Legal Issues Affecting Farm Transition

Shannon L. Ferrell and Rodney Jones[1]

Presented at the
Transitions in Agriculture: Implications for Research, Data Development and Policy Analysis Conference
Washington, D.C., March 20-21, 2013

I. Introduction:

The growing importance of the farm transition issue is abundantly clear from a variety of data sources confirming the growing concentration of farm asset ownership in an increasingly aged group of producers and, in many cases, off-farm landowners. This concentration of assets may be greatly compounded by what is anticipated to be the largest generational transfer of wealth in American history, as a recent study estimates that the so-called "Traditional" or "Greatest" generation will transfer $8.4 trillion in assets to Baby Boomers in the relatively near future.[2] At the same time that American agriculture is swept up in this unprecedented transfer of wealth, our farms face the same challenges as many other family businesses in trying to successfully survive a shift from one generation to the next – a transition that research suggests only 30% of them will survive.[3]

How can American farmers and ranchers improve these odds and successfully transfer their operations to the next generation of producers? This paper will examine the farm transition process, the legal mechanisms that can be used to transfer the farm to the next generation, and some of the challenges and opportunities of the current legal environment.

a. What is Involved in Farm Transition?

By its most basic definition, a "farm transition" is simply the process of transferring a farm or ranch operation to the next generation.[4] While simple to articulate, this process can be quite complicated as it involves three complex and inter-related factors. First, there must be a transfer of the ownership (or possession, in the case of leased assets) of assets such as land, equipment, and in the case of farms organized as separate business entities, ownership of the business itself. Second, there must be a transfer of control over those assets. If the ownership of farm assets is held by individuals, this may seem like a straightforward issue, but even in such scenarios, other farm stakeholders may wish to have a say in farm management decisions. If the ownership of farm assets is held by a business entity such as a corporation or limited liability company (LLC),

---

[1] Assistant Professor, Agricultural Law, Oklahoma State University Department of Agricultural Economics (shannon.l.ferrell@okstate.edu), and Area Extension Agricultural Economics Specialist, Oklahoma Cooperative Extension Service (rodney.jones@okstate.edu). The authors would like to thank Mr. Derrick Davies, Esq. and Dr. Derrell Peel for their contributions to this work. Portions of this paper are adapted from "Estate Planning for Farmers and Ranchers: Overview of Legal Issues and Concepts," presented at the 4th Annual John Huffaker Agricultural Law Course, Lubbock, Texas, May 20, 2010.

[2] ALICIA H. MUNNELL, ANTHONY, WEBB, ZHENYA KARAMCHEVEA, AND ANDREW ESCHTRUTH, HOW IMPORTANT ARE INTERGENERATIONAL TRANSFERS FOR BABY BOOMERS (2011) Center for Retirement Research at Boston College Paper CRR WP 2011-1, *available at* http://crr.bc.edu/wp-content/uploads/2011/01/wp_2011-1_508.pdf (last visited October 11, 2012).

[3] Family Business Institute, SUCCESSION PLANNING, *available at* http://www.familybusinessinstitute.com/index.php/Succession-Planning/ (last visited March 9, 2013).

[4] *See, eg.* Matthew I. Miller, *Farm Transition Planning as Compared to Preventative Health Care*, VIRGINIA COOPERATIVE EXTENSION FARM BUSINESS MANAGEMENT UPDATE, *available at* http://www.sites.ext.vt.edu/newsletter-archive/fmu/2008-12/FarmTransition.html *(last visited March 9, 2013).*

then control may be allocated among owners in a variety of ways. Third, there may be a desire to allow participation in the revenues of the farm business by those that may or may not have ownership or control stakes. This issue becomes particularly important when such participation is a major source of retirement income for a farmer or rancher, or when one generation wishes to provide farm income to off-farm heirs in lieu of granting them ownership in the assets themselves.

It should be noted that many farm management experts draw a distinction between "transition planning" and "estate planning." The primary difference between the two is that "transition planning" implies that ownership, control, and participation will be gradually shifted while the primary generation is still alive; "estate planning" implies that a plan is triggered only after the death of the primary generation and may be limited to a plan for shifting ownership. Given the fact that research suggests transition planning may be a more successful tool than estate planning for successful business transfers,[5] this paper will focus on the transition model.

b. What are the Legal Mechanisms Available for Farm Transitions?

The laws that govern ownership, control, and participation in a farm business are largely creatures of state law. The laws that govern the ownership of the assets that comprise the farm (land, goods, the business entity holding assets, etc.) necessarily define the parameters within which that ownership may be changed, either in life or at death. As a result, the legal mechanisms available to transfer the farm are largely a function of the state laws that govern the ownership of real property, goods, financial assets, and businesses. This paper will examine a number of these mechanisms along with the potential benefits and challenges of their use.

II. Estate Tools

In discussing the tools available to transfer the farm or ranch from one generation to the next, it is logical to start with those tools that have been traditionally used to transfer completely (more or less) ownership, control, and participation at death. Wills and trusts naturally come to mind first among these tools, but a number of other alternatives are also available in this category.

a. Wills

Defining the scope of the discussion of "wills" in this paper is a challenge as multivolume treatises could be (and have been) written on the topic, but such treatment is obviously well beyond the scope of this paper. At the same time, though, one does not wish to give short shrift to one of the most venerable and versatile estate tools available. A "will" is simply "a document by which a person directs his or her estate to be distributed upon death."[6] All states have laws governing the requirements to execute and enforce wills, and sixteen states have adopted the Uniform Probate Code to this end.[7]

---

[5] *See, eg.* Michael H. Morriss, Roy O. Williams, Jeffrey A Allen, and Ramon A. Avila, *Correlates of Success in Family Business Transitions,* 12 JOURNAL OF BUSINESS VENTURING 385-401 (1997).

[6] BLACK'S LEGAL DICTIONARY, 7th ed. (1999).

