The next generation of South Dakota producers, are the operations prepared for the transition of assets and management?

Gessner, Heather and Chowdhury, Niaz Murshed and Clary, Reid and Akinyemi, Abidemi and Moges, Michael and Quaye, Archibold

South Dakota State University, Brookings, SD, USA

6 December 2014

The next generation of South Dakota producers, are the operations prepared for the transition of assets and management?

Heather Gessner, Niaz Murshed Chowdhury,

Reid Clary, Abidemi Akinyemi,

Michael Moges, Archibold Quaye[1]

Abstract

This study used primary survey data and we found there is still a need for educational programming about creating both of these plans and the importance of writing them down, communicating the plan to the family members and not leaving the decisions until after the death of the current generation. There was a level of consensus found between the reasons farm operations were not creating estate or transition plans in our survey of interested third party participants and the responses reported by Universities. The transfer of knowledge to the next generation about the management of the operation and allowing the next generation more management and decision making opportunities needs to be included in the transition planning process. The dynamics of each family involved in a farm operation having an estate plan and a transition plan in place can prevent problems at the death of the senior generation involved in the operation. The written plans will aid in a smooth transition to the next generation, in a manner that accomplishes the goals of the family.

[1] Department of Economics, South Dakota State University, Brookings, South Dakota

Introduction

South Dakota's farmers are getting older, averaging 55.9 years of age (USDA, 2014).

With 37 percent of the 31,989 farms operated by a farmer 65 years of age or older (USDA, 2014), these operators are not retiring at 62-65 years of age. They may not retire fully from the operation until death. The advancing age of these producers is causing the next generation of management to take over decision-making and assumption of financial risk at an older age. Due to the current generation remaining involved in the operation, many are not preparing adequately for the successful transition of the farm assets to the next generation, nor are they adequately preparing the next generation to take over the management and decision making of the farm operation.

Transition of farm land and other assets will need to occur at some point. For many the transition may be to a family member successor. There are many reasons the transition to a family member is considered:

- Continued life of the operation (Mishra, El-Osta, & Saleem, Succession Decisions in U.S. Family Farm Businesses, 2010);
- Save on estate taxes (Mishra, El-Osta, & Saleem, Succession Decisions in U.S. Family Farm Businesses, 2010);
- Create additional money that can be divided between generations (Mishra, El-Osta, & Saleem, Succession Decisions in U.S. Family Farm Businesses, 2010); and
- Barriers to entry (ex. cost of farm ground) (Parson, et al., 2010)

However, due to the value of the assets (land being the major contributor, but also machinery and livestock) passing all of the farm operation assets to one individual may not be considered "fair" to family members not involved in the operation. From 2000-2014 the average value per acre of South Dakota land increased seven fold to $2470 (Janssen, Dillivan, & McMurtry, 2014). The 2012 average farm size was 1,352 acres (USDA, 2014) creating an average base value of the estate at $3,339,440 per family farm (figure excludes machinery and livestock). Because $3.3 million dollars is below the current federal estate tax level ($5.43 million exemption in 2015) (IRS, 2015), and South Dakota does not have an estate tax, farm operators may look to pass on the assets at the time of death or through the use of a trust in order to avoid capital gains taxes that would be incurred if the land is sold at realistic land values, which is required by the Internal Revenue Service (IRS).

Thus succession and estate planning is very important for operations that have a family successor interested in continuing the family farm business. Transition of ownership and management often occurs during a time of stress including: death, serious injury or illness or a major choice being reached by an heir (marriage, choosing an occupation, finding a place to live) (Anderson & Rosenblatt, 1985).

Despite years of education availability more than 50 percent of Iowa farmers had no estate plan and 71 percent had not named a successor (Duffy, Baker, & Lamberti, 2000). Minnesota Extension found similar results when they surveyed the participants at their programs: 58 percent of the participants said they did not have an up-to-date estate plan, and 89 percent did not have an up-to-date farm business transfer plan (Hachfeld, et al., Farm Transition and Estate Planning: Farmers' Evaluations and Behavioral Changes Due to Attending Workshops, 2009)

Problems/Risks Involved in the Transition

Like any business, the management of farms comes with its own associated problems and risks. Many risks hinder the smooth day-to-day operations of the farm including (but not limited to):

- Weather, diseases affecting the crops and livestock and fluctuating market prices;
- Death;
- Disaster;
- Disability;
- Divorce; and
- Disagreement (Thomas, 2013)

Let us examine each of these risk factors in detail.

