

Industry Focus:

Agriculture

~ James L. Turner

The succession issues for an agribusiness enterprise are not unlike those for other businesses. However, family members will be involved more frequently in a farming or ranching business than in other businesses. Family agribusiness enterprises commonly involve issues unique to that business sector. Let's review some of the obstacles to planning for business succession and how to overcome them.

Effects of Being "Land Rich but Cash Poor"

The principal distinction between agribusiness and other companies is that farms and ranches lack the liquidity of some other businesses. Farmers and ranchers are often considered to be "land rich and cash poor." Cattle operations yield only meager profits when compared to the value of the land. Grove operations require substantial initial investments of capital but only generate returns several years later, when the mature trees produce a marketable crop. Agricultural commodities are vulnerable to risks of bad weather, market-price fluctuations, and other factors. This lack of liquidity presents unique management and business succession challenges for those of you who own and operate an agricultural business, whether you are actively working in the business or you are an off-the-farm owner with a stake in the land and the business.

Generally, family members active in the business draw salaries. Typically, there is little left over, after other expenses and debt service are paid, for dividends to other owners. If you are among those laboring on the farm, this probably seems perfectly fair, but it may not seem fair to the other off-the-farm owners. Conversely, family agribusiness enterprises rarely provide health insurance to their employees, even to the family members involved in the business, and rarely do they provide retirement benefits.

Another consequence of lack of liquidity is that agribusiness owners often find it too expensive to hire professional managers. Due to lack of liquidity, as well as family voting/management control issues and the heightened risk of conflict in a family business enterprise, it is difficult to find trust companies or other third-party fiduciaries that will play a role in management as part of a succession plan. In addition, having underproductive assets in trust raises issues of fairness to the current income beneficiaries.

Limited Financing Options and the Insurance Alternative

Agribusiness enterprises in general, and family agribusiness enterprises (which tend to be smaller) in particular, have limited financing options to help with the liquidity needs of the business and with succession planning. The great recession did significant damage to several Farm Credit Banks (part of the Federal Farm Credit Banks Funding Corporation), which had lent for land development and speculation, limiting loan availability through the Farm Credit system. There are a few community banks around Florida involved in agribusiness lending, but restricted credit markets allow them to charge above-market interest rates to borrowers. Some national lenders extend loans to agribusinesses, but they frequently insist on mortgaging the land (and not just the operating assets) and require the personal guarantees of both on-the-farm and off-the-farm owners alike. This can put family members at odds with one another, creating the potential for conflict.

Limited financing options affect the ability of on-the-farm owners to buy out the off-the-farm owners as part of a succession plan, and limited cash flow from farming operations makes seller financing difficult. Providing liquidity through life insurance planning, where the lives of the senior family members are insured, is a valuable tool to fund buy/sell agreements among family members as part of a succession plan. However, unreliable operating cash flow to the farm or ranch often discourages senior family members from paying the related insurance premiums.

Speculative Land Value Versus Value as Farmland

If you own an agribusiness enterprise, then you probably know that the long-term value in family agribusiness is frequently in the land and not in the agribusiness operation itself. This potentially pits the on-the-farm owners against the off-the-farm owners in other ways. You, like other agribusiness operators, may want to encumber the land to secure debt for operational purposes or for capital investment. Debt for capital investments may cause a cash-flow drain and no return for several years. This may ultimately benefit on-the-farm owners through increased salaries, but only at the risk of loss through foreclosure of the land by the other owners.

On-the-farm family members who make a long-term investment in the operations do not want to see the land sold out from under them before they receive an adequate return on that capital investment. However, the off-the-farm owners may want to discontinue agribusiness operations to sell or pursue other opportunities. Whether you are an on-the-farm owner or an off-the-farm owner, you can see why this is often a source of tension between owners.

Because of the disparity in land value to agricultural production value, the value of the land for grazing or farming leases is traditionally low when compared to the intrinsic value of the land. This limits the opportunity for the off-the-farm owners to lease the land to the on-the-farm owners as a long-term solution to the business succession challenge.

How Can Solomon “Split the Baby”?

Theoretically, a family can divide up the land upon the death of the senior family members so each family member can pursue his or her individual goals. However, all land is not

alike. Zoning differences, environmental constraints, access issues, proximity to existing development, and other factors all make land difficult to divide fairly.

Dividing agricultural land also creates operational challenges. Certain economies of scale are associated with an agribusiness enterprise, and unless the on-the-farm owners will lease the divided land back from all of the landowners, the on-the-farm family members may need to change the scale of their operation. Then there are the inevitable operational questions about who gets the parcel containing the barn, the cow pens, the packing house, etc. Frequently, there is a requirement for reciprocal easements to ensure access to the parcels, as well as for drainage and utilities. Another requirement is often the division of permitted quantities of irrigation water. Sometimes the sale of all the land is required, which may ultimately hurt all who are involved.

Estate Tax Value and Payment Relief for Family Farmers

Fortunately, Congress has recognized the lack of liquidity that characterizes many family agribusiness operations. Certain estate tax provisions uniquely and favorably benefit farmers and ranchers, theoretically preventing a forced sale of the land and related operation for estate tax purposes. However, those benefits are limited. The provisions are Section 2032A of the Internal Revenue Code (IRC) and Section 6166, IRC. While a detailed explanation of these two code sections is beyond this article, a summary of those two provisions follows.