[7] These states are Alaska, Arizona, Colorado, Florida, Hawaii, Idaho, Maine, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Jersey, New Mexico, North Dakota, South Carolina, South Dakota, and Utah. National Conference of Commissioners on Uniform State Laws, PROBATE CODE, http://www.uniformlaws.org/Act.aspx?title=Probate%20Code (last visited March 9, 2013).

Wills can be highly flexible. A will only becomes operative at the death of the person making it.[8] This allows the person making the will (the "testator") to modify the will or completely abandon it and replace it with another instrument until the time of death, so long as the testator holds the mental capacity (also called "testamentary capacity") to do so.[9] Further, there are very few restrictions on parties to whom property can be given under the will. The will can also nominate an executor, allowing the client to choose a party in advance to oversee the probate process for the estate.[10] Contrast this with the scenario of intestate succession, in which multiple parties may come forward to seek appointment as administrator of the estate - some of whom the person who passed away (the "decedent") may not wish to have in such a role.

The disadvantages of the will are almost as numerous as the advantages, though. Perhaps foremost among them is a will must go through probate to have any binding legal effect.[11] Probate of an estate takes time, and this can be a problem if the ownership and control of business assets is left indeterminate while a potential successor is trying to maintain the family operations as a viable business. Another drawback to the use of a will through the probate process is that the will is subject to contest. Yet another disadvantage of the will is that the probate process is an open case in court, meaning that wills, inventories, and other documents must be filed and made available as public records. Farmers and ranchers may find this an incredibly uncomfortable circumstance to contemplate. As a corollary, there is a significant opportunity for the airing of "dirty laundry" or ill feelings among family members before the public. This may serve to exacerbate existing emotional issues among the client's potential successors. Finally, probate is a state-specific proceeding. For example, if a client passes away owning real property in Texas, Oklahoma, and Kansas, the property in each state would be submitted to its own respective probate in those states. This can additional cost and delay to the disposition of such property, meaning that the agricultural operation may be "tied up" for a longer period, threatening its viability.

b. Trusts

As with wills, just as many multi-volume treatises have been written about trusts. Indeed, the topic of trusts may well be even more complex than that of wills, for trusts - in addition to their frequent job of "just" disposing of property after the death of the person creating the trust (the "trustor" or "settler") - are often the vehicles to accomplish a number of other objectives. Since, again, a comprehensive discussion of trusts is well beyond the scope of this article, the discussion will center around the discussion of some general advantages and disadvantages of trusts as a farm transition planning tool. Trust laws may vary from state to state, but in 24 states, the Uniform Trust Code has been adopted to govern the creation and administration of trusts.[12]

[8] UNIF. PROBATE CODE § 3-101 (amended 2010).
[9] UNIF. PROBATE CODE § 2-501 (amended 2010).
[10] UNIF. PROBATE CODE § 3-203(a) (amended 2010).
[11] UNIF. PROBATE CODE § 3-102 (amended 2010).
[12] These states are Alabama, Arizona, Arkansas, District of Columbia, Florida, Kansas, Maine, Massachusetts, Michigan, Missouri, Nebraska, New Hampshire, New Mexico, North Caorlina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Vermont, Virginia, West Virginia, and Wyoming. National Conference of Commissioners on Uniform State Laws, TRUST CODE, http://uniformlaws.org/Act.aspx?title=Trust%20Code (last visited March 9, 2013).

For the purposes of this discussion, the focus will be on the use of revocable living trusts as an estate planning tool[13]

In counterpoint to the will, the trust and the assets it owns need not pass through probate, since it is a legal entity apart from the trustor with an independent existence that is not extinguished upon the death of the trustor. Thus, the disadvantages of probate experienced with a will may be reduced or eliminated (note, though, that trusts can carry their own complications if not carefully drafted that can incur delay and expense). This advantage can be extremely persuasive in the minds of many clients, particularly if they have concerns about the continuity of their farm operation. By establishing a carefully crafted trust, they can arrange for the relatively rapid transfer of control and/or ownership of farm assets after their deaths, thus minimizing the risk of damaging the viability of the farm operation.

Besides avoiding probate, trusts present a number of other advantages. Since trusts can largely avoid the probate procedure, they also avoid the public disclosure of inventories and other documentation that would become public record under a probate proceeding. They are much more difficult to contest. Wills must pass a multitude of hurdles in their formation and execution to be upheld.[14] Each of these requirements represents a potential point of weakness that could be exploited in a will contest. Conversely, trusts have relatively few execution requirements, being more in the nature of a contractual arrangement than a testamentary document, and thus are generally more robust in the face of challenges by potential heirs.[15]

Trusts do have disadvantages that often go overlooked. While it is true that trusts may avoid the expense of probate, those costs may go from the "back end" to the "front end" of the transition plan. That is to say, trusts may involve much more up-front costs than the disposition of property through a will. Clearly, an attorney will be required to draft and establish the trust, but that expense would often be matched in the formation of a will. The difference often lies in titling documents from the client to the trust. Further, if the trustor desires the use of an outside manager such as a bank trust department or attorney, the client will incur management fees during life that would not have been encountered through the use of a will. The fact that title to the trust assets is held in another entity, and that the assets may be managed by another individual or entity as well, also adds a layer of complexity to the management of assets held in trust during the lifetime of the client. If the trustor wants to lease or dispose of the property, he or she must, at a minimum, go through the trust to effectuate such a transaction. In some cases, he or she may actually have to go to the effort and expense of modifying the trust itself.

Perhaps the most important disadvantage of trusts as an estate planning or transition tool is the inverse of their advantage. While revocable living trusts can be highly *flexible* during the life of the trustor, they become highly *inflexible* after the trustor's death. The Claflin Rule prohibits the modification (or termination) of a trust if doing so would defeat or frustrate a "material purpose" of the trustor. [16] In plain English, this means that the requirements of a trust become frozen at the death of the trustor, meaning that their "dead hand" may greatly restrict how subsequent generations can use or dispose of far assets. This can greatly constrain the

---

[13] A revocable living trust is a trust established that may be revoked (abolished with the return of property put into the trust to the testator) during the life of the trustor (as opposed to a "testamentary trust" which is established by the will of a decedent).

