land as an investment. We buy it as an income producing assets for the farm business. The non farming heirs think their parents bought it as an investment.” What he meant by this is the increase in land values, in some cases twenty to thirty time its value when the parents came into possession of it, causes the non farming heirs to want their “fair share”. While the old saw that, “Blood is thicker than water” may still be true it is equally true that “Blood is not thicker than money.” What is not considered by the non farming heirs is the contribution to the parents’ wealth that has been made by the on farm heir, the successor.

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The contribution to the wealth of the business is made in several forms. One is the succession effect, that being when the owner/operator generation decides to have a successor and begins the process of increasing the income of the farm to support a second generation. That process may, and usually does, include the purchasing additional assets or adding a new enterprise. Either of these will increase the wealth of the business.

A second form of increase in wealth can be attributed to the successor effect. When the successor joins the farm business the business's has and excess of labour that must be employed. In this case the business may add assets or develop new enterprises. In either case, the wealth of the business is increase.

A third form of contribution to the wealth of the business is the wealth that is preserved by the successor providing services to the owner generation as that generation ages. In many families the successor may manage the farm business in lieu of the parents hiring a farm management company. The successor may also provide other services such as meal preparation, house cleaning, transportation for medical appointments, maintenance on the parent's home and other miscellaneous services. If the parents were required to pay for the services the wealth retained in the business would be decreased.

For those farmers who have a successor and are deciding how to divide assets in there estate plan, three approaches. One is to do nothing and to divide the assets equally among all heirs. A second approach is to "freeze" the asset value at the time the successor enters the farm business. Usually that value of the farm business assets are appraised when the successor enters the business and any increase in the value of the assets after that point in time is credited to the successor. The justification for the increase in the appreciated value being credited to the successor is that if there were no successor the assets could have been sold and the proceeds divided equally among the heirs.

Basics

Property Ownership - The manner in which land and other property is owned will determine how it can be transferred in the future.
Tenants in Common - each owner's respective share will pass according to their will.

Joint Tenants With Rights of Survivorship - the deceased owner's share will transfer immediately to the other owner upon the death of the first.

Life Estate - is an interest in real property for the length of your life, but no longer. The deed will say, "to A for life, then to B." A has full rights to the rents, profits and management of the asset during their life. Life estates are alienable but upon the death of A the ownership will pass to B.

Life Insurance – can provide the liquidity necessary to provide equitable treatment of nonfarm business heirs.

Business Entities – Business interests may be bought, gifted or earned and may be transferred through an estate plan.

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General Partnerships (GP) – All parties participate in the management and are personally liable for the actions of all other partners.

Limited Partnerships (LP) – Similar to a general partnership except that some partners have limited managerial control and therefore have limited liability for the actions of the other partners.

Corporations - Corporations completely separate business liabilities from personal liabilities. The majority shareholders have managerial control and minority shareholders have little managerial control.

Limited Liability Companies (LLC) – (Not all countries have this form of business entity.) Limited liability companies include certain attributes of partnerships and corporations. LLC's completely separate business liabilities from personal liabilities. Management can be similar to partnership management or corporate management.

Buy-Sell Agreements – Upon the occurrence of a specified event buy-sell agreement require an owner or the business to buy all or part of the ownership interest of another owner(s). Buy-sell agreement may be used to provide liquidity for the estate plan and by requiring the successor to purchase the assets or interests from the non business heirs.

First Option to Buy – When used in an estate plan the successor is offered the first option to purchase the assets/interested inherited by the non business heirs. The estate plan my require the option to be exercised immediately upon the death of the owner or may specify a later date.

First Right of Refusal - A first right of refusal requires the seller to offer the for sale asset to someone before it can be sold to another.
Trusts – A trust is a legal entity that holds and manages property for the benefit of a known or discernable beneficiary.

Gifts – Gifts made during the lives of the owners may be made to transfer assets to the successor.

Equal Distribution of Assets – The most common form to inheritance and one that potentially creates the most problems for the successor. Land is usually left in undivided common interests to all heirs or the land may be sold and the proceeds divided equally among all heirs.

Unequal Bequest of Essential Business Property – Short and intermediate assets such as machinery, equipment, livestock facilities, grain storage, tools, etc. may need to be passed to the successor in order to keep the farm business profitable. Such distributions are made without respect to equal distribution.

Valuing the Successor's Contribution - Often times the increase in net worth of the owners original farmland is largely attributable to the increase in value of farmland. Because the successor made no contribution to the increase in wealth it is fair that that the value be divided equally amongst the heirs. However, other business assets may have increased in value because of the contribution of the successor and additional farmland may have been purchased because due to the successor or

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succession effect. A portion of the increase in value from the purchase of the additional farmland credited to the successor as such purchase would not have been made had there been no successor. It is the owners' responsibility to calculate how much of the value of the additional land should accrue to the successor.

Lease Arrangements – When the farm owners reach retirement, either planned or due to age and infirmity, a lease of farmland at below market value facilitate the purchase of the owners interest in short or intermediate term assets. The money from the discounted lease is used to facilitate the purchase.

Salary – In the event the successor providing labour and management on and for assets owned by the parents such labour and services should be paid for by the parents. If the successor did to provide such labour and services the parent would be obliged to pay fair market value for them. Also, if the successor is utilizing time for labour and management for the parents the successor is taking that time from the successor's farm business. In the event the parents cannot pay for the successor labour and management they can adjust the estate plan by giving a larger share of the farm business assets to compensate the successor. In effect, the addition legacy is deferred compensation.

