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## An Agricultural Law Research Article

# Structuring the Farm and Ranch Operation for Business and Estate Planning

by

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# Structuring the Farm and Ranch Operation for Business And Estate Planning

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## I. INTRODUCTION

Much of the discussion concerning estate planning for farmers and ranchers focuses on the income and estate tax consequences of particular business forms or the economic necessity of estate planning for those in the agriculture industry. By contrast, there has been little discussion of the actual structuring of legal entities for business and estate planning purposes. Many lawyers do not understand the overall economic circumstances of the industry or the economic interworkings of the farm and ranch business while economists, on the other hand, do not have sufficient legal knowledge to discuss the legal problems of structuring businesses.

The result of this deficiency is evident. Many farm and ranch corporations recently coming into existence, although often technically acceptable, are economic Frankensteins. The owner-operators are often less than satisfied with them and accept them only because of the overriding need for such an entity. Local practitioners simply do not have available to them the information on how to structure these entities properly. There is just no ongoing discussion and criticism of the structuring being used.

Third, various state legislatures have passed laws against corporate ownership of agricultural land and the corporate operation of farm and ranch facilities. The intention of this legislation is generally to prevent conglomerates from competing in agricultural production (through vertical integration, etc.) and to preserve the family farm. For the most part, this legislation has not prevented the evil which it attempts to attack. Instead, it has simply made it difficult or impractical for farmers and ranchers to obtain equity financing or the most convenient and efficient estate plan. Because of this lack of analysis and basic definition in this area, there is almost no understanding among legislators, academicians and farm organization personnel of the nature of the practical problems involved and the manner of attacking the problem.

This article will attempt to provide some initial analysis and definition in this area. Often, practitioners, legislators, farm and ranch operators and even scholars working in the field are totally unfamiliar with basic concepts. For this reason a basic but detailed definition of some of these concepts is included. The article is far from exhaustive. It is intended as a beginning in answering some of the most direct concerns of farm and ranch families as well as their attorneys and to initiate discussion and criticism in this important area of the law.

## II. THE FARM AND RANCH UNIT

Business and estate planning for a farm and ranch family is a specific consideration by definition. It involves not only all the ordinary concerns of other businesses but also another very important item, namely, the forecasting of the future form of the whole industry (*i.e.*, agricultural food production). The industry[1] must be understood in its larger sense in order for the form and thrust of the business and estate planning decisions to coincide with the character of the industry as it will be in the next quarter century. Without this knowledge, it is difficult to provide either the existing or the future entrepreneur with a stable and competitive unit within the industry.[2]

### A. Business Life Cycle

The farm or ranch unit is generally a family farm or ranch operation[3] which has evolved through the efforts of the operator and his family during his adult productive life.[4] This evolution, historically, has been described as a three part cycle.[5] A potential entrant into a farming career generally begins as a farm youth, working on the farm with his father, a relative or an employer, until he acquires sufficient managerial ability, capital and land, either through contract purchase or leasehold interest, to encompass the "critical mass" of capital resources necessary to establish a viable economic unit sufficient to generate a competitive income and capable of survival and growth.

The second stage[6] of the agricultural cycle is defined as growth and survival. During this period, the entrepreneur attempts to extend his resource constraints by acquiring the services of addi-

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1. Investments in Nebraska farms and ranches alone in October, 1974, totalled 17.1 billion dollars. U.S. DEP'T OF AGRICULTURE, NEBRASKA STATE-FEDERAL DIVISION OF AGRICULTURAL STATISTICS.
2. *See* Boehlje & Boehlje, *Intergeneration Transfers: Is Agriculture Unique?*, 112 TRUSTS & ESTATES 172, 173 (1973).
3. Harl, *Estate and Business Planning for Farmers*, 19 HASTINGS L.J. 271 (1968).
4. Heady, Beck & Petersen, *Interdependence Between the Farm Business and the Farm Household with Implications on Economic Efficiency*, AGRICULTURAL EXPERIMENT STATION, IOWA STATE COLLEGE RESEARCH BULL. NO. 398 (1953).
5. M. Boehlje, The Entry—Growth—Exit Process in Agriculture, 5 S.J. AGRICULTURAL ECON., July, 1973, at 23. *See also* Boehlje & Boehlje, *supra* note 2; Brake & Wirth, *The Michigan Farm Credit Panel: A History of Capital Accumulation*, MICHIGAN STATE UNIVERSITY AGRICULTURAL EXPERIMENT STATION RESEARCH REPORT 25 (1964).
6. *Id.*

tional input through purchase and lease. New production techniques and increased labor and labor efficiency are added; reduced unit cost and expanding sales are the characteristics of this period. A major concern during this stage is maintaining a debt-equity structure that will guarantee survival through periods of adverse conditions of weather and marketing. Late in this period, growth emphasis may shift from expansion to consolidation of the previous gains and stabilization of income.

The final stage[7] of the family farm cycle is the exit or divestment stage. During this period, the entrepreneur tends to reduce his management responsibility while maintaining sufficient asset control to generate adequate retirement income. Simultaneously, estate plans are developed to transfer the acquired property to desired heirs.

**B. Business Characteristics**

The family farm and ranch unit has evolved through the efforts of the entrepreneur during his productive life. Its expansion is determined by certain definable limiting factors. These factors are fundamental and include the following: availability of labor, including that of the operator, family members and accessable employees; available real estate, owned and rented; and capital, including livestock, machinery, inventories, and financial resources available for expansion.[8] Of course, one of the major determinents of size involves the subjective elements of management capability, motivation, applied industry and the willingness to take risks.[9]

There are certain characteristics of the farm production sector which have been generally identified. First, farm firms have historically attempted to exploit economies of size and new technologies involving large amounts of capital.[10] This is evidenced in the expanding size of farms,[11] the increased complexity and expense of machinery and the increased sophistication of the technologies involving fertilizer, herbicides, seed, irrigation, hybrid livestock, and tillage methods. Second, not only are the capital requirements of farm production units increasing, these capital investments are

7. *Id.*
8. Financial resources may be acquired through inheritance, accumulated from the operation itself or credit from lending agencies.
9. Because these are subjective, they cannot be measured accurately, but they often account, more than any other single item, for the amount of financial success a farm or ranch operator experiences.
10. *See* Fiore & Kelley, *Agriculture Estate Planning*, in ALI-ABA COURSE OF STUDY, TAX PLANNING FOR AGRICULTURE (1974).
11. *See* Chart II, Part III, B *infra*.

generally nonliquid[12] and not readily marketable apart from the unit with which they are combined. Third, farm and ranch units are generally organized as proprietorships and infrequently as partnerships.[13] Therefore, the management function and the financial functions in farm and ranching are usually performed by the owner-operator. Probably the most distinctive characteristic of the industry is that historically farming is not only a business, but a way of life. Thus, the major assets, particularly the land, are an integral part of the family structure and there is a strong desire to perpetuate this for future generations.[14]

One of the major characteristics of the farm and ranch business is the manner in which the family wealth is produced. The average farm and ranch net income to asset ratio is about three per cent nationally, and has been declining in recent years.[15] In livestock operations, the income is typically a smaller percentage of assets than in the crop operations.[16] Liquid assets generally total less than five per cent of the total net worth. As a result, the family wealth has accumulated through the accrual of equity in the production resources, mainly land, building and livestock, and not the production of "incremental income" from which outside investments are purchased.[17] Historically, the earnings which have been

12. Wiggins, *Estate Problems of Farm Families*, 109 TRUSTS & ESTATES 918, 919 (1970).
13. In 1969 Nebraska had 54,897 farm units operated by family units, 7,476 operated by partnerships, 659 operated by corporations and 353 were operated as some other entity form. U.S. DEP'T OF COMMERCE, 1969 CENSUS OF AGRICULTURE pt. 20, § 2, at 4. *See also* Harl, supra note 3, at 271.
14. *See* Boehlje, *supra* note 5.
15. INTERNAL REVENUE SERVICE, BUSINESS INCOME TAX RETURNS, STATISTICS OF INCOME (1972).
16. U.S. DEP'T OF AGRICULTURE, ECONOMIC RESEARCH SERVICE PUBLICATION No. 230 (1972); U.S. DEP'T OF AGRICULTURE, ECONOMIC RESEARCH SERVICE (1972).
17. Although this is a common feature of a businessman's (including farmer's and rancher's) wealth, it is not always understood. An employee's or professional person's earnings are measured in specific time frame terms, that is, hourly, daily, monthly or annual earnings. His estate accumulation must be attained through savings from those earnings (after personal income taxes are paid and personal living expenses are excluded) or any earnings from investments and made from those savings. On the other hand, a businessman and, quite specifically, a farmer or rancher, has many living expenses which can be taken as business expense (*e.g.*, meat produced, some living and transportation expenses, telephone, publication, travel, etc.). In many operations, the family residence is part of the operation itself, thereby freeing the operator from any residential rental payment. The only personal income which must be extracted from the business are living expenses beyond those mentioned. The remainder may be "rolled back" into the busi-

left in the business rather than taken out as current income have supplied vitally needed working capital. Although the midplains farm and ranch operator may have a very substantial estate, in the past he has rarely had an income commensurate with persons in other businesses of equivalent size.