[14] *See generally* UNIF. PROBATE CODE ARTICLE II, Part 5 (amended 2010).

[15] *See generally* UNIF. TRUST CODE ARTICLE 4 (amended 2010).

[16] The "Claflin Rule" was pronounced in *Claflin v. Claflin*, 20 N.E. 455 (Mass. 1889)

operational adaptability of the farm and may actually defeat the purpose of the trust's creation – to "keep the farm in the family."

c. Other Tools

A wide range of estate planning tools continues to evolve, and space does not permit a full examination of them all. However, two of these tools do bear examination – life insurance and "transfer on death" deeds.

i. Life Insurance

Many farmers and ranchers overlook life insurance as a transition planning tool, but it can provide significant flexibility in satisfying a number of objectives. Closely akin to the use of life insurance as a means of providing support to a surviving spouse with dependents is its use simply to increase the value of the estate. If an individual feels that their estate will not contain sufficient assets to generate the income needed to support their spouse or provide a "satisfactory" legacy for their children, life insurance may be a low-risk means of increasing the value of that estate by simply pouring the proceeds of the policy into such estate, so long as the operation can support the payment of premiums. Another closely related use of insurance proceeds is to designate their use specifically for the payment of estate expenses, such as the costs of burial, administration, and taxes; this means such expenses need not be carved out of the estate itself.

Consider, though, the producer that has one or more children that want to eventually take over the farming operation, with one or more children that do not intend to actively participate in the operation. If the family wishes to transfer the farm to a successor, they will either need to pass the farm intact the on-farm successors and exclude the other(s), or they will pass the farm to multiple children, with the implication that no one child may have a farming asset base sufficient to support them. Enter the potential use of life insurance to "enhance" the estate. With an appropriate amount of life insurance, additional funds can be added to the estate. Now, the producer has the option of directing assets that could constitute a viable farming operation toward the children who have expressed a desire in continuing the operation, and directing assets that are not central to the agricultural operations - such as savings, financial assets, and the proceeds from the life insurance policy - to the other child.

Even if the producer cannot afford enough insurance to completely balance the farm and non-farm assets, they may be able to make significant progress toward such a goal. The producer may find this preferable to either giving children equal shares in the farming operation (which leaves the child hoping to operate the farm with an insufficient asset base, and leaves the other child with assets they may have no interest in retaining) or giving the child wishing to operate the farm all of the farm assets and leaving the other child a far smaller amount of assets (a situation which could cause significant emotional strain on the family after the client has passed).

Another often-overlooked use of life insurance is by the *children* rather than the parent. Consider again a scenario in which a child wishes to eventually take over the farming operation, but knows that he or she will likely have to split the operation's assets with one or more siblings. In such a scenario, this child may realize that he or she will have to purchase the interest of the siblings in order to have an operation of viable size. This could require mortgaging a significant portion of the remaining assets, putting the operation in an untenable situation. Thus, the child could purchase life insurance on the life of the parent(s), and use the proceeds to purchase the interests of the siblings.[17]

Yet another advantage of life insurance is that its proceeds are not required to go through the probate process to be allocated to their recipients (unless the beneficiary is the estate itself). This makes life insurance a potentially important vehicle in providing funds to survivors without the delay of waiting for the completion of the administration of probate. A final advantage of life insurance is that, pursuant to the Internal Revenue Code, life insurance proceeds are not considered part of the gross income of the beneficiary (though they will be considered part of the estate of the decedent for estate tax purposes).[18]

The primary disadvantage of life insurance comes from it cost, specifically the "up-front" nature of such costs. While the cost of passing property to a spouse or child through an estate is only fully realized at the death of the decedent, life insurance obviously incurs costs well in advance of that date. Additionally, while life insurance may carry relatively little risk, it can also be expensive relative to its rate of growth; other investments might provide better real rates of return. Finally, although not necessarily a disadvantage, one must also consider naming contingent beneficiaries of the life insurance policy in case the primary beneficiary should predecease the client.

ii. Transfer on Death Deeds

Transfer on death deeds ("TODDs") are growing in popularity as an estate planning tool. The Uniform Real Property Transfer on Death Act has been adopted by seven states, and is currently in legislation introduced in seven states.[19] Eleven additional states allow TODDs although they have not adopted the uniform law.[20]

A TODD works almost exactly as it sounds. A grantor of property executes a deed that transfers title to real property upon the death of the grantor, and then records that deed in the county land records.[21] TODDs are revocable during the grantor's life,[22] providing much of the flexibility of a will. To revoke a TODD, the grantor need only record a revocation deed or execute and record another deed (perhaps granting the property to another grantee) that expressly revokes the TODD.[23]

---

[17] For more information on these and similar strategies, see DONALD H. KELLEY, DAVID A. LUDTKE, AND BURNELL E. STEINMEYER, JR., ESTATE PLANNING FOR FARMERS AND RANCHERS, §11.7 (2002).

[18] *See* 26 U.S.C. §101(a)(1), Treas. Reg. §§1.101-1(a), 1.101-3

[19] Those states adopting the Act are the District of Columbia, Hawaii, Illinois, Nebraska, Nevada, North Dakota, and Oregon. The Act has been introduced in 2013 in Alaska, Maryland, New Mexico, South Dakota, Virginia, Washington, and West Virginia. National Conference of Commissioners on Uniform State Laws, REAL PROPERTY TRANSFER ON DEATH ACT, http://uniformlaws.org/Act.aspx?title=Real%20Property%20Transfer%20on%20Death%20Act (last visited March 9, 2013).

