Two-Generation Farming

Step 1: Getting Started

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Understanding the situation

Below are factors you should consider before selecting and developing a business transfer agreement. By carefully evaluating these factors, you increase your chances of successfully creating a two-generation business agreement.

Dynamic industry

Farming is changing rapidly. Farms are not only getting larger but more specialized. Farms of the future will be producing products for specialized markets and using technologies not yet developed.

Business transfer arrangements serve two roles:

• **Business Transfer Between Generations.** Business transfer arrangements have traditionally been used to transfer the business from one generation to the next. The business agreement is the vehicle for transferring ownership, management, and income between generations. This is extremely important for successful two-generation farming arrangements.

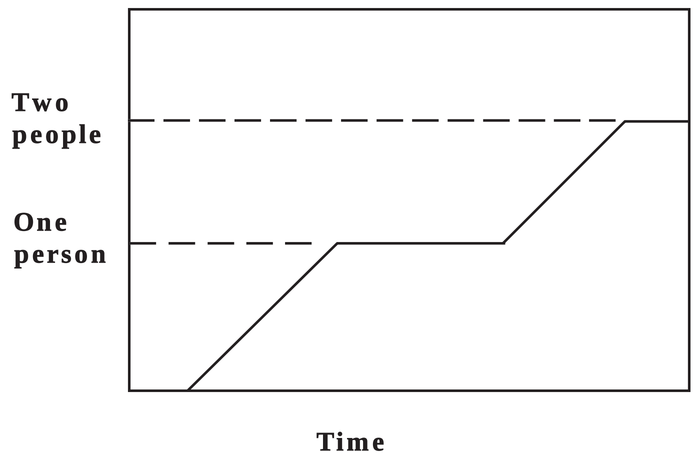
• **Strategic and Business Plans.** Astute managers try to anticipate future directions of the agricultural indus-try. To take advantage of these new directions, managers must make changes in their businesses. This is called a strategic plan. These business changes (strategic plan) are implemented with the use of a business plan. Put a different way, a strategic plan addresses, "*Where is the business going?*", and the business plan addresses, "*How will the business get there.*" To be successful, the business transfer arrangement should be coordinated with and become an integral part of the overall strategic plan and business plan.

Business expansion

Most farm businesses were developed to be one-person operations. Farm businesses were expanded until the farmer was fully employed or until management skills were fully utilized. Farmers usually would not consider expanding further by employing full-time hired labor. Farmers would often say, "*I've got about as much as I can handle now*."

Because most farm businesses are one-person operations, they need to be expanded when a young person returns to the business as shown in the chart. The farm must be large enough to utilize the labor and management of both generations and provide sufficient income for them.

Business Growth Curve



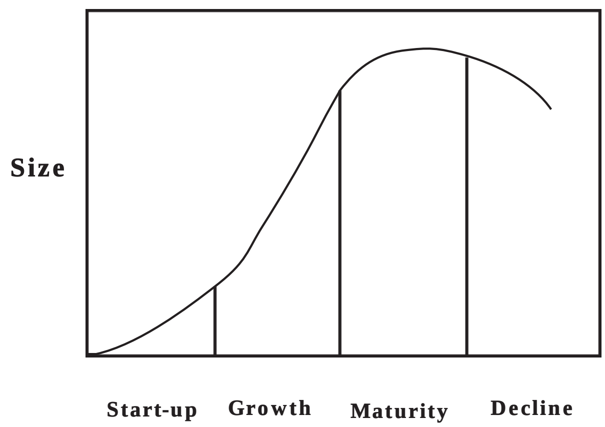
The expansion can occur quickly and easily if the young person brings sufficient assets expansion. However, the younger generation often has limited assets. So, business expansion requires utilizing the older party's assets. If the older party does not have sufficient assets, expansion must occur by borrowing or renting.

After years of reducing business debt, the older party may be thrust back into high debt levels when a young person returns to the farm. The older party should carefully consider whether they want to financially jeopardize the farm business and their retirement income by expanding with borrowed money. Even if the expansion and debt repayment go as planned, it may add stress and worry to the older partys' lives.

Business life cycle

Farm businesses go through a relatively predictable life cycle. The business life cycle often parallels the managers life cycle. Below are the stages of the business cycle.

Business Life Cycle



• **Start-up** — In this stage the manager attempts to assemble sufficient assets to start a viable business. During this period the fledgling business is vulnerable to failure and income is tight. The manager is often short of capital and know-how but possesses lots of enthusiasm.

