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SELECTING AND DEVELOPING FAMILY FARM BUSINESS ARRANGEMENTS

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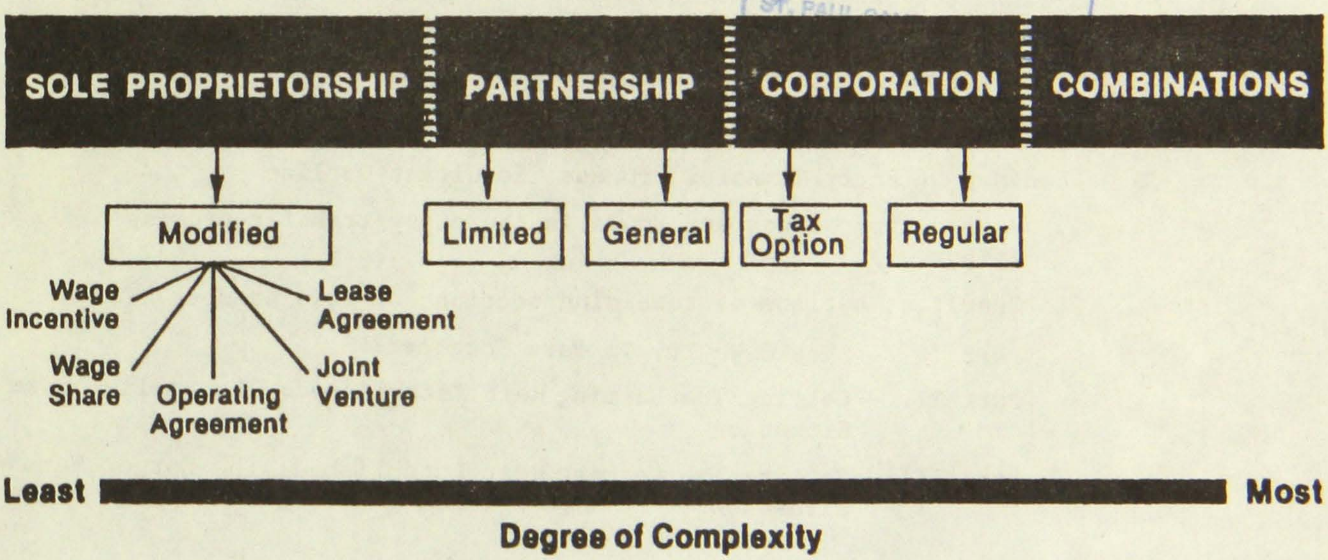
I. INTRODUCTION

A. Some things to keep in mind as you select and develop a family farm business arrangement.

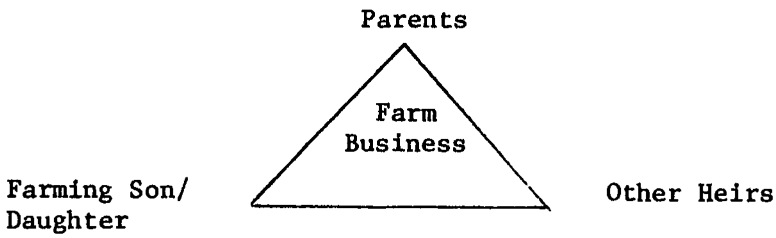
1. No shortage of possible arrangements



2. Any arrangement will work if you have:
   a. Good human relations
   b. Profitable business
   c. Workable operating agreement
      - Investment opportunity
      - Management involvement
      - Fair sharing of income
   d. Workable transfer plan

   Of course, some arrangements will work better than others in a given situation. The task, then, is to find the arrangement(s) that best fits your situation.

3. Each family/business situation is different. This will call for a different transfer plan and set of business arrangements.



<u>Differences</u>

Parents' success (size)	Dad's age versus son's
Parents' desires/objectives	Son's management ability
Parents' definition of fairness	Number of heirs; plans;
Son/father operated together?	expectations

4. Families should plan to spend considerable time and money to get job done right.

B. Road Map Of Entry/Transfer Process; Resultant Outline

1. A road map: stages and tools in the entry/transfer process (figure 1)

2. Resultant outline of remaining sections of this handout

   Part I - Should We Try To Farm Together?