[20] These states are Arizona, Arkansas, Colorado, Indiana, Kansas, Minnesota, Missouri, Montana, Ohio, Oklahoma, and Wisconsin. MARY RANDOLPH, STATES THAT ALLOW TRANSFER-ON-DEATH DEEDS FOR REAL ESTATE, http://www.nolo.com/legal-encyclopedia/free-books/avoid-probate-book/chapter5-1.html (last visited March 9, 2013).

[21] UNIF. REAL PROPERTY TRANSFER ON DEATH ACT § 9 (2009).

[22] UNIF. REAL PROPERTY TRANSFER ON DEATH ACT § 6 (2009).

[23] UNIF. REAL PROPERTY TRANSFER ON DEATH ACT § 11 (2009).

Perhaps the greatest single advantage of TODDs is they are not subject to probate.[24] As a result, they can be relatively inexpensive means of transferring property, and do not tie up the property in a lengthy probate process. At the same time, they leave the grantor in complete control of the property until death. The primary disadvantage of TODDs is that they must be carefully coordinated with other estate planning tools to avoid granting conflicting interests in property (*i.e.* giving the same piece of property to two parties under different instruments). It should also be noted that TODDs do not have any estate tax advantages over the gift of property through a will or trust; property granted by TODD remains in the taxable estate of the grantor.

III. Property Ownership Forms

The discussion now turns from tools intended solely to transfer property ownership at death to those that also serve roles in life. Property ownership forms clearly have implication to the owners during life, but many of these forms are selected specifically for the effects they create upon the death of one of the owners. Two of these forms are commonly selected specifically for these estate effects: the joint tenancy and the life estate.

a. Joint Tenancy

Perhaps the most popular ownership form selected for its estate impacts is the joint tenancy with right of survivorship ("JTWROS" or "joint tenancy"). This ownership form provides an expedient means for transferring the property on the death of one of the co-tenants without the property passing through probate; generally, a surviving tenant need only offer some legally-recognized proof of the decedent's death to transfer their share of the property's ownership to the survivor. [25]

It is a common misconception that only spouses may hold property as joint tenants, but this is not true. As a practical matter, any group of natural persons can serve as joint tenants. This means that if a client desires to transfer property to a spouse or child, the joint tenancy can be used to do so, passing to the survivor upon the death of the other joint tenant. For example, a client could hold property as joint tenants with a spouse and a child. Should client die first, his or her ownership would then be split among the surviving spouse and child. Then, if spouse should die, the property would remain with child.

Joint tenancy has the advantages of being a relatively simple and easy-to-establish means of providing a pathway for the disposition of property. However, it does have its disadvantages. Joint tenancy can be a rather inflexible tool. Should the client enter into a joint tenancy and later decide to change his or her mind, the consent of the other joint tenants must be secured, or else a partition of the property may be required.[26]

Joint tenancy can create unanticipated consequences. Consider the scenario in which a husband and wife hold property as joint tenants. It is the intention of both that the property pass to their child when they pass away. The husband dies first, leaving wife as the sole owner of the property. The wife subsequently remarries, and then places the property into joint tenancy with her new spouse. The wife then dies. This would have the effect of essentially "cutting off" the child from receiving the property. Such scenarios are not far-fetched, and caution must be exercised to avoid such consequences.

---

[24] UNIF. REAL PROPERTY TRANSFER ON DEATH ACT § 7 (2009).

[25] *See, e.g.* 52 OKLA. STAT. §912; COLO. REV. STAT. § 38-31-102.

[26] *See, e.g.* TEX. PROP. CODE § 23.001

b. Life Estate

As with a JTWROS, a life estate designates the recipient of property (almost always realty rather than personal property) upon the death of another party. In most cases, the property is granted "to [Grantee 1] for life, and then to [Grantee 2]." When created in this form, Grantee 1 will be deemed the "measuring life" since the duration of the life estate will be measured by the life of Grantee 1 (who may also be referred to as the "life tenant,") and upon the passing of that grantee, fee ownership vests in Grantee 2 (often called the "remainderman").

The life estate has the advantage of establishing a line of succession to property. Many times, a producer may want to ensure that property passes to a surviving spouse and then to a child or children. This allows the survivor to have the property for use or generation of income, and then provides some measure of comfort that the property will then pass to the child or children while reducing the risk that the property could be diverted to someone else, as in the case discussed in the preceding subsection with the remarriage of a surviving spouse. Outside of a life estate, the restriction of the succession to property beyond the first recipient would likely require establishing a trust. Additionally, life estates can be established in a will or trust, allowing the client to retain ownership and use of the property until their death.

The disadvantages of a life estate include the burdens it may place on the first to hold it, i.e. the person constituting the measuring life. In some respects, this individual serves as a fiduciary in that they hold several duties to preserve the property for the remainderman that may come after them.[27] Additionally, the life tenant will be restricted from making any sale of the property for obvious reasons, and can only enter into a lease of the property for the duration of their tenancy.[28] Potential tenants may be reluctant to lease the property due to the indeterminate nature of the duration of the life tenant's tenure in the property.

If a life estate is not created during life, *i.e.* it will be conveyed to the life tenant and remainderman through the will, the property will have to pass through probate. Some might also term this a disadvantage.

IV. Business Entities

To this point, the discussion has focused on those tools associated with "estate planning," – mechanisms that serve primarily to transfer property only upon the death of the decedent. For a number of reasons, though, the successful transition of a farm or ranch may need to take place during life to provide the maximum chance of survival for that operation. Thus, the discussion now turns to business forms and transactional tools that, among other things, may allow for a smoother transfer of ownership, control, and participation in life.

a. Limited Partnership

Almost all states recognize the limited partnership as a business entity, and the Uniform Limited Partnership Act has been passed in nineteen states.[29] The partnership is a commonly known business form. When most people think of this business form, they picture a "general

[27] *See, e.g.* 60 OKLA. STAT. §69.