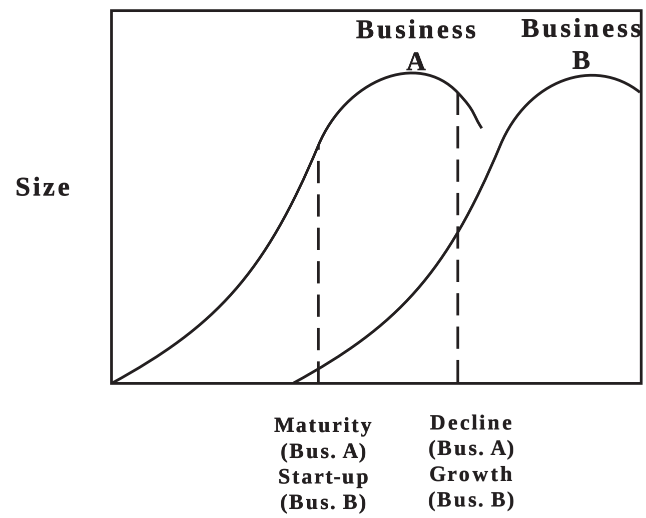
• **Growth** — During this period the business tends to expand rapidly in terms of acres of crops, head of livestock, or number of enterprises. The manager's skills develop. However, lack of capital may limit growth during this period.

• **Maturity** — During the maturity stage the manager has reached full employment and the size of the business stabilizes. This is often a period of good profits and excess capital. Also, the manager often has highly developed management skills, and concentrates on improving efficiency.

• **Decline** — During this period the manager begins to wind-down the business. Rather than making new investments, the manager utilizes current machinery and facilities until retirement. Surplus capital often exists but labor may be in short supply. Non-business goals receive higher priority.

By working together, the businesses of both the older party and the younger party can complement each other and maintain each of the businesses at a higher level of productivity and income generation. As shown in the second chart, when the older party's business is in the maturity stage, the younger party's business is often in the start-up stage. Also, when the older party's business is in the decline stage, the younger party's business is often in the growth stage.

Business Life Cycle



By farming together, the older party's business during the maturity and decline stages can provide capital and management skill for the younger party's business during the start-up and growth stages. Likewise, the younger party during the start-up and growth stages can provide labor for the older party's business during the maturity and decline stages.

Specialization with diversification

Multi-family operations can allow for specialized management while capturing the synergistic advantages of diversification. An example would be an operation with crop production, hog production, and beef production enterprises. One manager would specialize in crop production, another in hog production, while the third would be in beef production. Under this arrangement, there will be a tendancy to expand each enterprise to the level that one manager can effectively handle. Synergies, gained by combining enterprises such as hog and crop production, are obtained. The advantages of specialization, as well as diversification, are achieved within one operation.

Some multi-family arrangements are designed to coordinate activities. For example, one family manages a farrowing operation that provides feeder pigs to another family that manages a finishing operation. This may be preferable and more profitable than both families co-managing one large farrow-to-finish operation. Under this arrangement, the two operations could be located in different parts of the county, or even different parts of the state.

Planning your future

A key to the success of a two-generation business arrangement is a common understanding of where the business is going and what it will accomplish. If the parties involved have different ideas about the future of the business, the business arrangement may fail.

Many farm families have little idea of what they want to accomplish when the young person comes into the business. So they muddle through from day-to-day and year-to-year with little sense of direction of where they are going.

Where are you going?

Planning the future of a two-generation business arrangement is similar to planning a family trip. Plans for a family trip include short-term decisions such as *what you are going to do the first day* and *where you are going to stay the first night*. But long-term plans, including decisions such as *what is your final destination* and *how long it will take to get there*, also are needed.

When most farm families begin their journey of farming together, they usually have no long-range plans of *where they are going, how they will get there*, and *how much time it will take*. Instead, they focus on the initial problem of starting the young person in the business and leave the overall destination of the business arrangement to chance.

Are you all going together?

For a family trip to be successful, the family members must agree on where they are going and what they will do. When they arrive, however, each member usually has a different idea of what to see and do. If the desires of each member are not taken into account in planning the trip, the trip will not be successful.

For a two-generation business arrangement to be successful, the parties involved must agree on the future direction of the business. All parties involved must share a common vision of their future together in farming.

Your vision of the future

What are your goals and objectives for the future? Goals are broad and general statements of what you want to achieve. Objectives are precise and quantifiable measures of how you will achieve the goals. For example, the parent's goal may be to transfer ownership of the business to the younger person. Their objective may be to have 50 percent of the machinery ownership transferred within two years.

Goals

Most farm families have no formal goals . Rather they have vague, verbal ones that are not ranked by priority. Some farm families have written goals. But these are often not the ***real*** (personal and unwritten) goals of the family members.

You need to identify your goals both individually and collectively. Take some time to sit down and identify them. Write them down.

First identify your goals individually. Next, divide the family into three groups:
- the parents
- the farming children, and
- the off-farm children.

Within each of these groups, goals should be compared and examined.

Finally, the family should come together and share, compare, and re-evaluate their goals. See if there are any conflicting goals held by any of the parties. By communicating goals to each other, you can identify conflicts. If there are conflicts, try to reconcile them before proceeding.

A listing of potential goals are listed below. This is not a comprehensive list. You may have some that are not listed here.

