One of the most challenging issues in farm and ranch estate planning is how to treat farm heirs versus non-farm heirs. In the typical situation, one or more children come back to the farm or ranch to operate it when Mom and Dad retire. These are the on-farm heirs. The other siblings are the off-farm heirs.

Mom and Dad have two somewhat conflicting estate planning challenges: they want the family farm or ranch to continue operation in the family, and they also want to treat all their kids “fairly.” Giving equal shares of the farm/ranch to all the kids may make it difficult for the on-farm heir to continue to operate the farm or ranch. Giving the lion’s share of the estate to the on-farm heir may be (or at least seem) unfair to the off-farm kids. What to do?

There is also the challenge of the perception of differences between off-farm and on-farm sibs as to their contribution to the operation. The on-farm sib typically considers their sweat equity and contributions to management as key to the farm’s success. The off-farm sib(s) typically recognize the labor over years, but have a lower overall perceived value of the on-farm sib’s contribution.

Retired Iowa State University agricultural law professor Neil Harl has developed an approach that tries to balance the competing interests of keeping the farm or ranch operating into the next generation and treating each child more or less equally. Here is the Harl approach:

1. **Compensate the on-farm heir realistically for coming back to the farm or ranch.** Many parents under-compensate the on-farm heir (1) to reduce farm expenses and (2) with the expectation that the on-farm heir will be “caught up” when he or she inherits the farm. If the “catch-up” isn’t an explicit part of the estate plan, catching up won’t happen. Dr. Harl says “never close a year with deliberate under compensation of anyone.” The under compensation can be remedied e.g. by transferring an extra interest in the farm to the on-farm heir reflecting how much they were undercompensated that year. If this has been going on for a while, you need to be sure the books get balanced no later than when Mom and Dad retire.

   Undercompensating the on-farm heir can lead to problems down the road. First, this makes it more difficult to leave enough of the farm or ranch to the on-farm heir that they can make a go of it financially when Mom and Dad are gone. Second, unless the catch-up payment is taken care of before Mom and Dad are gone, it needs to be clearly explained to the family why the on-farm heir gets more from the estate than the other kids. If it isn’t explained, the apparent unfairness can lead to family turmoil.

2. **Rent the land from the siblings.** One way to see that all the kids get something of significant financial value from the farm or ranch is to divide the farm or ranch into two parts: a “production entity” owned by Mom, Dad and the on-farm heir, and a “land owning” entity owned by the kids. The production entity would own the equipment, livestock,
buildings, etc. used to produce crops and/or livestock. The land entity would own the land. This means the operating heir would rent the land from him/herself and his/her siblings. The shares could be equal shares or the on-farm heir could have a larger share of the land owning entity. I would recommend a rent formula that gives the operating heir a good chance to keep the farm or ranch profitable if prudently operated, and that would also give the off-farm heirs an opportunity to share in the operation’s profitability in good years.

One note of caution: be careful of the sweetheart deals. These deals can involve some very low values being placed on equipment, land, or leases that is typically being sold or transferred from the older to younger generation. In some cases, the values assigned are justified, and in some cases they are too good of a deal to be equitable to others in the family.

3. Give all the kids a way to get out if they want to. Some sort of buy-sell agreement should be part of the land-owning entity so that if off-farm kids (or the on-farm kids) want out the others will buy them out. Harl suggests a 15-20 year buy-out term to make the buy-out financially manageable for the on-farm heir (who is buying out the sibling that wants out). There are IRS rules regarding allowable interest rates and valuation methods but these can be used to develop a buy-out formula. Assuming it is important to Mom and Dad that the farm stay in the family, it is legitimate to use a formula that does not guarantee the off-farm heirs the maximum price for their share of the land. Agricultural land values fluctuate significantly, just as crop and livestock prices do, and no one is entitled to the maximum price possible.

4. Family communication is key. When Mom and Dad decide what they are going to do, they need to explain it to all the kids—what they are doing and why they are doing it. It may not be a happy conversation but hopefully all the kids will eventually see it as being reasonably fair in the long run.

There is no easy way to deal with the issue of fairness to children in estate planning. The Harl model is one approach, and as a minimum provides food for thought in working through this issue yourself.

Reference

http://www.extension.iastate.edu/agdm/articles/harl/HarlOct12.html