Often the family farm or ranch unit is a multigeneration operation with the senior generation owning the majority of the land. Typically, the operation is the mutual business effort of both the husband and wife and, quite often, their children.[18] It is not unusual to find one or more of the sons (and often a son-in-law) who are either part of or intending to become a part of the farming operation. The family planning situation is often complicated by the fact that there are other children who are making their lives and careers outside of the family farm but with whom the senior generation is concerned in their estate plan.[19] One other factor is that the cash accounting method, used almost universally by farm and ranch family proprietorships, has enabled these taxpayers to defer taxes and, when coupled with inflation, it has resulted in a very low tax basis for the operation's capital assets.[20]

## III. THE FARM AND RANCH INDUSTRY

### A. Supply, Production and Marketing Structure

Generally, this article is directed to the operation of farms and ranches as they appear in the central plains states in the mid 1970s.[21] Although there is a wide variance, these operations gen-

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ness to create an overall net estate. This itself has numerous advantages: (1) only principal payments on investments in capital assets are taxed, (2) a major portion of the estate, historically, has been accumulated from over all appreciation and inflation, none of which is taxed so long as it is not disposed of but all of which acts as an investment base for income production, (3) certain portions of income, such as income from some livestock production, are taxed at capital gain rates, (4) labor applied to the operation which increases its value is not recognized as an operating income from that labor; instead, this value is recognized in the increase in the operator's overall estate, the taxes on which can be delayed and either paid at capital gains rates, or simply added to the estate.

18. This usually results in a mixture of personal and business assets making it difficult to determine the tax basis of the various assets and even more difficult to assign the basis between the individual spouses. When grown children's estates are also commingled in a joint operation, the situation is complicated even further.
19. *See* Fiore & Kelley, *supra* note 10.
20. *Id.* at 250. *See also* Treas. Reg. 1.162-12 (1958).
21. This article can be applied to similar operations in the Southern and Western United States also.

erally produce grain, hay, row crops, feeder calves, feedlot beef and pork. These operations currently appear in a variety of structures, but most generally they involve family size units.[22] Supply inputs are acquired from different merchants, dealers and cooperative supply firms. Financing is generally obtained through accounts with local merchants, time credit arrangements through local dealers and local financial institutions.[23] Grain is marketed either through local elevators or fed to livestock on the farm where it is produced. Feeder livestock is marketed through central marketing facilities or livestock brokers.[24]

Because of this structure, the farm or ranch operator is confronted with certain factors over which, for the most part, he has little control; namely input resource item costs and the market price of his product. Although cooperatives, futures hedging, and similar activities could give the operator some degree of control, the individual control of the average operator is usually limited. At best, he can only choose between those products (*e.g.*, grain or livestock) which appear to be the best product at the beginning of each season and, within the limits of storage, perishability and financial need, exercise some judgment concerning the time of sale.

Consequently, the growth and success of the operator is determined by the economic use of his resources. He expands to the limit of his labor, land, capital and management capability and then attempts to market his product and control his costs within these limits. Efficient operation and exploitation of technology are the two major tools used to maximize profits from his operation.[25]

No one expects an immediate drastic change in this situation. Therefore, certain assumptions can be made: (1) agricultural production will probably continue its trend of increased use of sophisticated technology, (2) the intensive and expanding use of capital will continue, (3) its source of acquiring input, excluding

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22. *See* note 13 *supra*.
23. Land is generally purchased on mortgages arranged through local institutions or agencies, or purchased on contract or mortgaged from the former owners.
24. *See* Kyle, *Who Will Provide Production Management and Entrepreneurship for Commercial Farms in the Future?*, J. AM. SOC. FARM MANAGERS & RURAL APPRAISERS, Oct. 1972, at 79; Kyle, Sundquist & Guither, *Who Controls Agriculture Now?*, WHO WILL CONTROL U.S. AGRICULTURE, NORTH CENTRAL REGIONAL EXTENSION PUBLICATION 32, SPECIAL PUBLICATION 27, 3 (1972).
25. He generally does not, as those in other industries might, search out and compete for resources over a wide geographic area or market distinctive products competing in a market against similar products.

land and capital, generally, will remain the same, and (4) the nature of agricultural marketing—at least for grain and cattle—will continue to be the same. Therefore, our concern with projections must be in three areas: (1) how will the resource of land be held and used in agriculture, (2) from what source will the increased capital requirements come and (3) what will be the management structure of the agricultural economic unit. It would be impossible to pinpoint answers to these; this article will only consider these elements as they bear upon estate and business planning.

## B. Real Estate: Market Value and Unit Size

There exists a general awareness of the increasing market value trend in farm real estate. There is considerable concern, however, particularly among the older generation, that farm land prices may simply be cyclical and that we may be reaching the apex of the current cycle.[26]

As an indication of the historic trends in farm real estate value, reference can be made to the per acre average value of farm land in Nebraska.[27] Chart I graphs land values based on actual dollar

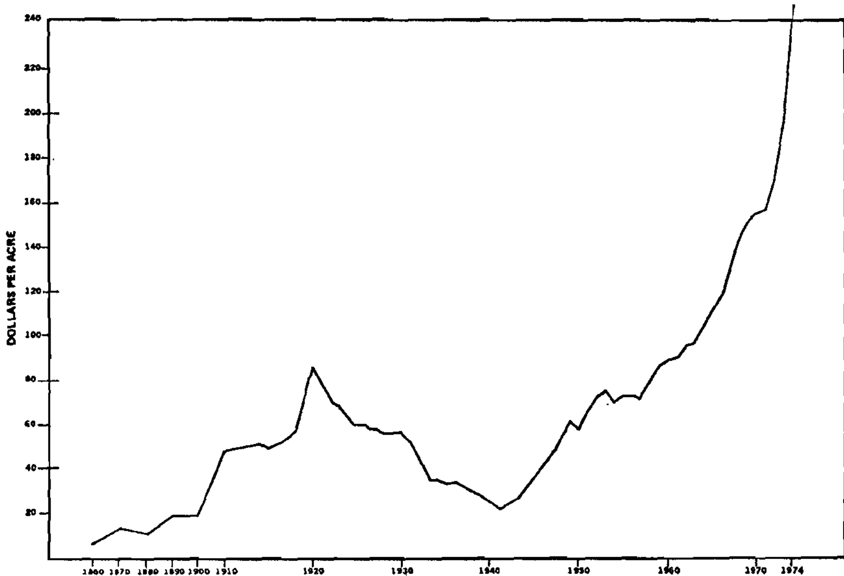


CHART I AVERAGE VALUE PER ACRE OF FARM LAND IN NEBRASKA
Compiled from "Farm Real Estate Market Development" Econ. Res. Serv. USDA

26. Knowledge of future values and prices is always less than perfect; in fact, speculations and opinions about future values and prices themselves effect the price.
27. Nebraska had 48,100,000 acres of land in farms and ranches having an

value with no adjustment for inflation. The price for real estate generally increased until 1920 when it began a general decline to its nadir in 1941. The current climb commenced in 1941 reaching the 1920 level again in 1960. To date, prices continue to climb but at an accelerated rate. Further, during the mid 1950s there were slight drops during some recessionary periods. There was, however, no overall "dive." Because of national and world food needs, experts predict that land values will remain high and probably continue to rise,[28] although possibly not at such a staggering rate.

Investments in land and buildings for the average individual farming unit follow a similar pattern.[29] In this instance, however, the 1920 high corresponds approximately with the 1950 level. In spite of the variable increases, the only year of decrease in average farm investment was 1955.

Since 1935 there has been an unabated increase in the average farm size in Nebraska as evidenced by Chart II. This corresponds

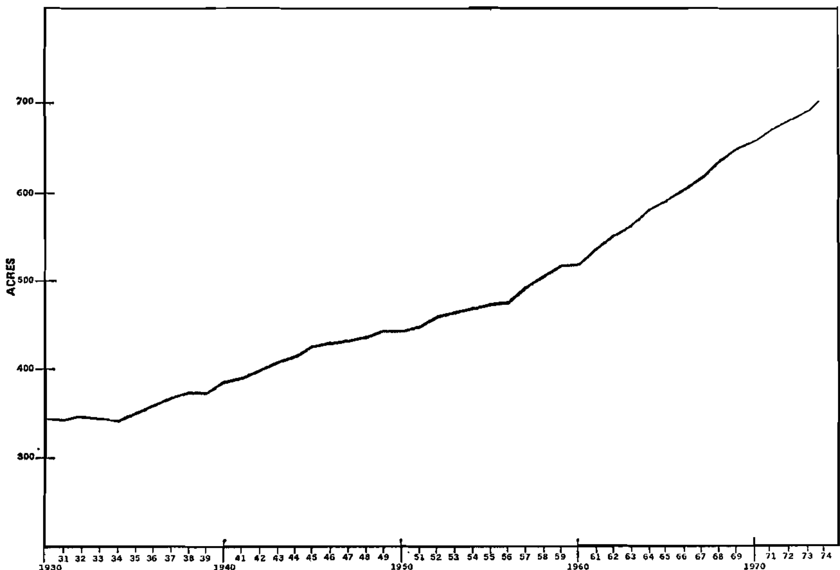


CHART II AVERAGE SIZE OF FARMS IN NEBRASKA

Compiled from unpublished statistics supplied by, Nebraska State Federal Division of Agricultural Statistics, Federal Building Lincoln Nebraska

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estimated market value of $8,935,000,000 in 1973. U.S. DEP'T OF AGRICULTURE, NEBRASKA STATE-FEDERAL DIVISION OF AGRICULTURAL STATISTICS.

28. Jones, *Long Run Outlook of Agriculture*, J. AM. SOC. FARM MANAGERS & RURAL APPRAISERS, April 1974, at 25; Crowley, *Actual Versus Apparent Rates of Return on Farm and Investment*, 35 AG. FINANCE REV. 52, 57 (1974).

