

Planning for the Next Generation^{*}

—by Neil E. Harl^{**}

I. Preliminary considerations

- A. Historically, relatively few farm businesses have survived beyond the generation of their founding (although land often stayed in the family). However, that is likely to change in the next few decades as a greater percentage of farm businesses will be continuing beyond the life spans of the founders.
- B. Especially when continuation of the farm business is seriously contemplated, estate and business planning should be carried on simultaneously, if possible, or at least in the same general time period because of important interrelationships likely to exist.
- C. The objectives of the individuals involved are relevant to formulation of individual estate and business plans and should properly determine the estate and business planning decisions within the range of applicable law. Articulated objectives are likely to be competitive, thus raising difficult questions of weighting of objectives.
 1. The parents, as decision makers in firms, may wish to pursue objectives—
 - a. To maintain reasonable security of income and capital for retirement.
 - b. To assure an equitable (but not necessarily equal) disposition of family wealth among the heirs, devisees and legatees at the death of the survivor.
 - c. To minimize death taxes and estate settlement costs at the first death or at both deaths.
 - d. To make possible continuation of the firm.
 - e. Benefit favorite charities.
 2. One or both of the parents may also articulate objectives—
 - a. To reduce or eliminate property management responsibilities for the surviving spouse.
 - b. To limit the dower right or distributive share of a successor spouse upon remarriage of the survivor.
 - c. Continue charitable giving (but beware of syndrome of “what I have is what I’ll need”).
 3. Heirs not associated with the business may, if given an opportunity, voice objectives with respect to—
 - a. Certainty of income from inherited assets.
 - b. Right to participate in management.

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- c. An assured market for their ownership interest.
 - 4. Heirs associated with the business may have objectives with respect to—
 - a. Certainty of rights to property upon the deaths of the parents.
 - b. Equitable entitlement to annual income each year based upon their contribution to the business.
 - c. Right to participation in business decision making.
 - 5. Additional satisfaction may be gained from charitable giving—
 - a. Provide support for causes considered worthy by the donor.
 - b. Support activities the donor would like to have done.
 - c. Communicate to heirs that charitable giving is important.
 - d. Reduce income and estate taxes.
- D. Specific objectives relating to transfer of ownership and management may be posited if the decision has been made for the family firm to continue as an economic entity into the next generation.
1. Each generation must face the choice of whether efforts should be made for the firm to continue beyond the death of the majority or sole owners as an economic unit or whether it should be assumed that assets will be recombined with those of other firms at retirement or death.
 2. If firms are “born” and also “die” within each generation, inefficiencies are noted in the early years and also in the declining years of the firm. Planning ownership and management succession to perpetuate the firm with the peak efficiency reached in the midphase of the family firm cycle may result in significant economic benefits to the firm

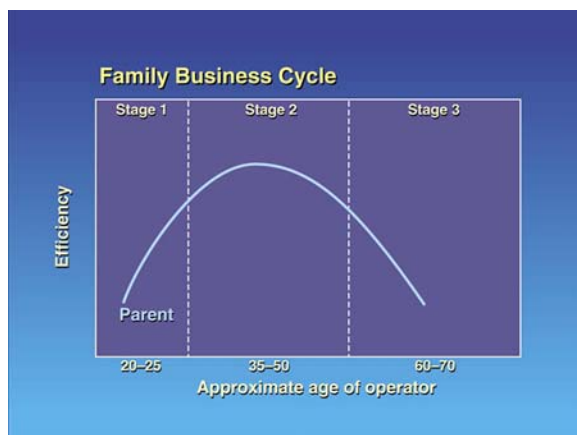


Figure 1.
Portrayal of firms that are “born” and “die” in the generation of the founding of the firm.

