

FAQ 13

How Do I Bring My Son or Daughter into the Family Farm Operation?

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Purdue Extension conducts an annual mid-winter “Farming Together” workshop that addresses this question directly. Contact Alan Miller at (765)494-4203 or millerwa@purdue.edu for more information.

Gerry Harrison, Department of Agricultural Economics, has developed an extensive set of resource materials on estate planning and legal issues in agriculture. Contact him at (765)494-4216 or <harrisog@purdue.edu> for more information.

Resources for Bringing the Next Generation into the Family Farm Operation

Resources	Sources
<i>Transferring the Farm</i> fact sheet series	http://www.extension.iastate.edu/pubs/Pm1474A.pdf
<i>Two Generation Farming</i> series (PM 1474a, b, c, d). Iowa State University.	1-800-876-8636 or http://www.extension.umn.edu/distribution/businessmanagement/DF6317.html
“Farm Succession Planning Steps and Checklist”	http://www.omafra.gov.on.ca/english/busdev/facts/04-085.htm
Ag Executive. Company offering newsletters on farm estate and business planning.	http://www.agexecutive.com

Date Prepared: April 2002

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Consider the three following possibilities:¹

- 1) The Spin-off Arrangement – At the core of spin-off arrangement is the intent to have two separate operations. Father provides resources such as machinery to the son's fledgling business. Son usually works on Dad's farm in return. This arrangement is essentially a joint venture where capital and labor are shared, but generally not profit or loss. The son may or may not be compensated by the father's operation given the other value changing hands between the father and son.
- 2) The Landlord-Tenant Arrangement – At the core of this arrangement is usually a desire by the father to reduce his involvement in farming and to hand over the reins to the son. Ultimately the goal is to end up with one operation managed by the son. This arrangement may involve a seasoning period where the son is compensated for labor and management, but has no capital and profits interest in the business. That is generally followed by a period where the son rents productive assets from dad and takes over renting other assets that dad had previously rented. This arrangement oftentimes involves a sale of certain business assets, such as the farm machinery from father to son, perhaps on an installment by a sale of selected assets such as machinery to the son. Or those assets may be gifted to the son over a period of time.
- 3) The Super Firm Arrangement – This arrangement combines the resources of father and son to produce one business entity in which both father and son share profits and losses. The arrangement may involve one or more formal business entities, and oftentimes has elements of the landlord-tenant arrangement as well. Generally, the forms of business organization will include partnerships and corporations, but not sole proprietorships. The super firm is characterized by intent to combine forces at all levels (employment, management, ownership), on an on-going basis. It oftentimes starts very similarly to the landlord-tenant arrangement, in that the son may first work solely as an employee or manager. It may also involve sales or gifts of capital interests in order to establish the son's ownership interest in the farm.

Any family business arrangement should provide the opportunity for the new generation of managers to build their management skills and to increase both their responsibility and authority. One advantage of the spin-off is that it has an inherent management development plan, because the son is thrown immediately into the role of risk-taker and decision maker from the beginning, even if the amount at stake starts out small. Generally, management development has to be carefully designed into the super firm arrangement.

Every family business arrangement must provide mechanisms that allow participants to change direction including increasing their ownership and exiting the business and to do that without causing major disruption. This is critically important for anyone considering a super firm arrangement.

Anticipating disruptive events and providing mechanisms for dealing with them if and when they occur is an important activity when planning for any major change in the business. Taking on a new business partner, even when it is your son or daughter, is a major change that demands careful planning.

Communication and respect are the cornerstones of any successful family business arrangement. Start the communication process early and stay at it. It is natural

¹ Adapted from Farm Estate and Business Planning by Neil Harl.

that people's values differ and those differences will show themselves in a family business in one way or another. So why not get them out on the table right up front during the planning process? Anytime you enter into a family business arrangement, make sure you know your new business partner well. If either father or son is hesitant to share information or to discuss important issues, look out. One very useful way to get a glimpse of the future for the partners is to develop strategic and operational plans for the new farm business.

It is extremely important before start-up to evaluate the impact of the new entrant to the business on the size of the business. If you divide the present volume of business in half by bringing in your son or daughter, will it still be big enough to make either of you a living? What additional resources and income will the new entrant bring to the business? These are critical questions for many new father-son farming operations and can provide the stimulus for productive communications.

Compensation of the new generation of managers should be based on their fair market value in the marketplace. Don't expect anybody, especially your own children, to be willing to work for less than they are worth for an extended period of time. However, you should take the nature of the work (and the attendant level or responsibility) that they are expected to do on the farm into account when determining the level of compensation. Develop a position description for your new partner. Compensation in the form of interests in the business should have immediacy. That is, don't expect children to work on the farm for the promise of an interest in the farm (or even the whole farm) at some unspecified time in the future.

Compensation should be based on labor and management contributions and performance. Separating participation in ownership from participation in labor and management, at least for compensation planning purposes, is a prerequisite to establishing fair compensation.

Some family farms are so highly capitalized that it may be unrealistic to expect the next generation to ever be able to purchase the farm from their parents outright. In such instances, consider severing the operating business from much of the farm's total asset base. This is a useful technique for putting the son or daughter in a position to buy a large enough capital and profits interest in the business to make the purchase worthwhile.

Expert legal and tax counsel are a necessity when planning for a change in the family business. Don't find out after the fact that you did it wrong. Invest time and effort in exploring your alternatives. Business management planners, farm management educators, and farming colleagues can all be useful sources of ideas and experience with what works and what does not work. Do your homework on this question. You'll be glad you did.

One should also think about the potential for giving off-farm family members an opportunity to participate in the farm as investors. Business entities, such as Limited Liability Companies, make it very possible to separate business interests that are merely investments from business interests that involve control over the farm operation, which allows the off-farm heir to be involved as an investor in the farm without being involved in the day to day management of the operation.

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