29. Compiled from U.S. DEP'T OF AGRICULTURE, ECONOMIC RESEARCH SERVICE

with the characteristic, set forth above, that the economies of scale in farming have continued to increase with the improvement in power in tractors and other technological advances. In spite of the more intensive use of real estate, indicators point to even further increases in the per unit size of farms and ranches.[30]

Even though land prices are subject to deflation from unpredictable psychological and political causes, a prolonged and extensive decrease in land values is unlikely in view of the widespread need for farm and ranch production. But even assuming a decline in land values, considering agricultural production costs and the increase of farm size, the amount of per unit operating investment in real estate will undoubtedly remain high. Although there may be short run fluctuations, informed forecasters expect an overall continued upward climb in capital investment requirements.[31]

### C. Operation Financing

Coinciding with the increase in farm size and capital expenditure has been a similar increase in production expenses. Between 1964 and 1969 production expenses for petroleum used for farm purposes in Nebraska increased by ten per cent.[32] Expenditures for labor increased 36 per cent,[33] expenditures for custom machine work increased 60 per cent,[34] and expenditures for commercial fertilizer increased 64 per cent.[35] Similar increases in other expenditures resulted in an increase in farm production expenses of approximately 63 per cent over that five year period.[36] Experience warrants the conclusion that an even greater increase has resulted during the past five years because of increased inflation, the rising costs of energy and fertilizer as well as the continued adoption of further intensive practices and technological improvements.

There has also been a substantial increase in the cost of farm machinery. With the advent of the center pivot irrigation system, increased tractor horsepower, highly sophisticated harvestors, ex-

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PUBLICATION NO. 520, FARM REAL ESTATE HISTORICAL SERIES DATA 1850-1970 and U.S. DEP'T OF AGRICULTURE, ECONOMIC RESEARCH SERVICE PUBLICATION NO. CD-79, FARM REAL ESTATE MARKET DEVELOPMENTS (1974).

30. *See* Harl, *supra* note 3, at 272-73, and authorities cited therein.
31. Kyle & Wiggins, *Estate Planning for the Family Farm,* 109 TRUSTS & ESTATES 918 (1970).
32. U.S. DEP'T OF COMMERCE, 1969 CENSUS OF AGRICULTURE, pt. 20, § 2, table 4, at 5.
33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.*

pensive grain handling and storage equipment, and more sophisticated livestock breeding and feeding operations, the amount of intermediate term debt has increased accordingly.

Over the 1964-1969 period, of farm operating units having annual sales and income of $5,000 or more, those units whose gross sales income totalled more than $20,000 increased from 27 per cent to 47 per cent of all farming units.[37] Granting that inflation has played a part in all these figures, the gross figures per farm unit have been on a sharp rise. Farm and ranch operators are necessarily dealing in larger sums requiring greater amounts of cash to finance production as well as corresponding sophistication and business practices in handling this cash.

### D. Management and Business Technology

Under the current arrangement of the agricultural industry in the grain and beef production unit, the more sophisticated methods of purchasing raw materials, financing and marketing, and applying management skills, are limited[38]—mainly by the lack of specialization and also by the general economies of scale.[39] Even when it might be advantageous to his operation, the operator simply does not have the time to acquire the intricate knowledge and daily information necessary to hedge adeptly in the futures market, either for raw products or for marketing his production. For the same reasons, he is rarely able to propose and use sophisticated financing arrangments known to other and more concentrated industries.[40] Also, because the resultant gains are marginal, the time and costs, both to the operator himself and in fees to brokers, attorneys, finance men and other specialists, simply are not warranted in ordinary sized farm and ranch units.[41]

Attempts to bring these advantages to the family sized operation have been in the form of either cooperatives[42] or the various farm organizations.[43] Although cooperatives have thrived and re-

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37. Compiled from U.S. DEP'T OF COMMERCE, 1969 CENSUS OF AGRICULTURE, pt. 20, § 2, table 4, at 1; Kyle, Sundquist & Guither, *supra* note 24, at 4.
38. Kyle, Sundquist & Guither, *supra* note 24, at 4.
39. Kyle, *supra* note 24, at 84.
40. *Id.*
41. *Id.*
42. Guither, Krause & Bottum, *Effects of Access to Technical Knowledge and Commercial Inputs*, WHO WILL CONTROL U.S. AGRICULTURE?, NORTH CENTRAL REGIONAL EXTENSION PUBLICATION 32, SPECIAL PUBLICATION 27, 29 (1972).
43. For example, the National Farmers Organization, the Farm Bureau Federation, the Grange, etc.

sulted in dividend paying abilities, they have not always produced the competitive capability to match the farm suppliers or the grain and meat processing and distribution industries. The benefits of the commodity exchanges, selective bulk purchasing, holding actions and the like for the most part have gone to businessmen other than farm and ranch operators.[44]

For these techniques to become a reliable and beneficial part of the average production unit, an increase in per unit size will probably be required.[45] This just one additional pressure on the institution of agriculture causing an increase in per unit size, and it is only recently beginning to have some effect. A smattering of units are now making use of commodity hedging, contract farming, operation financing through equity capital and other practices common in other industries. If these units prosper, the pattern will be established.

The point is that technological and economic factors are converging to force an increase in operating unit size, both in acres and as measured by economic elements. Absent a solid governmental policy to maintain farm producing units at their current size, this trend will no doubt continue.[46] Any estate or business plan involving farm or ranch resources which projects itself more than a few years into the future cannot ignore this trend. Regardless of the business form or governmental policy, farming units cannot escape the pressures to become somewhat larger if they are to avail themselves of some of the business forms and business practices used by other industries.[47]

## E. Industry Demography

For a farm operator to be replaced or to replace himself, there must be new, younger operators entering the industry—not just as employees but as managers and operators. Two statistics are relevant. First, and quite obviously, there has been a considerable decline in the number of farm operators resulting in consolidation of units. For example, even though Nebraska is more agricultural

44. Kyle, Sundquist & Guither, *supra* note 24, at 3.
45. Kyle, *supra* note 24, at 84.
46. *See* WHO WILL CONTROL U.S. AGRICULTURE?, NORTH CENTRAL REGIONAL EXTENSION PUBLICATION 32, SPECIAL PUBLICATIONS 27 & 28 (1972).
47. This is not to argue for a particular farm policy. That overconcentration has its disadvantages to society, both over all and to a great many farmers and ranchers themselves, is not disputed. *See* note 46, *supra*. Moderate increases in per unit size, however, may be a continuing necessity to enable both farmers and society to benefit from the economies of scale necessitated by both the business and mechanical-biological improvements in agriculture.

than most areas of the United States, thereby gravitating toward a more stable farm sector, it has shared in this decline.[48] This decline is a result of marginal operators leaving the industry and fewer young persons entering the industry to replace retiring operators. The result, a gradual increase in the mean age of the farm unit operator, is illustrated in Chart III. This situation has contributed to the trend towards larger operating units since there are only a limited number of new operators to be the transferees of farm units.[49]

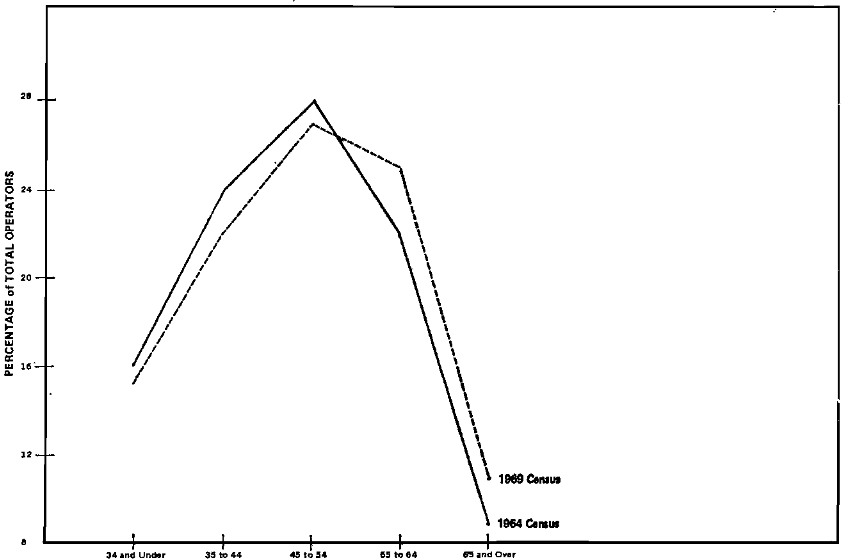


CHART III AGE OF FARM AND RANCH OPERATORS IN NEBRASKA
*Compiled from United States Commerce Department Volume 1, Part 20 of Area Reports, Bureau of Census, 1969 Census of Agriculture

Conversely, the nature of this trend towards larger, consolidated units has contributed to the increased age of the operators.[50] Technical sophistication requires time and maturity. Increased equity capital which is necessary for a viable farm operation must be accumulated over time, thereby decreasing the ability of the young farmer to compete. Also, where personal credit is involved, age is

48. Between 1964 and 1969, farm units in Nebraska decreased from 80,163 units to 72,257 units, which was a 10% decline. U.S. DEP'T OF COMMERCE, 1969 CENSUS OF AGRICULTURE, pt. 20, § 2, table 1, at 1.
49. Between 1972 and 1974, over 77% of the farm real estate transfers reported were for the purpose of adding to another existing farm unit. U.S. DEP'T OF AGRICULTURE, ECONOMICS RESEARCH SERVICE PUBLICATION No. CD-79, 31 (1974).
50. *See* Kyle, *supra* note 24, at 79.

often equated with stability giving the middle-aged operator a distinct competitive advantage.

