7 $ecrets of Effective Farmers Webinar Series: Succession Planning

MANAGE
Farm Business•Family Life/Finances
University of Tennessee Extension

Danny Morris
Lecturer, Agricultural Economics
University of Tennessee Martin
Email: dmorri25@utm.edu

October 1 2020

UTIA INSTITUTE OF AGRICULTURE THE UNIVERSITY OF TENNESSEE Real. Life. Solutions.

CENTER FOR PROFITABLE AGRICULTURE
UT EXTENSION INSTITUTE OF AGRICULTURE
A UNIVERSITY OF TENNESSEE - FARM BUREAU PARTNERSHIP

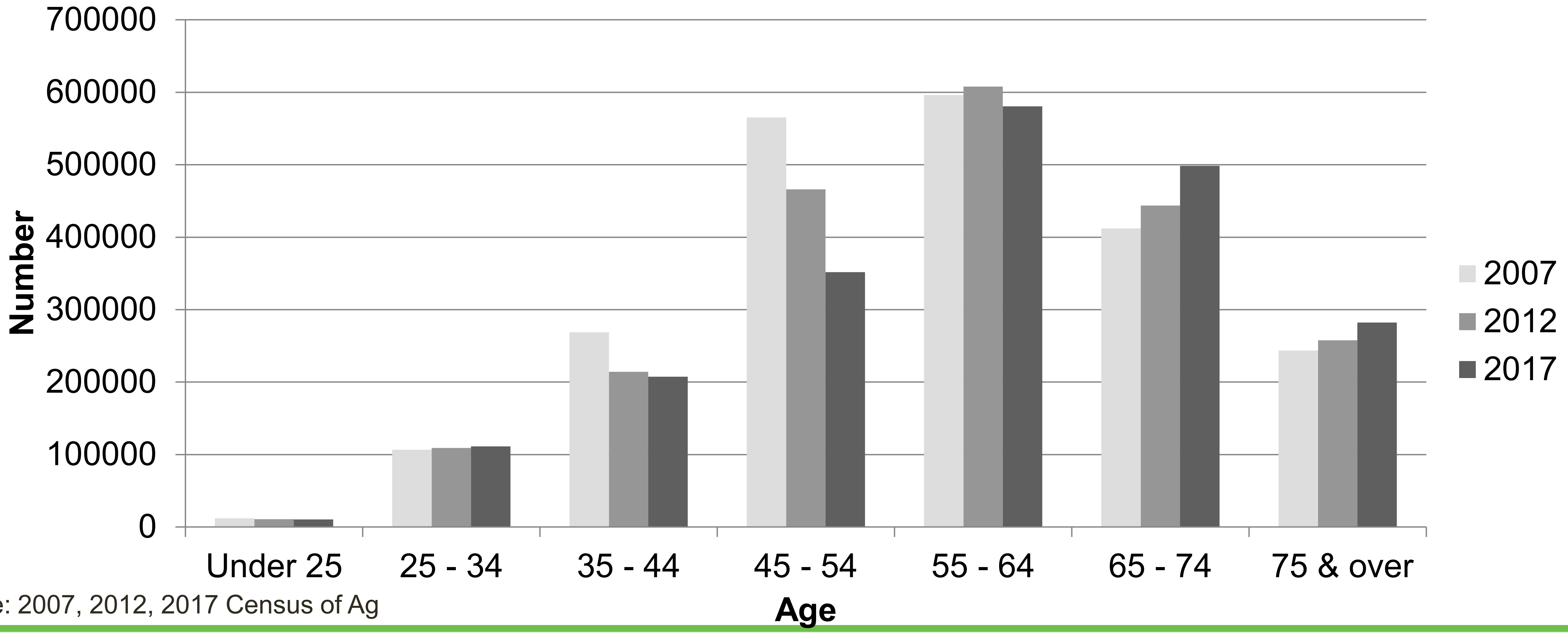
Farm Bureau

Succession Planning

Overview

- Communication is key
- Setting up a farm transition plan
  - What all needs to be included?
- Pass along all assets
  - Not just the physical ones
  - Handling non-farming family members
- Fair vs. Equal (or both?)
- Being the mentor
  - Guiding the next generation to success

Principal Farm Operators by Age



Source: 2007, 2012, 2017 Census of Ag

Background Information

- Over the next decade **half** of the farmers will retire and will be replaced by beginning farmers *(Katchova, 2010)*

- **70%** of farm ground will change hands by 2025 *(Kohl, 2010)*

- What additional factors have influenced the rate of farmland changing ownership?