Parents' (older party) goals

- Slow down, devote more time to travel and leisure.
- Turn over the business to the children.
- Maintain some involvement in the business.
- Protect against the breakup of the business.
- Treat all children equitably.
- Receive adequate retirement income.
- Retain sufficient business assets as security for unexpected retirement expenses.
- Minimize estate and income taxes.

Farming (younger party) child's goals

- Receive adequate income.
- Buy into the business.
- Participate in management.
- Gain control of the business over time.
- Increase the size or change the direction of the business.
- Incorporate new technology.
- Build personal equity.

Non-farm child's goals

- Inherit an equitable share of the parents' estate.
- Receive an equitable return on investment by remaining involved in the farm business.
- Participate in management if still involved in the business.
- Sell equity in the farm business to get money for other uses.

All family members' goals

- Maintain and improve the viability of the family business.
- Have and enjoy a pleasant family and home life.
- Have friends and enjoy good times with them.
- Do things that are new and exciting.
- Engage in community activities.
- Pursue a favorite hobby or sport.

Objectives

Objectives are measurements to determine if you achieve your goals. First you need to decide if achieving each goal is worth the time and effort. If so, follow these rules for developing objectives for achieving each goal.

- Be specific and positive.
- Set dates for accomplishing each objective.
- List obstacles for achieving each objective.
- List ways to overcome each obstacle.
- List rewards for achieving each objective.

Making it fair

Another aspect of business planning is to consider how each family member will be treated. Parents are often concerned about the fair treatment of each child. However, people differ as to what they consider fair. Some feel that each child is entitled to an equal share of the family assets. Others believe that the farming child should receive special consideration. Only the parties involved can determine what is fair in a given situation.

Is equal equitable?

Equal is not always equitable. The equal division of business property among farming and non-farming children may not lead to the equitable division that was planned. For example, if the farming child helped build the business, he/she may be entitled to a larger share of the business assets.

How much compensation?

After the parents have defined what they mean by equitable, they face the problem of how to actually divide the assets. For example, if all children are to be treated equally, and one child is given a certain piece of property, how much compensation should be given to the other children? Or, if one child has the use of a certain asset, how do the parents compensate the other children?

One method is to value the asset (or value the annual use of the asset) as if it were an arms-length transaction with a non-family member. The difference between the arms-length value and the preferential value to a child will determine the amount of compensation to each of the other children.

For example, assume you have decided to treat the farming and non-farming children equally. However, you are renting the farm to the farming child at a preferential rental rate. The amount of compensation to each of the non-farming children is the difference between the preferential rental rate and the *going* market arms-length rental rate.

Critical Success Factors

Before beginning any type of two-generation business arrangement, the parties involved should examine their situation carefully and make a preliminary judgment of their potential for developing a successful two-generation farming operation.

The following discussion is designed to help you analyze your situation. Below are *critical success factors* for determining the success of your two-generation farming operation. An honest evaluation of the following questions can help you assess your chances of farming together successfully.

- Are the parents ready for a partner?
- Is the younger party committed to farming?
- Does the family have a common vision of where they are going and what they want to accomplish?
- Is the farm large enough?
- Can you live and work together?
- Are there non-farming children and how will they be treated?

A discussion of each of these questions follows.

Are the parents ready for a partner?

Are the parents ready to bring a new person or family into the business and begin turning over management, control, ownership, and income? Parents are often delighted at the prospect of sharing the workload. But this new person is not a *hired hand*. After years of *calling the shots*, they are faced with the prospect of sharing control and management decisions. Also, because the business income is now shared, they may have to lower their standard of living.

Parents often want their son or daughter to return to the business so that the grandchildren will be nearby. But if you aren't ready to share the business and consider making changes, you probably aren't ready for a partner.

Is the younger party committed?

Is this an *I'll give it a try* situation? Or is the younger party firmly committed to farming. Is the younger party married? If so, does the spouse like farm life? If he/she is not married, exercise caution, as you do not know who all the future parties will be. There is always a chance a new spouse may not like farm life.

If there is some doubt regarding the younger party's commitment to farming, you should probably avoid getting into a partnership, corporation, or other business arrangement where there is co-ownership of property. A testing stage where you operate under an employer/employee arrangement would be easier to terminate.

What is your future together?

What do you want to accomplish with your business and business arrangement? Is your vision for the business consistent with that of the other family members? Only after a careful examination of each party's goals can a family begin to formulate a common vision of how the business will look in the future. The collective goals of all the parties will guide the family in developing the business, and the proper process and business arrangement for transferring the business.

Spend time defining your goals and discuss them with other family members. If any conflicts in goals arise, now is the time to reconcile the differences.

Is the business large enough?