Up to now, the impact of management ability on short run farm income[51] has been limited, the factors of weather, market prices, government programs and the national economic situation being overriding. As the capital needs for farming and ranching increase, both from the increased unit size and from technological advances and upgrading, management will have an increasing impact. This management not only requires technical training but also maturity and experience.[52]

Farming and ranching then, like other businesses with similar capital investment, will require managers with age and experience. The traditional method of entry into the field by building from a small farm unit to one of substantial size will become increasingly difficult. Farming units will either continue to consolidate or those farm and ranch units which are stable will require a legal and business form or organization which will provide continuity to allow the younger operator gradually to assume management control while allowing the current manager to withdraw gradually. This same process occurs in other industries; it is only unusual in its application to farming and ranching units.[53]

## IV. ECONOMIC ANALYSIS

### A. The Economic Elements

A business operation, including a farm or ranch operation, can be divided into economic elements. Generally, the element of greatest value in the farming or ranching operation is the real estate.[54] Next in value are the production assets, whether the machinery for a grain farming operation, the feeding facilities of a pork or beef production operation or the cattle herd of a ranching operation. The third element is the available capital,[55] which includes the re-

51. Fiore & Kelley, *supra* note 10; Kelley, *Estate Planning for Farmers and Ranchers*, 20 PRAC. LAW. 13 (1974).
52. Substantial inefficiency is experienced when each unit commences and dies every generation because there are shortages of management ability and capital in the early years and an overly conservative approach in business decisions combined with a shortage of committed labor in the declining years. Heady, Beck & Petersen, *supra* note 4.
53. *See* Kyle, *supra* note 24, at 80, 81, 83.
54. The total dollar value of the real estate less the existing debt against it yields its actual net value.
55. Not included in the economic value of the operation are certain items of the family estate as a whole. These include all of the family's nonbusiness assets such as the home (to the extent that it is not a part

tained inventories, accumulated cash of the operation and available credit.[56]

This analysis omits an economic factor which any sophisticated financier or investor would also designate.[57] This is the value of the ongoing business which includes two items: (1) the value of the operation as an integrated economic unit, and (2) the personal value of the operator to that business. The first item recognizes that the farming or ranching operator has aggregated a balanced combination of land parcels, improvements, machinery, livestock, and capital which, when combined with available family and hired labor and management, has created an efficient, integrated and profitable economic unit. In brief, this is the capability of the whole operation to produce a return beyond the investment costs of the individual parts.[58]

The second item is the recognition of the operator's value to the operation. This item acknowledges the difference in technical skill and business judgment of the operator compared to other potential operators.[59] It is here that the significance of his maturity and acquired judgment is given concrete recognition.[60]

For the most part, these have not been items to which real value could be attached in farming operations. The operator devoted a good portion of his business life cycle to bring together an integrated economic unit. If this operation is not to have a business life beyond the consolidation stages. That is, if it will be divested either as a "broken unit" or held beyond the point where it is a viable economic unit,[61] then it has no ongoing value to be preserved.

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of the farming operation), furnishings, family vehicles, and any other outside investments and assets.

56. If family earnings which have been withdrawn from the operation are again used for business purposes, they become a new contribution of capital. Likewise, if the nonbusiness assets are used as security on business loans, these would also be recognized for economic purposes as a form of new contributed capital.
57. Kyle, *supra* note 24.
58. *Id.*
59. Included are the operator's personal stability, business aggresiveness, technical and business training, business and financial contacts, etc.
60. These factors are generally recognized by bankers. This, in fact, is the reason that bankers will prefer one operator loan applicant over another even though both applicants may have substantially equal collateral.
61. It is common for an operator to hold part of his operation in his later years for partial employment during early retirement. If he does not keep the operation abreast of technical developments, even though it is a producing unit for him, it does not maximize its value as an ongoing unit. *See* Heady, Beak & Petersen, *supra* note 4.

The unit may then be disposed of[62] for nothing more than the combined value of its individual parts. Likewise, the operator has acquired business acumen throughout his life. When his services are most valuable (*i.e.*, during the consolidation stages of the business life cycle), his contribution to the operation is already beginning to decline. Therefore, the value of his management abilities is not recognized in valuing the entity.

**B. Salvaging the Lost Elements**

This, in short, is an area where a farm or ranch operator suffers a competitive disadvantage. If a business, other than farming, can obtain consideration for the value of (1) the business as an integrated unit and (2) the operator to the business when the operation changes hands,[63] and a farmer or rancher cannot, the farmer or rancher suffers a loss in actual compensation for these items. But in a larger sense, society also suffers a loss since the personal characteristics which go uncompensated represent a loss of production capability to the country.

What is sacrificed is the realization of a superior level of management and business skills of capable operators during their most productive period. In the consolidation stages of the business life cycle, the operator ceases to maximize the use of his reserve of business and technical judgment and established business relationships with financial institutions. Instead, he is "easing off" as he approaches retirement. It is left to the successor operator to acquire these skills in his own operation.[64]

To salvage and realize the value of this reserve of business acumen, a business organization should be established in the farming or ranching operation which would allow the efficient, industrious and capable farmer to apply his skills beyond the time when he contributes physical labor and direct supervision of the skilled labor of others to the operation.[65] This suggests a business organization which allows the farmer or rancher to be treated as the manager of any other business of moderate size.[66] When the op-

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62. This disposition may be either through lease, sale or estate administration.
63. In business, this is known as "blue sky" and includes customer good will and business relations. As for farming, business relations have some value; however, there simply is no customer good will to be included.
64. *See* note 52 *supra*.
65. Leonard Kyle predicts a continued growth and experimentation in business structures for this purpose. Kyle, *supra* note 24.
66. Currently the typical intergeneration operation is a father and son op-

erator reaches the latter part of his entrance-growth stages and is about to enter the consolidation stage, the business operation is ripe for conversion into a form where the growth stage can continue. For the growth stage to continue, however, additional labor and submanagement (other than that of the owner-operator) must be added to the operation.[67]

To realize the benefits of a mature businessman-manager, the owner-operator must move from a laborer-businessman to a manager-businessman with subordinate managers and laborers.[68] This necessarily requires a larger operation, both in acreage and amount of capitalization.[69] Here again, the economies of scale exert an upward pressure on the size of the farming operation. Also, a more sophisticated business form is suggested. A business form is needed which allows continuity of the operation from generation to generation, thereby allowing personnel to enter the operation as a technical laborer-submanager, to acquire management and business skill in an ongoing operation and then to move to a manager's position.[70] Further, a business form which allows the entrant to acquire an interest in an ongoing business over a period of time without estabishing a new, separate unit is required. A business form is needed which allows an interest in the farm assets as a whole to be fractionalized and partially owned by nonoperating heirs. This is an accepted and time honored business procedure for nonfarm businesses, but has been resisted within the farming and ranching sector.

## V. OPERATION FINANCING

### A. Common Methods of Financing

A second area where farm and ranch operators are strikingly dissimilar from other businesses of similar size is financing and the

eration which is only partially joined. The father aids the son initially by sharing machinery. The son rents some outside land and some of the father's with the father retaining some of the land. As retirement approaches, the father may sell the land to the son and distribute the cash to nonfarming children or he may divide the land between all of his children and the operating son rents their portion from the nonfarming children. Boehlje, *Intergeneration Transfers and Estate Management For Farm Families*, J. AM. SOC. FARM MANAGERS & RURAL APPRAISERS, Oct. 1972, at 43.

67. Boehlje & Boehlje, *supra* note 2, at 173.
68. Rhoedes & Kyle, *A Corporate Agriculture*, WHO WILL CONTROL AGRICULTURE NORTH CENTRAL REGIONAL EXTENSION PUBLICATION 32, SPECIAL PUBLICATION 28 (1972).
69. Kyle, *supra* note 24.
70. Kyle, *supra* note 24.

use of "outside capital." Basically, farm and ranch assets and resources are financed three ways:[71] (1) capital contribution by the owner-operator, (2) leases and leasehold interests, and (3) secured transactions including mortgages and contract purchases.

In the entrance stage of his business life cycle, the owner-operator through savings or, more likely, from family assistance, must have amassed a sizeable sum[72] to provide a financial basis for the operation. This is his initial capital contribution to the enterprise. As the operation becomes profitable beyond his living needs, profits[73] also are poured back into the operation as a further capital contribution. This money provides working capital, initial downpayments and funds to purchase, free of debt, certain resources.[74]

Real estate for the operation may be acquired through a cash or crop share leasehold or, if personal capital is sufficient, through a "financed purchase" by means of a contract purchase or a mortgage purchase. Likewise, major equipment may be acquired through contract purchases from dealers, mortgages through institutional lenders and, in some instances, through lease arrangements.[75] Further, as the owner-operator's equity in the operation increases,[76] remortgages or pledges may be used to provide additional capital.

