SUCCESSION PLANNING IN FARMING

GUIDED STEP

This document is a guide to help direct farmers, ranchers and business owners in considering succession planning.

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INTRODUCTION

Many farms and ranches in California, as well as across the world, are handed down from generation to generation with help from succession planning[1]. Succession planning can be described as a process that determines who will inherit the land and capital that make up a ranch or farm when the current owner becomes unable to, or chooses not to work, usually due to illness, old age or death. An example of traditional and successful succession planning would be a husband and wife passing their business or land down to their children, who in turn will later pass it down to their children. This is common in the agriculture industry because of the high amount of family farms in the United States[2] . Parts of the ranch or farm may be sold off in this process in order to pay off debts, or divided up to allocate space for multiple heirs. To take the emotion out of this task and make the right decisions for the business, the current generation should ask themselves[3]:

- Would your successor(s) be as committed to the land and family business as you are?

- Does the future generation have the desire to maintain the operation for the long haul?

[1] Goetting, M. A., Danes, S. M., Knerr, V., Leifeld, C., & Bradshaw, G. (2016). Transferring Your Farm or Ranch to the Nest Generation. *Montana State University Extension.* Retrieved March 5, 2019
[2] https://www.extension.iastate.edu/agdm/wholefarm/html/c4-56.html
[3] https://www.fbfs.com/learning-center/what-you-need-to-know-about-farm-succession-planning

- When the time comes, will you be ready to share control and management decisions?

If the answers to the previous questions are yes, then a traditional approach to succession planning should be put forward for the business to succeed. The traditional approach is useful for small family run farms, but it isn’t for every farm.

If the current generation does not pass their farm or ranch down to the next generation, then an alternative plan would need to be put into place. This would occur if the current generation would want to sell their land and business in order to obtain the money necessary for retirement, has no heirs, or if the next generation does not choose to be a part of the business.

As every family is different and unique, so is every succession plan. It is important to have a detailed plan in place that addresses all aspects involved in the transfer of power from generation to generation, and makes the entire process as streamlined as possible.

Below is a detailed guide to follow and steps to consider when creating either a traditional or alternative succession plan[4].

STEP ONE: HAVING THE CONVERSATION

Though these talks are never easy, it’s critical for both the current farmer and any heirs to understand what each member of the family wants in the future.

[4] http://msue.anr.msu.edu/news/farm_transition_and_succession_why_bother

Completing this phase long before the current generation retires insures that the business, and everyone's incomes, remain steady throughout the transition period. Because this phase includes heavy topics, such as the death of the current generation or other family members, independent facilitators, such as lawyers and farm consultants are brought in to help moderate and take the 'emotion' out of the conversation. It's important to start this stage early, before a premature death of a member of the current generation occurs. Doing so can prevent leaving the business unstable as the remaining family members deal with the consequential emotional distress of losing a loved one, coupled with the uncertainty of their business' future.

Farm transfer is a two-way street that must work for both generations involved. Traditionally, the older generation will often still be involved in the operations of the business and the younger generation begins to assume more responsibility of the farm's management, but that's not always the case. Often, only some of the next generation will be involved in the future running of the business, if any children are at all. These individual family members are generally at different ages and life stages, or choose to pursue different career paths. Because this stage is very sensitive, it is important to take your time and for everyone to be clear about their needs[5]. If no one in the next generation is willing to take responsibility for the ownership of the business, the current generation may choose to sell the business

[5] https://grdc.com.au/resources-and-publications/grdc-update-papers/tab-content/grdc-update-papers/2014/08/research-update

and use that money to fund their retirement, while the next generation choses different career paths. The current generation may also choose to keep the ownership of their land, while leasing it out to other farming enterprises, and using the monthly rent as income.

If any member of the next generation choses to take over the business, then it is up to them to work with the current generation to complete the following steps for a successful transfer of ownership.

Step Two: Decide What's Covered by Who

In this phase, the current and future generations will work together to determine who is responsible for what assets of the business[6]. Farming enterprises are unique from other types of businesses because of the use of land as an asset.