No matter how well the parties get along personally, a two-generation business arrangement may not succeed if the business earnings are inadequate or the business is financially unsound. The business must provide the parents with a desired level of living as well as provide for their economic security during retirement years. In addition, it should meet the younger person's living needs as well as permit adequate debt servicing and growth in business equity. Income the parties receive from outside the business also may be considered, such as off-farm investments and off-farm employment. Often some financial subsidies from the older party to the younger party is required, which may place additional stress on their financial position.

If there is any question regarding the adequacy or soundness of your financial situation, now is the time to contact your accountant, lender, or management consultant, and take a realistic look at the economic and financial feasibility of developing a two-generation farming arrangement.

Can you work together?

People relationships are critical to the success of any two-generation business arrangement, both in a family and non-family setting. If the people dimension is not right, then you should probably go your separate ways. Make a careful evaluation of your *people situation*.

Personal relationships

All parties need to be tolerant, understanding, and have the ability to overlook each others' faults. A business arrangement works best if the parties and families work together in a spirit of harmony and cooperation. In addition, mutual respect between the parties is important Problems can arise as to housing, spendable income, labor commitments, and life styles.

Business relationships

All parties should work towards similar goals to make the business succeed. When goals and values differ, care must be taken to arrive at a reasonable compromise. Joint participation in managerial decisions is another *must* if a two-generation arrangement is to succeed. Often a good arrangement consists of people who have different skills that complement each other, rather than people whose skills are too much alike.

How about other family members?

Usually a major concern of the young person is how to eventually gain managerial and financial control of the business. The magnitude of this concern depends on the nature and size of the business, the number of heirs involved, and the number of years before the parents' retirement.

You should recognize that another prime goal of the family is the maintenance of overall family goodwill. Plans should provide for the fair and equitable treatment of other heirs and the financial security of the parents. Agreements that unduly favor one family member should be avoided. Good communication among all family members is essential, particularly when arrangements are being changed or concessions made.

Giving it a try

One of the best ways to find out if you have a situation that will flourish in a two-generation arrangement is to farm together. A *testing* arrangement before entering into a more permanent business structure is advisable. If you have not tried to farm together, or have done so only on a limited basis, it is best that you spend some time testing this ability — perhaps two to three years.

The transfer process

The transfer process involves transferring the business from the older party to the younger party. An overview of the process is discussed below. Specific methods of transferring ownership and management and dividing income are described in the following sections.

This process involves the transfer of the ownership and management of the business, and the division of business income. A transfer plan that considers only one or two of the elements and not the third may lead to problems. For example, a young person who takes over management of the business and receives an equitable share of the income, but is not allowed to own any property, may become frustrated about not building personal net worth. More commonly, a young person who is not allowed to participate in management decisions or is continued on a wage basis too long may become resentful and impatient.

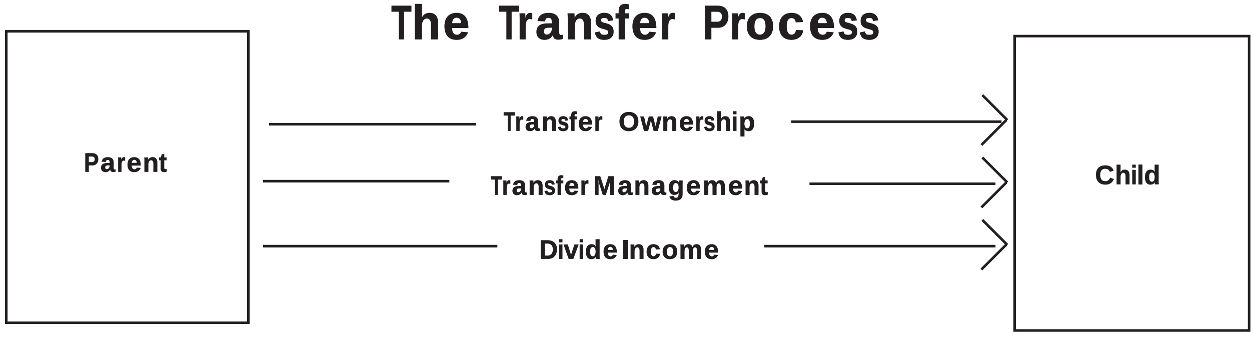
A dynamic process

Transferring the business to a young person is a dynamic process. The process begins when he/she comes into the business and ends when the older party leaves the business. More than one type of business arrangement is usually used during the transfer process. It may begin with the young person receiving a wage and end when he/she rents the farm from the older party. Any specific business agreement should be considered as a temporary arrangement that may be as short as one year or as long as a decade or more, depending on the length of the transfer process.