Death is the main reason for a transition plan to transfer the farm management and ownership from one generation to the next. Succession planning is necessary so when the death of the primary operator and decision maker occurs, the operation can continue in a smooth manner.

Disaster can be referred to as any occurrence that has a major impact on the business and threatens survival. Disaster situations could include: flood, hurricane, tornado, drought and/or a disease outbreak or contaminated feed on the farm.

Disability resulting from the increasing age of the principal operator, either mentally or physically is another reason for transition planning that will allow for the continued, smooth operation of the family farm. Additionally, all family members involved in the operation are exposed to dangerous situations that may lead to physical disabilities that limit or end their active involvement in the operation (Kansas State University Extension and Research , 2015).

Divorce is another major reason that necessitates a family farm transition plan. With a succession plan in place, there will not be a struggle over the land and major assets which the family farm requires to operate. That way, the family operation keeps running and does not collapse due to a divorce.

Disagreement may be the most likely problem leading to the collapse of the family farm. Areas of disagreement may include: management decisions, sharing of farm profits, capital allocations, and acquisition of credit for the business. Also, long hours of work can force individuals to stop actively participating in the business. Good communication is a vital link in the success of the farming operation. Bad communication has contributed to disagreements and the failure of some family farms. Failure to clarify the role of a successor(s) is often a challenge in farm transitions. Simply transferring your farm to a child and allowing him/her to decide how to run it is not a succession plan and doing so results in a low chance for success. It will be much more effective to transfer control of the farm if family members fully understand their current and future role in running it. In addition, a clear plan and direction for business will be of great benefit to one's successor. It is a good idea to develop a business plan that includes the retiree mentoring the successor. This plan should also extend beyond retirement (Hachfeld, Bau, & Holcomb, Farm transfer and estate planning, 2013).

The family farm is more than a profit maximizing enterprise. It is an asset whose future value depends on its continuity of operation. Ownership and control of the family farm are combined within the farmer's family and internally handed down through the family (Mishra, El-Osta, & Saleem, Succession Decisions in U.S. Family Farm Businesses, 2010).

The family farm sector relies heavily on intergenerational succession (Pesquin, Kimhi, & Kislev, 1999). Intergenerational transfers can be classified into the forms of physical capital and human capital. Human capital is a stock of knowledge, habit, social and personality attributes, including creativity, embodied in the ability to perform labor so as to produce economic value, while physical capital on the other hand refers to a factor of production, such as machinery, and building. Physical capital can be further classified into liquid and illiquid assets. For family farms, land constitutes a physical asset that is highly illiquid, indivisible to a large extent, and in most cases represents a large fraction, if not all, of family wealth. Failure to plan carefully for retirement and estate transfers can result in serious problems such as financial insecurity, personal and family dissatisfaction, and unanticipated capital losses (Nerlove, Razin, & Sadka, 1984).

Failure to seek outside advice is also one of the problems in transitioning as well being a challenge. Obtaining outside advice during the succession process is crucial for most business owners, especially for first-generation owners who have not been through the succession process before. (Hachfeld, Bau, & Holcomb, Farm transfer and estate planning, 2013). Being able to discuss the issues you are facing as a successor with others who have been through the succession process is invaluable because it helps a successor protect what is important, helps motivate, support, clarify issues, and also gives a successor the ability to set realistic goals.

Characteristics of Successful Transition Plans

Successful farm transitions rely on:

- Successor status (Mieke & Huylenbroeck, 2008);
- Operator age;
- Farm wealth; and
- Educational attainment of current farm operator (Mishra & El-Osta, 2008)

The reason the successor status is important is because it provides an incentive to expand the farm, to invest in capital, and to increase the output over longer periods (Mieke & Huylenbroeck, 2008). They tested the hypotheses of a positive succession effect, using an ordinary least square panel data regression model, on data provided by the Felmish Farm Accounting Data Network (FADN). Their results showed the existence of a positive succession effect (Mieke & Huylenbroeck, 2008). Another study using a Smith-Blundell test found that succession plans have a positive and statistically significant effect on financial performance. Farms with designated family successors have higher financial performance, both in terms of higher profit margins and returns to equity (Harris, 2012).