In the case of land, the current generation may retain the ownership of the land, and rent it to the next generation to farm, who will then use that money as their income. It is also common, if there is more than one heir, to split up the land, and have each heir oversee their own designated property. Even in these instances, the incorporation of the business may be left intact[7]. In order to reduce the tax implications of land transfer, parents may choose to gift land to their children. In California, a person can gift up to $10,000 of property each year to as many people

[6] McEowen, Roger A., J.D, Excerpts from Principles of Agricultural Law (Fall 2017 Edition), McEowen, P.L.C., 2017.
[7] McEowen, Roger A., J.D, Excerpts from Principles of Agricultural Law (Fall 2017 Edition), McEowen, P.L.C., 2017

as they like, without paying the gift tax[8]. This route is often only viable for larger operations. In the case of smaller family farms, if the older generation lives on the property, they could end up having to pay rent to their successors. In this case, transferring land upon death is the most common because it allows for the current generation to use the property and receive income from it through retirement.

The transfer of machinery can be dealt with in several ways[9]. The machinery and equipment can be sold outright, or in installments to the new successors, or the machinery is traded when the ownership is transferred. These options all have tax implications, so a tax advisor should be involved to help make this decision. To decrease income tax consequences, the current generation may gift the machinery to the next generation, but even this may result in a gift tax. As a final option, the current generation may lease their machinery and equipment to their successor. This has no tax implications, but they will have to determine before the lease is made who will pay for repairs.

In the livestock industry, feed and livestock are an asset like land and equipment. There are many ways for the transfer of ownership of livestock and feed to occur. If the business is breeding livestock, they can be sold altogether or by portions. Payments can be made in installments, or can be rolled over. In a roll-

[8] https://www.fbfs.com/learning-center/what-you-need-to-know-about-farm-succession-planning
[9] https://www.fbfs.com/learning-center/what-you-need-to-know-about-farm-succession-planning

over approach, the current generation owns the breeding herd, but the current and future generations share joint ownership of the offspring.

In the case of market livestock, many ranchers choose to transfer just before harvest, when the feed inventory is low, or in between the sale and replacement of market livestock[10]. This transfer can be done through gifting, or being sold to the next generation.

Because there are so many factors to consider when planning the transfer of farm ownership, getting an early start is crucial. Making a list of all assets, considering all options, and consulting a tax advisor are all great ways of making sure both the current and future generations are satisfied with the transfer, and the transfer is financially viable for all parties.

Many family farms begin the succession planning early, before a death that would constitute a shift of power occurs in order to avoid paying the Federal Estate Tax and other implications. Unfortunately, many farmers do not plan ahead, and the transfer of the estate occurs after death. In these cases, the Federal Estate Tax takes full effect. The Federal Estate Tax law states that all transfer of property at death, since 1916, will be taxed fully on the state unless prior arrangements have been made to transfer the estate[11].

[10] https://www.fbfs.com/learning-center/what-you-need-to-know-about-farm-succession-planning
[11] https://www.ers.usda.gov/topics/farm-economy/federal-tax-issues/federal-estate-taxes/

The Federal Estate Tax does have an exemption, though, it is stated, “Under present law, the estate of a decedent who, at death, owns assets in excess of the estate tax exemption amount ($5.45 million in 2016) must file a Federal Estate Tax return”. Although the exemption seems like a large amount, it is not uncommon for an entire agriculture enterprise to exceed this amount. This tax is often up to 40% of the valued estate, and can result in the farm needing to be sold to pay off the tax.

Step Three: All Wills are Valid and Assets Protected

When the time comes, the best protection the ownership of a business can have is a valid, notarized, and county filed will that assures the business ends up in the right hands. A will is a legal document that coordinates the distribution of assets after the testator’s (owner’s) death[12]. With a valid will, assets are protected for the beneficiaries (future generation), without the state deciding how to distribute them. The person named in the will to manage the estate is called an executor, because they execute the testator’s wishes stated in the will.

A will declares who will manage the testator’s estate after their death. The estate can consist of nearly anything, from the testator’s home, business, physical property, or even small sentimental items, such as photographs. A will can also serve to declare who the testator wishes to become the guardian for any minor children or dependents.

[12] https://www.fidelity.com/life-events/estate-planning/will

According to the AARP, two out of every five Americans over the age of 45 don't have a will[13]. If a person dies without a will, they'll become an interstate, meaning their estate will be settled based on their state's laws. In these cases, a judge will appoint an administrator to act as an executor to determine who the rightful heirs to the estate are, based on state laws. Because the administrator will be bound to the probate laws of the state in which the testator resided in, their decisions may not reflect the wishes of the testator or beneficiaries.