[28] *See Gibbs v. Barkley*, 242 S.W. 462, 465 (Tex. Comm'n App. 1922).

[29] These states are Alabama, Arkansas, California, District of Columbia, Florida, Hawaii, Idaho, Illinois, Iowa, Kentucky, Maine, Minnesota, Montana, Nevada, New Mexico, North Dakota, Oklahoma, Utah, and Washington. National Conference of Commissioners on Uniform State Laws, UNIFORM LIMITED PARTNERSHIP ACT, http://uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Partnership%20Act (last visited March 9, 2013).

partnership" in which all of the partners share unlimited personal liability for the debts and obligations of the partnership. Limited partnerships (sometimes called "LPs) are different in that at least one partner, the "limited partner" has limited liability – their liability for the debts and obligations of the partnership are limited to their investment.[30] Conversely, the "general partner(s)" have general, joint and several liability for the debts and obligations of the partnership.[31]

The limited partnership poses some advantages in that it can separate control and participation from the ownership of the business. A partnership agreement may specify that a limited partner has limited or no rights of participation in the management of the entity. Thus, a farm business could be placed into a limited partnership with off-farm children made limited partners and on-farm children made general partners. This allows off-farm children to participate in the revenues from the business without the requirement to participate in management decisions. By the same token, a farm business could be placed into a limited partnership with the parents being made limited partners and the successor generation made general partners. Revenues could then be shared with the parents as a form of retirement income. In either case, the liability protection of the limited partners' status can be an important advantage for them.

The obvious disadvantage of the limited partnership form is the liability exposure of the general partners, which is not an issue in other forms such as the corporation or LLC. Another question surrounding limited partnerships is whether the limited partners can actively participate in the management of the business. For years, the rule was that a limited partner that actively participated in the management of the partnership lost their liability protection.[32] While that rule has been eliminated in the latest version of the uniform act, not all jurisdictions have adopted that approach.[33] Thus, caution must be exercised when choosing this form.

b. Corporation

The corporation is likely as well-known as the partnership, though it may be more misunderstood. Many people envision the corporation as a tool used only by large businesses, but many small, family-owned businesses participate in this form as well. Corporations are one of the oldest recognized business forms, recognized since the Roman empire.

The principal advantage of a corporation for many participants is that the liability of any owner for the debts and obligations of the business is limited to the owner's investment in the business; they hold no personal liability. Another advantage of the corporate form is that a corporation can create multiple classes of stock with each class holding different rights of control (usually managed through the classes' voting rights) and participation in revenues (through preference for dividends). Perhaps the most important advantage to corporations in terms of transition planning is that can greatly facilitate the transfer of ownership of a farm business. For example, if a producer wanted to transfer ownership of real property over time, he would have to gradually convey a direct interest in the property, which would complicate the title to the property and incur a number of transaction costs. Additionally, once the recipient of those interests obtained their title, they would have significant legal rights to the property that could

---

[30] UNIF. LIMITED PARTNERSHIP ACT § 303 (2001).
[31] UNIF. LIMITED PARTNERSHIP ACT § 404 (2001).
[32] *See* comment to UNIF. LIMITED PARTNERSHIP ACT § 303 (2001).
[33] *See* UNIF. LIMITED PARTNERSHIP ACT § 303 (2001).

interfere with its ownership. Conversely, if the property was placed in to a corporation, the producer would simply convey shares of the corporation. Depending on the producer's goals, the gradual buildup of ownership could include growth of management rights through voting share ownership, or could be completely decoupled.

While corporations can be structured in a number of ways, many people place all corporations into two categories, based on their tax treatment: Subchapter S and Subchapter C corporations. Subchapter S corporations are granted "pass-through" taxation status – the taxable events of the business are regarded as the taxable events of the owners. Thus, revenues, expenses, deductions, and so forth pass through the entity and are recognized by the owners on their individual tax returns. The Internal Revenue Service (IRS) imposes a number of restrictions on Subchapter S corporations, most notably that they have only individuals (and not other corporations) as shareholders, that they have no more than 100 shareholders, and that they have only one class of stock.[34] This last restriction is perhaps the most critical for producers looking to separate ownership, control, and participation. On the other hand, Subchapter C corporations are taxed at the corporate level. This means that the corporation completes its own tax return and that the taxable events of the corporation are *not* recognized by the individual owners on their own tax returns. As a result of this separate tax treatment, corporate earnings may be taxed twice – once at the corporate level, and once at the individual level if the earnings are passed to the owners as dividends. However, Subchapter C corporations may also have a wider range of deductible expenses than Subchapter S corporations.

One additional consideration for producers considering the use of the corporate form is some states have prohibitions against the corporate ownership of farm assets. Nine states currently have such restrictions: Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, Oklahoma, South Dakota, and Wisconsin.[35]

c. Limited Liability Company (LLC)

The LLC is a relatively new entity form in the United States, with Wyoming becoming the first state to recognize it as a business form in 1977.[36] Eight states have enacted the Uniform Limited Liability Company Act,[37] though almost all states recognize the business form and many have adopted the uniform Act in part.[38]

In its comparatively short time as a business entity form, the LLC has grown rapidly in popularity. There are a number of reasons for this. First, the entity offers the same liability protection as a corporation for all of its owners (as contrasted to the limited partnership); members of the LLC are liable only for the debts and obligations of the business only up to the amount of their investment and are not personally liable.[39]

---

[34] 26 U.S.C. § 1361(b).

[35] NATIONAL AGRICULTURAL LAW CENTER, CORPORATE FARMING LAWS – AN OVERVIEW, http://nationalaglawcenter.org/assets/overviews/corpfarming.html (last visited March 9, 2013).

[36] Limited Liability Company Reporter, "LLC History," http://www.llc-reporter.com/16.htm (last visited March 9, 2013).