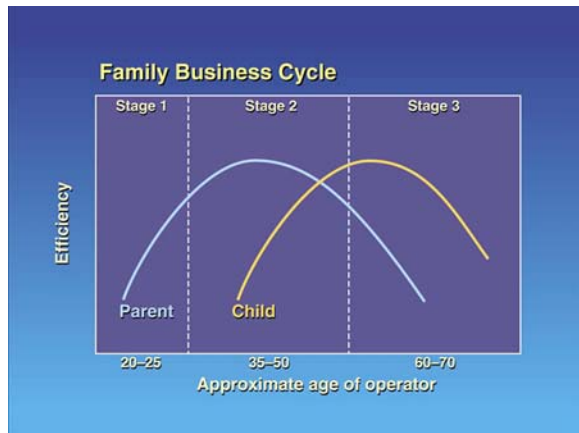


Figure 2
A model of succession planning with two generations.

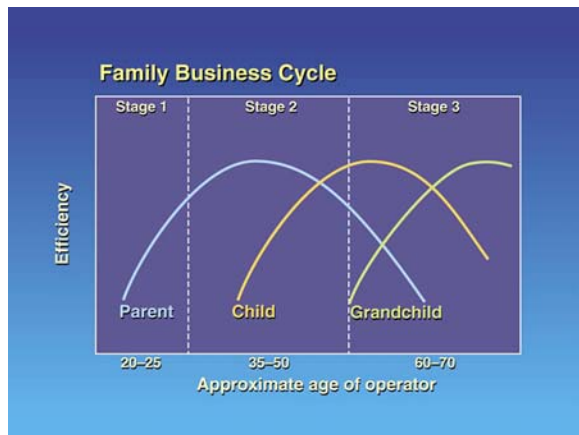


Figure 3
A model of succession planning with three (or more) generations.

3. Perhaps the greatest threat to continuation of the firm is the erosion of equity capital to pay distributive shares to heirs not associated with the family business unless the off-farm heirs are happy, cheerful and contented investors.
 4. If the decision has been made, at least tentatively, for the firm to continue, the heirs (children and grandchildren) may not hold identical objectives—
 - a. Off-farm heirs may, if given an opportunity, voice objectives with respect to certainty of income, salability of assets and availability of management rights after death of the parents.
 - b. On-farm heirs may have objectives with respect to—
 - (1) Certainty of rights to property upon death of parents.
 - (2) Equitable entitlement to annual income each year based upon contribution to farm business income.
 - (3) Participation in farm business decision making.
- E. Different styles of parent/on-farm heir relationships
1. Spin-off model

- a. Relationship is viewed as relatively short-run and is basically contractual in nature.
 - b. Memorializing understandings in writing is usually helpful—
 - (1) To encourage discussion over the entire range of possible problems.
 - (2) To combat the “selective recall” syndrome.
 - c. Be sure the expectations of all parties are at least parallel.
 - d. Maturing spin-off relationships typically move toward partnership status.
 - e. Proper characterization of the relationship is a common problem.
 - f. Watch economic vulnerability of the on-farm heirs for the first few years if death should occur prematurely or serious disagreements should arise.
2. Landlord-tenant model
- a. Usually most likely to be acceptable if parents are close to social security eligibility and are seeking to convert farm business income into investment income through a non-material participation lease.
 - b. Some landlord-tenant operations involving two generations of the same family suffer from excess landlord management input, gratuitously offered.
 - c. The parents may object to reduction of income to them as the landlord’s share almost inevitably is less than the amounts previously earned.
3. Superfirm model
- a. Indefinite commitment of the on-farm heirs to the family firm.
 - b. On a long-term basis, expect multiple ownership of resources and multiple participation in management.
 - c. Objectives of on-farm heirs relative to participation in decision making, sharing in annual income and attaining rights to equity capital over time become paramount.
 - d. Fundamental changes usually occur in the organizational structure of the farm business to accommodate multiple ownership and management interests. Attention tends to focus on the partnership and the small, closely held corporation.

II. Estate and business planning may involve the creation of a succession plan. Such a plan includes—

- A. Building a management team, which in turn involves—
 - 1. Stressing the idea of a team approach to making decisions.
 - 2. Focusing on developing management skills.
 - 3. Emphasizing cross training.