Though lawyers aren't required to prepare a will, wills drafted by an estate planning attorney help ensure that all farm transfer goals are met[14]. They can also incorporate trusts into a will or estate plan to ensure an uninterrupted transfer of a farming enterprise from the testator to the beneficiaries, and assure the testators and beneficiaries the assets will be distributed according to their wishes. Attorneys can also reduce farmer's estate tax obligations and help farmers use wills as a part of a larger strategic estate planning process that incorporates long-term health care planning, life insurance, and power of attorney decisions.

STEP FOUR: PENSIONS AND INVESTMENTS

When the older generation is ready to retire, they're going to require some sort of income. Studies show 65% of the Baby Boomer generation won't be able to retire comfortably, and 70% will be looking to delay retirement in order to save

[13] https://www.aarp.org/money/estate-planning/info-092010/ten_things_you_should_know_about_writing_a_will.html
[14] https://farmlandaccess.org/wills/#farmtransfer

more[15]. Pensions provide a source of income for the older generation which may allow them to use less of the business's resources. As business owners, farmers qualify for Simplified Employee Pension (SEP), Savings Incentive Match Plan for Employees (SIMPLE), and Qualified Plans[16]. Many individuals also use Social Security as a source of income after retirement.

The least complex retirement option for business owners, such as farmers and ranchers, is a Simplified Employee Pension (SEP)[17]. A SEP plan provides employers or self-employed individuals a simple method to contribute to their retirement savings, as well as their employee's[18]. These retirement contributions are made to an Individual Retirement Account (IRA) set up for each participant. A SEP IRA is a popular pension plan for many business owners because it doesn't include many of the startup and operating costs other employer-sponsored retirement plans include[19]. A SEP IRA also allows employers to set up plans that contribute to their own retirement at higher levels than other retirement plans, and the contributions are tax deductible. A SEP is a good choice for small family farms because of their lenient qualifications. A participant must be at least 21 years of age, have at least three years of employment, and be able to compensate $600

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[15] https://www.northernag.net/how-saving-for-retirement-can-save-your-farm-or-ranch-on-income-tax/
[16] https://www.extension.iastate.edu/agdm/wholefarm/html/c4-56.html
[17] https://joe.org/joe/2011august/tt7.php
[18] https://www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-seps
[19] https://www.investopedia.com/terms/s/sep.asp

minimum. It is important to note if the business owner has employees, they contribute more to their own plan than to theirs[20].

A Savings Incentive Match Plan for Employees (SIMPLE IRA) is another retirement plan popular among farmers because it may be set up by employers and self-employed individuals[21]. The qualifications are more stringent than a SEP IRA; the business may not employ more than 100 employees, must be able to compensate a $5,000 minimum in the previous years, and they must expect to earn at least $5,000 during the year the SIMPLE IRA plan is established.

Through a SIMPLE IRA, employers can choose to match their employee's contributions by 2% of each employee's compensation regardless of how much the employee deferred, or by a 3% matching contribution of the employee's elective deferrals[22].

A Qualified Retirement Plan meets the Employee Retirement Income Security Act (ERISA) guidelines. These types of plans include 401(k), profit sharing plans, 403(b), and Keogh(HR-10) plans[23].

Social Security is a pay as you go tax program in which workers pay Social Security taxes into the program and then flows back out as monthly income to

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[20] https://www.fbfs.com/learning-center/the-ultimate-guide-to-self-employed-retirement-plans
[21] https://davisfunds.com/document/read/simple_ira_savings_incentive_match_plan_for_employees
[22] https://www.irs.gov/retirement-plans/operating-a-simple-ira-plan
[23] https://www.investopedia.com/ask/answers/206.asp

beneficiaries[24]. These contributions are called a federal Insurance Contributions Act (FICA) tax, and are withheld from worker's paychecks[25]. This program is not only for people who are retiring, but can be utilized by disabled persons, and the families of retired, disabled, or deceased workers. In the case of self-employed people, like farmers, earnings are reported and taxes are paid directly to the IRS when the federal income tax return is filed[26].

Social Security is not meant to be the only source of income for people when they retire[27]. Social Security replaces a percentage of a worker's pre-retirement income based on their lifetime earnings.

