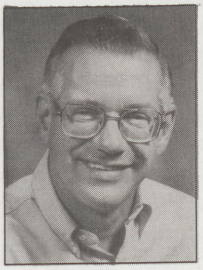
The Keys to Successful Estate Transfer

by Eddy LaDue and Carl Crispell



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Farm owners frequently bring members of the next generation into the farm business as part of the process of passing the farm to the next generation. This is a complex process which frequently involves: 1) developing a procedure for the younger generation to enter the business and obtain some assets and experience while the older generation maintains control, 2) operating the farm together for some period, often with changing asset ownership and management responsibility over time, and 3) a period of gradual exit of the older generation when the younger generation is the primary manager and decision maker.

Each of these stages in the transfer process usually requires the use of debt capital and may involve changes in the financing arrangements for the business. Unsuccessful farming-together relationships and transfer arrangements will often significantly increase lender credit risk. Successful arrangements usually result in larger businesses, larger loans and improved repayment capacity.

The objective of this article is to report the keys to successful farming-together and estate transfer arrangements obtained from a recent study. In the discussion that follows we first provide a brief explanation of the study and then discuss the keys to success as obtained from the study.

The Study

This study involved a personal interview of 46 farm families. These families were involved at some stage in the farming-together and transfer process. Three questionnaires were used in the interview. A business organization questionnaire was used to obtain information on the particular farming-together procedure the family was using. This included identification of the parties involved, their use of written and unwritten agreements, withdrawals and salaries, asset ownership, limitations on the powers of participants, profit sharing, and dissolution. This questionnaire was administered with all parties present. The other questionnaires were administered with only one party (and spouse) present.

The second questionnaire was used with junior parties. This obtained information on personal goals, transfer of ownership, management responsibilities and the transfer of those responsibilities, transfer plans, business goals, family interrelationships, compensation, concerns about the transfer process and the keys to successful transfer. The third questionnaire was used with senior parties. It covered the same information areas as the questionnaire for junior parties except that it focused on the senior parties' perspective.

The farms operated by these families were generally larger than average because they were supporting two or more family units. Average total investment was $787,000 with an average equity/asset percent of 63. Forty-three of the farms were dairy with an average of 112 cows per farm. The other three farms were fruit (primarily apple). Total crop acres averaged 379 per farm.

The 46 families on these farms included 46 senior partners with an average age of 61 years and 12.6 years of education, 36 senior spouses, 67 junior partners with an average age of 33 years and 14.3 years of education, 40 junior spouses and 14 other family members. Some spouses were not part of the business arrangement.

Keys to Successful Agreements

Two approaches were used to identify the keys to successful agreements. The first was to ask the participants in the survey for their list of keys. The second was for the authors to identify keys from the interviews and analysis of the data. In general, the keys identified by the authors were mentioned by at least one of the parties. Thus, the discussion that follows focuses on those keys that were deemed most important by either approach.

Good Communication. At the top of the list is good communication. All parties need to have the capacity to present their views and feel comfortable in doing so, and all need to be heard, that is, seriously listened to by the other parties. This includes the spouses of the partners as well as the partners themselves. Good communication can improve the performance of the business. However, the main contribution is to the interpersonal relationships of the individuals involved in the business. Discussion of the concerns of either party can often result in solutions that are acceptable to both parties. Allowing the concern to fester unattended may result in a larger problem that will harm the business and/or the farming-together relationship.

On one farm the father indicated disappointment with the son's lack of initiative. He wished the son would be more aggressive and shoulder more of the responsibility of running the farm business. However, the son was concerned that "(F)ather runs the business. He doesn't give me any responsibility. He is not interested in letting me do anything except labor." Clearly, improved communication would improve this business.

At the top of the list is good communication.

Use Good Consultants. Finding and making use of good consultants also ranked high by both parties. Since development of farming-together relationships and transferring the business to the next generation occurs only once or twice per generation, most farmers are not expert in the many facets and alternatives for such arrangements. Family members may also be too close to, and emotionally involved with, the situation to make the best decisions without input from outside advisors.

Management and finance consultants can help identify the best alternatives for a family or business and can help isolate problems and suggest possible solutions. Accounting or bookkeeping consultants can determine the potential feasibility of alternatives and can document and monitor progress. Legal consultants can put desires and plans in legal form. Families that make use of such talent are more likely to succeed.