4. Developing a system of routine communication.
 5. Implementing routine, non-threatening evaluation.
- B. The “power” issue, which involves the issue of who can control decision making. From a planning perspective, that involves—
1. Needing to create an environment in which decision making power is secondary to quality of decision-making input.
 2. A “power audit” to focus upon decision making power under alternative scenarios.
 3. Consideration of the choice of organizational structure.
- C. Assuring fair compensation is a fundamental part of a succession plan.
1. It is important to compensate each individual fairly each year (salary, bonus, payment in equity interest in business).
 2. The hazards of deliberate under-compensation with intent of “someday” making it right are well known.
- D. A succession plan should anticipate disruptions, such as—
1. Premature retirement or death.
 2. Retirement or death at or near expected time.
 3. Dissolution of marriage and division of ownership in the business.
 4. Serious disagreements.
 5. Major tort or other liability.
- E. Valuing ownership interests is a key part of protecting owners, especially minority owners.
1. Several options are available—
 - a. Book value.
 - b. Appraisal.
 - c. Periodically re-negotiated fixed price.
 - d. Value set in a market.
 2. Valuations may be subject to discounting—
 - a. Minority interest,
 - b. Non-marketability,
 - c. Co-ownership,
 - d. Potential income tax liability.

- F. Protecting minority owners is important to younger generation individuals especially in corporations. Several basic options can be employed—
 - 1. Assured market at fair price for ownership interest.
 - 2. Carefully drafted provisions for triggering first option and buy-sell agreements.
 - 3. Modification of traditional decision making rules—
 - a. Super-majority vote.
 - b. Below-majority vote.
 - c. Pre-decide key issues (voting trust, pooling agreement, shareholders' agreement).
 - d. Cumulative voting.
 - e. Pre-emptive rights.
- G. Phased retirement focuses on encouraging older individuals to retire and may involve—
 - 1. An appropriate level of compensation.
 - 2. Access to retirement benefits and social security (particularly for those under age 70).
 - 3. Development of a reduced-responsibility position on the management team.

III. Principles of estate and business planning

- A. Never give ownership interests away unless you are prepared to lose the property because of dissolution of marriage, death or actions of creditors.
- B. In general, do not structure the business such that off-farm heirs are involved in ownership or co-ownership of the operating entity (off-farm heirs pose few problems as co-owners of the real estate—indeed, this is necessary to deal with a major loss of capital otherwise from the firm at the deaths of the parents). With ownership of the operating entity comes an interest in management and collisions in expectations often occur.
- C. A major concern is how to assure the income desired by parents in retirement from the cash flow of the operation and still leave sufficient income for the others involved in the operation.
- D. Always test organizational options against both a worst case and a best case scenario.
- E. In general, estate planning and business planning should be carried on contemporaneously to assure adequate integration of the two.
- F. A major concern is how to assure a perception of fairness among the children and other interested heirs.

IV. Planning for an exit strategy from the beginning

- A. It is a fact of life that someone is necessarily a minority owner of a business venture unless the business has only one owner or ownership is divided equally between two owners. If a business operation runs smoothly, there may be little concern about minority status but if matters do not run smoothly, minority owners may be in a highly vulnerable state.

1. Thus, the concern may be one of trying to rebalance power in a manner that increases the power of the minority owner—
 - a. By adjusting the vote required for decision making (up or down).
 - b. By providing the owners a market for their ownership interest at a fair price, spread over a reasonable time period at a reasonable rate of interest.
 - c. By predeciding certain key issues in an owner's agreement, voting trust or similar document.
 2. In the alternative, if serious differences occur, the exit strategy could involve—
 - a. A partial or total liquidation of the business.
 - b. A redemption of ownership interests.
 - c. A split-off of part of the business to separate warring factions.
 - d. An agreed upon shift from an equity interest to a debt interest.
 - e. A shift to passive investor status, usually with diminished involvement in management.
- B. It is critically important for the principals to realize from the beginning that a lifetime of employment is less likely to be within the scope of reality than was the case a half century or longer ago, even in a family-farm operation. The operation is less likely to be damaged economically if a well thought out plan is in place to move individuals into and out of the firm, consistent with their life cycles and their employment preferences.