Contract Sales – When the owner generation withdraws labour and management from the farm business their need to own physical assets diminishes and there remains the need for a stream of income. The owner generation may decide to sell land and other assets via a contract sale. By using a contract sale the interest is paid directly to the owner generation as well as the principle. The successor has the right to possess and use the land and the senior generation receives a stream of income. An additional benefit is that the ownership of the land has passed to the successor and the senior generation my leave the contract payments to the not business heirs. Lastly, in the event of a material change in circumstance the senior generation may forego a payment during difficult economic time and the successor may be able to make additional payment during propitious times.

Farm Management Compensation and Compensation for Personal Care – It is not uncommon for the successor generation to provide business management services and to provide personal care for aging parents. These are services that, but for the presence of the successor, the parents would have to purchase at fair market value. Depending on the longevity of the older generation the provision of such services can last for years or even decades and the aggregated value can be rather large.

The spreadsheet set forth below list some of the services the successor may provide and the annual value based upon local rates can be calculated. In a case study developed by the Beginning Farmer Center the annual value of the service was $17,707.82 based upon United States Department of Labour wage rates. With the increasing life expectancy of the owing generation it is not difficult to envision the provision of these service for ten, twenty or thirty years. If the services are provided for ten years the total is approximately $177,000.00 dollars.

Other service may be needed that can be added to the list and appropriate compensation calculate for each. The spread sheet is not meant to be a formula but is a tool so that a discussion can be held on the value of these services and when and how they will be compensated. Hopefully the family

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will be able to use the spread sheet to generate a number that can be the beginning of discussions on the equitable distribution of the owner's assets and recognize the contribution of the successor to the wealth that has been accumulated and preserved from the date he/she joined the farm family business.

Successor's contribution	Value* /hour	Hrs./ Week	Weeks/ Year	Yearly Value
Personal Care				
Cooking				
Cleaning (Washing dishes, vacuuming, dusting, cleaning bathroom)				
Laundry				
Bathing, dressing, grooming				
Transportation to Doctor, for Groceries, etc.				
Pickup and delivery of pills and other supplies				
Other				
Other				
Total Personal Care				
Farm Maintenance				
Farm Management				
Personal Financial Advisor				
Bookkeeping				
Farm Labour				
Mechanics				
Lawn Mowing, Snow removal and Grounds keeping				
Other				
Other				
Total Farm Maintenance				
TOTAL				

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<table>
<tr><td rowspan="3">The value of the successor's contribution to the wealth of the business</td><td rowspan="3">The value of the nonfarm business heir's share. Determined as the value of the assets at the time the successor joined the business.</td><td>Number of Heirs</td></tr>
<tr><td></td></tr>
<tr><td>Total Net Worth</td></tr>
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<tr><td colspan="3">Assume the On Farm Heir is also the primary caregiver</td></tr>
<tr><td>3 Year Care Adjustment</td><td colspan="2"></td></tr>
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<tr><td>5 Year Care Adjustment</td><td colspan="2"></td></tr>
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<tr><td>7 Year Care Adjustment</td><td colspan="2"></td></tr>
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<tr><td>10 Year Care Adjustment</td><td colspan="2"></td></tr>
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Summary

Successful farm family business succession plans provide for the transfer of money, management and assets to the succeeding generation and should be implemented over a set period of time beginning when the successor joins the business. Short and intermediate term operating assets should be transferred to the successor during the life of the owning generation as those assets generate sufficient income to support the successor's family and provide for income for the owner generation during their retirement. As the ownership of these assets is transferred to the successor the management of those assets must accompany the transfer so that the successor is responsible for management. With the increase in the contribution of the successor the compensation of the successor should also increase.

The owner generation must distinguish between personal assets that may be divided equally among all heirs regardless of their contribution to the farm family business and farm business asset. All too often the owners decide that the fairest way of dividing their assets, both personal and business is to divide them equally among heirs. Such a division does not account for the contribution of the successor to the wealth accumulated by the owners. With the increase of asset values, primarily land, and equal division may result in the cessation of the farm family business.

The way farm assets are owned plays an import and sometimes limiting role in how those assets may be transferred. Common ownership of asset allows them to be passed to anyone in an estate plan while joint ownership with rights of survival causes to ownership to pass to the remaining joint owners.

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The selection of a business entity as a part of an estate plan should be carefully considered. All business entities change ownership and limit management and control and may not be compatible with other succession planning considerations such as transfer of management and income.

Buy-sell agreements, option, and right of first refusal provide the opportunity for the successor to acquire the farm business assets. The funding of these agreements is sometime difficult and may result in the farm amassing unmanageable debt or require the sale of assets to purchase other assets.

Favourable lease terms allow the successor to use the money generated from the lower lease price to purchase business assets. Contract sales can be similarly used to facilitate the purchase of farm assets.

An often overlooked contribution to the owners' wealth is the value of the services provided by the successor. The successor should be compensated at the fair market value for the services when such services are provided. In the alternative, the owners may wish to provide in their estate plan for a larger portion of the assets to pass to the successor as a form of deferred compensation.

Over two thousand years ago the Greek philosopher Aristotle stated, “The worst form of inequality is to try to make unequal things equal.” This is equally true in mathematics and farm business succession planning

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