CHOICES
The magazine of food, farm, and resource issues
2nd Quarter 2013 • 28(2)
A publication of the Agricultural & Applied Economics Association

The Policy and Legal Environment for Farm Transitions

Shannon L. Ferrell, Michael D. Boehlje, and Rodney Jones

JEL Classifications: N25, L21, H25, K22, K11
Keywords: Agriculture, Business and Securities Law, Business Objectives of the Firm, Business Taxes and Subsidies, Property Law

Farm asset ownership is growing increasingly concentrated, and that ownership continues to shift toward an increasingly aged group of producers and off-farm landowners. In addition to these issues, American farms and ranches face the same challenges as many other family businesses in trying to successfully shift from one generation to the next—a transition that research suggests only 30% of them will survive. Does the current policy and legal environment give producers the incentives and tools to both keep the farm in the family and the family on the farm? This article will examine the farm transition process, the policy and legal mechanisms that influence it, and the challenges and opportunities posed by the current policy and legal environment.

What is Involved in Farm Transition?

"Farm transition" is the process of transferring a farm or ranch operation to the next generation. 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 business entities, ownership of the entity. Second, there must be a transfer of asset control or management (or perhaps both). Third, there may be a desire to allow economic participation in the farm business by those that who may (or may not) have ownership or control stakes, such as an off-farm heir. Transition planning is also distinguished from "estate planning" in that transition planning focuses on the gradual shifting of these three factors during the life of the founding generation while estate planning generally focuses on the transfer of these factors only after the death of the founding generation.

Policy Issues Surrounding Transition Planning

Three dimensions of federal agricultural policy have important implications for the transition of farms between generations and the success of new beginning farmers. First, crop and livestock prices and income support programs that mitigate the consequences of low prices, low incomes, or both, provide a safety net that is particularly important for those early in their farming career who are often more highly leveraged and have not yet built up strong financial reserves. For example, direct payments for a southern plains wheat farmer might cover approximately $14 per acre of the roughly $200 to $250 total annual costs per acre. Countercyclical price programs were designed to provide a safety net when prices fell below a certain level, though the low "trigger" price levels have meant the programs have provided little safety in recent years. Newer federal program options evolved that provide "revenue" protection when the combination of yields and prices fall well short of recent averages, such as the Average Crop Revenue Election (ACRE) program.

Second, crop insurance can be an important tool for beginning farmers, but it may present some unique challenges for them. To obtain the most effective coverage for crop insurance, farmers must provide proven yields (APH) for the past five years; if proven yields aren't available, they must use typically lower county yield averages. It has been suggested that beginning farmers be given more flexibility to determine yields for crop insurance coverage so as to obtain more effective insurance protection. An interesting issue with price support programs, income support programs, and federally subsidized crop insurance is the potential impact that these programs might have on land rents. Many argue that farmers bid the risk-reducing benefits of these programs into land values and cash rents. This increases costs and cash flow vulnerability for beginning farmers. Consequently, beginning farmers may be less competitive in land acquisition markets compared to large-scale, well-established farmers because of the potential unintended consequences of these programs.

It is important to note the future of price and revenue programs and crop insurance is uncertain; at the time of this writing, Farm Bills have passed the Senate and the House, and many elements of these programs may change as the bill continues to be considered.

The third dimension of agricultural policy impacting farm transitions is comprised of the credit and finance programs for beginning farmers. Legislation underlying the Farm Credit System (FCS) as well as current FCS policies encourages Farm Credit lenders to provide targeted programs and services to young and beginning farmers. More explicitly, the U.S. Department of Agriculture (USDA) Farm Service Agency has a number of programs that offer both direct and guaranteed loans to "qualified beginning farmers" and other farm borrowers who do not qualify for credit from conventional commercial lenders. A mainstay of the current Farm Services Agency programs (as well as their predecessors) are loans to purchase farmland, in most cases with lower interest rates as well as lower down payments than are typically available from conventional lenders. At the same time, though, the current credit and bank regulatory environment poses challenges for beginning farmers, at least if they seek ownership of farm real estate. For more on this issue, see the article by Kauffman also appearing in this issue.

Although land control is critical to success for many beginning farmers, it is less clear that buying land (even with subsidized costs and favorable loan terms) is a wise allocation of the very limited capital of most beginning farmers. Farm land generates very low gross sales as well as cash earnings per dollar of capital invested compared to other farm investments such as machinery or livestock facilities, and highly leveraged purchases of any asset (much less farmland with low cash flow generation) makes the borrower very vulnerable to default on debt servicing with even a small reduction in income or increase in cost. It is not clear that public policy that intended to incentivize cash-strapped beginning farmers to make such investments and take such risks is good for the farmer-borrower, let alone a desirable use of public funds.

A potential fourth branch of policy affecting farm transitions comes from state programs. States have taken a number of approaches including "matchmaking" programs to pair exiting producers with beginning ones, educational and facilitation services for those wishing to engage in transition planning, linked-deposit and interest incentives for banks lending to beginning farmers, and tax credits for retiring producers who lease agricultural land to beginning farmers.

