

## Constructing a Farm Succession Plan: Elements to Consider

Many farm families dream of passing the farm on to future generations, but the reality is that relatively few farm and ranch businesses survive the generation of their founding. In a 2001 survey of farmers in twenty-six states, thirty-nine percent classified the farm as being in the family for three or more generations, while thirty-six percent classify the farm as first generation. The 2014 Iowa Farm and Rural Life Poll revealed that fewer than half of the farmers surveyed had identified successors for their farm operations. These numbers show that a goal to transition a family farm operation to future generations takes more than dreams – it requires concrete steps to build a succession plan.

A succession plan can provide helpful guidance as individuals move into and out of the farm operation in keeping with their own individual life cycle. Critical issues in succession planning include:

- Planning for shifts in management from one generation to the next.
- Transitioning asset ownership from generation to generation.
- Anticipating events that could disrupt management and ownership succession.

Seven major elements of a succession plan include the following.

### 1. Build the Farm Management Team

Multi-generational operations only survive if the individuals involved are successful in building an internal management team. This typically involves:

- Stressing the idea of a team approach to making decisions rather than simply deferring to senior individuals.

- Focusing on developing management skills in the incoming generations.
- Emphasizing cross training to develop skills and experience at all levels.
- Developing a functioning and effective system of routine communication.
- Implementing routine, non-threatening evaluation of all team members so everyone comes to understand their strengths and weaknesses.

### 2. Address the Power Issue

Succession planning involves the issue of who can control decision making. From a fundamental planning perspective, this requires creation of an environment in which decision making power is secondary to the quality of decision making input. A succession plan should contain a “*power audit*” to focus upon decision making under alternative scenarios.

**Example:** A farmer died unexpectedly at age 48 leaving a spouse (who received 48 percent of the stock in a family farm corporation) and four children (each of whom inherited 12 percent of the stock). The children have generally voted as a block since that time to pursue an aggressive expansion strategy with no dividends declared. Mother is extremely unhappy that her stock has produced no income in decades. She is confident that her late husband never once thought about who would have the whip hand of control.

### 3. Anticipate Disruptions

Related to the “*power*” issue, but involving a broader range of concerns, is the matter of anticipating disruptions in the gradual shift of

ownership and control to future generations. It may be that everyone will die in an orderly manner, all marriages will remain intact, and no serious disputes will arise. But, a succession plan should focus on the “*what if*” possibilities. What if individuals die or retire prematurely; or one or more marriages were to be dissolved with a possible division of farm ownership? When serious and fundamental disagreements arise, how will these situations be mediated? Are risk management tools in place to cover major tort or other liabilities to the operation? These types of developments are difficult to plan for but failure to plan can produce wrenching consequences. A strong succession plan will consider these possible disruptions and provide for contingency plans.

#### **4. Assure Fair Compensation**

Especially for younger generation individuals who have little decision making power, it is important to address the matter of compensation for labor and management contributions – what is sometimes referred to as “sweat equity.” It is important to compensate each individual fairly each year. If cash compensation would strain the farm operation cash flow, part of the compensation could be paid in increased equity in the business.

#### **5. Value Ownership Interests**

Periodic valuation of ownership interests on a fair and equitable basis is a key part of protecting owners and heirs of the farm business. Valuation methods will vary, depending on the farm business structure – such as whether the farm is in a sole proprietorship or general partnership structure, or in a corporate or limited liability structure. The ownership interests of senior majority owners should be valued as well as the interests of minority owners. From year to year, methods for valuing the farm and ownership interests may include measuring total net worth of the operation and assigning interests to the owners. Another methodology could be looking at discounted earnings, by calculating the value of expected future earnings in current dollars. Periodic appraisals may be necessary – of land, buildings, implements, livestock, and other farm assets. The owners may agree upon a periodically

re-negotiated fixed price based upon an inventory of all assets in the farm business. The services of financial, accounting, tax, and appraisal professionals will be necessary.

#### **6. Protect Minority Owners**

In addition to providing for a fair and equitable valuation of ownership interests, minority owners can be protected from the possible harshness of majority rule in other ways. Carefully drafted provisions for triggering first option and buy-sell agreements can be used to create a market for stock or other forms of ownership interests. Traditional decision-making rules can be modified in various ways to provide greater protection for the minority owners. Examples may include providing for a greater than majority vote (or perhaps a below-majority vote) for certain types of decision-making. Other key issues may be decided by agreement, such as contracts for employment for a specified number of years, which may include compensation agreements.

#### **7. Encourage Phased Retirement**

Another element of a succession plan focuses on encouraging senior individuals to retire. Components may include appropriate levels of retirement compensation. Planning for non-farm retirement income is vital – and must be encouraged throughout the working years. This includes making adequate payments into Social Security and other investment vehicles for the purposes of generating non-farm retirement income. Reduced-responsibility positions on the management team should be established for those approaching the retirement years so that incoming generations transition into decision-making activities.

#### **In Conclusion**

In the final analysis, a successful plan of succession in the farm or ranch business depends heavily on the personal chemistry of the individuals involved. However, a carefully considered and thought-out succession plan can be helpful in shaping expectations and in providing a framework for implementing the steps needed for an efficient and tranquil transition.

## References

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