One other valuable source of financing is the establishment of business credit by the farm or ranch operator. As the owner-operator becomes known in the community as a stable, sound, reliable operator, credit becomes more available to him. This is a valuable asset of the operation, both for expanding the available

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71. In addition, there is short term financing both by carrying accounts payable to suppliers and by unsecured institutional loans.
72. *See* discussion of the "critical mass", *supra* at II, A.
73. This, crudely speaking (ignoring alternative costs, etc.), is known as "economic profit."
74. Ultimately, capital contribution, uncompensated capital improvements, appreciation above depreciation, the value of the assets as a "total integrated unit" as opposed to their individual value, and inflation generally, combine to make up the owner-operator's net worth.
75. The Financial Accounting Standards Board has recently raised the need to consider leases as a form of financing to be recognized on a balance sheet as an asset and liability and is now drafting an opinion which could force companies to capitalize a substantial portion of outstanding leases. *See* FORBES MAGAZINE, Jan. 15, 1975, at 42. An indirect means of equipment financing is custom work, such as in grain harvesting, to the extent that it alleviates the need for individual operators to purchase that equipment.
76. The reduction comes about through debt reduction, through asset appreciation (either through inflation or otherwise) and through uncompensated capital improvements. *See* note 74 *supra*.

working capital and easing the pressures on the operator to obtain adequate working capital.[77]

**B. Equity Financing**

The source of financing which, while common to other businesses, is generally missing in the farming and ranching industry is the "outside equity financing."[78] This is a broad term generally referring to the contribution of risk capital with no obligation upon the operation or its operator to pay a fixed rate of return on that capital during its use nor an obligation to repay it to the contributor during the continuance of the operation. Implicit is the fact that the management is not directly affected by the contributor-investor. His influence is indirect, either by terms established at the time of the contribution[79] or, in the case of stock purchases, by the right of the contributor-investor to participate from time to time in the choice and direction of the management.[80]

The outside contributor-investor receives a share of the operating profits of the business[81]—instead of interest or rental as a percentage of his contribution.[82] He also shares, through partial

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77. This is one of the items alluded to in the foregoing section which is lost if the operator is not actually retained in an ongoing operation or if he ceases to make maximum use of this in his own operation. It is generally personal to the owner-operator and attaches only in an indirect way to the operation in his absence.
78. *See*, Smith & Krause, *Financing Future Farm Production—A Look at Three Scenarios*, 35 AG. FINANCE REV. 10, 11 (1974).
79. In the instance of a limited partnership, the management arrangement is set forth in the partnership agreement and, at least in the case where a limited number of parties are involved, is negotiated between those parties.
80. Corporate investors participate through their stock voting rights by annually electing a board of directors. The board then handles routine affairs during the year.
81. In a corporation, the operating profit is distributed as dividend payments. The distribution, however, is a management decision and may be foregone, under certain circumstances, if the profit is needed within the operation as future working capital.
82. Inherent in a loan are certain theoretical attributes. The principal is loaned to the debtor to be applied to his use with no direct control by the lender except for his right to call the loan for violation of the lending agreement. The cost to the borrower and the benefit to the lender is the interest. The principal and interest must be repaid on a fixed date or in fixed installments. Repayment is unrelated to the success to which the principal is put. If the borrower fails in the endeavor, he must still repay the principal and agreed interest in full on the agreed date. Likewise, if he encounters substantial financial success from his application of the loaned funds, his only obligation is to repay the principal and agreed interest. The interest rate is nego-

ownership of the business assets generally, in the appreciation of the overall value of the operation. Ultimately, upon the dissolution of the business and the distribution of its assets, his contributed capital is returned. More likely, however, he will recoup his investment by selling his interest in the operation to another outside party.[83]

There are, of course, two main business forms used for this purpose. The classic form is the business corporation. The contribution-investment is made by purchasing either preferred stock, which may offer the holder a preference in dividends and recovery upon dissolution, or common stock which has no such preferences.[84]

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tiated between the lender and borrower based on the supply of available lending sources and the need for credit, the amount of servicing the loan will require, the duration of the loan, the risk of the borrower's financial failure, and the general business relationship between the parties.

It should be recalled that borrowing, as a form of financing, has had a stormy history for over two thousand years. (*See, e.g.*, J. BELL, A HISTORY OF ECONOMIC THOUGHT 24-45 (2d ed. 1968).) Even today it meets with some scorn and resistance, the financial institution being viewed as an oppressing "money-lender" and the borrower as a rash adventurer. In fact, however, financing simply allows an asset to be used while its cost is being paid; thereby the true cost of the asset is paid by its own use.

Inherent in a lease is an agreement by the lessor to allow the lessee to use the leased asset for a fixed period in exchange for rent. The rental may be a percentage of the production of the asset realized by the lessee or it may be a specified sum. If it is a specified sum, it is generally paid periodically without regard to the success or failure of the enterprise to which the asset was applied. The lessee is generally unrestricted in the use of the leased asset except as specified in the lease arrangement. The rent is based upon supply and demand for the asset, the relationship of the parties, the nature of the asset, etc. Although often not considered a form of financing, a lease is, in fact, a means for the lessee to obtain use of the asset without advancing its full cost. Its disadvantage is that it must be returned at the expiration of the lease and, in the event of a cash rental agreement, there is an obligation to pay a fixed return for its use at a fixed date.

83. An acknowledged disadvantage to outside contributor-investors of equity capital is the possible lack of liquidity of the investment; that is, the inability to find an immediate buyer for his interest if he wishes to sell his stock or partnership interest before termination and liquidation of the business. This is particularly true in a smaller closely held corporation. The investor, however, must consider this possibility before investing, and it is presumed that there were other sufficient benefits to him to justify the investment to offset the liquidity problem.

84. The corporate form offers other financing possibilities. The security or debenture bond is a private mortgage by the corporation which is ordinarily segmented into numerous parts known as debentures or bonds. These bonds are sold to holders in various amounts who are

The second business form is the partnership[85] containing an "outside" partner or partners.[86] It is somewhat more cumbersome when applied to a variety of investors but it has several tax advantages. It allows capital gain advantages,[87] it allows the investor the advantages of operation and accounting loss "pass throughs"[88] and it avoids the problem of double taxation.[89]

These forms allow an outside party to participate in what, in his estimation, appears to be a profitable venture which, either through operating income or appreciation, will return a profit beyond that

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then in the general position of mortgagees. The holders generally would not enforce their rights separately, but only through a trustee established at the outset to handle payment of interest and principal and to enforce the security agreement in the event of default.

Another form of financing is a convertible security or debenture. This is simply a debt instrument containing an option on the part of the creditor to convert the debt instrument to a stock share. The possibilities offered by this financing form often attract investors who otherwise would not be interested in providing financing.

85. Variant forms of a partnership containing all of the same principles are the joint venture or syndicate. However, these do not have the liability shields of the limited or silent partnership. *See* notes 90-91 *infra*.
86. A partnership may be either general, where all partners participate in the management decisions, or one containing "silent" or "limited" partners, where one or more of the participants, the general partners, have total responsibility for management, and the other partners, the silent or limited partners, contribute only capital and have no managerial responsibilities except for the contractual limitations and directions contained in the partnership agreement. The advantage of being a silent or limited partner is that it contains a "liability shield" similar to that provided by a corporation. *See* notes 90-91 *infra*.
87. A corporation pays taxes on its capital gains at a special rate while a partnership may separately state its capital gains benefits and pass these on to its member partners to be treated at the preferential capital gain rate on their personal income tax returns. *See* INT. REV. CODE OF 1954, §§ 702, 1201 [hereinafter cited as CODE].
88. Operating and accounting losses incurred by a partnership (to the extent of the partner's tax basis and liability) may be passed on proportionately to the individual partners to be used on their personal returns to reduce their personal tax liability on other income. CODE § 702. A business corporation, except for a "subchapter S" corporation, *see* note 93 *infra*, simply suffers the losses on its books and tax returns and cannot pass this on to its stockholders.
89. A corporation's profits are taxed to the corporation and only its after tax earnings are available for division and distribution to its shareholders as dividends. These dividends, when received by the stockholders, are subject to taxation again as personal income to the shareholders. CODE § 702.

    A subchapter S corporation is entitled to be taxed as a partnership, thereby avoiding the problems mentioned in notes 87-88 *supra*. *See* CODE §§ 1371-1379.

which would be earned through a deposit in a financial institution or making private loans at available interest rates. So long as the investor-contributor invests through the form of a corporation or limited partnership,[90] he has no liability exposure[91] beyond the amount of his invested capital.,

Most major industries, other than farming and ranching, although many started on a small scale and grew to their current size, have recognized this source of capital and made it an integral part of their industry financing. Not all of these have grown to financial behemoths. Numerous local and area businesses have used this means of financing and have resisted being swallowed up by national corporations or losing their local identity and control. It is not logical to argue that this form of financing should not be applied to farming or ranching because local control would necessarily be lost.[92] That potential exists in any form of financing.

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90. A limited partner, provided he takes no part in the active management of the partnership, has no personal liability for the debts or obligations of the partnership. *See* NEB. REV. STAT. § 67-207 (Reissue 1971). A silent partner is in a similar position except that a silent partnership arrangement is a common law and not a statutory business form.

91. There may be contractual liability for debts incurred by the partnership which it cannot pay, or tort liability for acts of negligence by the partners, agents or employees. In either case, the capital contribution of the limited or silent partner may be consumed in paying such obligation, but the creditor cannot look beyond the partnership to any of the silent or limited partner's personal funds. NEB. REV. STAT. § 67-207 (Reissue 1971).

92.
> The nonfarm activities of corporations with farming operations are often relatively small, local operations; however, there are a number of large, vertically integrated agribusiness corporations that produce farm products as a source of supply for processing or marketing activities.
>
> In its 1968 study, the U.S Department of Agriculture (USDA) found that 63 percent of all corporations with farming operations in the 48 contiguous states were engaged solely in farming; 15 percent were engaged in farming plus agribusiness activities; 18 percent were engaged in farming plus nonagribusiness activities; and 4 percent were of the combination or conglomerate type.
>
> Farming was the major activity of 72 percent of these corporations (63 percent engaged solely in farming plus 9 percent with other activities), the second ranking activity of 25 percent, and the third or lowest ranking activity of only 3 percent. These figures indicate that the great majority of the corporations engaged in agriculture are basically agriculturally oriented.
>
> Most farming operations conducted by corporations that are engaged solely in farming or in farming-plus-agribusiness group and 51 percent of the conglomerate group (farming plus both agribusiness and nonagribusiness) had farm sales in excess of $100,000.

NATIONAL PLANNING ASSOC. PUBLICATION NO. 131, THE EFFECTS OF FEDE-

Feed and processing companies can gain complete control of poultry operations simply by the terms and conditions established for advancing credit without ever obtaining an ownership interest in the operation. Landlords can maintain a peonage system of land rental through sharecropping. Financial institutions can "break" feeding operators by withholding vitally needed financing and then, when economic conditions are favorable, proceeding into the feeding operation themselves or financing the operation on a participating basis leaving the operator as a poorly paid custom feeder.