Most consultants who worked with the families surveyed did an excellent job. The biggest problem was the reluctance of farmers to hire, pay and make use of the good consultants available to them. All consultants are not created equal. One family had a three-inch-thick partnership agreement. However, the blanks in the agreement that had been left for the value of assets, income distribution and other critically important numbers were still blank four years after the agreement was prepared. The family thought they had a partnership agreement. But, the consultants had not worked with the family to develop an agreement. They had only developed an agreement form.

Openness. Openness, particularly with respect to goals for the business and transfer process was mentioned frequently by the junior generation and somewhat less frequently by the senior generation. The junior generation was particularly concerned about agendas or plans that the senior generation does not want to, or does not make the effort to, share with junior parties. Senior parties sometimes wonder whether the junior parties really want to continue with the current farm business.

In most cases, where problems exist, the problem is one of not knowing the other parties' goals or plans, rather than suspecting a sinister plan to treat the other party poorly. For example, on one farm the father's will was very important to the asset transfer plan. However, the father refused to disclose exactly what was in his will. This created a high level of uncertainty for the son who was staying on the farm.

Get it in Writing. Both parties, but particularly the junior generation, stress the need to get things in writing. Getting things in writing forces the parties to agree on what is to be put in writing. That is, it makes the parties think about and agree as to what the arrangement is to be. It also provides a permanent record of agreements reached.

One caveat about getting things in writing is that the things that are written down can be changed. Any farming-together or transfer agreement needs to be reviewed periodically and changed as needed. As time passes the character of the individual changes, the business changes, the business environment changes and the goals of the people involved change. To accommodate all of that change, the written agreement may also need to be changed. A farming-together or transfer agreement should be treated like a living thing that must be molded and modified as the needs and desires of the people involved change.

Agreements need to be reviewed periodically and changed as needed.

The families interviewed were asked what personal expenses are paid by the business. Their responses were compared to the business agreement. For 60% of the farms that provided written agreements, current practice did not agree with written document.

Willingness to Compromise. A willingness to compromise was particularly important to the senior parties but was mentioned by both. Whenever two parties are joined in any venture as complex as farming and one that determines the personal future of the parties involved, differences in goals, desires and opinions are sure to arise. In order for the venture to succeed, all parties must be prepared to compromise their position for the good of all.

Fathers must realize that the younger generation is joining the business, not becoming the caretaker of Dad's business. The business is not something that father built that the son or daughter must maintain. It's something that father started that is to be nurtured, which may involve change. The younger generation must realize that joining the business, that may someday be theirs, does not immediately make them owner and manager. They will have to work at it a while. Also, Dad may be right!

Have a Successful Business. A successful business is important for at least three reasons. First, there is serious question whether the younger generation should want to get involved in, and eventually take over, an unprofitable business. If the business is not profitable, it cannot be expected to generate income for the lifetime of the younger parties. Starting another career while they are young may be a better long-run strategy. It may be in everyone's best interest to sell the farm, let the older generation live from the proceeds and the younger generation inherit any remainder, rather than stay on the farm solely to inherit it. Second, if the younger generation is expected to buy the business from the senior parties, there must be enough income for them to live and pay for the farm, as well as to provide an income for the senior parties, while the transfer process is occurring. Third, when the older generation retires, even if they retire on the farm, there must be enough income from the business to pay the retirement income, the younger generation's living expenses and the cost of replacement labor to do the work formerly done by the older generation.

This does not mean that unprofitable businesses cannot be transferred. Several of the 46 surveyed businesses were basically unprofitable. However, if such businesses are transferred, other arrangements must be made for living expenses and transfer procedures. Living expenses on such businesses are often handled by off-farm income. This usually involves off-farm income, often earned by one or more spouses working off the farm. Transfer of such farms must rely heavily on gifting and/or inheritance.

A joke that arose out of the 1980s asked the question "What is child abuse for a farm family?" The answer was "Leave the farm to the kids". Obviously, this implied that all farms were unprofitable, which was not even true then and certainly not now the situation. But it may almost be appropriate for some unprofitable farms where son or daughter will not be able to make it profitable either.

Seniors Must Give Up Some Control. The older generation must be willing to give up part of their control of the business. In order for the younger generation to learn management, the older generation must let them do some managing. This means giving up some of their management control, at least over parts of the business. If the younger generation is to become a true partner in the business, they must have ownership control of some of the assets.

It may be in everyone's best interest to sell the farm.