Federal Tax Policy

Elements of federal tax policy affecting the transitions of farmland have been discussed in the most recent *Choices* theme issue regarding the American Taxpayer Relief Act of 2012 as well as in the article by Williamson in this theme issue. This article will, thus, avoid going into much detail about current federal tax policy. However, it should be observed that recent changes moving the unified estate and gift tax credit to a level that allows $5.25 million dollars (inflation indexed) of property to be passed tax-free means approximately 98-99% of all estates will no longer be subject to an estate tax. This frees many producers to focus on substantive elements of their transition plan rather than undertaking measures solely to mitigate potential estate tax burdens. The potential capital drain in family business transitions of payments to non-business heirs—who want to receive their "inheritance" in cash or similar form—will remain, and it has been and likely will continue to be the most significant challenge in maintaining the capital structure of family businesses during the transition process.

Legal Issues Surrounding Transition Planning

The laws that govern the ownership, control, and economic participation of the assets that comprise the farm necessarily define the parameters within which that ownership may be changed. As a result, the 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.

In discussing transition tools 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 "will" is simply a binding set of instructions for the distribution of a person's property upon his or her death. Wills can be highly flexible in that there are very few restrictions on parties to whom property can be given under the will. They pose some disadvantages, though. A will must go through the probate process to have any legal effect. This process can be lengthy, expensive, and, by necessity, is also public. This can add cost and delay to the disposition of farm property, meaning that the operation may be "tied up" for a longer period, threatening its viability.

Trusts are often touted as overcoming the disadvantages of wills. In counterpoint to the will, the trust and the assets it owns need not pass through probate, allowing for the relatively rapid transfer of control, ownership, and participation in the revenues generated by farm assets, and this has been a main selling point for many attorneys in encouraging their clients to form trusts. Trusts can be constructed to last long after the passing death of the producer founding generation which means they can enable the founders to exercise control over the operation long after their deaths.

Wills and trusts may be well-suited to a number of *estate* planning objectives, but they have disadvantages as *transition* planning tools that often go overlooked. Perhaps the most important disadvantages of wills and trusts as estate planning or transition tools are the inverse of their advantages. While highly *flexible* during the life of the trustor, they become highly *inflexible* after 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, which means that the restrictions of a trust become frozen at the death of the trustor. Thus, the trustor's "dead hand" may restrict how subsequent generations can use or dispose of farm assets and may actually defeat the purpose of the trust's creation—to "keep the farm in the family."

Beyond estate planning tools, some forms of real property ownership and transfer can also have transition-planning effects. For example, the joint tenancy with right of survivorship (JTWROS) and life estate are frequently used to provide for the transition of property ownership upon the death of one party. JTWROS places ownership of real estate in a co-tenancy between two or more parties (frequently, but not always, a husband and wife); when one of the co-tenants dies, his or her interest in the property is redistributed among the surviving tenants and does not have to pass through probate. A life estate gives lifetime rights to real estate to one party, with ownership transferring to another party upon the death of that owner, again without going through probate. Although these forms have advantages, they can trigger some unintended consequences as well, particularly if parties do not die in the sequence anticipated by the producers involved. To avoid some of these consequences, some landowners turn to Transfer on Death Deeds (TODDs), which have been adopted by a growing number of states. TODDs leave ownership with the producer until his or her death, and transfer title to the property to a designated recipient; such property, thus, avoids the need for probate. It should also be noted that TODDs do not have any estate tax advantages over the gift of property through a will or trust.

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 that may allow for a smoother transfer of ownership, control, and participation in life.

Limited partnerships (sometimes called LPs) have at least one "limited partner" with limited liability—his or her liability for the debts and obligations of the partnership are limited to his or her investment. Conversely, the "general partner(s)" have personal liability for the debts and obligations of the partnership, meaning both his or her investment in the partnership and his or her personal assets may be at risk for the partnership's liabilities. The limited partnership can separate control and participation from the ownership of the business, allowing added flexibility when balancing the interests of on-farm and off-farm heirs. The obvious disadvantage of the limited partnership form (in contrast to the corporate and limited liability company (LLC) forms) is the liability exposure of the general partner(s). Another question surrounding limited partnerships is whether the limited partners can actively participate in the management of the business without losing their limited liability protection. For many years, participation in management meant the loss of the limited partner's liability protections. This rule is being reexamined and changed in some jurisdictions; indeed, it has been abolished in the Uniform Limited Partnership Act itself.

In a corporation, the liability of any owner for the debts and obligations of the business is limited to the owner's investment in the business; he or she holds no personal liability. A corporation can also create multiple classes of stock with each class holding different rights of control and participation in revenues. One consideration for producers considering the use of the corporate form is that some states (Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, Oklahoma, South Dakota, and Wisconsin) restrict corporate ownership of farm assets.

The LLC is a relatively new entity form in the United States, first authorized in 1977 and now recognized by almost every state. 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, but this growth stems primarily from the fact that the LLC offers the same liability protection as a corporation for all of its owners (in contrast to the limited partnership) while offering even greater flexibility in who can own interests in the entity and how its management can be structured.