[37] These states are California, the District of Columbia, Idaho, Iowa, Nebraska, New Jersey, Utah, and Wyoming. National Conference of Commissioners on Uniform State Laws, REVISED UNIFORM LIMITED LIABILITY COMPANY ACT, http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Liability%20Company%20(Revised) (last visited March 9, 2013).

[38] *See* National Conference of Commissioners on Uniform State Laws, REVISED UNIFORM LIMITED LIABILITY COMPANY ACT, Prefatory Note.

[39] REVISED UNIF. LIMITED LIABILITY COMPANY ACT, § 304 (2006).

There are very few restrictions on who can own interests in the LLC (compared to an S corporation).[40] One significant advantage an LLC has over an S corporation is the ability of an LLC to be "owned" by different types of entities or individuals. In an LLC, an individual, a trust, another LLC, a partnership or even an S or C corporation can be a "member" under LLC law. An S corporation, on the other hand, is, by law, only allowed to have as shareholders individuals or certain types of specialized trusts. This limitation is particular problem in succession planning, as most common types of trusts used in estate planning are excluded. Only special types of trusts, called "qualified subchapter-S trusts," or QSSTs, can hold stock in an S corporation.[41] Particularly where a revocable trust is to be used for estate planning, an LLC is a much simpler and less expensive entity choice over the S corporation, as the membership units of the LLC can be owned directly by the revocable trust.

Income tax considerations are also a big part of entity choice. Both S corporations and LLC's can be taxed like partnerships, meaning that all income is passed through to the owners directly.[42] If an LLC opts for pass-through taxation, the income of the business is not taxed at the entity level first, but instead is split among the owners and all taxes are paid by the individual owners directly.

An LLC also gives the producer great flexibility in planning for the future of the business through the use of a properly and thoughtfully created operating agreement. An operating agreement is an agreement between the members of an LLC, and creates the "rules" by which all members will have to abide in the future. The operating agreement contains everything from who can be a member or owner of the LLC, to restrictions on transfer of the units, to distribution of income. The rules governing the LLC operating agreement allow it enormous flexibility[43] – in many cases, far greater flexibility than the bylaws of a corporation could afford. They can create several different classes of ownership, making an LLC an ideal entity where investment partners are co-owners with operating partners or where some owners (such as off-farm children) may be allowed to participate in revenues but not control of production assets. This makes the LLC a powerful tool for use in transition planning, allowing the producer to create an operating agreement that very specifically tailored to the needs of their operation.

d. Other entities

While corporations have been with us for centuries and limited liability companies (LLCs) have now been with us for decades, there are yet newer forms including the limited liability partnership (LLP), the statutory business trust, and the family limited partnership (FLP).[44] More recently, the "series LLC" has emerged[45] and may eventually prove to be a flexible tool for farmers and ranchers specifically looking to give some heirs greater control over operating decisions while still affording other heirs the opportunity to participate in the revenues

---

[40] REVISED UNIF. LIMITED LIABILITY COMPANY ACT, § 102(15) (defining "person"), §401 (establishing who may become a member of an LLC) (2006).

[41] See Title 26 US Code section 1361, et seq, which includes the use of an Electing Small Business Trust ("ESBT").

[42] The IRS' "check the box" regulation allows LLCs to elect whether they desire to be taxed in the manner of either Subchapter S or Subchapter C corporations. Treas. Reg. §§ 301-7701-1, 301-7701-2, 301-7701-3.

[43] *See* REVISED UNIF. LIMITED LIABILITY COMPANY ACT, § 110 (defining the scope, function, and limitations of the operating agreement) (2006).

[44] *See* Carol R. Goforth, *The Series LLC, and a Series of Difficult Questions*, 60 ARK. L. REV. 385 (2007).

[45] Series LLCs are sometimes called "Delaware Series LLCs" as Delaware was the first state to authorize the formation of such entities. *See* DEL. CODE. ANN. tit. 6, §18-215 (1996).

generated by the farm, all under one overarching entity.[46] Each of these entities has unique traits, and thus unique consequences in each farm transition application, and a discussion of each is beyond the scope of this paper.

V. Transactional tools

An unstated assumption in many farm transition conversations is that the farm or at least pieces of it will be "given" to the party(ies) that will succeed the current operator. To borrow the lyric, however, “it ain't necessarily so.” The producer and his or her successors may use commercial tools that allow the successor to gradually pay for their interests. As discussed with business entities above, the producer may gift ownership shares in the business to accomplish this. However, in some cases the producer and successors might choose to have a purchase and sale of these membership units. The consequence of such transactions is that ownership, control, and likely participation will gradually shift from the producer to his or her successors.

There are a number of transactional tools that can, to a greater or lesser degree, accomplish these ends without the need to hold the farm in a business entity. While there are a host of such commercial tools available, two of the most common are the installment sale (sometimes called a "buy/sell agreement") and the long-term lease. In an installment sale, the client and his or her successor enter into a contract for the purchase of assets by the successor, with the purchase price of the assets to be paid over time through a defined schedule of "installment" payments. This arrangement can provide significant tax advantages for the client as the gain (if any) realized via the sale is taxed as it is received, rather than being recognized entirely when the contract is formed.[47] The successor has the advantage of "locking in" both the title to the asset and the price for its purchase, and can now count on having that asset in his or her control without wondering whether it will or will not be given to them in the disposition of the client's estate. There is also a potential advantage in the emotional context of the transaction with respect to children that do not wish to participate in the operation of the farm, in that the successor is purchasing their interest, rather than receiving it as a gift. This may assuage some "entitlement" issues. Additionally, payments for the assets may (but may not) increase the estate to the advantage of all parties.