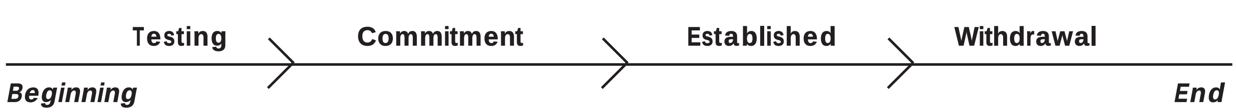
Length of the process

The length of the process often depends on the maturity and technical skills of the younger party and the length of time until the retirement of the older party. If the younger party is mature and understands farming, and the older party is close to retirement, the transfer process may be relatively short. But if the younger party is young and uncertain about his/her future and the older party does not plan to retire for quite some time, the process may take many years. Difficulty may arise if the younger party is ready and able to take over the business but the older person is not ready to retire; or if he/she is ready to retire but the younger person needs several years of nurturing to gain the necessary skills and maturity to run the business.

The Transfer Process



The Transfer Stages



The transfer stages

Most businesses go through four stages in the transfer process: testing, commitment, established, and withdrawal. The business agreement determines how the farm income will be divided, based on the contributions of capital, labor and management by each party. As these change, the type of arrangement or its provisions need to be changed. A more in-depth discussion of business agreements is presented in the second of this series titled, *Two-Generation Farming: Step 2: Selecting a Business Arrangement, Pm-1474b.*

The testing stage

Most families have little experience in operating a business together. It is recommended that they first enter a testing stage — a stage similar to an engagement period in a courtship. The objective is to determine whether the young person really wants to farm and how well the parties can work together.

Wage agreement. Many farm families find the easiest way to begin is with a wage. The wage should be reasonable and the arrangement considered temporary.

Wage-incentive plans. With an incentive, the young person's income depends partly on the success of the business. These plans are often used to motivate a young person to take more interest and responsibility in the business.

The commitment stage

After the young person has made a commitment to farming, he/she begins to contribute personal property and management in addition to labor to the business. This stage includes various *joint operating agreements*, which provide a vehicle for dividing income in *multi-person* arrangements. It also includes *sharing agreements* for use in *spin-off* arrangements.

Enterprise operating agreement. The young person becomes involved in one specific enterprise by furnishing personal property, management, and labor. He/she receives a share of the income from the enterprise but works for a wage on the rest of the operation.

Farm business operating agreement. The young person furnishes a portion of the personal property, labor, and management for the entire operation. He/she receives a share of either gross or net farm income based on his/her business contribution. A sharing of net income may indicate the presence of a partnership.

Labor and machinery sharing agreements. Each party has a separate farming operation, and they share machinery and labor.

The established stage

In this stage, both parties are fully engaged in farming. The young person has acquired sufficient maturity and skills to manage the business. The older party is still fully involved in the business. This stage includes the *corporation* and *partnership* for use in *multi-person* arrangements. In this stage, the *spin-off* arrangement is usually represented by *two separate businesses.*

Corporation. A corporation may be used in a multi-person arrangement. It is useful when there is a large and growing business, and continuity, control, and transfer of the business are key concerns.

Partnership. The general partnership also is used in a multi-person arrangement. It can provide an on-going means of doing business, represent a stepping stone to incorporation, or revert to a sole proprietorship upon the withdrawal of a partner.

Separate businesses. After the young person spins off from the parents' operation, a distinct and separate business is formed. Depending on individual circumstances, the parties may continue to share labor and machinery, or they may be completely separate.

The withdrawal stage

The last transfer stage occurs when the older party withdraws from the business at retirement. They often continue to own the real estate, but provide little or no business personal property, labor, or management.

Lease arrangements. The young person may obtain the use of the older party's business real estate with a lease arrangement. A traditional crop-share, cash, or livestock-share lease can be used.

Corporation. Because a corporation is a separate legal entity, it continues even though the parents withdraw from active participation in the business.

Transferring ownership

The time and method of transferring personal property (i.e., machinery and livestock) from the older party to the younger party should fit within the overall business transfer plan. The transfer of real property (land and buildings) may be influenced by estate planning considerations.

The ownership of farm assets can be transferred by sale or gift during the parents' life, or at death according to the parents' will or under state law if there is no will. Each transfer method has tax consequences, so you should discuss all options with your tax advisor.

Machinery

Various methods of transferring machinery ownership to the young person are presented below. The value of machinery can be determined with an appraisal by either a dealer or an auctioneer.

Sale

Two considerations in a machinery sale are the cash-flow needs of the buyer (younger party) and the income tax consequences to the seller (older party). In an outright sale where a full cash payment is made at the time of sale, taxes resulting from depreciation recapture and capital gains are due in the year of the sale.

With an installment sale, the cash payments are spread over a period of years. However, depreciation recapture and capital gains on depreciable property between related parties are included as taxable income in the year of sale. You may want to check with your tax advisor on the minimum interest rate allowable for tax purposes. An alternative is to sell one machine per year to spread out the depreciation recapture and capital gains.

Ownership may be transferred when the machine is traded. If the new machine is to be owned jointly, the value of the trade-in can count towards the older party's contribution to the new machine. To simplify record keeping for a jointly owned machinery line, the ownership division should be the same for each item (for example, 50-50). An alternative is for each party to own specific machinery items.

