Succession Planning on the Family Farm

The family farm is a vital aspect of American industry and a significant contributor to the economy. But maintaining a thriving farm operation is no small task, given the level of financial commitment, opportunity and risk associated with agriculture and agri-business. Yet families across the country continue to dream of the day the farm will pass to the next generation.

Prepare for your future and ensure your farm stays in good hands.

Succession planning can help ensure that dream will become reality. In 2008, the Cooperative State Research, Education and Extension Service (CSREES) reported that 70% of U.S. farmland would change hands by 2028. Without adequate succession planning, CSREES reports that farms are more likely to go out of business, be absorbed by larger neighboring farms, or be converted for non-farm use.

By creating a succession plan, a family's vision and intentions for their farm can be addressed and implemented purposefully. Succession planning helps ensure the farm can continue operating with sufficient economic viability to financially support multiple generations. It allows all children to be treated fairly, while acknowledging the difficulty of treating them equally. Finally, the plan works hand-in-hand with the retiring generation's estate plans.

But succession planning is more than an exercise for aging farm operators. It's a process, not a one-time event—and it's a valuable business practice that provides clarity, direction and accountability. Discuss your succession plans openly and honestly with all involved, and take into consideration their concerns. Doing so preserves harmony among family members, allowing them to continue to build the farm and its agricultural legacy.

MANAGING FAMILY WEALTH

Failure to set up a succession plan often results from a lack of information about where to begin, what items to include, and who to turn to for assistance. Family farms, in particular, may struggle with unique characteristics that extend beyond the business to personal relationships. It's those ties among parents, children, siblings, spouses and in-laws that make a succession plan such a necessary part of managing both business funds and personal wealth.

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Without an established succession plan, state law dictates how the farm and its assets are distributed when the owner of record dies or becomes incapacitated. Most families prefer to make their own decisions rather than letting the government do it for them.

The need to transition family farms from one generation to the next is growing. The average age of U.S. farm operators was over 57—and aging—in 2007, according to the USDA's Census of Agriculture. The number of operators who were 75 and older grew by 20% between 2002 and 2007, and the number of those under age 25 declined by 30%.

It's clear that the security of retirement with the older generations and the livelihood of current and future generations depend upon the review and coordination of both personal and business wealth strategies.

That's why farm owners should consider developing a will, along with power-of-attorney and trust documents that help mitigate applicable state and federal estate taxes. Appropriate insurance policies should be in place to protect property and life, and to provide for disability and long-term care. Make sure the beneficiaries are up-to-date and the protection amounts remain adequate.

Title all commercial bank deposit accounts properly—to the business or the individual—to make the most of FDIC insurance. Revisit all investment accounts regularly to keep the risk tolerance in sync with your intentions and retirement plans in-line with current economic conditions.

Ideally, the farm will be able to help retiring family members meet expected financial needs. Each individual's estate plan and succession plan should provide the amount of income each person needs for retirement. Determine what obligation the farm business has to each retiree so those expectations and obligations don't adversely affect the farm's financial position. And on a personal front, review your estate plan annually, as well as any time there's a significant life change, such as marriage, children or divorce.

ASSEMBLING YOUR ADVISORS

Wealth management strategies such as succession and estate planning take at least three to six months to develop. Scheduling a series of family meetings will help bring relevant transition issues to the forefront, where they can be addressed.

Actively involve the family's attorney, accountant, agricultural banker, investment advisor and insurance agent in these meetings, too. Check to see if your bank offers investment and insurance guidance; this may eliminate the need to involve additional parties. Many families find it helpful to ask one of these advisors to serve as a meeting facilitator. Although it may seem like all of the answers should emanate from within the family, unbiased and objective viewpoints provide much-needed perspective and help to neutralize conflict.

Recognize and address conflicts as they occur. Have realistic expectations of the issues that may arise when family members are encouraged and expected to speak freely, openly and respectfully. If disputes over the future of the farm are allowed to simmer, family unity and the long-term success of the farm will be harmed.