This means that some of the assets of the business must be transferred to (sold to, given to, bought by) the younger generation. If the older generation is not ready to give up control of some of the business, they are not ready to enter into a farming-together relationship. In these cases it may be better for the younger parties to seek employment elsewhere until the senior generation is ready. If the older generation is unwilling to transfer ownership of some of the assets to younger parties, a transfer to the next generation cannot occur.

Some advisors suggest that the younger generation focus on trying to get father to give up some function that he does not like to do or something at which he does not excel. Although this may not be the younger generations' first choice of something to manage, it may be a good chance to obtain experience and demonstrate ability.

Be Equitable to All. Any farming-together relationship and transfer arrangement must be equitable to all parties. This refers to the children of the senior generation who are not part of the farming operation as well as all of the parties involved in the farming business. The important principle for this issue is that equitable does not necessarily mean equal. The son or daughter who stays on the farm and fulfills the parent's dream of keeping the farm in the family or keeping the business the father has built up over a lifetime, as a going, profitable business, does not have to be given equal treatment relative to the children who leave the farm upon graduation from high school or college to seek other careers.

The younger generation who stay on the farm help maintain and build the farm assets. These assets should not then be shared equally among all of the senior generation's children. Most non-farm heirs do not expect to inherit an equal share of the farm business that they have had little to do with for years. Those who do, should have the situation explained at an early age. Appropriate treatment of non-farm heirs should be given careful consideration.

Some farms are not sufficiently profitable to allow the younger party to buy the farm. If the father wants the son or daughter to get started in farming, he may have to treat the farm heirs differently than the non-farm heirs.

Transfer Gradually. Transfer of the business should be a gradual process. The farming-together and transfer process may take several years or several decades. In many cases it is the desire of both parties for the younger generation to enter the business, farm with the senior party for a number of years, gradually take over control of the business, and then become the sole owner of the business when the older generation retires. This desire can be fulfilled with a gradual shifting of ownership and management.

The younger generation will usually try to increase ownership of assets as rapidly as possible until they own a proportional share of the assets, or at least of the non-real estate assets. Then the generations can farm together on an equal ownership basis until the estate transfer process starts in anticipation of the senior party's retirement or death. The appropriate rate of transfer of the senior generation's share of ownership will depend on the magnitude of assets to transfer, the amount of non-farm assets, desires of the older generation and many other factors.

Throughout the entire farming-together process, the transfer of management may be occurring. In the early years, the older parties should be providing the younger generation with management training opportunities by giving them responsibility for specific management functions. As the younger generation develops managerial capacities their responsibilities can be expanded. Management responsibility does not have to coincide with asset ownership. Many non-farm businesses give management responsibility to employees who have no ownership interests. The shift of managerial control can occur throughout the farming-together relationship and may be largely completed before final transfer of ownership occurs.

Appropriate treatment of non-farm heirs should be given careful consideration.

The results are often disappointing when the process is not gradual. A son came home from college, father wanted to get out of farming, so he offered to sell the whole business to the son. The son thought this was a great opportunity to be farming on his own immediately. However, the son ended up with 100% debt, and this farm, like most farms, was not profitable enough to make the payments on 100% debt. The son was never able to get his business under control with the heavy debt load.

Have a Dissolution Plan. One thing that the normal farming-together process demonstrates is that every partnership or other farming-together relationship must be, and will be, dissolved at some point in time. Everyone expects that to occur. Further, many farming-together relationships are dissolved for reasons other than transfer of the business. The economic environment may change such that continuation is not viable. The parties may decide they just cannot operate a business together. One of the parties may decide they no longer want to farm. A divorce may cause dissolution. Thus, every agreement should have a dissolution plan. The plan should allow for the expected and the unexpected. It is usually much easier to agree upon procedures for withdrawal, asset distribution and debt allocation at the time the business is being formed than at the time of an unexpected dissolution.

Mutual Respect. Mutual respect among all parties is required. The younger partner must mature from the teenage rebellion stage when the parents are assumed to know nothing and have suspect motives. He or she needs to respect the older generation's experience and desires. On the other hand, the older generation must treat the younger parties as business equals and not as children. It is often difficult for parents to see and treat their children as adults after spending so many years working with them as babies, toddlers and teenagers.