There are yet newer business entity forms including the limited liability partnership (LLP), the statutory business trust, and the family limited partnership (FLP). More recently, the "series LLC" has emerged, which allows an umbrella LLC to have "series" or "cells" underneath it with their own liability protection from each other. This form 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 generated by the farm, all under one overarching entity.

Perhaps the most important advantage of corporations, LLCs, and some other business entities in transition planning is they can facilitate the transfer of ownership, control, and economic participation in a farm business. If a producer wanted to transfer ownership of property over time, and such property were owned individually or in cotenancy, he or she would have to gradually convey a series of direct interests in the property, which would raise a number of title and liability issues. If the property were placed into a business entity, such as a corporation or LLC, 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. Similarly, economic participation rights could be retained by the producer as a retirement income source or could be conveyed to an off-farm heir who did not wish to actively participate in farm operations.

Conclusions: Challenges and Opportunities

Federal tax policy and farm programs frame the challenges and opportunities for transitioning farm businesses from current to future generations. Current federal estate tax policy need not result in serious capital drains from the business during the transition process for most farms given the small number of farms likely to face the tax. Compensating non-farm heirs who want their inheritance in a more liquid form still presents a potential capital drain for the on-going farm business, but, in many cases, can be at least reduced with proper planning. Federal farm programs that provide a safety net for farms are particularly important to beginning farmers, but may have unintended consequences if they encourage larger, well-established operators to be more aggressive in their land rental and buying behavior and bid prices above those that beginning farmers can afford to pay. Highly subsidized credit programs to purchase farmland may actually increase the financial risk and vulnerability of beginning farmers because the programs encourage the beginning farmers to use their limited capital to purchase an asset that generates relatively little cash but demands substantial cash flow to service the debt.

The current legal environment provides a wide range of tools to deal with both estate and transition planning issues. The challenges of succession planning, then, may be in the ability and willingness of both producers and consulting professionals to confront the difficult questions inherent to transitioning farms to the next generation. For their part, governments and universities can rededicate themselves to educational efforts about the importance of transition planning and in providing producers with an 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.

The solutions for transferring the farm business to another generation will likely not be as simple as producers envision. Producers and the consultant community need to examine ways they can create true "business succession" plans. While this is something about which all owners of small or closely-held businesses should be thinking, such issues take on even greater importance for the farms and ranches that produce the food, fiber, and fuel for a growing world.

For More Information:

Armbruster, W. (2013). Theme overview: agricultural implications of the American Taxpayer Relief Act of 2012. *Choices*, Q1 2013. Available online: http://www.choicesmagazine.org/choices-magazine/theme-articles/tax-theme/agricultural-implications-of-the-american-taxpayer-relief-act-of-2012

Claflin v. Claflin, 20 N.E. 455 (Mass. 1889) (First judicial pronouncement of the "Claflin Rule").

Family Business Institute. (2013). Succession planning. Available online: http://www.familybusinessinstitute.com/index.php/Succession-Planning/

Goforth, C. 2007. The series LLC, and a series of difficult questions," *Arkansas Law Review,* 60:385-486.

Del. Code. Ann. tit. 6, §18-215 (1996). (authorizing statute for Delaware Series LLC).

Iowa Code Ann. § 175.37 (2007). (Beginning Farmer Tax Credit).

Iowa State University Beginning Farmer Program. (2013). Iowa State University Beginning Farm Program. (2013). Available online: http://www.extension.iastate.edu/bfc/ .

Kaufmann, N. (2013). Credit Markets and Land Ownership for Young and Beginning Farmers. Choices, Q2, 2013. Available online: http://www.choices-magazine.org/choices-magazine/theme-articles/transitions-in-agriculture/credit-markets-and-land-ownership-for-young-and-beginning-farmers

Missouri Department of Agriculture. (2013). Missouri Beginning Farmer Loan Program. (2013). Available online: http://mda.mo.gov/abd/financial/begfarm.php .

National Agricultural Law Center. Corporate farming laws – an overview. Available online: http://nationalaglawcenter.org/assets/overviews/corpfarming.html.

U.S. Department of Agriculture. (2013). USDA programs and services: grants and loans. Available online: http://www.usda.gov/wps/portal/usda/usdahome?navid=GRANTS_LOANS.

Williamson, J. (2013). Agriculture, the Tax Code, and Potential Tax Reform. Choices, Q2, 2013. Available online: http://www.choicesmagazine.org/choices-magazine/theme-articles/transitions-in-agriculture/agriculture-the-tax-code-and-potential-tax-reform

Shannon L. Ferrell (shannon.l.ferrell@okstate.edu) is an Assistant Professor and Extension Specialist in agricultural law with the Oklahoma State University Department of Agricultural Economics. Rodney Jones (rodney.jones@okstate.edu) is an Associate Professor and Extension Specialist in agricultural finance with the Oklahoma State University Department of Agricultural Economics. Michael Boehlje (boehljem@purdue.edu) is a Distinguished Professor in the Department of Agricultural Economics at Purdue University. The views expressed here are the authors' and do not necessarily represent those of their respective institutions.