Top Eleven Pitfalls in Farming

- Not knowing your Cost of Production (COP).
- No plan for transferring the farm to the next generation.
- Inadequate financial recordkeeping.
- Lack of a clearly defined business plan.
- Lack of communication.
- Avoiding or deferring taxes.
- Lack of financial reserves.
- Not managing family living expenses.
- Following your neighbor.
- Jumping on the latest/newest/hottest enterprise.
- Not training the next generation.

SMART Goals

- Specific
  - Pinpoint what you are trying to accomplish
- Measurable
  - Be able to measure the goal in some manner
- Attainable
  - Do not set unreal expectations
- Relevant
  - Set goals that apply to your business
- Timely
  - Make sure your goals are on an acceptable timeline

Why do farm families struggle to communicate?

Common Barriers to Communication

- Lack of role separation
- Not an easy topic to discuss
- Noise and Stress
- Off-farm heirs and on-farm heirs
- Generational differences
- Personality differences
- Gender differences

Source : David Marrison OSU Extension

How can we improve family business communication?

- Start with your communication
- Take time to explain
  - Today's farm language
  - Transition planning terms
- Learn about personality types and communication styles
- Hold family business meetings
  - Outside facilitators can help

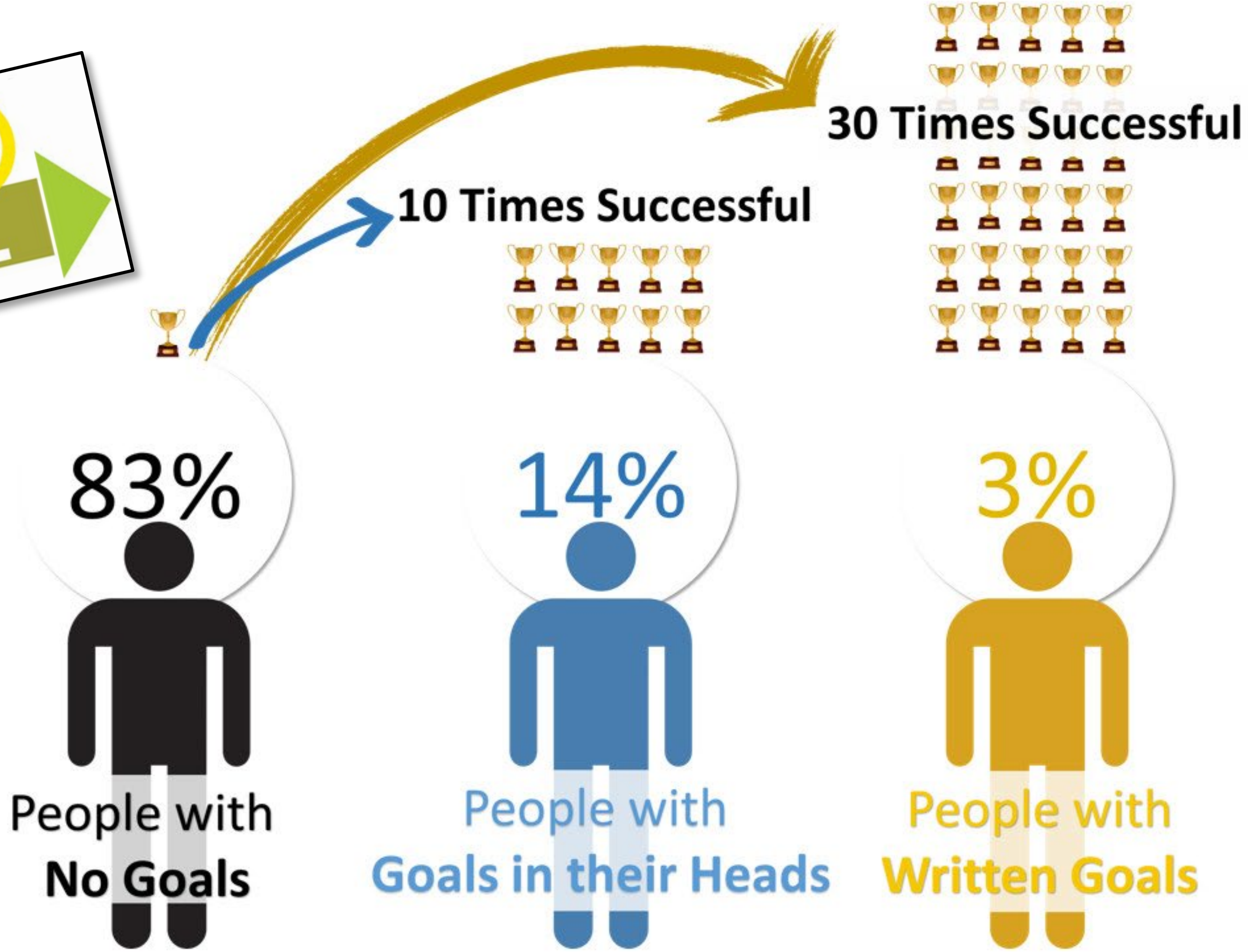
Source : David Marrison OSU Extension

Transition Planning Includes . . .

- Estate Planning
- Tax Planning
- Business Planning
- Retirement Planning

- Family Goals
- Management Transfer
- Labor / Responsibilities
- Exit Strategy

Having a Written Plan is Crucial



What needs to be in a succession plan?

- Organizational structure of the farm
- Legal instruments to transfer assets
- Financial information on the farm
- Important contact information of business partners
  - Lenders, accountants, attorneys, and other key business partners
- Timeline of next generation to begin taking on more responsibility and play a larger role in the operation.

Choosing the Right Organizational Structure

- Ownership structure of the farm
  - Establishes the management team
  - Helps to define who is responsible for farm debts and business liabilities