   Part II - Getting The Farming Heir Established: The Smaller Farm Situation

   Part III - Getting The Farming Heir Established: The Larger Farm Situation

Stage 1: Assessment
Should we try to farm?
Together?

Stage 2: Testing
To farm?
Together?

Stage 3: Establishment/development
Getting farm heir established

Separate units
— Heir rents separate unit
— May exchange labor/machinery?
— Parent co-signs notes?

Together
— Shift personal property/management
— Provide for untimely death
  — Insurance
  — Provisions in will
— Later — plan for real estate transfer

Stage 4: Consolidation/transfer
Secure farm heir's position in farming/firm up transfer plan

— Complete personal property/management transfer
— Shift control/ownership of real estate
— Rental property?
— Options to buy?
— Sell/give part?
— Rest in limited partnership?
— Provisions in will

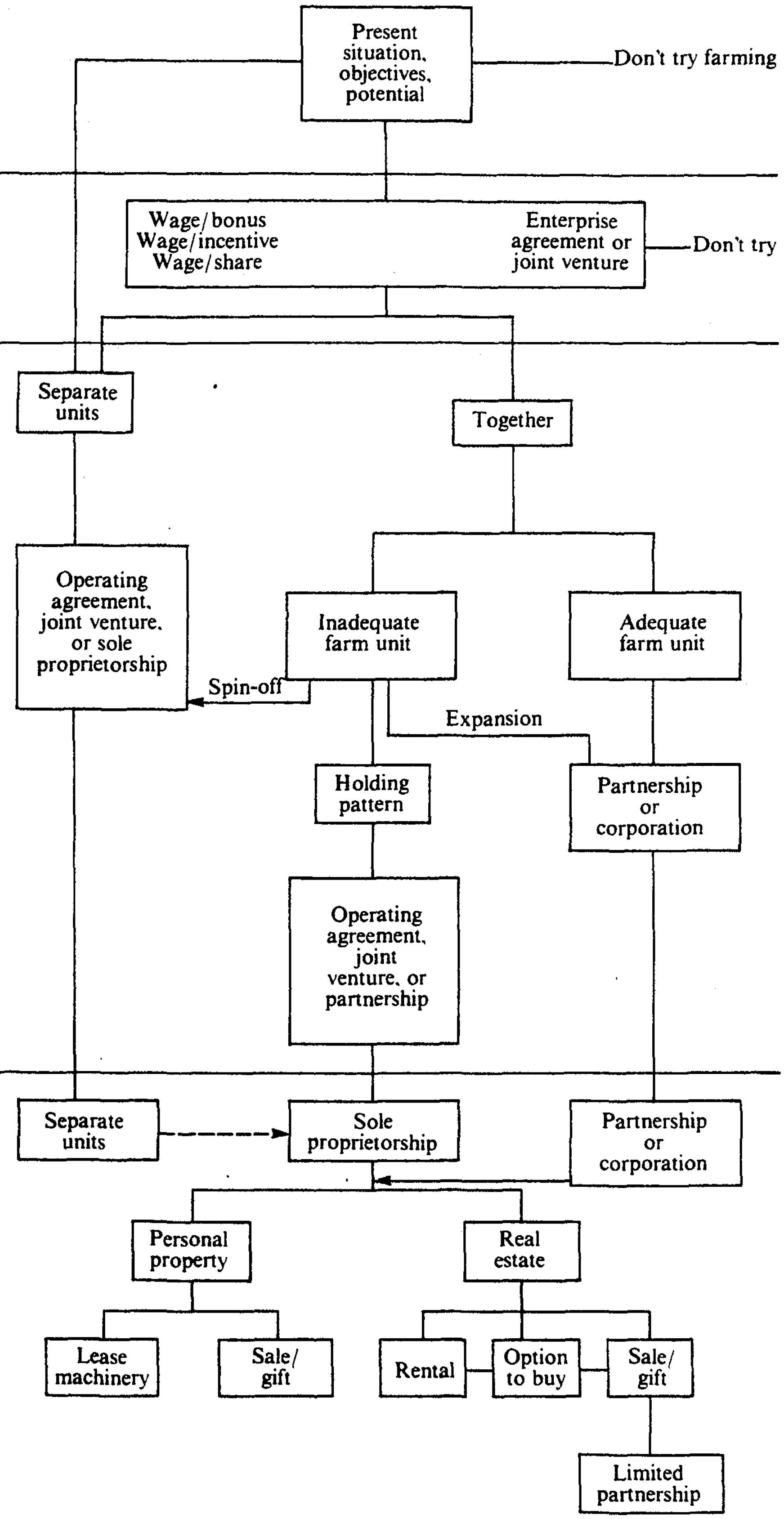


Figure 1. Road Map Of Farm Entry/Transfer Process

PART I

SHOULD WE EVEN TRY TO FARM TOGETHER?

I. STAGE #1 - ASSESSMENT - MAKING THE FIRST CUT!

Key Concern: Should We Even Try To Farm Together? - Worksheet FM 221

A. Description Of Our Present Situation (page 2)

1. Family situation
2. Farm business situation
3. Present arrangement/future plans

B. Our Potential For Farming Together (pages 3 - 6)

1. Do you really want to farm? together?

   a. Does farming son/spouse have commitment to farming?
   b. Does farming son/spouse have ability to make a good manager?
      - Goal oriented? organized? attention to details?
      - Hardworking; aggressive; positive attitude?
      - Willing to sacrifice to get started? grow into volume?
      - Will take time to manage: keep learning; seek good advice?
   c. Can family members live, work, manage together?

   Some possible sources of tension when farming together:

conflicting goals	unequal work loads	son's wife disgusted with:
can't work together	unequal housing	- work
housing/life styles	unequal spending	- hours
financial squeeze		- finances
		- living arrangements

2. Is the business profitable enough?

   a. Will it provide income security for parents while permitting farming heir to gain equity in business?
   b. Getting a farming heir started often involves a "subsidy". What might yours amount to?

Breaks on Sale/Gift Inventory Items	
Machinery sale	$________
Land sale	$________
Feed/livestock	$________
Tools and supplies	$________
Annual Cash Breaks	
Machine use	$________
Land rental rate	$________
Building use rent	$________
Operating interest rate	$________
Land interest rate	$________
Dad's labor	$________
Free house rent	$________
Baby-sitting	$________
Total	$________

c. Can you do this without jeopardizing your financial security and family goodwill of other heirs?

3. Can a realistic transfer plan be developed?

   a. Is dad willing to shift management responsibility?
   Barrier: dad's often willing to give up work load but not decisionmaking responsibility.

   b. Are parents willing/able to shift property ownership over time?

Personal barriers	Tax barriers
Financial protection (inflation)	Gift tax
	Capital gains tax
Desire for control	Investment credit recapture
Treatment of other heirs	Stepped up basis at death
	Use valuation rules

4. Conclusions: should we even try to farm? together?

   a. If answer is no - read no further!
   b. If answer is maybe - need testing stage (next section)
   c. If answer is want to farm but not together - develop separate unit
   d. If answer is want to farm together - need to develop arrangement and transfer plan - see parts II and III

II. STAGE #2 - THE TESTING STAGE - THE SECOND CUT

Situation: The Son Has Not Farmed Much Or You Have Not Farmed Together Much

Key Concerns: Do You Really Want To Farm? Together? Big Enough?