A hypothesis that age of the CEO has both a direct and indirect (through behavioral variables) influence on succession planning found that the operator's age was positively associated with formal succession plans (Marshalls, 2006). This could be attributed to the fact that we are observing an increase in older farm operators than in previous generations (Pitts, Nussbaum, Kaplan, Fowler, & Becker, 2009). In the 2001 Agricultural Resource Management Survey (ARMS) data, only 16 percent of farm operators in the 35 to 44 years of age category have a succession plan in place (Mishra, Johnson, & Morehart, Retirement and Succession Planning of Farm Households: Results from a National Survey, 2003).

Financial pressures from farm asset transfers may negatively impact subsequent farm investments. Thus successful transitions are important. Finances are important during transition because only 16 percent of farms with a net worth of $50,000-$99,999 had succession plans in place. The number grew to 44 percent for farm households with a net worth over one million dollars, based on 2001 ARMS data (Mishra, Johnson, & Morehart, Retirement and Succession Planning of Farm Households: Results from a National Survey, 2003). The financial status of the operation is critical to the successful transition as 98 percent of U.S. farm are family operated, even the largest farms are predominantly family run (Hoppe & Banker, 2010). Also 12 percent of large-scale family farms contributed 84 percent of the value of production. And, large-scale farms are more profitable as compared to small farms, which may be why there is a statistical difference in transition planning based on scale of farms (Hoppe & Banker, 2010).

One of the barriers to entry discussed above was the cost of land. Financing is a large component to the agricultural landscape and one that can expose minorities, low-income families and first-time creditors to high interest costs (Vallabh & Chatrath, 2008) thus leading to added stress for the new operator. Many farm operators would like to avoid the stress of land loans for their successors; however there has been little research to determine the financial institutions' perception of the succession and estate plans of their client operators. The continued support of the agricultural finance industry is thus a large component of a successful farm transition.

Opportunities for Assistance and Education

The U.S. University Extension programs and other profit and non-profit organizations and businesses provide programs that educate the primary operator and the incoming successor on the tools and methods available to them (Parson, et al., 2010). .

Past participation surveys of educational programs have been shown to encourage the operators who attended to make changes to their estate plans. Fifty-nine percent of the respondents reported having started developing their farm business transfer plan, compared to 81 percent at the end of the meetings who said they planned to begin the process and 12.5 percent reported having implemented their transfer plan (Olson, et al., 2009). In South Dakota 82 percent of the attendees of Extension programs indicated they have started their estate plan and 79 percent have started their succession plan (Gessner, 2014).

The combined value of the assets, tax implications, family dynamics and continuation of the family operation are all important reasons for farm families to create estate and transition plans. Failure to do so will make the years following the death of the older generation harder on the family in terms of relationships with siblings and financially as they are now have all the management and risk of the operation.