The party most often not treated with mutual respect is the daughter-in-law. Senior spouses (mothers) often believe the daughter-in-law should assume the same place in the business that the mother assumed when she became part of the business a generation ago. However, the world has changed. Young women are expected to get the same college or other training as young men. Women are encouraged to embark on careers which will contribute to the now normal two earner family. Such women who marry farmers may desire to continue with their career plans. Further, their greatest contribution to their (the younger parties') family may involve them working at an off-farm job and having relatively little to do with the farm per se. In cases where the daughter-in-law does want to be involved in the business, she will frequently want to be more directly involved in management and decision making than did the prior generation.

Both the senior partner and senior spouse need to recognize that the younger partner's family normally contains two different people than does their own family. The best decisions for that family may be different than decisions reached by the senior generation when faced with similar problems. The fact that the younger generation reaches different decisions does not mean that the daughter-in-law is trying to undermine the business or avoid responsibility for contributing to overall family success. However, she has every right to expect her husband, and thus the farm business, to contribute to their long-term family welfare.

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One element that may cause the appearance of lack of mutual respect is family culture. Some families' culture involves open, aggressive and thorough discussion of all issues with no off-limits questions or issues. Other families approach issues more subtly, quietly develop facts and ideas, gradually evolve towards solutions and decisions and do not directly confront issues that could result in serious disagreements or hard feelings. Both cultures, and all variations in between, can be successful from both a family and business perspective. However, as is usually the case, the younger partner and both senior parties are from one culture, the junior spouse can be the odd person in the group until (s)he adopts to the new culture. It is easy for the junior spouse to be considered a loud-mouthed trouble-maker or a devious, behind-the-scenes operator, depending on which family culture (s)he was brought up in. In these situations, both families may feel a lack of mutual respect.

Trust. Individuals who work together on a regular basis and who's financial future depends on unwritten as well as written agreements with each other must have trust. The weight placed on trust can, of course, be reduced by getting all agreements in writing. However, it is impossible to put everything in writing. All parties must trust that the other parties have the best interest of the business and a successful farming-together relationship at heart and that they will follow through on verbal agreements. It, of course, follows that all parties must also do these things.

Keep it Simple. Failure of many of the families surveyed to follow complex income distribution and asset transfer agreements reinforces the need to keep it simple – that is, keep the transfer agreement simple. The basic ideas and premises of any agreement should be understood by all parties. Any detailed calculations must be understood by the person responsible for maintaining the records and that person must have a commitment to keep the records up to date.

The more simple an agreement, the more likely it is that everyone will understand and follow it. The other side of that statement is that more simple agreements are more likely to result in income distributions, asset transfers or management responsibilities that could be called inequitable by some standard. Each family must consider those potential inequities and decide whether such inequities are of concern to them. For example, sharing income equally does not reward the senior generation for having more equity capital in the business. If no one in the business is worried about that fact, equal sharing of income is a simple rule that may be used.

Many farms with capital accounts, where the ownership of each individual changes each year based on the earnings of the business and the amount of each person's share of the income that was left in the business, had not kept the accounts up to date, some for so long that reconstructing the accounts would be a monumental task. One reason for this was that the farmers did not understand how the accounts were calculated, and thus, placed little priority on being sure the calculations were made each year.

One simple arrangement said that the son's ownership would be that portion of the farm equal to the son's years on the farm divided by the sum of the father and son's years on the farm. That is, if the father had been on the farm 25 years before the son joined, the son's ownership after one year would be 1/(26+1) = 1/27th

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of the farm. After year two he would own 2/29ths of the farm. While this procedure has the disadvantage that the son's percentage gain declines each year, it is easy to understand. The same result could be obtained by agreeing that the younger generation's ownership would increase, say, 2% of the farm or, say, 4% of the cattle and equipment each year. In using these procedures, care must be exercised to ensure that the change in ownership is consistent with the combination of earnings that the younger generation may leave in the business and the gifting limits in tax law.

Younger Generation Attend College and/or Work Off-farm. Many advisors, as well as the farmers visited, suggest that the younger generation go to college and/or work away from the family farm for a few years before entering the business. There are a number of reasons why this can be a key to success. First, it provides training and experiences for the younger generation which improves their management ability and gives them a broader perspective on how farms can be operated and how management can function. Farm businesses will have to change over the lifetime of the younger generation. Those who have worked on other farms or on non-farm businesses should have a wider array of experiences to draw upon in making the management decisions necessary to successfully make the changes necessary.

For the farms studied, the 15 farms where one or more of the junior partners had worked off the farm before entering the business had 1989 labor and management incomes per operator of $19,600 compared to $4,700 for the farms where the junior party returned directly to the farm from school. Thirty-three of the farms had at least one junior partner who attended college. These farms had average labor and management incomes of $11,000 compared to $5,400 for all other farms. In both cases, the apparent success of the transfer process was higher for those with off-farm experience or college training.