The following are some alternative business arrangements for use in the testing stage (FM 222)

A. Employer-Employee Type

1. Wage/bonus (page 2, FM 222)

   a. Easy way to start
   b. Caution: reasonable wage; don't do it too long
   c. Pay son good hired man's wages
      - Keep son motivated
      - Test son's ability to handle money
      - Test financial adequacy of business
      - Insure that won't last too long
   d. Possibly have year-end bonus

2. Wage-incentive (page 2 and 3, FM 222)

   a. Wages plus incentives
   b. To be sound
      - Son must be able to influence outcome
      - Incentive large enough to warrant effort
      - Have written agreement? Purpose - son's responsibility, method of calculation, arbitration
   c. Wage and income share (page 4, FM 222)
      - Son works full-time, receives monthly wage and share of net or gross

B. Joint Working Agreements - Optional Phase

1. Heir usually furnishes labor and some personal property
2. Generally keep on short-term basis; tends to blend into stage 3 - establishment phase
3. Joint working agreements (page 5 and 6, FM 222)
   a. On home farm - enterprise arrangement (page 5)
   b. Separate business - joint arrangement (page 6)

C. Testing Stage And Beyond

1. Length of testing stage?
   a. Purpose: determine whether you want to farm? together?
   b. 2 - 3 years usually long enough to answer this
2. Where to from here?
   a. Quit farming?
   b. Develop separate farming units? advantages

No goal conflicts	Still share labor
- Son can expand	Still share machinery
- Dad can slow down	Individual responsibility
Few joint decisions	Have pride of ownership
- Marketing	Preserve independent nature
-Purchasing	

   c. Decide to farm together?

- Advantages

For farming heir	For parents
Start in going business/ more income?	Protect income and investment in later years
Grow into business without excessive debt	Can let up gradually
Access to management advice	Management assistance for surviving spouse
Less confinement to farm duties	Less confinement

- Options

Small farm: holding pattern or expansion - part II
Larger farm: partnership or corporation - part III

PART II

GETTING THE FARMING HEIR ESTABLISHED: SMALLER FARM SITUATION (STAGE 3A)

Situation: You Want To Farm Together But The Business Is Too Small For Two Families
Key Concerns: To Permit Son To Build Equity And Gain Management Experience Without Jeopardizing The Parents' Financial Situation

I. ROUTE #1 - SPIN-OFF

A. Heir rents separate unit; builds equity in machinery/livestock

B. Joint venture arrangement - at least for awhile (see FM 222)

1. Exchange labor/machinery
2. May operate livestock together, crops separately or vice-versa

C. Transfer not normally big issue

1. Heir has his own; parents need what they have
2. Home farm business may terminate on dad's retirement or possibly be taken over by "spin-off" heir

II. ROUTE #2 - HOLDING PATTERN - UNTIL DAD'S RETIREMENT

A. Heir builds farming future around existing farm business

B. Heir may rent additional land or facilities or work off-farm

C. Whether father and heir enter a joint venture, enterprise agreement or partnership arrangement will depend on the situation

D. At dad's retirement (or possibly before)

1. Heir rents farm/buys or leases personal property
2. Buy-sell options and agreements are established
3. Some real estate may be sold - contract for deed
4. Heir(s) may invest in expansion of home farm

E. The above strategies are often applicable in a widow/heir situation

III. ROUTE #3 - BUSINESS EXPANSION

A. Dad/heir decide to expand

B. Expanding the home farm - fundamentals, planning tools (North Central Regional bulletin #34 "Managing Your Farm Financial Future" is available from your County Extension Office.)

C. Normally use partnership or corporate arrangement (see Part III).

PART III

GETTING THE FARMING SON ESTABLISHED: LARGER FARM UNITS (STAGES 3B & 4)

Situation: You Get Along Well Together And You Have A Large Enough Business For Two (Or More) Families

Key Concerns: Should You Be In A Partnership Or Corporation? How To Form One? When And How To Transfer Property?

I. TRANSFER CONSIDERATIONS/ARRANGEMENT ALTERNATIVES

A. Transfer Considerations And Guidelines

1. A key task facing farm families is how to develop an effective plan for transfer of assets and management responsibility so that (1) the parents' security will be protected, (2) the farming heir will get established in farming and (3) nonfarm heirs will be treated fairly.

2. Some general transfer guidelines

   - Parents should maintain a considerable financial base for their own security and well being--$200,000 to $400,000; preferably in inflation-proof land.