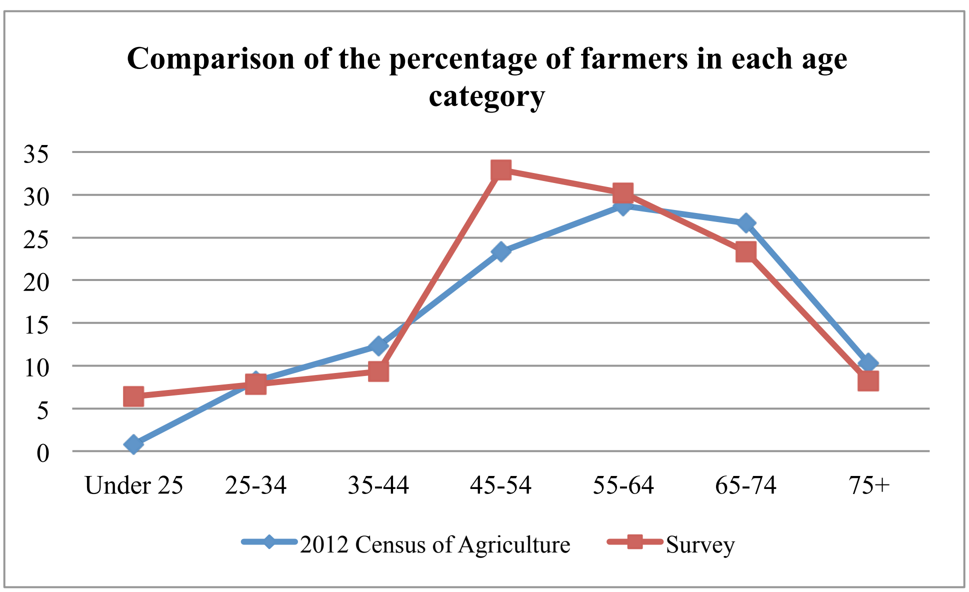
Due to the value of the land and other assets involved in an average sized operation, and the dynamics of each family involved in a farm operation having an estate plan and a transition plan in place can prevent problems at the death of the senior generation involved in the operation.

Method

To determine the preparedness of South Dakota's next generation producers we used an informed third party evaluation. The survey tool was created to determine if the level of preparedness was affected by number of generations farming together, or if the size (as determined by the total assets of the operations) had an effect on planning by the operations.

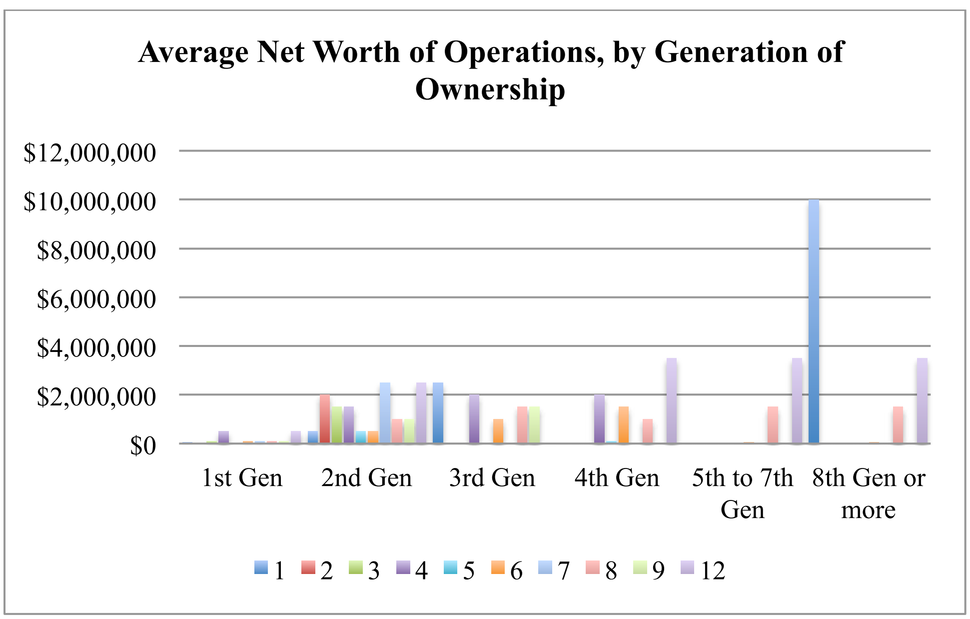
To qualify for the survey the third party respondents were asked if their client portfolio was 50 percent or greater agricultural lending. This was important to the evaluation as we wanted the third party to be actively engaged and working with South Dakota farmers. The survey was sent to 40 South Dakota's lenders and had a 30 percent response rate (n=12) with all responders qualifying based on the above criteria. Age of the senior member of the operation followed the distribution indicated in the 2012 Census of Agriculture (USDA, 2014) (Figure 1).