  - Sets up parameters for transferring business ownership and control of the farm

Business Structure

- Things to keep in mind:
  - Management of the Farm
    - Will the business be managed by one person or by a team of people?
    - Do you intend the business to continue on after your death?
  - Liability of the Farm
    - Are you involved in a business where you might find yourself and personal assets placed at risk?
    - Do you need to limit the personal liability of the owners from the debts and obligations of the business?

Business Structure

- Things to keep in mind:
  - Taxation of profits
    - Double taxation occurs under certain business structures. The business is taxed on profits and the owners of the business are also taxed on the profits they receive from the business.
    - Pass through entities allow for business to pass on profits to the owners without being taxes. The taxation of profits occurs at the owners personal income tax bracket since the earnings are directly passed along to the owners.

Business Structure

- Most commons business structures:
  - Sole proprietorship
  - Partnerships
    - General
    - Limited
  - Corporation
    - S-corporation
  - Limited liability company
- The choice of structure plays a large role in transferring ownership interests and control of the farm!

Why worry so much about entity structure?

- If you have other existing businesses, you may want to separate things to protect other assets.
- Desire to limit personal risk from the business.
  - Business structure can help with that.
- Transfer of business from one generation to the next can be partially taken care of with the correct business structure.
- Written business agreements, such as operating agreements, can mitigate disputes between business partners.

Legal Instruments to Consider

- Will – you need to be the one that makes the plan for your farm and family, not the state.
  - Dying without a will is called “intestate”, which means that the state will rely on their laws called the code annotated that determines who will inherit your assets.
- Power of Attorney – allows another person to make financial decisions on your behalf.
- Medical Directive – enable someone to make decisions regarding your health in the event that you cannot.