   - Parents shouldn't try to get heir into land market too soon--unless they are able to subsidize it. Personal property and management should be key early concerns as far as transfer.

   - However, parents should be willing/able to shift considerable property and management responsibility over time or let the heir know right now that they are going to hang on real tight!

B. General Characteristics Of Partnerships And Corporations

1. General guidelines - where they fit?

   a. Where the corporation fits
      - Larger growing business and income tax problems
      - Where continuity, control and transfer are problems
      - Complex business situation - several "partners"

   b. Where the partnership fits
      - In-between sole proprietorship and corporation
      - When combined with limited partnership maybe as good as corporation as far as transfer is concerned
      - Cannot compete with tax rates and benefits of corporation

II. USING THE PARTNERSHIP AS A TRANSFER AID - A GOOD, FLEXIBLE TOOL

A. Advantages/Disadvantages

Since the corporation is considered the "ultimate" arrangement for businesses, the advantages of the partnership tend to be the weaknesses of the corporation and vice versa.

1. Advantages

   a. Flexibility in organization and operation

      - "Overgrown sole proprietorship"
      - Can be formed and dissolved with few legal restrictions
      - Can do almost anything that is legal and agreed to by partners; tax treatment flexible
      - Generally less costly to form/operate

	General Partnership	Regular Corporation
General Nature	Two or more owners contribute assets to business. Share management, profits, losses	Legal person separate from shareholders-owners; separate person, separate taxpayer
Ease And Cost Of Formation	Can be organized with or without written agreement.	Must be formally organized and registered with Sec. of State. Organization and maintenance costs greater than partnership--need good attorney and accountant.
Business Development And Growth Considerations		
Source Of Capital	Partner's contribute assets on outright, use only or lease basis; loans.	Contributions of shareholders for stock or debentures; sale of stock, bonds, other loans. Lease of assets from shareholders and others.
Limits On Business Activity	Partnership agreement.	Articles of incorporation and state farm corporation law.
Liability	Each partner liable for all partnership obligations. Need good partner; good insurance program.	Liability of each stockholder limited to his investment in corporation - unless sign as individual.
Management/ Control	Management shared equally unless specified in agreement.	Shareholders elect directors who manage business through officers elected by directors; person(s) with 51% of stock controls.
Owner/ Employee/ Benefits	Partners usually considered self-employed, not employee. Social security and other benefits about same as sole proprietorship.	Operator/owner becomes employee of corporation. Paid salary. Social security rates higher; more benefits available because of employee status.
Income Taxation	Partnership files an information return but pays no tax. Each partner reports share of income or loss, capital gains and losses as individual. Taxed at individual (14-50%) rate. 60% deduction for capital gains.	Corporation files tax return and pays tax on income; salaries to shareholder-employees deductible. Capital gains offset by capital losses; no 60% deduction. 1983 tax rates: 15% first \$25,000, 18% on second \$25,000; 30% on third \$25,000; 40% on fourth \$25,000; 46% over \$100,000. Shareholders taxed on dividends paid.
Retirement And Transfer Considerations		
Effect Of Withdrawal Or Death On Continuity	Dissolved at death or with-drawal of partner. May be reformed.	Not affected by death or withdrawal of individual unless they are critical to management or financing of business.
Ease Of Transfer/ Dissolution	Individual items of property must be sold/gifted.	Transfer shares of stock rather than underlying property. Liquidation often has adverse tax consequences. (Consider at formation)

b. Flexibility in estate transfer

- When combined with the limited partnership, can transfer property easier and with less tax
- Step up in basis of assets can occur at death under section 754
- Property distributions on liquidation of a partnership can be returned without large capital gains
- The redemption or buy-out of a retiring partner can be handled as ordinary or capital gains

2. Disadvantages

a. Income tax treatment

- Partnership income flows out to individual--thus, do not gain another tax unit or have favorable tax rates like regular corporation
- Because partners are not employees, not eligible for as many fringe benefits

b. Control lines of authority not as clear cut as with corporation

- Management decisions 50/50 basis unless agreed to otherwise

c. Very fragile tool/liability consideration

- Less continuity - anytime partner leaves, partnership dissolves
- Unlimited liability - responsible for acts of other partners

3. Where the partnership best fits

a. Between the sole proprietorship and corporation

b. When combined with limited partnership may meet estate planning needs as well as corporation

c. Cannot compete with corporation tax rates and benefits

B. Developing Your Partnership Share Arrangement/Transfer Plan - Early Going (See FM 223, 224 and 225)

Key Concerns: To build heir's equity in business as rapidly as possible while protecting parents' interests. Put emphasis on transfer of personal property and management responsibility.