Figure 1



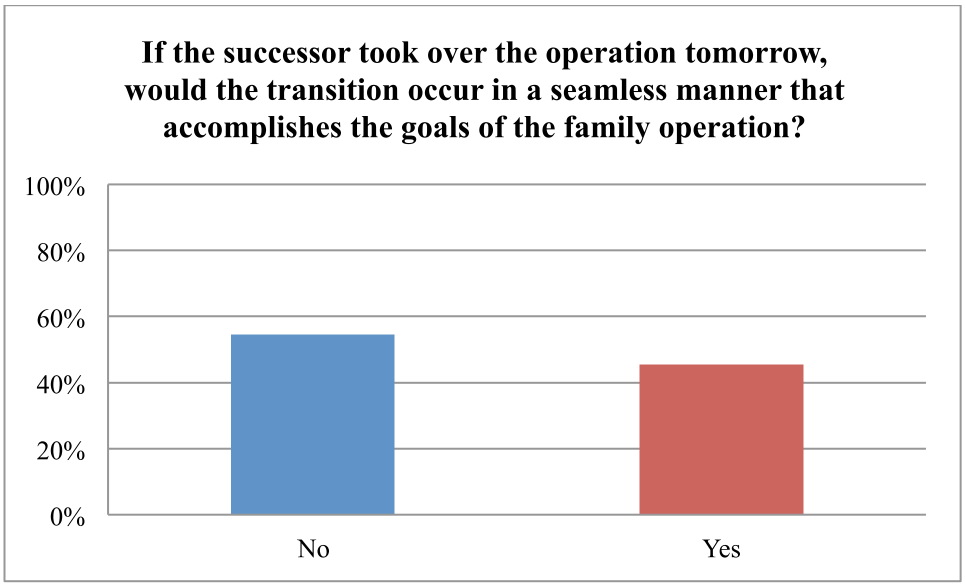
With the federal estate tax level set a $5.43 million in 2015 (IRS, 2015), we also asked the respondents to indicate the average net worth of the operation, as categorized by the generation of ownership. In retrospect net worth was not the correct terminology for the survey tool as the federal estate tax is based on the value of all the assets, not that value subtracted from the liabilities of the farm operation. While the average net worth of the producers did not reach the federal threshold, it could be assumed that the total value of the assets would be higher than the net worth indicated and may push the larger operations above that threshold level. Further, there was a wide range of values presented due to the number of generations the farm had been in the family (figure 2). At the fourth generation of family ownership, the operations appear to either maintain their size, or either maintain a land base for the family or become a much larger operation.

Figure 2



Based on the responses, if the successor generation was forced to take over management of the farm operation tomorrow, 50 percent of transition (n=6) would not occur in a seamless manner that accomplishes the goals of the family operation. These farm operations would not specifically have a successor returning to the farm operation, but half of all South Dakota 31,989 farm operations would end in the family's goals not being accomplished (figure 3).