V. Tax treatment of leased property (see “Tax Treatment of Leased Property” attached)

- A. General rule — activities of an agent are imputed to the principal
1. Fifteen year installment payment of federal estate tax under I.R.C. § 6166. In a 1981 IRS ruling, a farmer was incapacitated and the farms were managed by the spouse under crop share lease. The wife's activities were imputed to the incapacitated farmer at his death.
 2. Income in respect of decedent.
 3. Passive loss rule for S corporations.
 4. Personal holding company tax and status of rent for the family-owned business deduction. In an important 1957 case, income from crop share leases on Iowa farms was not “rent” for personal holding company purposes where the land was managed by a professional farm management firm. The landowners were bearing the risks of production and the risks of price change and the activity level of the farm manager was imputed to the landowners.
- B. Rule for situations routed through I.R.C. § 1402 (imputation is blocked for those producing agricultural or horticultural products).
1. Rent as self-employment income.
 2. Special use valuation of land for purposes of material participation.
 3. Material participation for the family-owned business deduction.

- C. Presence of paid manager or agent destroys the principal's own record of involvement.

VII. It may be helpful to develop a liquidity plan as part of the overall estate plan

- A. The liquidity plan represents a conscious effort to select the most appropriate techniques for solving the liquidity problem and should have four components—
 - 1. A realistic assessment of the liquidity needs at the deaths of both spouses, in the case of a married couple, or the deceased alone in the case of a single individual.
 - 2. A review of all feasible liquidity augmenting techniques available including sale of inventory, sale or mortgage of land, life insurance, savings, installment payment of federal estate tax, special use valuation of land, family-owned business deduction and corporate stock redemption.
 - 3. Selection of the most economically advantageous of the alternatives.
 - 4. A listing of all pre-death requirements that must be met for eligibility of the selected techniques.
- B. The liquidity plan serves as a constant reminder to the family of the requirements for liquidity-solving techniques being relied upon. For example, unless accompanied by careful planning, 15-year installment payment of federal estate tax, special use valuation of land, the family-owned business deduction and "Section 303" corporate stock redemption may not be available to solve liquidity problems after death.

VIII. Future of federal estate tax

- A. The transfer taxes (other than federal gift tax) are repealed for deaths after December 31, 2009, with no federal estate tax, no generation-skipping transfer tax and a carryover basis at death (losses of decedent's basis or fair market value with adjustments which are adjusted for inflation).
 - 1. However, all 2001 Act provisions "sunset" for gifts made, decedents dying and generation-skipping transfers after December 31, 2010, with the federal estate tax returning to an applicable exclusion amount of \$1,000,000, a maximum rate of 55 percent and a new basis at death.
 - 2. The applicable exclusion amount in the meantime is set at—
 - \$2,000,000 per decedent for 2006-2008
 - \$3,500,000 per decedent for 2009.
 - 3. The federal gift tax base \$,000,000 applicable exclusion amount until 2010 and beyond.
 - 4. The federal estate tax rates are—

2006	46 percent
2007-2009	45 percent
 - 5. A new income tax basis at death is scheduled through 2009.
- B. Why carryover basis is objectionable.
 - 1. Must produce records of income tax basis for each asset
 - 2. Locks assets into families over time.
 - 3. Basis calculation is complex.