1. Step #1 - Who's going to contribute what? How will profits be shared?

a. Use 50/50 share arrangement wherever possible

(Share arrangement and profits same percent; equity grows faster)

- Real estate - rented to partnership
- Machinery - leased to partnership, unless heir owns considerable machinery, then move toward 50/50 ownership
- Shift ownership of other personal property to 50/50
  - Contract sale on breeding livestock
  - Sale/gift of other personal property over 2 year period (December/January)

b. Alternative - fixed contribution arrangement

- Use where dad needs more income, situation less certain or more risky; unrelated parties?
- Determine annual use value of R.E., machinery, labor and management
- Junior partner buys into other personal property in same percent as partners' contributions; profits shared in same percent

2. Step #2 - How are you going to operate together?

a. How will decisions be made? Who's managing what?

b. What limits will be placed on partner's activities?

3. Step #3 - How will partnership be dissolved (see C-1 below)

C. Developing Your Longer Term Transfer Plans

1. Planning for the worst (don't get into partnership unless have a dissolution plan for untimely death situation)

a. Partnership is very fragile tool - dissolves when partner leaves, retires, dies

b. Must protect parents if junior partner leaves

- First option; penalties

c. Should protect junior partner in case of dad's death

- Special bonus provision in will
- Buy-sell agreements on personal property and real estate (funded with insurance or purchase arrangement)

2. Planning for the retirement years and beyond

a. Partnership dissolves upon retirement if one heir goes to sole proprietorship. Two or more heirs as partners - partnership or corporation

b. Complete transfer of personal property and management

- If possible, 5 years prior to retirement heir should buy all of new machinery - investment credit recapture
- Lease machinery still on investment credit
- Use contract sale/gift on personal property

c. Rent real estate to heir; have option to buy

d. If possible provide sale/gift on at least base unit

- Use contract for deed
- May want split sale/gift
  - Farmstead → sale (depreciation)
  - Bare land → gift

e. Consider use of limited partnership on other land

- Can transfer units by sale or gift
- Can retain control as long as have 51 percent of units
- See section IV

3. Planning for transfer at and after dad's death

a. Protect spouse but avoid excessive tax

- Avoid joint tenancy and simple wills
- Consider trusts, balanced estates, outright to heirs, disclaimers

b. Fair treatment of heirs

- Depends what has happened before death
- "Bonus" approach for farming heir

c. Provide flexibility in wills and trusts

- So farming heir can gain control over time

III. USING THE CORPORATION AS A TRANSFER AID - THE "ULTIMATE" TOOL

A. Advantages/Disadvantages

1. Advantages

a. Income tax savings

- Federal corporate rates lower than individual
- Corporation represents another taxing unit--split income
- Two tax years--fiscal for corporation/calendar for individual--manage taxes better
- Safety valve - convert to Sub S
- Fringe benefits - retirement and life insurance plans, meals and lodging - employee status

b. Estate planning

- Ease of transfer - stock
- Retention of control - 51% of voting stock
- Minority discounts - 15% - 25% discount
- Fixed value securities = freezing values
- Sale of corporation stock - entirely capital gain
- Caution:
  - Special use valuation - qualifies if decedent had 20% of voting stock and 15 or less shareholders
- Installment payment of estate taxes - o.k. if use crop share lease

c. Legal attributes

- Perpetual life
- Limited liability

2. Disadvantages

a. Complexity and maintenance costs

- Formation - more costly than partnership
- Annual report to state
- Need for professional help - legal, accounting
- Intangible - learning the ropes

b. Payroll tax costs

- Social security - 14.0% versus 11.3% (1984)
- Salaries to family members and social security
- Unemployment tax - which officers are employees
- Workmen's compensation - family officers can decline

c. Termination

- Taxation - subject to tax on retained earnings and appreciation

d. Other tax problems

- No long-term capital gains deduction
- Partial incorporation and investment credit recapture
- Accumulated earnings and personal holding company tax
- Investment credit recapture on sales