Second, a period of separation provides a break following the younger generation's childhood for the older generation to adjust from the parent-child relationship to an adult-adult or partner-partner relationship. High school or college graduates would expect to be treated like adults by others. However, it is often difficult for the senior generation to make that switch. A son who returns home after being successful in some other business is almost certain to receive the respect of an adult from his parents.

Third, it provides the junior party a chance to try something else to be sure they really want to farm. It does no good for the senior generation to have the junior parties stay on the farm but not like it, and decide after a few years that they want to do something else. Some of the surveyed junior parties who were most committed to the farm had worked off the farm before joining the business.

Fourth, the senior generation may be too young to want to give up any control of the business. They may be only 40 or 45 years old, in their prime, and just getting the business underway. Such people may be willing to share the work but not the management or control. This can be particularly important on small farms where the opportunities to share management and control are fewer and the likelihood that the total management responsibilities exceed the senior generation's abilities is less.

Work for Wages for a While. Most families need a period of working together before management and ownership starts to transfer and before the final farming-together agreement is developed. That is,

A period of separation provides a break following the younger generation's childhood.

the younger generation should first work for wages for a while. This gives the families a chance to see whether they can really work together before deciding to do it for an indefinite period of time. A trial period also gives the younger generation a chance to see if they really like to farm full-time. More than one son has returned to the home farm, entered the business, insisted on building a new, bigger barn and then decided he did not really want to farm after all. The parents are then left with a large farm and, usually, a large debt load.

Of course, working for wages cannot go on forever. In some cases a year or two may be long enough for everyone to feel comfortable. In other cases it may take four or five years. However, periods of longer than five or six years usually indicate a problem of some type, (i.e., procrastination, son incapable of management, lack of family harmony). Those farms where the junior partner worked for wages for six years or less, had much more successful transfer arrangements than those where they worked for seven years or more.

Competent Junior Generation. In order for the business to transfer, the junior generation must have the competence to run the business. Unfortunately, or fortunately, not all sons or daughters have the same capacities as their parents. Just because the senior generation is capable of managing a farm does not necessarily mean that the junior generation will be able to do so. The junior parties may have strengths in other areas. Both parties must make this assessment. The assessment is particularly difficult because the question is not whether the junior parties are now good managers, but whether they will develop into good managers. It is also not a question of whether they are responsible, hard workers, it is a question of whether they are managers. In some cases, the senior parties must realize that a transfer of the business will not work or that management capacity must be obtained from another source.

Give the Younger Generation a Break. Nearly all of the transfers studied involved some sort of financial break for the younger generation. The break can take many forms; 1) gifting of assets, 2) selling the younger generation assets at very conservative (less than market value) prices, 3) allowing the younger generation to develop assets under very favorable terms (calling every other heifer calf junior partner property), or 4) father working for son at zero wage.

For some businesses, particularly those with limited profitability, giving the younger generation a break is absolutely necessary. In other cases, it may assist the younger generation considerably or just be good business.

Usually, the benefits to the senior generation include the knowledge that after they die less will be paid in estate taxes, and a conviction that the farm will stay in the family. However, the senior generation may also gain monetarily. On more than one of the study farms, the senior generation believed that their current net worth was higher now, even though they had given the junior parties considerable assets, than it would have been if they had kept the assets and the younger generation had not come home to the family business. With the son or daughter home, they had improved and expanded the business so that the senior generation's current share was larger than the total would have been otherwise. In these cases, the senior generation clearly "gained from giving". To accomplish this, the business must be reasonably profitable and the junior generation must have managerial ability and ambition.

The success of any business depends on each generation knowing more than the prior.

Teach the Junior Generation. The senior generation must realize that one of their responsibilities is to teach the junior generation. Most 18 year olds, or even 25 year olds, do not know how to manage a farm. They must learn how. The senior parties must teach them what they know and provide opportunities, or encourage them to take opportunities, to learn things the senior party does not know. The success of any business depends on each generation of managers knowing more than the prior generation. This process also involves pointing out the good and the bad things they do and rewarding them for doing a good job.

Conclusions

Violation of any one of these keys may not be fatal to the farming-together relationship or transfer of the farm business. However, the higher the proportion of the keys that are followed or given careful consideration, the greater the likelihood of success. ▲