In fact, use of this added source of financing in many instances could inject more vitality into the farming and ranching economy. In appropriate cases, it could free local operations from conditions of unavailable or insufficient financing or make them independent of local financial institutions. Further, in some instances it could free the farmer or rancher so that he would be better able to bargain with financial institutions for the balance of his needed capital. Also, since equity financing frees the operation from heavy interest expense, the need to make regular periodic debt reduction payments, and the often awesome burden of cash rental payments, it could also prove to be a valuable tool to get an expanding agricultural operation over short run problems regularly encountered because of economic cycles.

For this type of financing to be practical and available, however, the operation must be sufficiently large to warrant the necessary financial and legal services required. Second, it requires legal and financial practitioners with more than a minimal understanding of the subject matter and an ability to lead and educate the farm and ranch operator in exploring the possibilities of this type of financing. These practititioners also must have the ingenuity and originality to tailor a business form properly to meet the unique needs of the operation and likewise to satisfy the needs of potential investors.[93]

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ERAL INCOME TAXES ON THE STRUCTURE OF AGRICULTURE.

Only 42 (6%) of the corporate operated farm units in Nebraska in 1969 had ten or more shareholders while 617 (94%) had ten or fewer shareholders. U.S. DEP'T OF COMMERCE, 1969 CENSUS OF AGRICULTURE, pt. 20, vol. 1.

93. It is argued, with some validity, that farm and ranch units must grow substantially in order for this method of financing to be a truly viable alternative. Smith & Krause, *supra* note 78, at 10-12. However, initiative and education on the part of local investment banking firms, lawyers and other financiers could provide a source of capital sufficient to attract investors and intermediate sized farm and ranch firms into this general area.

## VI. ECONOMIC ELEMENTS IN ESTATE PLANNING

### A. The Business Life Cycle

Consideration must also be given to the chronological point within the owner-operator's business life cycle when he confronts his overall estate planning problems[94] or completely reviews and updates a former plan.[95] If he is in his entrance stages or growth survival stages, he can be treated, for the most part, as any other businessman, giving special attention to the particular features of his own business needs. This will probably include a heavy debt structure, severe lack of liquidity and a business highly dependent upon the continued personal management and labor of the owner-operator.[96] Likewise, the cash method of accounting used in many operations has resulted in a method of income tax deferral and a continual prepayment of expenses leaving an estate of substantial net worth with a low tax basis and a relatively low cash producing capacity if the owner-operator is excluded.[97] All of the tools, including adequate life insurance, wills, and inter vivos and testamentary trusts, etc., should be considered by the planner. At this point, however, if the children would not be capable of continuing the operation after the operator's death, it may be futile to emphasize a structure to preserve the business operation. The main thrust here should be to preserve the assets against the liquidity problem which would be encountered upon the owner-operator's death.

Business and estate planning encounters wider considerations when the owner-operator is in the consolidation stage of his business life cycle. There is a great reserve of business acumen and established business credit in the successful operator. The operation has depended upon the operator not only for his business supervision but also for his physical labor; now, however, he is less willing to devote his physical labor and, as a result, may be consolidating his entire operation to provide a comfortable income with less need for physically exhausting output. Not uncommon in this situation is a family structure where at least one of the younger

94. Estate planning occurs at any point in a person's life, from early adulthood to death, at which that person does any act in reference to the disposition of his property in the event of his death. What is being discussed here is the relationship of business forms to the business needs of the farmer or rancher with a substantial estate.
95. Again, all of the means and tools which apply to estate planning in businesses and families likewise apply to farmers and ranchers and their businesses.
96. *See* Part II, B, *supra.*
97. *See* Fiore & Kelley, *supra* note 10, at 250.

family members is prepared to enter the farming or ranching field as a lifetime endeavor.

An owner-operator at this point faces two broad alternatives. One is to maintain his ongoing operation while bringing someone else, generally his son, son-in-law or another outside party, into the operation; the other is simply phasing out his operation over a period of time as he enters retirement and ultimately transferring the assets to the next generation.[98] If his operation is to be phased out, the goal of the estate plan should be to transfer the assets to the next generation after adequately providing for the owner-operator and his spouse during their lifetimes. Also an arrangement to prefer a family member, probably a son, in the leasing of the real estate and ultimately effecting a contract purchase may be desired. This is a standard farm estate planning problem to be handled by wills, trusts, lease purchases and contract sales, gifts and title arrangements, and possibly a private annuity.

### B. The Business Entity as a Solution to Difficult Estate Problems

#### 1. *The Non-continuing Operation*

Even in a "phasing out" situation, a business form[99] can serve

98. This is an important decision. If the operator chooses to maintain the ongoing operation, he must be capable of and willing to work with others, share authority and management, and be committed to long term growth. If he chooses to phase out the operation, he must be willing to confront the emotional consequences of that choice.

99. Although there are a great number of business forms, they break down into four general categories. First is the proprietorship, which is any operation which is carried on by a single individual without any formal organization. Even though the proprietorship may be carried on in a business name, this does not chanage its character. The second common business form is the partnership. It includes joint undertaking by two or more persons. The partnership may be general or limited. A limited partnership requires adherence to the governing statutes in its formation and the filing of the organizational documents. *See* Nebraska Partnership Act, NEB. REV. STAT. § 61-201 *et seq.* (Reissue 1971). The third broad category is the business corporation. This business form likewise requires the sanction of statutes for its organization and existence. *See* Nebraska Business Corporation Act, NEB. REV. STAT. § 21-2001 *et seq.* (Reissue 1970). The fourth form is trusts. There are a variety of forms which these can take; they may come into existence by formal document, by oral declaration or intent.

In addition to the foregoing, there are various other minor business forms, such as cooperatives, nonprofit corporations, estates, and the like. Although these are recognized as special tax entities and must be considered in estate planning, they are not sufficiently significant to be discussed here.

a number of functions. By titling the property in an ongoing business entity, the real estate can be transferred, in total or in part, with far fewer title problems;[100] ownership of land and major improvements can be fractionalized for distribution among heirs while guarding against a partition action by one of the heirs;[101] various business forms allow gifts to be made without loss of control of the assets;[102] and in some instances, business forms provide a means for current income tax savings.[103] Additionally, and often of major importance, some business forms, notably corporations, can reduce property valuations for estate tax purposes,

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100. Real estate held in a corporation or limited partnership is not affected by the death of a shareholder or member. The decedent's stock or partnership interest is merely probated, not the title to the real estate itself. Likewise, if the business entity contains substantial diverse personal property, items need not be inventoried, valued and distributed through the probate proceedings; these simply remain a part of the ongoing entity, and only the stock or ownership interest is probated. *See* NEB. REV. STAT. § 67-221 (Reissue 1971).

    Likewise, transfers of stock or partnership interest between the parties do not require public recording but are made simply by registering the transaction on the private books or by contracts between the parties.

101. In estate planning it is often necessary, to meet federal gift tax exemption requirements, to give various shares of an estate of specific monetary value which will include both real estate and personal property. A corporation's ownership is represented by its stock which is easily fractionalized; a partnership's ownership is represented by ownership shares which likewise can be fractionalized, though not quite as easily as a corporation's. Both are much easier than fractionalizing title to real estate and/or items of personal property.

    Another problem of fractionalizing ownership in real estate and/or personal property is that any one of the owners (*e.g.*, the recipients of a gift share) can demand at any time a partition and force the sale of the property. A properly planned business entity can provide a vehicle for distribution which will prevent such a partition.

102. So long as the owner-recipient maintains the majority of the voting stock of the corporation, remains the controlling general partner of a limited partnership, or provides acceptable trust arrangements in a trust, he can give away the other interest in the entity and still maintain control. To the extent that the gift is actually and effectively a recognized distribution for value for estate tax purposes, his estate is reduced to that extent and his estate will realize the resultant savings on future federal estate taxes. *See*, Byrum v. United States, 408 U.S. 125 (1972). *See also* Harl, *supra* note 3, at 277-78.

103. The first $25,000 of a corporation's income is taxed at a flat rate of 22%. To the extent that the corporation income reduces the controlling owner-operator's personal income and he avoids distribution without encountering the corporate accumulated earnings tax, he can effect income tax savings. Trusts and partnership arrangements likewise can provide income tax savings by distributing income among multiple entities for tax purposes, thereby placing portions in a lower income tax bracket.

providing the consequential reduction of federal estate taxes.[104] One other important element to many families is that a properly conceived business form may provide a vehicle to encourage the children to maintain the family real estate intact, after the death of their parents, as an investment as well as for sentimental reasons.

This vehicle could be an entity holding the real estate as an investment and leasing it to provide investment income. During the balance of the owner's active life, the property could be leased to the operator himself; after his retirement, it could be leased to a family member in farming or ranching or, if desired, to anyone else. In the meantime, ownership can be fractionalized and distributed, thereby reducing the value of his estate for federal estate tax purposes.[105] A properly conceived entity can provide him with control over the assets even after the gifts are made and prevent partition of the land by recipient heirs. This entity could also allow the donor to manage the investment property for the recipients of the gifts.[106] Likewise, since all children would receive a portion of the rental as investment income and would share in any appreciation of land values, there would be no reason not to maintain it as an investment into the future. Continued family ownership can be ensured by specifying that any interest sold must be offered first to family members. Redemption and buy-out provisions can also be included to ensure an avenue of escape for any of the heirs who wish to liquidate their interest.

### 2. *The Ongoing Operation*

Additional possibilities arise if the owner-operator wishes to maintain the operation as an ongoing business without interrup-

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104. This is the concept of discounting the value of minority interest in unlisted corporations below the proportional share of the underlying assets that the interest represents; a similar result also may be argued with reference to the majority interest. *See* Rev. Rul. 59-60, 1959-2, CUM. BULL. 237; Rev. Rul. 67-54, 1967-1 CUM. BULL. 270. *See also* Kelley, *supra* note 54. Whether this principle will also be applied to partnerships has not yet been tested.