3. Summary: where the corporation tends to fit best

a. Large, growing business with tax problems

b. Where continuity, control and transfer are of concern

c. Complex business; where owners are business-like

B. Corporate Formation: Two Key Issues

1. What property to put in corporation?

a. Incorporate total farm or just operating unit?

b. Major considerations

- Why are you incorporating?
  - If for tax reasons or getting farming started/control - then operating unit o.k.
  - If for ease of transfer - leaving land out doesn't solve major transfer problem
- Other considerations
  - If no land in corporation - require personal signature on loan
- Will earnings build up in corporation? growth entity?
- Partial incorporation may cause investment credit recapture unless use long-term lease on land rented from shareholders.

2. What type of capital structure to use (common/preferred stock; debentures)

   a. One or more classes of stock; one or more classes of debentures

   b. Using debt securities/preferred stock

      - Reduces investment (stock) needed by on-farm heirs to gain voting control
      - Places "cap" on further increases in estate value for parents. Increases accrue to common stockholders.
      - Assures income to parents/spouse upon retirement
      - Problem? proposed regulations would severely restrict use

C. Corporate Formation - Some Resultant Options

1. Option #1 - all property in corporation/common stock

   a. Easy to transfer - all stock

   b. Problems: control - farming son has to own 51 percent of total assets (shares); parents - getting income out after retire; if corporation terminated - tax problem on gain and retained earnings

2. Option #2 - All property in corporation - use common and preferred stock, debentures

   a. Easy to transfer - all in units

   b. Parents would retain preferred stock/debentures

      - "Freezes" value of that portion of assets
      - Provides source of income for parents/off-farm heirs

   c. Reduces amount of capital son would have to control (51% of total assets)

   d. Would face capital gains problem if dissolve corporation

3. Option #3 - keep some property out of corporation

   a. Breeding stock kept out - better capital gains treatment as individual taxpayer

   b. Most of land kept out - particularly low basis. Put this land in limited partnership, rent land to corporation

   c. Reduces amount of assets son would need to control 51 percent of corporation

   d. Problem: investment credit recapture unless have long-term lease

D. Transfer Strategies - Dad's Retirement

1. Sale/gift of stock; redeem stock

2. Real estate outside corporation

   a. Rent farm to corporation, have options to buy

b. Sale/gift of base unit if not in corporation

c. Consider use of limited partnership on other land

3. Provide flexibility in wills; options

E. Forming And Managing The Corporation

1. Need good attorney and accountant on continuing basis

2. Need to be willing to learn the ropes of operating with a corporation

IV. REAL ESTATE TRANSFER TOOLS: SALES, GIFTS AND LIMITED PARTNERSHIPS

A. Option To Buy

1. Description: Use where parents want heir to have farm but not right now. Rent farm to heir and give him option to buy at future date.

2. People considerations

a. Parents' security

- Retain title till option is fulfilled
- Receive rental income during option period
- Who is responsible for improvement, etc?

b. Farming heir

- Assures heir of chance to buy farm
- If carefully drawn, may be able to specify price now - see your attorney

3. Tax considerations

If freezes value, may save income tax if property is inflating in value.

B. Installment Sale - Contract/Mortgage

1. Description: dad sells farm to heir with low down payment. Must charge at least 6 percent interest on sale of land to family member. Has to be 9 percent if to unrelated party, land sales above $500,000, or sale of buildings, personal property, etc.