Social security is one of the most commonly unitized retirement benefits for Americans. As of June 2018, 175 million people paid Social Security taxes and 62 million people received monthly Social Security benefits[28].

STEP FIVE: MAKE SURE THE NEXT GENERATION HAS THE NECESSARY SKILLS

Before stepping back, the older generation should make a point to mentor the younger generation and teach them about their business.

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[24] https://www.nasi.org/learn/socialsecurity/overview
[25] https://money.cnn.com/retirement/guide/SocialSecurity_basics.moneymag/index.htm
[26] https://www.ssa.gov/pubs/EN-05-10022.pdf
[27] https://www.ssa.gov/pubs/EN-05-10024.pdf
[28] https://www.ssa.gov/pubs/EN-05-10024.pdf

For many farming and ranching families, getting their children involved in the agriculture industry happens at a young age. From the early age of five years, children can enroll in 4-H Cloverbud programs where they complete hands-on projects in areas like science, health, and agriculture[29]. Once in high school, students can take part in agricultural education courses and join the National FFA Organization, where they can learn about the different career fields in agriculture[30].

These organizations teach the next generation valuable technical and leadership skills, while keeping them engaged in the agriculture industry. After high school, students can choose to apply these skills in their career fields, or continue their education at a university with an agriculture department. At university, a student can concentrate their studies to a specific agriculture industry, or study business.

Once the next generation is ready to come back to the family farm the older generation should take it upon themselves to mentor and guide their successors. The mentor should identify the critical functions of the company and walk their successor through each of these areas[31].

[29] https://4-h.org/parents/programs-at-a-glance/
[30] https://www.ffa.org/about/
[31] https://smallbusiness.findlaw.com/closing-a-business/succession-planning-for-small-businesses.html

If there are other people involved in business, such as partners, the older generation should make sure their successors are acquainted with them. When making an introduction in a business context, a younger person, or junior member of the team, is introduced to the older person, or senior member of the team[32]. The new generation should also introduce themselves to all clients, distributors, vendors, workers, and anyone else who may be involved in the farming operation.

Agriculture is a hands-on industry that utilizes heavy machinery and equipment. The next generation should be familiar with the operating instructions and any certifications that must be obtained. Though there is no formal training program or certification to operate these machines, it is important that business owners adhere to the Occupational Safety and Health Administration's (OSHA) employee operating instructions, and insure that everything is up to code[33].

In order to apply or supervise the use of restricted use pesticides (RUPs), a person must be certified in accordance to Environmental Protection Agency's (EPA) regulations, as required by federal law[34]. Business owners should be familiar with their state's regulations, which can be more stringent that the

[32] https://herbusiness.com/blog/how-to-introduce-people/
[33] https://www.osha.gov/Publications/osha2254.pdf
[34] https://www.epa.gov/pesticide-worker-safety/how-get-certified-pesticide-applicator

federal requirements. As of 2015, the state of California has the strictest rules on pesticide application to date[35].

As the older generation begins to step back from the business, the younger generation will begin to take more responsibility, and eventually implement their own routines and strategies. If the younger generation wants to stray from the previous management practices, they should determine what resources will be needed in their business and who will be responsible for them[36]. These resources include labor, equipment, contractors, accountants, legal advisors, sales people, and administrative support. Depending on the size of the business, the owner should decide if everything will be done “in house”, or if outside help is required to meet these responsibilities.

Once the younger generation begins taking on more responsibility in the business, both the new and the older generations should work together to discuss some of the issues facing their business. The older generation can provide insight on patterns, trends, and persistent issues that affect the business, as well as the traditional approaches used in treating them. The new generation can learn from the previous generation while still using modern ideas and resources to bring a fresh perspective to help find innovative solutions to these issues.

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[35] https://www.mercurynews.com/2015/01/14/california-debuts-nations-strictest-rules-on-pesticide/
[36] https://www.faa.gov/about/initiatives/records/tools/10-step_records_management_plan/

The successors of the business should be knowledgeable of the issues facing the industry as well. Some common issues facing agriculture include water rights, labor, wages, government regulations, and trade[37]. By becoming knowledgeable of their business and the agriculture industry, the next generation will have the necessary skills to take over their business.

[37] https://www.cfbf.com/top-issues