Legal Instruments to Consider

- Trusts – legal agreement names a person as the "trustee" of the assets included in the trusts.
  - The creator of the trust is called the "trustor" or "grantor".
  - Trustee manages the assets according to the direction given from the trust to benefit the trust's "beneficiaries".
  - Commonly used to transfer assets such as land from one generation to the next.
  - Also used to provide funds for raising children that are minors or children with disabilities.

Legal Instruments to Consider

- Testamentary Trust – type of trust created in a will.
  - Can be used to reduce estate taxes and preserve income for surviving spouses.
  - Smaller estates may not benefit tax wise by creating this type of trust
- Living Trust – created while the trustor is still living, unlike a testamentary trust that is created by a will.
  - Called a revocable trust since the trustor can make changes while they are alive and retain absolute control of the assets of the trust.
  - Become an irrevocable trust upon the trustor's death.
- Irrevocable Trusts – can be created during a trustor's life to remove assets or property permanently from the estate, meaning assets put into an irrevocable trust is final.

Other Things to Consider

- Bank Accounts – those that are joint on checking accounts supersede anything you have in a will.
  - Same goes for retirement accounts (i.e. 401k accounts) and life insurance policies
  - Those listed as either joint account holders on banking accounts have access to funds even if your will says all assets are to split evenly among your heirs.
  - If you have a live insurance policy, those listed as the beneficiary will receive the death benefit and the will cannot contest that.

Other Things to Consider

- Healthcare – setting up a plan that covers your medical expenses and ensures the quality of care that you desire.
  - Long Term Care policies
  - Setting up an advance care plan that give direction for your health care
  - Taking care of funeral arrangements ahead of time
- Important questions to answer
  - What will happen to my estate if I go to the nursing home?
    - Look back period is 5 years
  - How will my spouse and children be impacted by medical bills?

Other Things to Consider

- Having enough liquid assets for retirement to cover unforeseen expenses.
  - For example: Farmer retires from active production and children now run the operation. Father and mother maintained all of the land to receive the rental income to cover their cost of living. However, a major expense arises that has to be covered, are there sufficient cash reserves to cover it or would an asset need to be sold (i.e. land)?
- Setting up retirement accounts early in life can help provide you with liquidity in your later years.

Passing Along All Assets

- When we discuss, estate planning we tend to focus on:
  - Wills
  - Taxation issues
  - Business transactions
- What about transferring the knowledge and skills to ensure that the next generation is successful?

Successful Farm Transition Plans Should Answer These Questions (and others…)

- How does management transfer?
- How do assets transfer?
- How will income be distributed?
- Who will oversee the succession?
- How can we minimize the unknowns?
- How can I make the farm transition from one family to the next easy on my, very likely, grieving family?

Farm Transition: More than a Transaction

- Successful farm transition goes beyond the business transactions
- It include passing along the production knowledge to the next producer
- Review business agreements and include the next generation in them
  - Allow next generation to be part of lease agreements and financial agreements
  - Leases need to address what happens when you die if your successor is not on them
  - UT Extension has resources for lease agreements
- Your farm transition can have all of the business items in place, but can easily fail if you have not prepared the next generation on how to manage the farm.

Onboarding the Next Generation

- Bring them into making production decisions
  - Making purchases and determining crop mixes or livestock production practices
  - Commenting on equipment being purchased and features chosen
- Allow them to participate in conversations with key business partners such as lenders, attorneys, and accountants.
  - You don't want that first conversation to take place after your passing away.
- Possibly working some of the farm in their name, selling the commodities in their name, and filing their own Schedule F.

Handling Non-farming Family Members

- Likely one of the toughest things to do in transitioning a farm to another generation
- Being fair is often desired by all, but being equal is not often possible.
  - One must considers fair, the other does not.
  - Dividing up things equally could render a farming operation no longer a viable business that can continue on.
  - So what do you do? No easy answer unfortunately.

