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Balancing family and business in farm transfer planning

by Anna Richards

As farm ownership progresses through generations, it becomes more and more likely that owners may have one or more children or heirs that are not actively involved in the business. While this is certainly not a bad thing in terms of their individual interests and goals, it can begin to pose a unique challenge in the context of estate and succession planning. Often, the majority of an individual business owner's wealth is tied up in farm or farm-related assets. The challenge then becomes balancing the ability to pass wealth on to their family members with the ability of the business to continue to operate successfully.

ASSESS YOUR CURRENT SITUATION

The process of business succession planning involves managing three main categories: asset transfer, cash flow management and business management transfer. The first two, while complex, are fairly mechanical. The first step is to know what you're starting with. To get an accurate snapshot of your full financial picture, you'll need to prepare a balance sheet and income statement, much like you do for your business. While this seems straightforward, it's important to identify how business assets are owned, and what that means for you and your ability to transfer or liquidate them.

Owning individual business assets, like cows, equipment and land, is very different than owning LLC units or corporate stock in an entity with multiple owners. Your ability to access those assets is often limited by an operating or buy-sell agreement that dictates how and when you can get value from them. If we're talking about LLC units, remember that your capital interest (the portion of the business assets you own) and profits interest (the percentage of profits allocated to you) are not necessarily the same. Ideally, your business should hold annual meetings in which you review these legal agreements and sign a certificate of value, ensuring those values are readily accessible and current. Working with your accountant, attorney or business consultant to help sort out these numbers and ensure their accuracy is vital to the process.

DETERMINE YOUR GOALS

Before designing a plan to manage these assets, it's critical to understand what the goals and priorities of the senior generation are. It's difficult to chart a path if you don't know what destination you're trying to reach. Dedicate time to working through what is most important to you, knowing that it may not always be possible to achieve all goals at once, but the better you can articulate and prioritize them, the more successful you'll be in building a plan that accomplishes them. It's helpful to work with a third-party consultant to facilitate this part of the process. It's often beneficial to have them meet with each party involved individually, to understand their personal goals and concerns. This may include other business partners (both family and nonfamily) and other family members.

When talking about goals in the context of family wealth and business preservation, there are a few key questions that help identify the structural options that best fit:

- Do you want your non-farm children (or other heirs) to benefit from your business assets?
- If so, when? During the lifetime of the business or only if it ceases to operate?
- If during the business's lifetime, should the benefit they receive be guaranteed or based on the performance of the business?

Once you've identified your current situation and your goals, these questions provide a simple framework to move through some potential options.

QUESTION 1: DO YOU WANT YOUR NON-FARM HEIRS TO BENEFIT FROM YOUR BUSINESS ASSETS?

If the answer is no, then we simply look at what non-farm assets are

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available. Common personal assets could include cash and investments, life insurance, vacation or rental homes, personal residences or ownership in other non-farm businesses. When looking at the values of these assets, it's important to remember that equal is not necessarily equitable. The value to the recipient is affected both by the level of management the asset requires, and their ability to generate income from or to liquidate it. Life insurance is a very commonly used tool to address the non-farm heirs, as it provides a tax-free, lump-sum distribution of cash. The limitation to this asset, of course, is that it generally doesn't provide that benefit until after death.

Cash is the simplest to manage and most liquid of all assets, and can also be transferred and enjoyed during lifetime. While many farm business owners have been hesitant to take cash out of the business to accumulate outside wealth over their lifetime, business consultant John Lehr of Farm Credit East ACA encourages his farm owners to take large draws from the farm, as long as earnings are available to support them, for good reason. Besides helping to build outside investments to manage this farm-family balance in planning, large draws help keep individual's equity from growing so large that their eventual retirement or buyout would cripple the farm. It also facilitates what he calls "cash flow conditioning". If the business is conditioned to pay out cash at these levels, when that payment turns into a retiring partner payment or equity buyout when a member retires, it isn't a shock to the system.

Personal assets such as a personal residence, vacation home, personal collections, etc., can also have significant dollar value, but may also have sentimental value and may be harder for heirs to liquidate. Rental homes or ownership in other businesses may provide some additional revenue streams, but also require more active management by the recipient.

