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White paper

Farm and ranch transition planning

The longevity dilemma

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Farmers and ranchers are living longer. No surprise here, but the longevity of farmers and ranchers who are the primary business owners poses specific and unique dilemmas to their transition planning.

Let us look at a hypothetical example. Sam, for business and liability purposes, has placed his farm in a limited liability company. He is the sole owner of the limited liability company (LLC). Adam, the oldest of his three children, is active in the farm while the other two children are not. Sam is not ready to relinquish ownership or control of the farm. And like most parents, he wants to treat his children equal. Therefore, his estate plan has been set-up to divide all his assets, including the farm, equally between his three children. Subsequently, at his death, each child will receive 1/3 of the LLC farming business, since that is his primary asset.

At age 70, Sam is in very good health. His son, Adam, is 45 years old and has been working hard on the farm for over 20 years. Sam owns 100% of the LLC and farming assets while Adam has no ownership interest. Sam expects to live another 20 years to age 90 (his parents passed on in their 90s) which would make Adam 65 years old when he finally inherits his 1/3 of the farming business. At that time, Adam wants to consolidate the ownership of the business into his name so he can control the day to day operation of the farming business. To accomplish that, Adam will likely need an independent valuation of the farming business and then enter into an arrangement with his two siblings to pay them for their 2/3 of the farm. Under Dad's current plan:

- Adam will work on the farm his entire life to inherit the same amount as his siblings.
- When Adam receives his 1/3 of the farming business, his siblings will receive the controlling 2/3 of farm LLC. Since they own 2/3 of the farming business, they also control the management decisions and may take 2/3 of the income.
- Adam will have to negotiate with his siblings to purchase their interest in the farming business.
- Adam will probably incur significant debt to purchase his siblings' interests.

And while his siblings are enjoying retirement, Adam will be using the remainder of his life paying off the principle with nondeductible after-tax dollars. And he will also pay the agreed upon interest on the debt.

If you think this is unfair, it gets worse. When talking to Sam, it became apparent that Adam had been entrusted with running the operation while Sam became involved in community and political affairs. In other words, Adams' competency gave Sam the freedom to involve his time in something other than the farm.

We are not done yet! Sam admitted that over the last 20 years, Adam had significant involvement in tripling the value of the farming business during that time frame!

This is the common dilemma of longevity in business transition planning. Without aggressive lifelong planning (the earlier the better) and the awareness that fair does not mean equal, the child involved in the family business will:

- not acquire significant ownership rights until he is advanced in years,
- benefit the non-active siblings with his hard work and good management by increasing the value of the business,
- pay more to his siblings because of the increased value of the business, and
- acquire debt to become the controlling owner.

This is not only unfair to the active child, Adam; it also jeopardizes the ability of the farm to successfully survive to the next generation. Without planning, Adam is in a bad situation and the farming business that Sam spent a lifetime of blood, sweat and tears to create and nourish may die with him.

Planning options

Without going in depth, we will review a list of planning options and describe how they may be beneficial.

LLC unit ownership plan

Sam may want to consider, as part of the compensation to Adam, to include unit values of the LLC. Sam can arrange that the management of the company remain with him until death, while Adam's ownership rights increase over time. This gives Adam an immediate reward for his hard work and an incentive to continue working for the family farm.

A gifting program may be installed as well, but a careful analysis and guidance by tax counsel is advised to insure that the gifting program is not considered compensation.

Buy/sell arrangement

Another option is for Adam to enter into a buy/sell arrangement with his Dad. Here the arrangement could be funded with life insurance on Dad with the premium paid by his son. Dad can assist Adam with the payment of that life insurance by increasing his son's pay. He could increase Adam's compensation to an amount that would pay the premium and the increased taxes associated with the pay increase, making the arrangement cash flow neutral to Adam. The benefits of this arrangement are that Adam has the assurance of getting the business after Dad is gone for the agreed upon price, and Adam will have a tax free life insurance death benefit to pay off his siblings to consolidate his ownership in the farm.

The IDGT can be used to 'freeze' the value of an asset by transferring the asset into a grantor trust and then creating an installment note for the business' current value.