Handling Non-farming Family Members

- Consider giving non-farming family members other assets that would allow the farming operation to continue
  - Land with residence(s); will likely require surveying to be done to remove from tillable land
  - Life insurance to provide cash that is equal to the value of other farm assets that those engaged in the operation are receiving
- Farming family members may need to finance farm land and/or equipment to generate sufficient cash to "buy out" non-farming family members.
- Consider taxation issues for all parties involved.

Handling Non-farming Family Members

- This can be the most complex part of your transition.
- If the plan is for the farming operation to cease just continue ownership of land with sale proceeds/rent being divided evenly, get a lawyer and write it up.
- However, if the farm is to continue, you need to decide who gets the farm assets.
  - Example: If you have 5 children, how does one keep farming with one-fifth of the assets?

Mentoring the Next Generation

- Farm transitioning is so much more than a transaction.
- Transferring the knowledge and skills that you have developed over decades of farm experience can help build a solid foundation for your successors.
- Consider some keys of farm management:
  - Production
  - Financial/Business
  - Personnel
  - Family

Mentoring the Next Generation

- Production:
  - Actively engaged in planting, maintaining, and harvesting crops.
  - Being involved in feed choices for livestock and discussing medical treatments.
  - Troubleshooting equipment and maintaining implements
  - Having a say in infrastructure changes
    - Doing anything that you can to help them gain experience in operating a farm.

Mentoring the Next Generation

- Financial/Business:
  - Participate in conversations with key business partners
  - Possibly have some of the operation financed in their name to build equity in the farm
  - Assist in making marketing decisions in when to sell crops/livestock
    - Discuss the different markets available and marketing tools (i.e. forward contracting, options, futures, etc.)
  - Be involved in discussions with landlords to build relationships

Mentoring the Next Generation

- Personnel
  - Some of your employees may think of your successor at the little kid they used to see ride on the combine with you.
    - Could lead to a lack of respect when you pass and they take over.
  - Consider having your successor handle payroll so that farm labor gets used to see that person in a managerial role
  - Have your successor to delegate daily tasks to farm employees to begin the transition of management of the farm

Mentoring the Next Generation

- Family
  - Start having conversations with the entire family of you how you plan to transition the farm
  - Helps to avoid any family conflicts by letting people know what to expect upon your passing
  - Whatever you do, try to minimize any potential conflict that could cause family issues after your death.
    - Consider reactions from children, children’s spouses, and maybe even grandchildren.
    - In some cases, this may not be possible. Things can get complicated real quick when it comes to family.
  - Try to avoid favoritism to mitigate family conflict!

Goals of a Transition

- Gathering the necessary financial information to determine the best way to move farm assets from one generation to the next.
- Establishing expectations from the senior generation and those inheriting/purchasing the farm assets.
  - Non-farm family members included.
- Providing enough income that the senior generation can sustain their desired level of living.

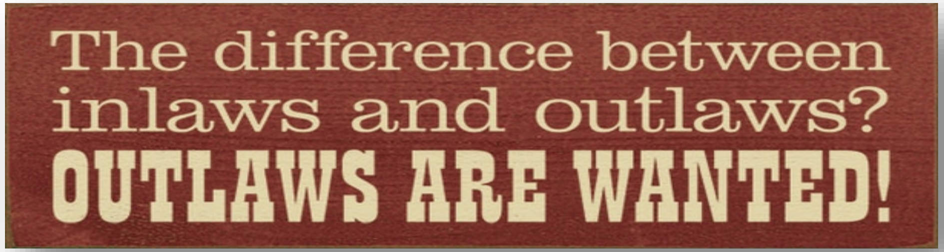
Helping the Next Generation Build Equity

- Sweat equity does not go far as collateral in lending.
- Have the younger farm family members purchase equipment or have a smaller RLOC to put in their own crop.
  - Have them market their crop.
- Help them explore new ideas and enterprises early (seed dealer, excavation work, etc.) to diversify farm income.
  - Grants them “ownership” of their interests.
  - Shows you their management potential.
    - If they fail, time is on their side and you are still around to help them learn.