One of the most important steps is getting the right group of interested parties around the table. Start by defining "family." Does it include blood relatives only? In-laws? Consider what role step-children, grandchildren, nieces, nephews, cousins and others currently have, may have, or want to have in the future. Then identify which family members actually want to be successors, with hands-on responsibility for the business. Not every family member will be equally interested or qualified, and family farms usually don't provide opportunities that fit everyone's strengths and interests.

The initial discussions will help your family and advisors set the framework for the farm's succession plan, the roadmap as to how the generational transition is to be carried out, with a timeline of milestones to achieve before management control and ownership changes. The plan is a clear nod to the eventual retirement of the current generation of owners and their financial needs.

These meetings will also likely lead to the creation of additional planning documents that fit together. For example, a strategic plan outlines the farm business's long-term path. And a business plan details ways to maximize the profit and equity returns by reviewing systems, products and related income streams.

Together with the succession plan, these documents outline goals for individuals, the family as a whole, the farm, and retirement preparations. These plans guide the business and validate decisions—and they serve as a guide in the event of a crisis. Advance planning gives the family and farm the best chance to successfully ride out an emergency.

Once the plans are in place, remember to review and update them regularly to reflect the changing state of the family, the farm operation, the economy and other factors. Rely on the business's advisors for assistance in formulating and maintaining the documents.

INVEST IN AN INDEPENDENT BUSINESS APPRAISAL

One of the tools that will greatly ease the succession planning process is an independent business appraisal. Knowing the accurate value of the farm's assets helps both the retiring and inheriting generations assess their financial picture.

The appraisal encompasses a thorough analysis of several years of the business's operations and an opinion about the future of the industry, the economy, and the farm's long-term performance potential.

The farm's intangible aspects are factored into its value, so the valuation method should be relevant to farming and provide a valid and supportable dollar amount. Confidence in the final number is based on the integrity of the underlying process.

You may feel you can accurately estimate your farm's value based on the recent sale of a nearby property. But a past transaction isn't necessarily indicative of current values. Land values rise and fall with broader national economic changes as well as those of the local community. It's important to find an appraiser who's familiar with agriculture in your area. Your banker can recommend a reputable independent business appraiser.

EVALUATING POTENTIAL SUCCESSORS

The need to turn the farm over and actually letting go are two very different things. It's natural for the succession process to cause internal conflict for the retiring generation. After decades of toiling daily and making critical decisions, letting go is an emotional experience.

As you plan to turn the farm over, expect and encourage your successors to do things differently. Each generation will face new challenges, new technologies and different economic times. Traits of successors should match the future needs of the farm, so look for individuals who can build on past successes while leading the farm into the future.

Ideally, a succession plan helps the family analyze its current situation, examine the future and develop an action plan for transferring assets, managerial control, and eventually ownership. An informal Farm Journal survey found that even though 80% of farms plan to transfer control to the next generation at some point, only 20% are fully confident in their transition plan. The clearer and more specific the succession plan is, the more likely it will succeed.

The first step is to determine the farm positions that require a succession plan. For example, if both parents hold active and critical roles within the operation, they both require successors.

Create job descriptions that clearly describe the skills needed to perform critical tasks, then identify the family members who possess those skills. Writing job descriptions highlights gaps in ability and knowledge. This allows you to determine whether the gaps can be filled with additional education and training, and whether there is time to groom a family member or if it's necessary to hire a successor from outside the family.

It's entirely possible that all of the skills needed to keep the farm operating successfully won't be found within the family. Be objective when identifying who's capable of managing the farming business. Refrain from trying to fit a round peg in a square hole. For some positions, a successor might be obvious because of education or experience. That may not be true for other jobs. Remember, working on the farm is not the same as running the farm. Identify strengths and weaknesses, and compare them to the critical tasks of the jobs. Note each individual's personality and temperament, including his or her ability to communicate and cooperate with others.

Sometimes naming an outside successor is the right decision. In the short term, the choice buys time to develop a promising family member. In the long term, it can be beneficial if there is no appropriate or available family successor. And the family can choose to retain controlling ownership even if a successor isn't a family member.

While measurable and objective assessment is crucial, don't ignore your instincts. Assess potential successors' work ethic, motivation and willingness to learn. Applying both objective and subjective measures, rather than one or the other, leads to a greater chance of making the best selection.