However, if the answer to the question above is yes, we move further down the list.

QUESTION 2: DURING THE LIFETIME OF THE BUSINESS OR ONLY AT LIQUIDATION?

If the intent is for non-business heirs to benefit only if the business ceases to operate, two potential structures to consider are limited (non-voting) business interests, and a continuation trust structure. In both cases, what you're giving the heir is the right to the value of a share of the business assets if they are liquidated, but not the right to liquidate it themselves or draw capital out of the business. This allows the business to use that capital to continue to operate, without the risk of having to buy it out.

A limited business interest essentially gives the heir some capital ownership in the business, without giving them a say in how the business is run on a daily basis. They are allocated at least some share of the profits and losses, which allows this capital interest to grow over time if the business is profitable, but in this case the operating agreement would not allow for those profits to actually be distributed. Therefore having the limited member would not affect the management or cash flow of the business as long as it was operating. However, if the business were liquidated, they would receive their proportionate share of the proceeds after liabilities were paid.

A continuation trust structure works in a similar fashion, but adds an additional layer of protection. In this scenario, instead of passing business interests directly to the heir, they are placed in a trust that can continue on long after the grantor has passed away. As above, the trust still receives some portion of the profits and losses, so it continues to grow with the business, and the heir is not able to withdraw the capital. However, the interest is owned inside of a trust structure, giving some additional protections to both parties. Since the business interest is owned by the trust and not the individual, it is protected from their creditors, lawsuits, divorce proceedings, etc. They also have a representative in their interest in the form of the trustee. A trustee has a fiduciary responsibility to the heirs, meaning that they are required to act in the best interest of the eventual beneficiary. In other words, they can ensure that the business assets are not being managed in a way that intentionally takes value away from the beneficiaries.

From the standpoint of the active managers of the business, this may mean they need to involve the trustees

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in some major business decisions. The tradeoff, however, is that they're able to continue to use the capital to grow and run the business. As with the simpler limited interest above, if the business is liquidated, the trust receives its share of the proceeds, which can then be distributed to the heirs, or possibly even their heirs depending on the life of the trust and the business, as directed by the trust documents. It's important to remember that a trust is an incredibly flexible tool and can be written to accomplish almost anything you want it to, within the confines of the law. This is just one specific example of the multitude of ways a trust could be written.

In both of these instances, all of the initial equity and future earnings are preserved within the business, allowing it to continue to use this capital until the business is liquidated. However, if the intent is for them to receive some benefit from the business while it is operating, there are several other options to explore, including modifying the above structures. In order to narrow them down, we ask the next question.

QUESTION 3: SHOULD THE RETURN BE RELATIVELY FIXED OR BASED ON THE PERFORMANCE OF THE BUSINESS?

If a guaranteed return is preferred, one very common way to accomplish this is through the use of land rents. In many farms, the ownership of land is already separated from the operating assets for liability purposes. Leaving land ownership to an off-farm heir provides them with the opportunity to earn regular rental income, as well as the appreciation in value of the land itself. It's important, however, to think back to your goals and priorities when determining how the ownership and lease agreements should be structured. If continuity of the business is a priority, it's crucial that the farm have security in its land-base. You may want to consider ensuring that the operating entity has first right to lease the land, a method for setting fair rental rates, first right to purchase if the heir wants to sell, and set terms for how it would be purchased to protect business cash flow.

Julie Richardson of Van Erden Richardson Law Firm PLLC works with farm businesses to develop these agreements.