Gift

Gifting machinery usually will not trigger income taxes but may have gift tax consequences. With a gifting program, the income tax basis of the machine will transfer from the person giving the property (older person) to the recipient (younger party). A gift tax may be incurred for gifts not covered by the annual gift tax exclusion of $10,000 per recipient. Check with your tax advisor for specifics on your situation.

The equitable treatment of other children is a concern with a gifting program. If a gift is made to the farming child, should a gift of equal value be made to non-farming children?

Leasing

A leasing program may be of value if the young person has limited capital. The size of the lease payment should be based on the cost of owning the machine (depreciation, return on investment, insurance and housing) and may run from 15 percent to 20 percent of the machine's value. A decision should be made on who pays for repairs and major overhauls.

Feed and livestock

Strategies for transferring feed and livestock ownership are discussed below. Often feed and livestock ownership is adjusted to the same percentage as the livestock income is divided.

Breeding livestock

The older party may sell a portion of the breeding herd to the younger party. An installment sale may be used. Also a *roll-over* approach can be used with breeding livestock. The older party continues to own the breeding herd but the offspring is owned jointly with the younger party. When the original breeding animals are sold, the older party receives the income from the cull sale. Subsequently raised replacements are owned jointly.

Feed and market livestock

An ownership interest in the feed and market livestock can be sold or given to the young person. One approach is to transfer ownership at the low point of the feed inventory (just before harvest), or between the sale and subsequent replacement of market livestock. Another alternative is to transfer ownership over two tax years by making transfers at the end of one tax year and the beginning of the next tax year.

Instead of selling the young person an interest in the market livestock on hand, the livestock can be *inventoried*. When the livestock is subsequently sold, the original owner (older party) will receive the *inventory* value of the livestock with the remaining proceeds divided between both parties. Be careful that the use of the inventory concept does not change income tax reporting.

Land

Land can be transferred during life by sale or gift, or at death. Often land is held by the older party until death, although a building site may be transferred earlier.

Transfer by sale

Land can be sold to the young person. The two major options are the cash sale and the installment sale, although other options such as the private annuity exist. A cash sale may not automatically reduce estate and inheritance tax liability because the sale proceeds may be taxed in the estate at the eventual death of the parents.

An installment sale can be used to spread the sale proceeds over several years with the original owner (older party) using the annual payments for living expenses. However, periods of inflation will reduce the real value of the fixed annual payments and, over a period of years, may substantially shrink the purchasing power of their income. Conversely, during a period of deflation the real value of the annual payments will increase, which may place a financial hardship on the buyer (younger party). Also, because the term of the contract is a fixed number of years, the seller (older party) may outlive the income stream.

Transfer by gift

Land can be given to the children. Each person (donor) can give up to $10,000 of property each year to each of as many people as he/she would like, with no gift tax due. Together, a husband and wife can give $20,000 each year, even though the property is owned by only one of them. A substantial amount of land can be transferred if there are several recipients. Remember, with a gift the parents give up ownership of the property. So if income from the property is needed to cover living expenses, or if the property is needed as security during retirement, a gift program should not be used.

Transfer by will

Land is often transferred at death according to the decedent's will. Transferring land at death allows the parents to use the property and receive income from it all through retirement. The major taxes assessed on property passing at death are the Federal Estate Tax and the Iowa Inheritance Tax. No Federal Estate Tax is due on taxable estates of $625,000 for 1998 (increasing to $1,000,000 by 2006 and thereafter), assuming none of the unified credit was used previously.

The Iowa Inheritance Tax is assessed on property passing to each heir. Property passing to children (including adopted children and biological children), stepchildren, and other linear descendents is not subject to tax. For a brother or sister, son-in law or daughter-in-law, there are no exemptions, and the tax starts at five percent and runs up to 10 person. For a non-related person, there are no exemptions, and the tax ranges from 10 to 15 percent. Attorney's fees and other estate settlement costs are also due.

Transfers at death may be eligible for *Special Use Valuation* and the *15-year Installment Payment* of Federal Estate Tax.

Income tax considerations

The method used to transfer land will greatly affect income tax liability. This is especially true of land with a low income tax basis. If the land is transferred by sale, the seller (older party) pays income tax on the amount of gain between the tax basis and the sale value of the property. The buyer (younger party) receives the property with a new basis equal to the purchase price. If the land is transferred by gift, the parents pay no income tax and the child takes over the parents' tax basis. If the property is passed at death, the parents pay no income tax on the gain and the child receives the property with a new tax basis equal to the federal estate tax value (usually the fair market value) in the estate. The gain on the difference between the original tax basis and the market value at death is not taxed. Obviously, there is often a substantial income tax advantage of transferring land and other property at death compared to transfers during life.

Transferring management

A successful two-generation business arrangement depends on the smooth transfer of management. Below are some approaches to help you make this transition.