4. Results in gain to heirs, up and down the income and asset scales.
- C. Importance of new basis at death to farmers and ranchers—
1. Income tax basis of raised animals is zero.
 2. Inventories of raised grain and feed are also zero.
 3. Machinery is often depreciated rapidly, resulting in low or zero basis.
 4. Real property basis is often low.
- D. The substantial uncertainty over the future of transfer taxes poses a huge challenge for planners. Here are some suggested guidelines for planning—
1. Balance the estates (provided balancing is philosophically acceptable).
 2. Be particularly careful not to underfund the marital share as the unified credit applicable exclusion amount increases between 2006 and 2009.
 3. Plan to review wills and trusts more frequently than would ordinarily be suggested.
 4. Communicate thoughts on the future of the transfer tax system to Senators and Representatives in Congress.
 5. Plan to die in 2010.
- E. Prospects for further legislative action
1. Future action by Congress is expected to be influenced by three major considerations—
 - a. The fiscal condition of the country (at the moment, this factor would suggest that a partial reversal of the 2001 action may occur).
 - b. Who controls the U.S. House of Representatives, the U.S. Senate and the White House.
 - c. The attitude of the American people.
 2. My own projection is that the Congress will revisit the 2001 Act, probably in 2007, and will—(1) eliminate repeal of the federal estate tax, (2) leave the ramp up in the exclusion in place and set the exclusion at \$4,000,000 per decedent, \$8,000,000 for each decedent and spouse, (3) leave the federal estate tax with a rate of 15 percent on the first \$25,000,000 of taxable estate and 30 or 35 percent above that level and (4) retain the new basis at death.

IX. Basic considerations in structuring the farm business

- A. Creating multiple entities, *e.g.*, land held in one entity (or retained in individual ownership) with the machinery, livestock, equipment and inventory held in another may—
1. Provide flexibility in meeting the retirement obligations of the parents.
 2. Create additional options for meeting the objective of fairness to the off-farm heirs without their involvement in the farming operation.

3. Reduce the investment needed by the on-farm heirs in gaining control of the operating side of the business.

B. But creation of multiple entities may also lead to problems—

1. If land is held in a separate corporation taxed under the regular method of taxation, problems may arise relative to the personal holding company tax. In a leading case, income from crop share leases was not “rent” for personal holding company purposes where the land was managed by a professional farm management firm.
2. The IRS position since 1995 has been that rent for land leased to the operating entity, even under a cash rent or non-material participation share lease, may be subject to self-employment tax if the lessor is materially participating as a partner, employee or managing member of the operating entity.
 - a. In four Tax Court cases and a 1996 private letter ruling, that conclusion has been reached, focusing on the word “arrangement” in the statute—

“(a) the term “net earnings from self-employment” means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss

“(1) there shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer; except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if such income is derived *under an arrangement*, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity.” (Emphasis added).

- b. Three of the cases were appealed to the Eighth Circuit Court of Appeals which focused on the “nexus” between the lease and the farming operation and stated that “the mere existence of an arrangement requiring and resulting in material participation...does not automatically transform rents received” into self-employment income.
 - (1) The court pointed out that rents consistent with market rates “very strongly suggest” that the rental arrangement should stand on its own as an independent transaction without self-employment tax being due.
 - (2) The three cases were remanded to the Tax Court which , in 2002, indicated agreement with the Eighth Circuit Court of Appeals. In October of 2003, IRS announced a non-acquiescence in the three decisions.
 - (3) Two more cases were litigated in 2004, one with excessively high rents (SE tax was imposed) and one where the rent was reasonable (SE tax not imposed).
 - (4) Another case from New York was pending before the Tax Court but has been settled for \$35,000 on an assessment of \$105,000 of SE tax.
- c. Legislation has been introduced to change “an arrangement” to “a lease agreement” in the statute.
- d. Solutions (if litigation or legislation does not solve the problem)—