> *"A right of first refusal and a first option to purchase are two different mechanisms," she said. "The right of first refusal requires that the land owner, or landlord, provide the tenant with notice of any purchase offer received from a third-party. The tenant must then match the terms of the third-party offer and may then purchase the property. In contrast, a first option to purchase puts the control in the tenant's hands and enables the tenant to decide when he would like to purchase the land. The first option to purchase language in a lease includes more details on the purchase than the right of first refusal because in this case, the tenant is not matching an offer from a third-party, but purchasing the property on their own terms. Therefore, the option to purchase in the lease agreement includes terms such as purchase price, payment terms, closing documents to be provided by seller/purchaser and closing timeframe. Inclusion of either the right of first refusal or the first option to purchase as a term of a lease agreement is always beneficial to the tenant because it allows the opportunity to purchase the land, but does not require a purchase if the tenant is unable to do so at a certain point in time. This provides some security to the tenant that the land may be available to purchase in the future, if the terms are met. It is not uncommon for a farm to have a lease agreement even when the landowner is a member of the operating entity. Even in this case, it is beneficial to include a right of first refusal or first option to purchase in that lease agreement. This helps to secure the land for the operating entity if there is a future issue between the member-landowner and the operating entity or other members. Similarly, this protects the operating entity if the member-landowner passes away leaving family members to handle this land."*

Besides these lease agreement provisions, the ownership structure of the land can also greatly impact the future management of it. Leaving land directly to multiple individuals as tenants in common may seem like the simplest method, but it can lead to

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significant management challenges down the road. Placing the land instead in a real estate LLC owned by the individuals provides a framework for managing lease agreements, buying and selling property, and ownership transfer.

One word of caution in managing leases within the farm and family is to be aware of unintended equity transfer. Many rents are often still determined by the cash flow needs of the rental entity, which is usually the real estate taxes, insurance, and principal and interest payments. It's important to evaluate how that compares to fair market value rent. If the two entities – the operating and the real estate – are not owned by the exact same people at the exact same percentages, and the operating entity is essentially over- or underpaying for rent, then someone is getting an unfair economic benefit at the detriment of someone else. It's best to pay rents at an agreed upon fair rent per acre, and to work carefully with your accountant to ensure that the balance of these cash flow needs are being accounted for correctly.

To add a further level of protection, the real estate LLC ownership can be placed within a trust. From a cash-flow standpoint, the operating entity would still pay rent to the LLC, and the trust could then distribute the rental proceeds to the beneficiaries. Since the assets would be owned by the trust rather than the individual, however, they would be shielded from the beneficiary's estate. Not only does this keep land values protected for estate tax purposes, but from their Medicaid and marital estates as well. This allows the land to stay in the trust for multiple generations, ensuring the operating entity has the ability to use the assets, and providing a cash flow stream to the non-farm heirs. If the farm ceased to operate, however, the trust would then be able to either rent the land to someone else, or distribute or liquidate the assets to the beneficiaries.

Another option to create a relatively stable return to the non-farm heirs without forcing the operating entity to buy out their capital is to leave them a limited interest in the operating entity as discussed above, but also incorporate a guaranteed payment for use of capital. This is essentially a payment that looks a lot like interest, a "rent" for the capital that the limited member is leaving in the business. When determining what that amount is, you may want to consider the value of the capital share, current and historical market returns (what would they get if they were able to withdraw that capital and use it somewhere else?) and historical business returns. As in the prior example, the limited member would also still have a right to their share of the proceeds if the assets were liquidated.

Finally, if the goal is for the non-farm heirs to receive a benefit during the business lifetime that's subject to the performance of the business, we can look at profit distribution and performance-based capital distributions. Allowing a limited member to withdraw their allocated share of profits each year may again seem relatively simple, but it could pose a significant cash-flow challenge to the business in years of high profit, when that capital needs to be reinvested into capital improvements or debt reduction. Instead, it may be more appropriate to create pre-determined tiers that allow the business to distribute certain dollar amounts at varying levels of profitability. The key to making this successful is to use a consistent and fair profitability metric that accounts for business growth over time. For example, profit per cow tiers or return on asset tiers may make more sense than looking at the total net profit of the business, as one would expect that dollar amount to go up over time as the business grows and may make the original tier structure obsolete.

Remember...

Business succession and personal estate planning are incredibly personal processes, and no two plans look identical. No matter what plan works best for your business and family, remember that using the right team of professionals and good communication throughout the process are key to making it successful. Individual owners have the right to use the value of their business ownership as a personal asset in estate and family wealth planning. Their business partners have the right to understand this planning and how it affects their ability to continue to operate the business. The better everyone involved understands your goals, the more successful you will be in achieving them.

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