For a business arrangement to succeed, participation in management by both parties is important. The younger party should be given an increasingly important role in management. This transfer will not occur if the parent always *pulls rank* or persists in saying "*I decide*" rather than "*we decide*."

While the parental objectives of *taking things easier* and eventually turning over control of the business are honorable ones, too often a hidden objective is present. *Taking things easier* often means the young person does much of the hard physical labor, while the parents continue doing all the planning and decision making. Also, *eventually turning over the business* often means training the young person until he/she thinks pretty much the same way the parents do.

A young person often comes into the business wanting to contribute his/her knowledge. However, his/her ideas are often subject to questioning by the parents, and friction develops. Soon the parties assume traditional child-parent roles. The parents give decrees and try to discipline the young person. The young person becomes rebellious and resentful at being treated like a minor child.

Both parties must realize that initially the young person is going to make his/her share of management mistakes. One of the objectives of the business arrangement is to provide a *training ground* for developing the young person's management expertise.

Goals and objectives

Management decision-making is the way in which goals and objectives are achieved. Therefore, it is important that family members reach consensus on the relevant business goals and objectives. Otherwise business decisions will be in conflict.

For example, the farming child may want to have the largest farm unit in the county, but the parents' goal may be to eliminate all farm debt. So, conflicting management decisions are occurring. However, the conflict is not with the management decisions, but rather with the incompatibility of the goals. Once the parties reach consensus on business goals, the management conflict should disappear. It may be helpful to establish a time each week or month, depending on family needs, for discussions of business affairs, goals, and objectives.

Decision-making authority

The key is to find a decision-making structure that develops the younger party's management ability while protecting the parent's financial interest and desire for control. Two general structures are presented below.

General manager

With this approach, one party has final authority (general manager). Logically this may be the older party. Both parties have responsibility for on-going operating decisions. The young person is involved in major decisions, but the final authority rests with the older party. This provides a managerial learning process for the young person by placing him/her in a position to make on-going operating decisions while being involved in overall decisions. This approach works best in the early stages of a two-generation arrangement. As the young person gains management skills, the role of the general manager can be decreased, transferred to the young person, or modified.

Equal voice

Another approach is to give each party an equal voice in decision making, but with a provision for final authority if there is disagreement. Methods of final authority could be:

- vote by all parties;
- vote weighted by size of capital contributions;
- one party given final authority; or,
- outside arbitration.

Each party should understand how the final authority mechanism works in resolving disputes. Ideally, few disputes should ever reach the final authority process. With this method, both parties are more involved in decision making than with the general manager method. This approach often works best in the middle or later stages of a two-generation arrangement.

Division of management responsibility

Many business arrangements are more effective if the daily management responsibilities are divided between the parties. This will result in management specialization which may cause better and more informed decisions to be made. The division may be based on individual interests and skills. Dividing management responsibilities reduces disagreements between the parties and promotes the development of the young person's management skills. Overall decision-making can be accomplished with one of the methods discussed above.

Enterprise division

One party may be given management responsibility over the cropping program while the other is given responsibility over the livestock program. Each party can make operating decisions as long as they conform to the overall objectives of the business. Decisions of major importance or decisions affecting the overall business would need to be approved by all parties.

Functional division

The division of management responsibilities can be based on business functions such as marketing, finance, or production. For example, a party with interest in record keeping and computers may be given financial management responsibilities, while the other party may have the responsibility for marketing decisions. The parties must communicate these decisions to each other. Any decisions that directly affect both functions can be made jointly. For example, the marketing decision of selling grain affects the financial cash flow of the business.

Management styles

People have different management styles because they have different personalities. Some managers are analytical and like detail (such as record keeping). Others rely on strong interpersonal skills and are good at networking and team building. Still others are drivers and enjoy competition and risk-taking.

Examine your management style and the styles of the other parties in the business. What are their strengths and weaknesses? A two-generation arrangement may be more successful if the parties have different management styles. Managers with different styles often complement each other and compensate for the other's weaknesses. For example, an analytical decision maker may get too involved in facts and details and not seek the advice of other family members. Conversely, a manager with strong personal skills may be overly concerned about the needs of individuals and have difficulty making decisions that are in the best interest of the business. However, in certain situations, the parties may have management styles that clash.

Withdrawing from management

Every two-generation arrangement reaches the stage where the older party withdraws from active management of the business. This is often a difficult stage for them. It is important that it progress smoothly. The young person may facilitate the transition by asking the older party for advice on management decisions.

Dividing income

An important step in developing an arrangement is to determine how income will be shared between the two generations. Below are methods to help you divide the business income between the parties in an equitable manner.

The transfer of business ownership or control results in a transfer of business income. For example, by transferring business assets to the young person, the business income generated from these assets also is transferred to them. The income is usually in the form of rental income or a share of the business income. If the young person contributes labor to the business, he/she receives either a wage or a share of the business income as compensation.