The disadvantage of this arrangement from the producer’s perspective is that he or she will be relinquishing title to the asset before they pass away. The successor has the disadvantage of having to pay for the asset (and recall that if the asset is sold for less than its fair market value, the difference between that value and the contractual price may be considered a taxable gift pursuant to IRS regulations.[48]

Long-term leases may work in many of the same ways as the installment sale. Such arrangements can facilitate the use of farm assets by a successor while also providing a stream of payments to the client that can be recognized as income over time rather than all at once upon commencement of the arrangement (and such payments may be deductible by the successor). The long-term lease may be used where financing for an installment sale may not be available or where the financial mechanics for a sale or outright gift of assets are untenable. Additionally, leases will sometimes be used to establish an arrangement that provides an accommodation to children that do not desire to operate the farm. In such circumstances, the client may enter a

---

[46] For a more in-depth discussion of the series LLC’s attributes, and the current questions surrounding how they may be deployed, *see generally* Goforth, *supra* note 44.
[47] 26 U.S.C. §453(c).
[48] Treas. Reg. §25-2512.8

lease with a term that he or she feels will substantially exceed their lifetime, and makes provisions in their estate documents that the payments from the lease will be allocated to those children. This provides a source of income to such children in lieu of receiving farm assets, and provides the successor with the use of such assets. The disadvantages of the lease are much like those of the installment sale: relinquishing an asset before death, and the need for the successor to cash-flow the lease payments.

VI. Barriers to implementation

Having reviewed all these concepts, one could make the argument that there is no shortage of tools available to producers who wish to transfer their farm or ranch business as an intact, viable business to the next generation. Why, then, has there been such discussion about the ability (or inability) of farm families to accomplish this goal. In many cases, it may be due to communication issues, equitable considerations, or a simple lack of wiliness by the producer to "let go."

a. Communication Issues

Many examinations of small business transitions list problems in communications between the primary generation and the successor as the critical piece in successful transition.[49] Dr. Danny Klinefelter succinctly summarized some of the most significant problems in succession communication:[50]

- A "command and control" management style: perhaps less more frankly called a "dictatorship" model, this depicts a scenario where the primary generation believes there is no need to involve the successors in any aspect of management or planning. It should be noted that this can be a characteristic of the so-called "Traditional" or "Greatest" generation (those born prior to the Depression or World War II).
- Secrecy: This can be an extension of the command and control style, but it can also be derived from a sense that other farm stakeholders simply do not need to know (or should not be worried by) the operational details of the farm or ranch.
- Failure to admit "I'm wrong" to the other party(ies): Once a primary generation member or successor has committed to a position, they may be highly reluctant to acknowledge when new information comes to light that makes them re-evaluate their stance. This can lead to entrenchment and the negative escalation of emotions in the succession discussions.
- Unresolved conflict: Many times, a conflict about succession planning may not arise from the plan at all, but instead is a result of another conflict that one of the parties feels has not been resolve or, in more extreme cases, cannot even be raised to the attention of the other party.
- Failure to fight fairly: Conflict is almost inevitable at some point in transition discussions. However, many families fail to observe the rules of fair, productive conflict resolution. At a minimum, the following rules should be observed: "avoid

[49] *See, eg.* Morriss, *et al.*, *supra* note 5 at 390.

[50] *See* Danny Klinefelter, Successor Development and Management Transition on Family Farms and Ranchers, Texas AgriLIFE Extension, (2009), *available at* http://www.carolinafarmcredit.com/cfc3/Tepap/Successor%20Development%20and%20Management%20Transition%20on%20Family%20Farms%20and%20Ranches.pdf (last visited March 9, 2013).

> personal attacks, don't drag others into taking sides in the argument, don't use subversion, focus on the issue at hand (i.e., don't dredge up old issues), and keep heated discussions in private."

Resolution of these issues is critical to the genuine involvement of all farm stakeholders in productive farm transition planning.

b. Equitable Considerations

In dealing with the successor generation, many producers (and humans in general) think that all children must be treated "equally" or identically. Both they and their children might be better served in considering that children should be treated "equitably" or fairly in light of their desire to contribute to the farm or ranch as an on-going business. Two equitable considerations frequently arise in the context of farm transitions: the "Farm Kid / City Kid" conundrum and the problem of "sweat equity."

i. The "Farm Kid / City Kid" Conundrum

As alluded to earlier in this paper, many producers are confronted with the situation in which one or more children wish to remain on the farm ("farm kid(s)") and contribute to its growth, while one or more other children do not desire to return to the farm although they may still have a strong emotional stake in its fate ("city kid(s)"). In many cases, producers seek to avoid conflict among the children by simply treating them equally. This may mean that both farm kids and city kids are made co-tenants of farm assets where each have an equal stake in the ownership and management of those assets. In seeking to avoid conflict among his or her children, the producer may have *guaranteed* conflict by such an arrangement. It may be that the best arrangement for the continued viability of the farm or ranch may be to seek an *equitable* arrangement that allows a greater proportion of farm assets to pass to the farm kid, even though such an arrangement may not result in the *equal* treatment of the children involved. To compensate for this, the producer may choose to allocate more liquid financial assets (such as investments, life insurance proceeds, etc.) to city kid. Successfully managing these scenarios requires both open and honest communication with all farm stakeholders and long-range planning to ensure that the producer has the means available to provide allocations of non-farm assets to a city kid.

ii. The Problem of "Sweat Equity"

In the authors' experience working with farm and ranch families in the transition planning or estate planning process, the concept of "sweat equity" often comes up. The basic premise is as follows – one child either has been working, or is anticipated to work, side-by-side with a senior farming generation for a period of years while both generations of families simultaneously contribute to the growth of the business, and draw some family living stipend. The concept has been sarcastically referred to as the "someday son, this will all be yours" compensation plan.

The younger generation is expected to work in the business for a cash stipend that is typically considered significantly less than a market wage for their skill set, with the implied understanding that they will someday inherit a larger share of the physical assets than any siblings they might have, hence the term "sweat equity." The argument is often made that the off farm siblings also come out better in the end, because the assets grow faster due to the work of the farm sibling, so even though they may ultimately inherit a smaller share, the overall base will be larger so they end up better off (the reader may be stifling a laugh, but in the authors' experience, this is a frequently-made argument).