105. It has been held that even non-income producing assets can be held in corporate forms for the sole purpose of estate planning. Britt v. United States, 431 F.2d 227 (5th Cir. 1970).

106. The job of management will be done by the trustee of a trust, the general partner of a limited partnership or the corporate officers of a corporation. In many instances, the owner-operator will serve this function in the investment entity and may be compensated for his services. This compensation is a legitimate means to withdraw some of the earnings of the investment entity as income to the owner-operator and an expense to the entity thereby avoiding some double taxation (*See* note 92 *supra*).

tion into the next generation. The possibilities are unlimited, but the objectives are the same—to provide adequately for the current generation and transfer the assets to the next generation in an equitable, economic and convenient manner—with one additional consideration. The new consideration is to ensure that the child or children being brought into the operation do not receive undue advantage over the other heirs or, on the other hand, that participating heirs do not suffer professionally to the advantage of other heirs.

If continuity of the operation is desired, the estate plan should then include an additional business form which provides this continuity. There must be some means of bringing the entrant member of the next generation into the operation not only as an employee but also as partial owner with an ability to acquire additional equity ownership in the operation. Acquisition must come not only through gifts and inheritance (in which case nonparticipating heirs will receive additional ownership) but also through earned shares and opportunities for personal investment in the operation. If significant portions of the fruits of an operating heir's business efforts are diluted by a future division with the other heirs, there may be no incentive for the operating heir to participate in the operation.

This creates a dilemma for business growth also. A primary means for farmers and ranchers to realize the economic benefits of their professional industry has been to forego current income in favor of estate accumulation.[107] If these benefits eventually fall into the father's estate to be divided among all heirs rather than to the participating heir directly, he has prejudiced himself by entering the operation.[108] To protect himself he must either sever his relationship with the parents' operation when he has accumulated a "critical mass"[109] of capital to commence a separate operation, or he must receive a higher incremental income sufficient to reflect his true current earnings[110] and invest this outside the operation.[111]

107. *See* note 17 *supra.*
108. Boehlje & Boehlje, *supra* note 2.
109. *See* discussion of the "critical mass" *supra* at II, A.
110. Reference is made to the amount the young entrant can earn in a competing or similar operation or business, both inside and outside farming and ranching. It is not necessarily the return which his labor and efforts bring to the operation itself, but only what his alternative earning capacity is. To determine what this should be is a difficult and often contentious process which itself can be a divisive factor within the family.
111. It is possible that he could buy an additional interest in the operation, but this would require a continual valuing of the operation to determine its value at the time the increment is to be purchased.

Because farm and ranch operations generally have a low liquidity, the funds to pay a salary or wage commensurate with that which can be earned elsewhere are often unavailable. If funds are raised through normal financing channels, the operation can be severely hampered and borrowing power, vital to the entire operation, may be restricted. Without this capital, the operation cannot continue to grow and will not provide sufficient income to sustain families in both generations. This problem, because it is often not understood in the economic sense either by the participant or the estate planner, is the basis for numerous family problems that develop both during the time of the ongoing operation and later during the administration of the estate.

The problem is in the reconciliation of all the various objectives. The owner-operator has assets of substantial value which he wishes to maintain, to the extent necessary, to provide himself and his wife a comfortable standard of living and security during their lifetime. He may wish to commence distribution of any assets exceeding this need. In any event, he will wish to make provisions for distributing all the assets upon the death of himself and his wife. He is also capable of further productive efforts during his life and may accumulate additional assets. He may be interested in providing incentives for family members to enter the operation, treating them fairly in the operation but giving equal consideration to all other heirs.

These objectives can be achieved only if the operation is viewed in its economic sense. The separate consideration of the economic elements of the estate simplifies the problem. These elements are:

(1) Land: Land is usually the asset with the highest value and also has other important features. It will not depreciate, and in fact is the single item most likely to appreciate substantially. Also, its value to the operation has some standards by which it can be measured—specifically, rental value. Therefore, if the land is separated, the balance of the estate is considerably reduced.

(2) Production Assets:[112] These assets have the next highest value and, when considered with land, create a substantial portion of the estate. These items, however, do depreciate. Therefore, estate plans and value to any ongoing business must make allowances for this.

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112. It is not always easy to separate land and production assets (*e.g.* buildings, irrigation facilities, etc.). Each operation and item must be considered individually.

(3) Operating Capital:[113] This includes values available to the owner-operator which are readily determinable and vary greatly depending on the estate. The value of these assets is their economic alternative use value, *i.e.* their interest producing capability. The owner-operator can retain these outside the operation and apply them to it as he desires. His personal value to the operation will reflect, in part, the value of the operating capital available to him. Likewise, these will be reflected in the capital structure and ownership of the new operation.

(4) Personal Items: These include all nonbusiness assets and may not always be distinguishable from operating capital. Generally, however, all items which can be withdrawn from the business without disabling the operation are included.

(5) Owner-operator's Personal Value: Although this is a major factor to any business, it is a "flowing resource" whose only value is in its use. Although it can be valued to the business, the value disappears when the owner-operator, by choice or circumstances, ceases to apply his abilities to the business. Therefore, it is a factor in business planning but in estate planning can be a liability whose potential loss must be covered by insurance.[114]

Each of the foregoing—except the nonbusiness assets—is a necessary element in the ongoing business. By categorizing assets in this manner, the relative values of each can be accounted for and, the various elements, when viewed individually, can be handled more easily for estate planning purposes.

First, the personal items can be handled as in any other estate using, most likely, direct will provisions and, in some instances, trust provisions. All of the principles which apply to planning an estate of any other type would also apply here.

Since a major means of estate planning for large estates is to reduce the estate by inter vivos gifts, a business form, created to hold the land and its major improvements only, has numerous benefits. The point is that whether or not an ongoing operation is to be established, there is a substantial benefit in maintaining the ownership of the land separately.[115] Therefore, regardless of the operator's desire for an ongoing operation, it is often advisable to establish a business entity separate from the operating business entity for the purpose of maintaining ongoing ownership of the

113. This includes cash, savings, harvested crops and marketable livestock.
114. Except for the future assets which it produces and which are added to his estate.
115. Fiore, *Analyzing and Planning the Finances and Estate of the Family Engaged in Agriculture*, 1 ESTATE PLANNING 96, 99 (1974).

land. The owner-operator can then distribute the ownership of this investment entity among all heirs equally.[116]

The land, when separated, can be rented by the investment entity to the operation. This allows the land to be used in the operation with the true value of the land taken as an expense of the operation.[117] At the same time, the rental fulfills various other estate planning needs. First, it provides a source of income to the owner-operator in addition to any income which he might earn from participating in the separate ongoing operation. Second, it provides a means—through a properly conceived entity—for the ownership of the land to be fractionalized and distributed while preserving in the owner-operator the control of and the income from the operation. Third, it may provide a structured entity which can be maintained by all heirs as an investment after the death of the present generation. This allows all heirs to be treated equally and without prejudice either in favor of the participating or nonparticipating heirs. Likewise, since all heirs—both participating and nonparticipating—share in the rental income and any appreciation in value, there is an incentive to maintain the land as an investment. Additionally, the participating heir is not prejudiced by the operation's rent payment to the investment entity since the rental would presumably be competitive with equivalent real estate.

The next items to be considered are the production assets. If an ongoing business operation is established,[118] these items can be converted into a liquid state by a contract sale to the ongoing entity. For estate planning purposes, the disposition of the individual items of personal property which are included in the production assets has then been accomplished; the contract rights and their proceeds are then simply handled as liquid or quasi-liquid assets of the estate.

Likewise, the operating capital is either in the form of liquid assets or, to the extent it represents funds loaned to the operating entity, simply a debt instrument owned by the owner-operator. It is treated as other debt instruments in an estate plan. These, combined with personal savings accounts, outside business assets,

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116. This entity serves the identical function as discussed in Part VI, B, 1, *supra*, and would be structured exactly as that entity.

117. For larger cash grain operations, rented real estate constitutes the major portion of real estate, totalling approximately 60% of their land, U.S. DEP'T OF AGRICULTURE, ECONOMICS RESEARCH SERVICE PUBLICATION NO. 249, FARMLAND TENURE PATTERNS IN THE UNITED STATES, 35 (1974).

118. This entity serves the identical function as the entity in Part VII, *infra*, and would be structured exactly as that entity.

and the like, are combined in the estate plan simply as liquid assets.

This leaves one other item to be handled by the estate plan. This is the stock or partnership interest which the owner has in the business. To the extent that the business succeeds, his value in that operation increases. Upon the owner's death and probation of his estate, or upon his future retirement, this ownership interest will be represented in his estate at its increased value or sold to the participating heirs. The proceeds of such a sale will then be divided among all the heirs, thereby treating them all fairly.[119]

Since this is an ongoing entity, the stock or partnership interest of the owner-operator is all that is included in the estate. This has a readily determinable value through standard appraisal procedures. That portion owned by the participating heir or heirs would not be included in the estate. Quite likely, if the business entity is properly planned and structured, it will include a buy-sell arrangement to ensure the liquidity of the stock or partnership interest. All of the objectives and needs of the participating members would then be served.

## VII. STRUCTURING THE ONGOING ENTITY

The ongoing business should have individual continuity. Its members, whether partners or stockholders, will include the owner-operator and any person he is bringing into the operation, conceivably one or more members of his family. The type of legal entity used will be determined by the nature of the operation, tax considerations and the relative merits of each of the various business forms.[120] The business can take as many structural forms as can be conceived. There are, however, some general lines which it will follow.