In the early stages of a two-generation arrangement, the young person usually has little ownership and control, so his/her income may be relatively small. In some cases, parents may need to subsidize the young person's income through a gift. Gifts can result from an outright transfer of money, paying the young person an abnormally high return on business assets, or paying an abnormally high wage. As the arrangement progresses, and the young person gains a larger share of the control and ownership, his/her income also will grow. At this time the older party may need to be certain they retain sufficient ownership and control to maintain an adequate income for themselves.

The sharing arrangement should be reviewed periodically. If the ownership pattern or labor and management contributions change, the income sharing arrangement should be updated to reflect these changes. A common mistake and source of conflict in two-generation farming arrangements is the failure to keep income sharing agreements current and accurate.

The two common income sharing models are:

- **Contributions model** — the value of each party's contribution is the basis for dividing gross income.
- **50/50 model** — a return is paid for each party's contribution and any profits (losses) are shared equally.

Contributions model

The first step in developing the contributions model is to calculate the annual value of each party's contribution of real estate, personal property, labor, and management. Gross income and possibly some of the production expenses are then shared in the same proportion as each party's respective contribution of resources. Ownership shares of the inventory of feed and livestock are often adjusted to reflect the same proportion.

Example

In the example below, the annual value of the older party's contribution is $72,000, or 75 percent of the total. The young person contributes 25 percent, or $24,000. Note that the land contributions of $40,000 and the machinery contribution of $12,000 represent the annual ownership costs or rental value of these assets, not their sale or market value.

Contributions

	Older Party	Younger Party	Total
Land	$40,000		$40,000
Machinery	12,000	$3,000	15,000
Labor	14,000	16,000	30,000
Management	6,000	5,000	11,000
Total	$72,000	$24,000	$96,000

Older party's share = $\frac{72{,}000}{96{,}000}$ = 75%

Younger party's share = $\frac{24{,}000}{96{,}000}$ = 25%

The older party receives 75 percent of the gross cash receipts and pays 75 percent of certain production expenses. They also pay the expenses and debt payments on their individual assets contributed to the business. The younger party receives 25 percent of the gross cash receipts, pays 25 percent of certain production expenses, and pays the expenses and debt payments on his/her individual assets contributed to the business. As shown in the example, the older party receives a net cash flow of $49,000 and the young person receives $26,500 from the business.

Cash flow

	Older Party	Younger Party	Total
Gross income	$132,000	$44,000	$176,000
Prod. expenses	- 48,000	- 16,000	- 64,000
Net return	$84,000	$28,000	$112,000
Land taxes	$- 8,000		$- 8,000
Land debt	- 25,000		- 25,000
Machinery debt	- 2,000	$- 1,500	- 3,500
Net cash flow	$49,000	$26,500	$75,500

The contributions model is often used as a transitional step between a wage arrangement and a partnership or corporation. It is commonly of short duration and the relative contribution shares may change frequently. This model is used in developing several types of agreements such as an *enterprise operating* or *farm business operating agreement*. Bookkeeping may be more complex because the relative contributions of each party will change over time, requiring a change in the agreement.

50/50 model

In the 50/50 model, the contributions of land, personal property, labor, and management are paid a return similar to a rental arrangement or a wage. The remaining net returns or profits are shared equally between the two parties. To simplify record keeping, feed and livestock inventories are often owned on a 50/50 basis.

Example

In the following example, net business income of $112,000 is computed by subtracting the business expenses from the gross income. Next a return (rental fee or wage) is paid to each party for the use of land, machinery, labor, and management. The remaining $16,000 of profit is divided equally between the two parties.

Income and expenses

Gross income	$176,000
Production expenses	- 64,000
Net return	$112,000
Older party's land	$- 40,000
Older party's machinery	- 12,000
Younger party's machinery	- 3,000
Older party's labor and mgmt.	- 20,000
Younger party's labor and mgmt.	- 21,000
Profit	$16,000

Each party's return consists of the rental or wage return from their respective resources plus 50% of the profits. As shown below, the older party receives $80,000 and the young person $32,000.

Returns

	Older Party	Younger Party	Total
Land	$40,000		$40,000
Machinery	12,000	$ 3,000	15,000
Labor & Mgmt.	20,000	21,000	41,000
Profit	8,000	8,000	16,000
Net return	$80,000	$32,000	$112,000

Each party's net cash flow consists of the return computed above less the expenses and debt payments on their individual assets rented to the business. In the example, the older party retains $45,000 and the young person retains $30,500, which can be used for family living or invested in the business.

Cashflow

	Older Party	Younger Party	Total
Total return	$80,000	$32,000	$112,000
Land taxes	- 8,000		- 8,000
Land debt	- 25,000		- 25,000
Machinery debt	- 2,000	- 1,500	- 3,500
Net cash flow	$45,000	$30,500	$75,500

The 50/50 model is often used when the arrangement will remain stable for several years. This approach may be interpreted from a legal perspective as a partnership because there is a sharing of profits and losses.

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