Installment sale

If the farm business is rapidly growing and the value of the farm business is placing Sam in a situation where his estate may have significant federal estate taxes, another planning option is to 'freeze' the value of the farming business and allow it to grow rapidly outside of his estate by selling the farm business in an installment arrangement to Adam. Once Adam becomes the owner of the farming business any additional growth will be in his estate and not his Dad's. Sam will receive installment payments over the course of the agreed upon term. If Sam were to die prior to the final payment, the remaining payments will be made to his estate and ultimately to the beneficiaries of the estate.

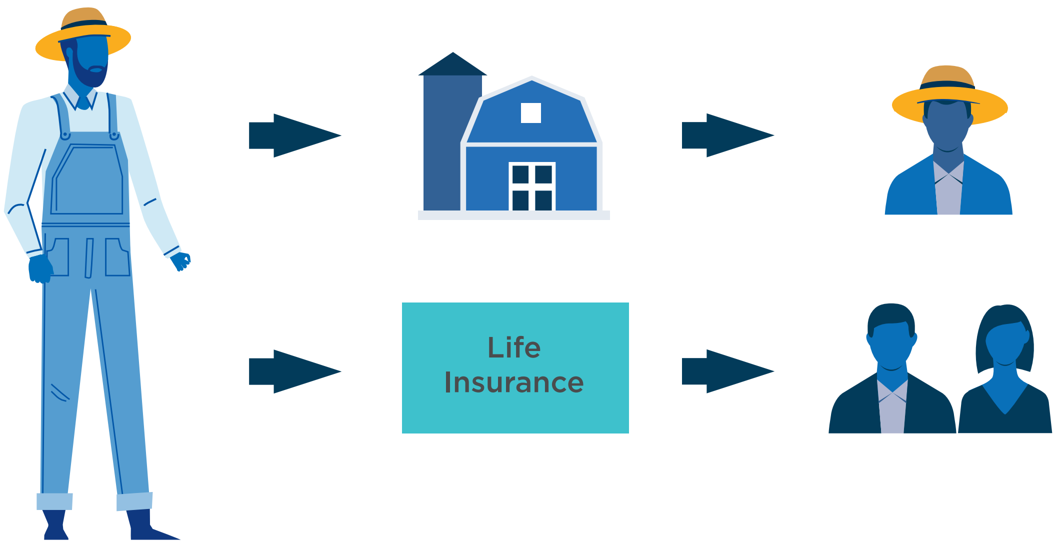
Intentionally defective grantor trust (IDGT)

The IDGT is also a 'freeze' technique that can provide some additional control and benefits by using a properly drafted trust. The IDGT can be used to 'freeze' the value of an asset by transferring the asset, in this example the family farming business, into a irrevocable grantor trust and then creating an installment note for the business' current value. This is a complicated technique that requires a lawyer who specializes in advanced estate planning.

Inheritance offset

Sam, as sole owner of the farming business, could continue as sole owner of the business and leave it entirely to Adam at his passing. But he's been unwilling to do so, thinking it would be unfair to his other children. He could offset the 2/3's value of the farming business that he would have left them, with the income tax free death benefit from life insurance. This can be done by naming his two children that are not involved in the business, as the beneficiaries of a life insurance policy on his life. At Sam's passing, Adam inherits the full value of the farming business and his siblings receive the cash from the life insurance death benefit as a full or partial offset of the farming business value they didn't receive.

Inheritance offset – Nonfarming heirs receive cash from life insurance death benefit instead of farming assets



Valuation of the business

A qualified appraiser should be involved any time there is a sale or transfer by gift of any business interest.[1] A quality valuation of the business interest involved can provide a good defense to challenges from the IRS or family members.

Conclusion

The parent and active child (or children) have an interest in the business transfer being equitable to the family members and in it providing the greatest chance of a successful transition to the next generation. That success is unlikely to happen without proper planning and implementation.

The strategies and techniques discussed can help accomplish the goals and objectives of the parties involved. Successful transition planning involves having the discussions, doing the planning, implementing the strategies with the right legal documents and financial products, and having regular reviews to keep the plan up-to-date. Tomorrow's success depends on today's preparation.

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[1] Also applies to transfers as compensation