Section 2032A: Valuation Relief

Section 2032A is a valuation provision that allows real property used in agribusiness to be valued for estate tax purposes at its current use valuation rather than at the highest and best use valuation standard that would otherwise apply, provided the decrease in value for 2015 decedents cannot exceed \$1.1 million. The benefit is limited to those estates where the farming or other closely held business is a substantial part of the entire estate. Twenty-five percent or more of the adjusted value of the decedent's gross estate must comprise the adjusted value of real property used in the business, and 50 percent or more of the adjusted value of the decedent's gross estate must comprise the adjusted value of real or personal property used in the business. The real property can be owned by an entity rather than the decedent, but the decedent or a member of the decedent's family must satisfy the material participation tests described below, and the ownership interest in the entity must qualify for Section 6166 (discussed below).

To limit the benefits of Section 2032A to those estates in which the decedent or family members historically were active participants in farming or other closely held businesses, Congress requires both a "qualified use" of the property by the decedent or a member of the decedent's family for at least five out of the eight years prior to death and a qualified use on the date of death. The decedent or a member of the decedent's family must have "materially participated" in the business for five or more of the last eight years before the earlier of retirement, disability, or death.

Section 6166: Installment Payment Relief

Section 6166 provides that an estate of a citizen or resident of the United States can elect to defer payment of a portion of estate tax (basically, that fraction that is attributable to the inclusion in the gross estate of a substantial “interest in a closely-held business”) for up to five years, after which the deferred portion can be paid in up to 10 installments; and it allows at least a part of the interest on the unpaid balance of the tax to be paid at the rate of 2 percent. However, the following conditions must be met:

1. The decedent must hold an “interest in a closely-held business” on the date of his or her death; and,
2. The value of the decedent’s “interest in a closely-held business” must exceed 35 percent of the adjusted gross estate.

“Interest in a closely-held business” for Section 6166 means: (i) a trade or business carried on as a proprietorship, (ii) a partnership carrying on a trade or business if either the partnership has 45 or fewer partners or if 20 percent or more of the total capital interest in the partnership is included in the decedent’s gross estate, or (iii) a corporation carrying on a trade or business if either the corporation has 45 or fewer shareholders or if 20 percent or more of the value of the corporation’s voting stock is included in the decedent’s gross estate.

The privilege of deferring the payment of estate taxes may be terminated, with payment due upon notice and demand, if 50 percent or more in value of the interest in a closely-held business is distributed, sold, exchanged, or otherwise disposed of, or aggregate withdrawals of money and other property equal or exceed one-half of the value of such trade or business.

Emotional Attachments

Perhaps the most significant issue when dealing with family businesses in general, and with family agribusiness enterprises in particular, is the parties’ emotional element of decision-making. As agribusiness owners, you know there is a certain romantic appeal to owning and living off the land. If yours is a typical family, it reveres the farming or ranching tradition and heritage and is reluctant to leave such legacies behind. Family farms and ranches have often historically been used for family gatherings and other recreational uses. Therefore, it becomes difficult to deal with the associated business issues based on logic rather than emotion. If you are considering a potential division of the family land as part of a succession plan, then you will face issues such as who gets the ranch house and use of it, who gets the old campsite or the fishing hole, or any of the other landmarks where memories have been made. In this sense, dealing with the succession plan for family agribusiness enterprises involves many of the same emotional issues as when passing on the legacy vacation home.

Fairly Balancing Competing Interests

The success of any succession plan for a family agribusiness enterprise turns on recognizing the conflicting interests described above and fairly addressing the interests of all family members involved. If the operation is to continue with on-the-farm and off-the-farm

owners, the on-the-farm family members must be fairly compensated for their services. That compensation must consider the common fact that most family members are under-compensated in the early years when working for mom or dad and also account for whether the family members have the benefit of health and disability insurance or any retirement benefits. At the same time, the off-the-farm owners must be protected. The operation may not afford to pay much in the way of lease payments or dividends, but at least the investment those family members have in the land ought to be protected. The on-the-farm owners should not expose the land to debt, making it subject to loss on foreclosure. Furthermore, the on-the-farm owners should not, even at their own risk and expense, make long-term capital investments in the agricultural operation without acknowledging that the off-the-farm owners have no obligation to keep the land in agribusiness use indefinitely and can sell it or change the land use to a more productive one.

If the on-the-farm family members can afford, through long-term installment payment plans acceptable to the other family members or with insurance proceeds, to buy out the family members not involved in the operation, the price and terms must be fair to the off-the-farm owners.

If the assets are to be divided so each branch of the family can make its own decision regarding whether to stay in agribusiness or sell its interest in the land, the division of assets must be fair and should consider not only the physical and market attributes of the parcels of property to be divided, but also the emotional ties that come with them.

The Communication Imperative

Because relationships are at stake in this effort, frequent and good communication is essential. It is better to get issues on the table and deal with them when they arise than to let them fester and become the source of relationship problems disproportionate to their impact on the business. It is vital for senior family members to plan for and communicate their wishes regarding the succession of the family agribusiness operation to their children—and to other family members involved in the operation of the business—before the founders die. You would do well to remember that it is much easier for a parent to address any sense of unfairness with a child than for siblings to address those issues with one another after the senior family members are gone.



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