GROOMING YOUR SUCCESSOR

After completing a thorough selection process, begin the transition to the next generation by committing to a timeline. Use milestones instead of dates to gradually shift decision-making responsibilities and authority to the successor. A single milestone generally shouldn't take more than a year, so break down any long-term processes into shorter increments. Factor in additional time if particular successors are assuming a greater share of the duties, and consider how long it will take for the retiring owner to get comfortable with the transition.

Communicate succession decisions not only to family members and employees, but also to outside business partners and customers. This is particularly helpful if members of the retiring generation stay active in the farm business during the transition. Everyone should be well aware when the succession process is complete—and that must be respected by the retiring generation as well as by those who work for and with the new leaders. The transition should feel natural, without shocking the business.

Remember that succession planning addresses ownership as well as day-to-day farm operations. The farm may be owned by one person, a family or a partnership. Ownership changes usually occur after the leadership succession is complete. Some families may choose to make adjustments during the transition and again after it's completed.

While sole proprietorships are the most common form of business organization for farmers, alternatives include general partnerships, limited partnerships, corporations and limited liability companies. Review the legal structure that governs the farm's ownership. Changes may be needed, as the structure can affect tax management, estate planning and the succession itself. Consider how any change could impact access to capital, liability, management control and flexibility, continuity, taxation and costs associated with the structure itself.

IS THE PLAN FAIR OR EQUAL?

In succession planning, concerns often arise about how to equitably address heirs who work the farm and those who don't. Some family members contribute to the farm's success, while others don't. Siblings in particular may feel they're due a fair and equal share of the farm and its profits. Even parents may disagree about how to distribute assets among their farming and non-farming children.

Fair treatment isn't likely to be equal treatment for any number of reasons. Non-farming heirs may have received money toward college tuition or a home. The farming children's labor actively contributes to the farm's revenue, so they may argue for a greater sum. Some families accommodate the farming heirs to keep the farm from being sold. And, because of proximity, farming heirs often take on more day-to-day tasks in caring for the aging generation.

Several approaches could be implemented to address the issue.

> Buy/sell agreements outline specific sale terms, ownership restrictions, triggering events and timelines regarding the farm's various assets. Farm heirs have some certainty they'll eventually inherit the farm, while non-farm heirs receive a previously agreed upon price.

> Individual insurance policies that pay out cash proceeds upon the parents' deaths may name non-farming heirs as beneficiaries, while farm assets may be left to the farming heirs.

> Wills and trusts prepared by the parents may take into account the value of previously distributed assets and special circumstances. These documents can also take into account the transfer of assets to children not in the business.

Above all, it's critical to focus on the farm operation's viability, the family's financial security, and leadership development within the next generation.

PROTECTING THE LAND

The Land Trust Alliance says that commercial development associated with urban sprawl consumes two acres of productive agricultural land each minute. The Alliance comprises 1,700 organizations dedicated to conserving property for agricultural, natural, recreational, scenic or historical value primarily through the use of conservation easements. Today, conservation easements protect more than 37 million acres across the country.

Conservation easements are a commonly used way for owners to protect the farmland itself while turning business operations over to the next generation. Landowners using a conservation easement retain ownership of the property, but voluntarily place deed restrictions on all or part of their land to limit non-agricultural development. Conserved property can still be farmed, and the owner remains eligible for state and federal farm programs. Easements allow for future construction and development necessary to operate the farm, and lots can even be set aside for family members. If needed, the conserved land can be used as collateral. Landowners remain eligible for qualifying tax benefits, too.

Most agricultural conservation easements are permanent agreements. If the property is sold, the conservation easement legally binds the new owners. Be aware, that a court can modify or end the conservation easement if over time the nature of the area or property changes significantly. Eminent domain proceedings can also override the easement.

Since easements are usually granted in perpetuity, an outside party monitors and enforces their terms. These third parties can be local government agencies or land trusts, which are independent, nonprofit organizations that acquire conserved land through donation or purchase. Land trusts can also assume stewardship of already conserved land.

THE IMPORTANCE OF ESTATE PLANNING

To keep the farm in the family after the owner's death, it's necessary to plan for the sizeable impact federal estate taxes can have on heirs. Make sure to work closely with your bank and your attorney to consider the impact of current legislation and laws governing the planning process.