Ideas for Getting the Next Generation Onboard

- Is the next generation simply farm labor paid in wages/salary?
- Is the salary increased to annually to allow them to buy more of the farm assets?
  - Consider gifting assets (work with tax professional to determine tax implications)
- Potential ideas:
  - Profit sharing
  - Share leasing
  - Creation of LLC with stock sharing

The Unthinkable: In-laws (or Outlaws!)



- Conversations need to occur for those marry into the farm.
  - They man not want to be involved in the farm and/or have their spouse (your family members) involved anymore.
    - People see the worth of farm assets and want their “fair share”.
- Reality is life can get messy with death, divorce, remarriage, having kids, etc.
  - Farms can be protected from a divorcing spouse by not allowing direct access to farm assets.
  - Good business structuring can help separate personal assets from farm assets.

How long should a transition take?

- There is no concrete ruling on this.
- Farm Transition Specialist, David Baker, with the Iowa State University recommends 4-5 years with a 1-2 year trial period.
  - As a part of that transition process, include a trial of a year or two, a time of joint-decision making, and a period of letting the successors make the decisions, with the out-going owners still available for more direct consultation.

Business Planning Bottom Line

- Farm businesses that developed a business plan were 2 times more profitable
- Producers who communicate were 21% more profitable.
- Producers who separated business and family issues were 63% larger and had 22% higher net income.

Source: Business Planning Lite, Dr. David Kohl, Virginia Tech

Business Planning Bottom Line

- Producers who have not developed a transition/estate plan/business plan vs. those that have a plan in place:

Business Planning	No Plan	Plan in Place
Estate Plan	5.01% ROA $54,929 Net Income	7.55% ROA $96,342 Net Income
Transition Plan	6.70% ROA	8.82% ROA

Source: Business Planning Lite, Dr. David Kohl, Virginia Tech

How much expansion to afford a transition?

NFIFO: Net Farm Income from Operations

Used to pay family living, taxes, debt service, growth

Kentucky FBM Annual Summaries

Net Farm Income from Operations

(Revenue – Operating Costs – Interest)

	2011	2012	2013	2014	2015	2016
NFIFO Ratio	0.26	0.23	0.23	0.10	0.06	0.06

Kentucky Farm Business Management Annual Summaries

NFIfO: Net Farm Income from Operations

Used to pay family living, taxes, debt service, growth

So, need $4 or more of gross revenue for every $1 of net!!

In 2014 - 2016, need $10 + more of gross revenue for every $1 of net!

How much expansion to afford a transition?

- An additional $100,000 of **gross** won't do it
- Divide $100,000 by NFIFO Ratio
- NFIFO averaged 0.23 (2012 - 2013)
- $100,000/0.23 = $434,783 of Gross Revenue
- Have not included debt service yet
- Need **$4 to $5 of gross** for every $1 of net