First, the operation will require basic economic elements: land, labor and capital. The land will presumably be leased, at least in the initial stages. The labor will be contributed by the owner-operator and the entrant or entrants. The missing element is, of course, capital, both to finance the production assets[121] and to pro-

119. The product of the operating heir's effort is represented by his ownership interest in the ongoing business entity. Therefore, he is not treated unfairly by having entered into business with the owner.

120. A comparative analysis will not be undertaken here. For a thorough discussion on that subject, see *Contemporary Studies Project: Large Farm Estate Planning and Probate in Iowa*, 59 IOWA L. REV. 794 (1974), and Harl, *supra* note 3.

121. *E.g.*, the machinery in a cash grain operation, the feeding facilities in a feeding operation, and the herd in a ranching operation.

vide working capital for the operation. The manner in which capital is obtained—presumably from the owner-operator—will determine the ownership of the operation; ownership, in turn, will dictate management and the method of compensating the participants.[122]

Three general forms suggest themselves:

(1) The owner-operator can contribute the production assets and the needed working capital in full, retaining full ownership of the new operation. Those entering the operation will initially serve as employees with a wage agreement and a right to buy into the operation over a period of time. This is advantageous if the new entrant is young and has had little opportunity to obtain management and technical experience. This plan maximizes the owner-operator's control over the operation and at the same time allows an entrant who wishes eventually to acquire an ownership interest to do so more rapidly because the net value of the business is reduced considerably when the value of land is not included.

(2) The owner-operator may contribute only the production assets and lend the operation the needed working capital. The owner-operator would enter initially as full owner with the same employment-buy in arrangement for the entrant. This alternative, however, further reduces the overall net value of the entity thereby allowing the entrant to earn or purchase a significant portion of the operation even sooner.

(3) The owner-operator may contribute no assets. He may simply contract to rent the land to the operation, to sell it the production assets, and to lend it the working capital. The owner-operator and the entrant then begin the operation on a more equal basis of ownership and compensation. As the operation succeeds, the debt for the production asset purchase is reduced and the entrant's net worth—as that of the owner-operator—increases.

Compensation arrangements must be considered also. In any of the foregoing plans the owner-operator will receive a substantial income from the rental of the land. This is exclusive of anything that he may earn from participation in the operation. If he is selling the production assets or lending working capital to the operation, these are additional sources of outside income to him. In addition, he is entitled to a portion of the operation's earnings after deducting the above items plus all operating expenses.

At the early stages of the operation, he may be willing to con-

122. Fiore, *supra* note 115, at 100.

tribute considerable labor and most of the management. This should be reflected in his compensation. If he is the sole owner, he may wish to keep a significant amount of the income himself. He will, however, have to pay a sufficient wage and make suitable arrangements to attract the entrant to the operation. If the wages and potential for equity accumulation are not sufficient, the entrant will not feel that he is being treated fairly and family disharmony may result. If there is insufficient cash generated by the operation to pay a significant income, possibly ownership shares can be part of the entrant's compensation.[123]

If the owner makes no initial contribution of assets or capital, then the owner-operator and the entrant can start on a more equal basis of ownership. Compensation can be in the form of a division of the overall profits. The owner-operator's reserve of business acumen and business contacts should be reflected in his compensation. Profits can be divided on a proportional basis with the owner-operator receiving a higher proportion, or perhaps there could be an agreed wage to the owner-operator and to the entrant, with the profits above this wage being divided equally. Numerous other possibilities also suggest themselves.

In addition to capitalization of the business entity and the compensation of the participants, another item that should be considered is retained earnings and capital expansion of the operation. As income is generated, there will be, in addition to substantial debt reduction, a possibility of buying new assets and real estate. The choice is between paying out the profits for the participants to invest or retaining the earnings for investment by the entity.[124] Since the entrant will own a substantial amount of the operation, real estate can be acquired without fear of prejudicing his interest. As the owner-operator approaches retirement, his interest in the operation will decrease and the entrant's will increase. Thereby, the increased value of the business will devolve to the heir whose efforts produced a substantial part of the increase. Before the owner's retirement, the entrant can protect himself with a buy-out

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123. This provides a form of financing labor and preserves badly needed capital for the operation while treating the new entrant fairly and protecting his interest against nonparticipating heirs.

124. If the entity is a corporation not choosing to elect subchapter S status for income tax purposes, *see* note 89 *supra*, then the entity earnings will be subject to double taxation upon distribution to the shareholders thereby reducing the amount available for reinvestment. For this reason, retention of these earnings in the corporation and making the investment at the corporate level would be preferable. However, during the time of such retention, the accumulated earnings tax problem must be considered. *See* note 133 *infra*.

arrangement in the event of his early death. In this manner, both participating and nonparticipating heirs will be protected.

One other item should be noted. Because the owner-operator will, through one manner or another, control a significant portion of the corporate assets, he can obtain recognition of his personal value to the operation. Whether this is through rental proceeds from the land, interest and principal payments from the sale of the production assets, or interest from loaning operating capital, he can provide himself with a substantial income apart from his compensation for labor and share of profits. In addition, it may be necessary when the operation expands for the owner-operator to make some personal guarantees in borrowing outside capital or financing major purchases. In return for these personal guarantees, he should receive additional economic recognition of their value and not just compensation for his labor and management ability.

## VIII. BENEFITS AND CAVEATS

It is not the intent of this article to consider the relative merits of various business forms and no attempt will be made to do so.[125] There are, however, numerous technical traps for the unwary which can wreak havoc on an operation if they are not considered. No attempt will be made to cover this area extensively; only a few caveats of major consequence will be touched upon.

One of the first problems concerns the tax consequences encountered in forming the entity. Property cannot be transferred tax free to a corporation[126] when it has a negative tax basis; such a transfer will incur immediate capital gains treatment.[127] Before a corporation is used, the problems regarding double taxation[128] should be considered and, if the asset to be placed in the corporation will be disposed of in the foreseeable future, it must be remembered that corporations are not entitled to certain capital gains benefits allowed individuals.[129] The problems of double taxation are not limited solely to entities using the corporate form. In some instances, the Internal Revenue Service may determine

125. *See* note 120 *supra*.
126. For tax free transfers to a controlled corporation see CODE § 351.
127. *See* Wiebusch v. Commissioner, 59 T.C. 777 (1973) (a transfer to a corporation of assets with a secured debt in excess of the asset's tax base which debt was assumed by the corporation resulted in a taxable transfer). *See also* CODE § 357(c).
128. *See* note 89 *supra*.
129. CODE § 1201.

trusts[130] and limited partnerships[131] formed properly under state law to be taxable as corporations under federal income tax law.

If the asset is real estate deriving a substantial rental income, the personal holding company tax[132] may be present. If income tax benefits are sought through retention of income, accumulated earnings tax problems of corporations also must be considered.[133]

A corporation does provide the benefit of discounting.[134] Likewise, it might provide a workable means for the nonparticipating family members who may be interested in holding the assets as an integrated unit into the future if realistic income is obtained from rentals and anticipated capital appreciation.[135]

A major consideration in structuring a corporation is whether certain heirs might be unwillingly "locked into" an ongoing business with no realistic market for their stock. Provisions can be made for nonoperating children to "cash out" at their discretion. This can be done through redemption agreements, sales agreements or even dissolution provisions within the corporate or partnership articles.

It should be noted that gifts of minority stock in a corporation must in fact be gifts and not simply a facade for delaying enjoyment of all benefits until the donor's death. If the government determines this to be the intent, no reduction will be recognized in the estate value for estate tax purposes.[136] However, if the gift is properly made, a dual benefit may be obtained. Not only is the estate reduced by the amount given, the entire estate, both majority and minority interests may be discounted.[137]

## IX. CONCLUSION

Farm and ranch operations historically have been family businesses with the business life cycle paralleling the adult life cycle

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130. Treas. Reg. § 301.7701-4(b) (1960).
131. Treas. Reg. § 301.7701-3(b) (1960).
132. CODE §§ 541-47. Note, however, that income from crop sharing arrangements involving corporate owned agricultural real estate which arrangements include provisions for the material participation by the corporate owner in the manner of cultivation and use of the realty is not considered personal holding company income. Commissioner v. Webster Corp., 240 F.2d 164 (2d Cir. 1957). Neither are Soil Bank Act payments as part of the rent received under a crop sharing arrangement considered personal holding company income as long as the lessor corporation participates in a significant way in the farming decisions. Rev. Rul. 67-423, 1967-2 CUM. BULL. 221.
133. CODE §§ 531-37.
134. *See* note 104, Part VI, B, 1 *supra*.
135. *See* Part VI, B, 1 *supra*.
136. *See* note 102 *supra*.
137. *See* note 104 *supra*.

of the owner-operator. The operation is usually characterized by intensive use of available capital resulting in a low income to asset ratio and low liquidity. The farm and ranch business operation, although advanced technically, has not generally made use of complex or sophisticated business, management or financial techniques. For the most part, this is the result of economies of scale and business attitudes.

The basic economic elements (land, production assets and working capital) have dominated farm and ranch economies with the owner-operator receiving notice primarily for his labor and only occasionally for his business acumen. A change in the nature of the business structure could salvage this element to the benefit of the operator as well as society generally. Likewise, farming and ranching have not made use of equity financing which could free them, in certain cases, from the problems of inadequate capital, pressures due to economic cycles, and increase their ability to bargain and compete in the financial world.

By using more sophisticated business forms, many of the difficult problems encountered in estate planning could be solved while reconciling the needs of the heirs returning to the farm or ranch and those entering other endeavors. To meet these objectives, it is often advisable to place the real estate in one entity, an investment entity, and to transfer the other production assets to an operating entity. The former can serve as the primary vehicle for estate planing purposes and the latter can provide continuity to the ongoing family business.