As far as these taxes go, farming families are hit harder than most. In May 2009, the USDA Economic Research Service found that a farm owner is more than twice as likely to owe federal estate taxes as the typical decedent. And owners of large commercial farms are more than 10 times as likely to owe estate taxes as other farm owners are.

Most farmers don't have sufficient resources on hand to pay a sizeable sum. However, life insurance, when properly owned by a life insurance trust, can create the necessary liquidity. Heirs use the life insurance policy proceeds to pay the federal estate taxes.

PREPARING THE FARM FOR SALE

Of course, families always have the option to sell the farm, a decision that brings with it a completely different set of considerations. Sell it all at once or in smaller parcels? Will the barns, outbuildings and personal residence(s) go with the acreage or be sold separately? Sell outright or on a contract for deed? Such a contract makes the seller the lender, and the payments received are considered taxable income. Consider the risk of potential buyer default.

The appraisal obtained during the initial succession planning stages is critical if you make the decision to sell. It gives you a starting price to share with neighboring landowners who may be interested in expanding. For added exposure to prospective buyers, hire a professional real estate agent who specializes in farm properties.

Some farmers choose to auction their land. Fierce competition among bidders can bring a purchase price far above initial expectations. If you go this route, set a reserve price to avoid selling the farm for an amount below market value. Consult a professional auctioneer to determine if this is a good choice for your family.

Another option is a tax-free 1031 real estate exchange that allows the farm property to be exchanged for other like property. Using a 1031 exchange postpones taxation of the gain. Consult your tax advisor to learn if this might work for you.

Remember that selling the farm does not always mean selling the property. Many farmers retain ownership of the land as a valuable part of a diversified retirement portfolio that may also include stocks, bonds, savings and retirement plans. Renting the farmland to another farm operator is common. The fellow farmer works the land and pays an agreed-on price for the use of it.

Regardless of the way the farm and the property are disbursed, any sale will trigger curiosity and—likely—concern among any paid employees.

Consider writing clauses about employee retention into the buy/sell agreement. It's possible the buyer will need at least some of the farm's staff to continue working permanently or during a transition period, and financial incentives may be offered since retention ensures continuity in the farm's operations. Employees who aren't retained may be offered severance packages or assistance in securing employment elsewhere.

During the course of a sale, it's virtually impossible to prevent snags with employees, customers or vendors. But honest and prompt disclosure reduces risk and prevents the rumor mill from generating unnecessary fear and confusion. Limit speculation by telling employees what you know. After years of mutual loyalty, this is not the time to destroy valued relationships. Keeping communication channels open can lead to a relatively smooth transition.

PLANNING FOR EMERGENCIES

Never underestimate the damage a natural or man-made disaster can do to your business. On a family farm, divorce, disagreements and untimely death or disability can seriously compromise the farm's daily operations and ongoing viability.

If your family doesn't already have a plan in place, an unexpected event will typically force succession by crisis. In this instance, rely on family advisors for assistance. Much can hang in the balance if arrangements aren't handled correctly and in a timely fashion. Don't underestimate the value of the advisors' objective counsel during times of high family emotion.

That being said, formal succession plans usually result in better outcomes if a crisis occurs, because directives and decisions were made in better times under less duress. When formulating a succession plan, outline practical steps that would prepare the farm to function in an emergency. These might include cross-training people in (or outside of) the family on the fundamentals of each critical job, from bookkeeping to barn and field duties. Make sure more than one trusted person has access to financial accounts and other critical records in case the primary decision-maker isn't available.

IN CONCLUSION

The first step in succession planning—making the decision to get started—is usually the hardest, but it's also critical to your farm and your family's livelihood. Gather the family for a conversation. Assess the skills of potential successors. Review and update financial data. Contact family advisors for assistance. As each of the tasks is completed, your family's security is being enhanced.

Whether succession is achieved through careful planning or by crisis is up to the family. However, the discussions, decisions and documents that make up a formal succession plan prepare inheritors to successfully grow the farm in the future while giving the retiring generation the opportunity to fulfill their dream of passing down an agricultural legacy.

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