On the surface, this may sound like a reasonable plan; in practice, however, it rarely ends up with the desired result. In fact, the authors' experience has been that families are quite often torn apart because of it. The problems with implementation of the concept appear to be three-fold: First, as has already been mentioned, there is often insufficient stakeholder communication from the start. Rarely is everyone aware of what the arrangement is. Siblings don't know the details of the compensation arrangement, and are typically shocked when the estate is settled and they find out about the "delayed compensation" plan. The argument about a "larger pie" is a tough sell at that point. Second, there is a problem with being able to accurately predict how the physical assets will grow over time. Unless one is willing to re-evaluate the estate plan every year, it is extremely difficult to predict the value of the asset base at any point in time and instill any notion of fairness into the final settlement. Finally, similar to the second problem it is impossible to predict well in advance when death will occur.

Again, unless the estate plan is updated often, it can quickly become unfair. For example, imagine a plan put in place based on a 20 year expected life concluding with the farm sibling getting some inflated share of the real estate and machinery, but the non-farm siblings would still inherit some of those assets. If death occurs very prematurely, the off-farm siblings will rightly feel cheated, regardless of the magnitude because the on-farm heir just made a windfall. On the other hand, the farm heir could essentially slave away for 35 years after the onset of the agreement, and feel that over that length of time they have essentially built 100% of the value of the current physical asset base, and then end up giving a share of it away.

The authors' overarching recommendation is that "sweat equity" arrangement be avoided altogether. Producers would generally be better advised to set up an ownership structure that allows the entering generation to build an appropriate ownership stake as they work into the business. Simultaneously, labor and management contributions should be compensated at market rates along the way, and if individuals choose to "invest" their wealth in the growth of the business they can do so.

Of course when this is mentioned the argument that often arises is that the farm simply does not generate enough profit to pay a fair wage for the entering generation while continuing to support the older generation. Quite frankly, this is a red herring, and should be quickly dispelled as such. If there is not enough profit, then the farm either has a profitability problem, or a scale of operations problem that must be addressed before a transition is even considered. If it cannot pay for the labor expended, then it will not support growth either.

Despite this, the authors have seen instances where the "sweat equity" concept has worked well. Those are instances where the entire family engaged in open and honest communication from the very beginning regarding what the ultimate plan for the farm's transition was going to be.

c. Willingness to Transfer Ownership, Control, and/or Participation

Where producers are unwilling to transfer any elements of their operation before death, they face the peril of eroding their equity in the farm or ranch enterprise. Older producers tend to own a great deal of their agricultural land (77 percent of producers over 65 own all the land they farm),[51] but they often decrease production or switch to less-intensive enterprises as they age. The average value of sales per farm for producers over 65 years of age is 42 percent lower compared to farmers 45 to 64 years old, despite that their farm size is only 7 percent smaller.[52] To an extent, this is understandable and perhaps even rational economic decision. For many producers, their farm or ranch and its assets represent their only "retirement" investment. Thus, they are simply consuming retirement savings. However, they may not realize that they are unnecessarily consuming those savings; in some cases, greater returns might be realized by allowing the successor generation to use the assets in a more intensive enterprise that might generate greater returns and reduce or even eliminate the consumption of equity. At an extreme, the consumption of equity could lead the producers to outlive their savings, placing them in the 46.1% of Americans dying with less than $10,000 in assets.[53]

VII. Conclusions

The current legal environment in most (if not all) states afford producers with a wide range of tools to deal with both estate and transition planning issues. The challenges of succession planning, then, do not seem to spring from the legal environment, but rather the willingness of both producers and their legal professionals to confront the difficult questions inherent to transitioning their farms to the next generation. For their part, our governments and universities can rededicate themselves to educational efforts about the importance of transition planning and in providing producers with a broad array of plain-English tools and materials that enable them to evaluate their options and to engage in deep, meaningful dialogue with the stakeholders of their farm or ranch.

At the same time, state bars may wish to consider adopting board certifications for farm estate planning which such certifications to not exist. Estate planning is, itself, a highly intricate area of practice, and agricultural transition planning is even more so. Many times, producers are frustrated with the challenges in finding qualified legal counsel that can understand the operational peculiarities of their operation and create a well-fitted transition plan. Such certifications would, at a minimum, allow producers to know that attorneys so-certified possessed a skill set suited to their needs.

In the end, the challenges of farm and ranch transitions can only be confronted by the producers themselves. In many respects, today's farm operations are no different than any other small or closely-held business, and the way that agricultural attorneys and advisors handle planning for the farming business should take a similar approach. Tackling the issues that farmer-clients face by utilizing only the traditional tools of estate planning, *i.e.* wills and trusts, may no longer suffice. Whether producers want to believe it or not, they are business people, and the solutions for transferring the farm business on to another generation will likely not be as simple as they envisioned. Producers and the legal community need to examine ways that the tools of estate planning can be paired with a few other simple measures and devices to create a true "business succession" plan – something about which all owners of small or closely-held

---

[51] USDA NASS, 2007 CENSUS OF AGRICULTURE FACT SHEET: FARMERS BY AGE, *available at* http://www.agcensus.usda.gov/Publications/2007/Online_Highlights/Fact_Sheets/Demographics/farmer_age.pdf (last visited October 11, 2012).
[52] *Id.*
[53] JAMES POTERBA, STEVEN VENTI, AND DAVID A. WISE, WERE THEY PREPARED FOR RETIREMENT? FINANCIAL STATUS AT ADVANCED AGES IN THE HRS AND AHEAD COHORTS, National Bureau of Economic Research working paper (May 26, 2011), *available at* http://economics.mit.edu/files/7553 (last visited March 9, 2013).

businesses should be thinking. This is especially true for the farms and ranches that produce the food, fiber, and fuel for a growing world.