2. People considerations

a. Parents' security

- Parents may retain control through contract provision
- Reduces uncertainty of annual income; increases uncertainty of outliving assets
- Will income from sale be enough to live on? last long enough?

b. Farming heir

- Have control of property during productive years
- Benefits of inflation accrue to new owner
- Know where property is going - if keep up payments

c. Other heirs

- If farm priced too low, windfall to farming heir plus inflation
- On death of seller within the term of the contract, remaining payments go to heirs - income continues. If original contract written for too long a time period, heir's money may be tied up too long

3. Tax considerations

a. Estate and gift taxes - reduce size of taxable estate - may involve gift tax if priced too low - remaining debt on contract part of estate

b. Income tax - reduces income tax paid - lower brackets because of spreading over period
- delay of tax payments = time value of money
- new basis is sale price

Capital gain tax on debt remaining at time of death must be paid by estate if remaining contract is forgiven or bequested to farm heir.

C. Gifts

1. Description

a. May give up to $10,000 ($20,000 if spouse consents) per year per person tax free. Can't have any "strings" attached to gift. Above this amount, subject to same tax rate and credits as estates at federal level.

b. Minnesota has no tax on gifts, so may even want to make gifts beyond amount of federal credits.

2. People considerations

a. Parents' security

- No income from gifted property
- Lose control of property forever

b. Farming heir

- Have control over property
- Benefits from inflation accrue to heir
- Can be used with sales to bring debt payments in line with income

c. Other heirs

- Can be used to treat heirs more fairly
- Indiscriminate giving to farming heir can alienate heirs

3. Tax considerations

   a. Estate/gift - Gifts beyond annual exclusion use up unified credit. With no Minnesota gift tax, may want to do this.
      - Unlimited marital deduction gift to spouse can be used to balance estate.

   b. Income tax - Giver pays no income tax on receipt of gift
      - person receiving gift assumes donor's tax basis in property. Therefore, should give high basis property when possible.

D. Limited Partnership (See Example)

1. Description

   A limited partnership is a special form of partnership permitted by state law to have one or more partners whose liability for partnership debts and obligations is limited to their investment in the business. A limited partner is just an investor; a limited partner who participates in management becomes liable for all partnership obligations as a general partner. A limited partnership must have at least one general partner who handles the management of the business and who is fully liable for all partnership debts and obligations.

2. People considerations

   a. Parents' security

      - Can begin shifting ownership without losing control
      - Source of income; share in inflation
      - Easier to transfer partnership units than pieces of property

   b. Farming heir

      - Provides for continuity of business if proper provisions for sale
      - More management control than corporation if you are a general partner
      - Can buy land in small units; can rent land

   c. Other heirs

      - If own units, permits sharing in income and inflation
      - May be easier to treat heirs fairly than with installment sale or gift
      - Provision for sale of interest should be assumed

3. Tax considerations

   a. Estate/gift - transfer of units reduces size of estate
      - may reduce potential gift taxes because giving units not property

   b. Income tax - taxed as individuals
      - shifting smaller units by sale - reduce capital gains

E. Resultant Transfer Guidelines

1. Parents with larger estates should feel free to live it up - spend some of it! Also, hang onto plenty to meet future needs.
2. You should consider annual gifts at least to extent of annual exclusion ($10,000/$20,000) - otherwise lose chance to transfer property tax free. May want to give gifts and use up some credits and even pay some federal gift tax to get property out of estate. Parents should gift appreciating property, though heirs will be concerned with basis.
3. You may want to sell some property on contract or set up buy-sell option to freeze value.
4. May want to put remainder in limited partnership.
5. Have a workable death transfer plan - balanced estate, trust, qualify for special use valuation.

V. A REMINDER

A. This Educational Material Has Been Designed To Help You

1. Size up your family/business situation
2. Decide which business arrangements to give serious consideration to
3. Complete some of the steps necessary to set up various business arrangements so that you can make better use of your advisors

B. You will now have to spend some time and money to get the job done right

1. Study this material and your situation carefully: determine where you are at and decide where you want to be and how you might get there
2. Seek out good help - accountant/attorney/consultants - to help in selecting and developing your business arrangement
3. Communicate your plan to the family; revise it as needed