Challenges and Opportunities

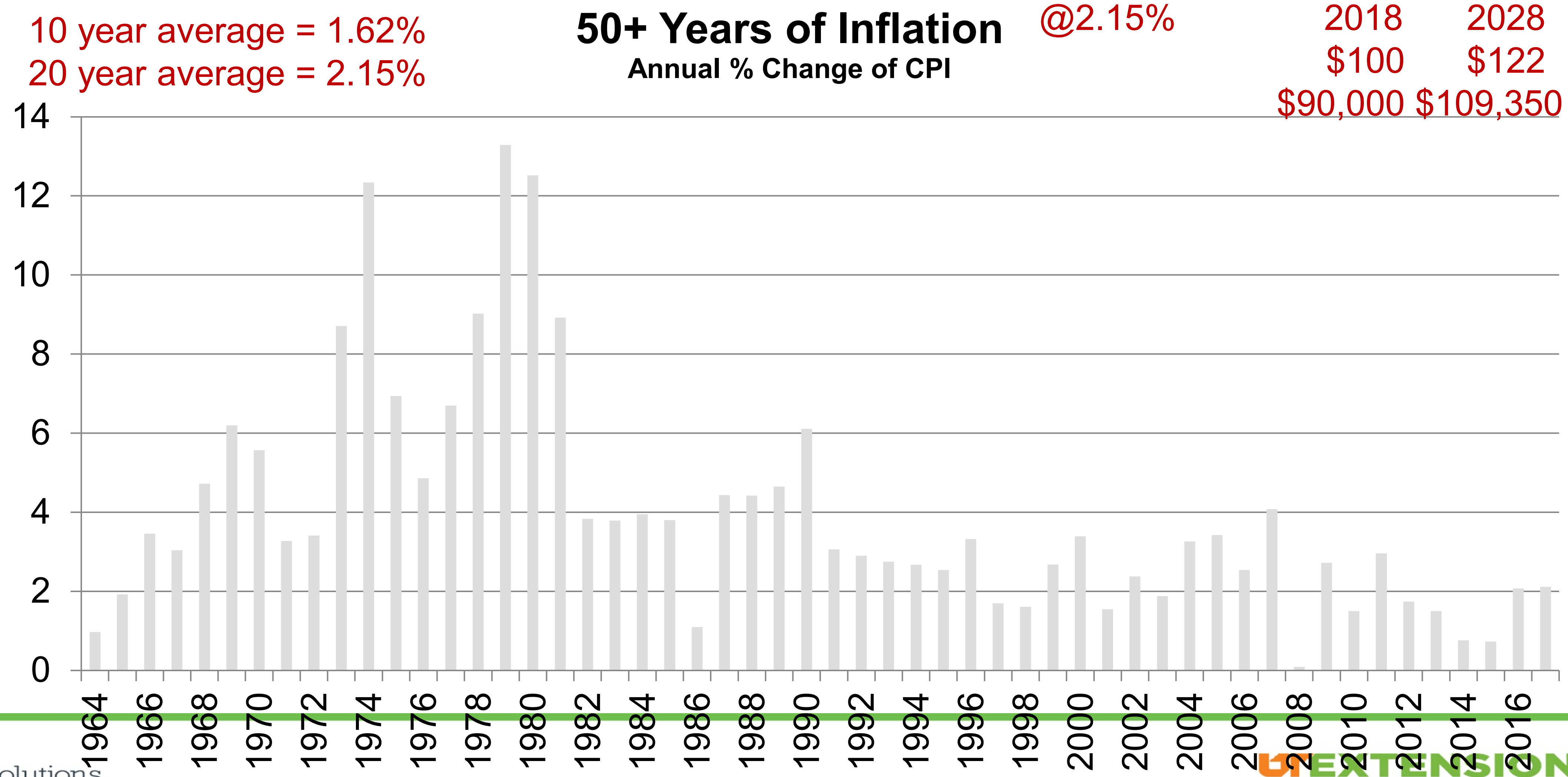
- A major challenge is to determine whether the business can afford the transition.
- Often a bigger challenge is to determine how the family wants to handle the transition.
- The greatest challenge is to create and execute the transition plan.

Challenges and Opportunities

- Adequate retirement income for the parents is most likely going to be **first priority**
- Determine retirement income needs
  - What are lifestyle costs today?
  - Will any costs change when in retirement?
  - How much income from Social Security, pensions, savings, investments, the farm?
  - Adjust for inflation

Challenges and Opportunities

10 year average = 1.62%
20 year average = 2.15%



@2.15%

2018	2028
$100	$122
$90,000	$109,350

https://farmlandlegacy.utk.edu/

Other resources . . .

Iowa State Extension

http://www.extension.iastate.edu/valueaddedag/page/resources-iowa-farm-transition-and-beginning-farmers

Conclusion

- A written and well thought out farm transition plan is needed.
- Communication is paramount.
- Your are passing along more than just assets.
  - Train your successor so they can succeed.
- Consider how to handle non-farming family members in your estate plan.
- Get started on your farm transition plan!

7 $ecrets of Effective Farmers Webinar Series: Succession Planning

Danny Morris
731-487-0222
dmorri25@utm.edu