- (1) Transfer the land to a spouse who is not involved in the business.
 - (2) Transfer the land to an entity (other than a grantor trust) such as a limited partnership or LLC.
 - (3) Pay the self-employment tax.
 - (4) Retire from the business.
 - (5) Die.
3. Several tax provisions impinge directly upon liquidity plans for an estate comprised principally of a farm or other closely-held business and suggest that attention be given to the organizational structuring of the business in planning to meet liquidity needs. The choice of organizational structure may influence eligibility for—
 - a. Installment payment of federal estate tax for the portion of the tax attributable to a closely-held business.
 - b. Stock redemption after death to pay death taxes and estate settlement costs.
 - c. Special use valuation of land at death for federal estate tax purposes.
 - d. The family-owned business deduction (through 2003).
 4. Separating the land from the rest of the assets used in production may create other problems—
 - a. The production side of the unit is usually a voracious user of capital and a reasonable rental to the owner of the land may lead to a build-up of capital in that entity.
 - b. The land normally represents an important part of the collateral for production credit.
 - c. Multiple entities tend to lead to complexities in accounting and capital transactions.
 - d. A group of controlled corporations is limited to one set of graduated rate brackets.
 5. An important question to ask is why the organizational structure of the farm business is being changed—
 - a. If to provide an opportunity for a child or child-in-law to obtain a substantial interest in (or control of) the production side of the operation, leaving the land out reduces the investment necessary to accomplish the objective.
 - b. If to solve the parents' estate planning problems, leaving the land out means that the asset of perhaps the greatest value will not come within the production entity part of the estate plan. There are, however, other possibilities—
 - (1) Inter vivos or testamentary trusts to keep the land together until it can be purchased by the on-farm heirs.
 - (2) Retention of the land in individual ownership by the parents with perhaps an option to the on-farm heirs to acquire the land at the death of the surviving parent.
 6. The structuring of the farm business may also affect—
 - a. The deductibility of losses under the passive loss rules.

- b. Whether losses on the sale of property are capital losses (limited to \$3,000 per year) or trade or business losses (deductible without limit).
 - c. Whether stored crops and growing crops are income in respect of decedent at death.
- C. Eligibility as a “person” for purposes of limitations on federal price and income support benefits
- 1. A corporation is treated as a “person” entitled to one federal payment limit. An individual shareholder may be considered as a separate person if engaged in the production of the crop as a separate producer and owns 50 percent or less of the stock (including stock owned by a spouse, minor children and trusts for the benefit of minor children).
 - 2. In contrast, partnerships, joint ventures, tenants-in-common and joint tenants are not considered a separate person. In general, each individual or other legal entity sharing in the proceeds is considered a separate person.
 - 3. A husband and wife are considered as one person even though both own assets and provide labor and management for the operation.
 - 4. Two or three entity rule—
 - a. A person may not hold, directly or indirectly, a substantial beneficial interest in more than two entities.
 - (1) The limit is raised to three if the person does not receive farm program payments as a separate person.
 - (2) An interest of less than 10 percent is generally not considered a “substantial beneficial interest.”
 - b. A husband and wife are considered one person except that if the spouses before marriage were separately engaged in unrelated farming operations, each spouse is treated as a separate person with respect to the farming operation brought into the marriage by that spouse so long as the operations remain separate.
 - c. A person must be “actively engaged” in farming to receive farm program payments.
 - (1) The individual’s share of profits or losses from the farming operation must be commensurate with the individual’s or entity’s contribution to the operation.
 - (2) The individual’s or entity’s contributions must be “at risk.”
 - (3) An individual must make a significant contribution of —
 - (a) Land, capital or equipment and
 - (b) Active personal labor or active personal management.

Tax Treatment of Leased Property

	Eligibility			Agent's Activity Imputed
	Cash	Non MP Share	MP Share	
Income in respect of decedent	--	Yes	No	Yes
Passive activity losses deductible				
Active participation	Up to \$25,000	No	No	No
Material participation	No	No	Yes	No
Deductibility of losses (§ 1231 or capital)	Capital	§ 1231	§ 1231	Yes
Personal holding company income	Yes	unc	No	Yes
Special use valuation				
Pre-death	Yes, if to family	Yes, if to family	Yes	No
Post-death	No, except spouse or lineal descendant**	Yes, if to family	Yes	No
Family-owned business deduction				
Pre-death material participation	No	Probably No	Yes	No
Post-death material participation	No	Probably No	Yes	No
Family-owned business deduction				
Pre-death rents	Yes*	Yes*	Yes	Yes
Post-death rents	Yes*	Yes*	Yes	Yes
Installment payment of estate tax	No	Yes	Yes	Yes
Rent as self-employment income	No	No	Yes	No
Self-employment tax (if not materially participating in business)	No	No	Yes	--
Self-employment tax (if materially participating in business)	Yes	Yes	Yes	--

* If to a member of the family as tenant.

** If rented to member of the family of the spouse or lineal descendant of the decedent.