Figure 3

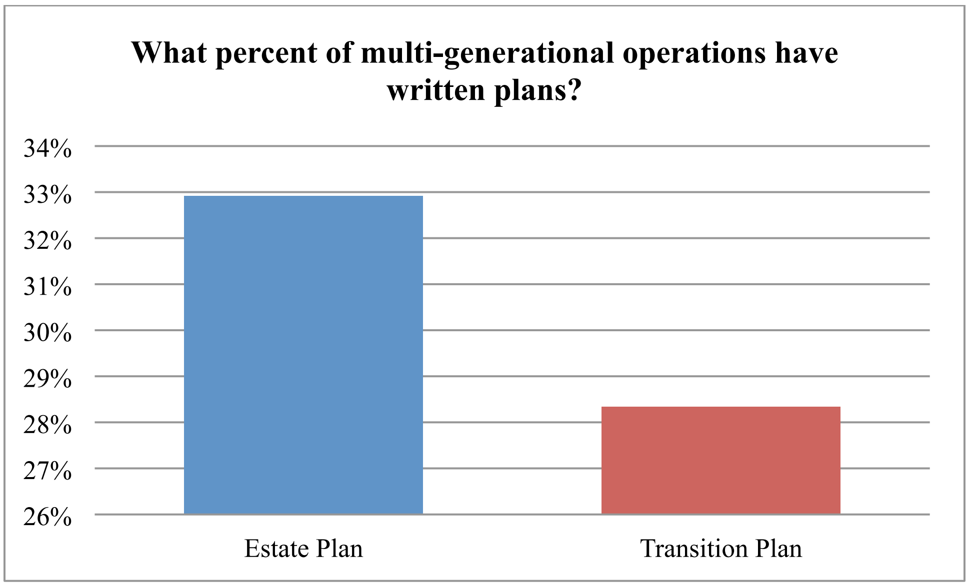


The survey found (10 responses) 10 to 89 percent of the operations included at least two generations working together with a mode of 40-49 percent. With 11,835 farms owned and operated by someone 65 or older these results indicate 4,734 to 5,799 South Dakota family operations will have transition difficulties.

Reasons for the succession not accomplishing the family's goals were: lack of planning (n=3), parents were still making the decisions (n=2), lack of general management and operational understanding (n=2) and taxation issues (n=1).

Lack of planning was listed as a key reason for the goals of the family not being accomplished. The respondents were further asked to indicate the percentage of the multi-generational farm operations that have a written and defined estate plan and transition plan (figure 4). The range regarding the estate plan was very large ranging from 10-19 percent to 80-80 percent among the responses; however, the average was 32.9 percent having a written and defined estate plan. The range for the written and defined transition plan was also large with responses ranging from 9 percent or less to 80-89 percent. The average was 28.3 percent.

Figure 4



Written plans were mentioned five (n=5) times when asked about their ideas of ‘effective’ estate planning and/or transition tools included. This open ended question had the following responses:

- Written plans (n=5)
- Wills (n=4)
- Trusts (n=3)
- Life insurance (n=2)

Communication about the plan with family members, family goals, taxation and knowledge and experience were also listed as tools needed.

Disagreement has been listed as one of the leading problems affecting a smooth transition plan (Thomas, 2013). Communication and having a written plan as indicated as being important, could be considered critical to the operation, especially when considering the number of multi-generational farm operations reported by the respondents (figure 5,6 7 and 8). This indicates multiple families are involved in the operation and each individual may have different expectations about the transition of management and the assets involved in the family operation. Without more information on the demographics on the families operating together it is hard to make any further assumptions about the level of communication that needs to occur.

Figure 5

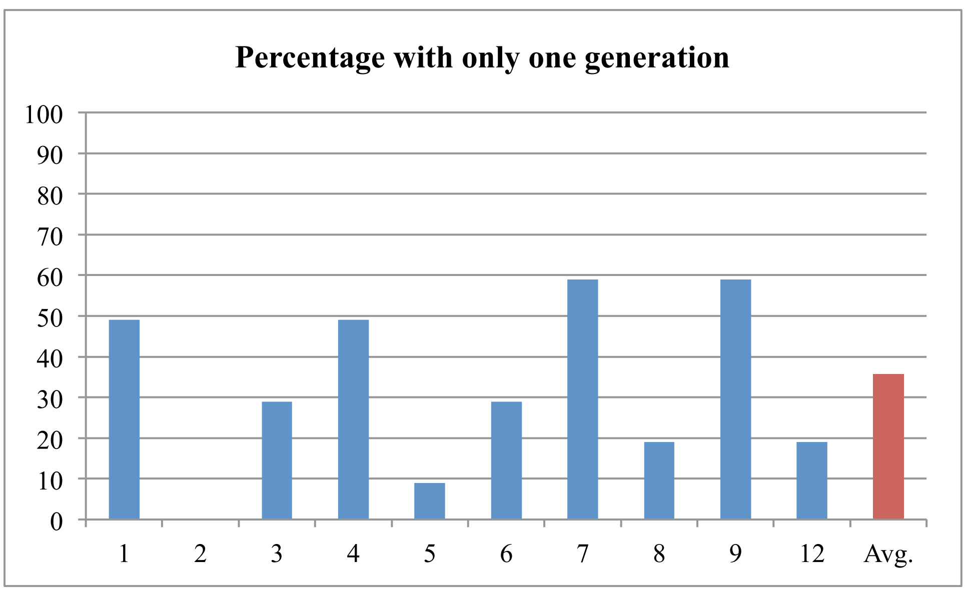


Figure 6

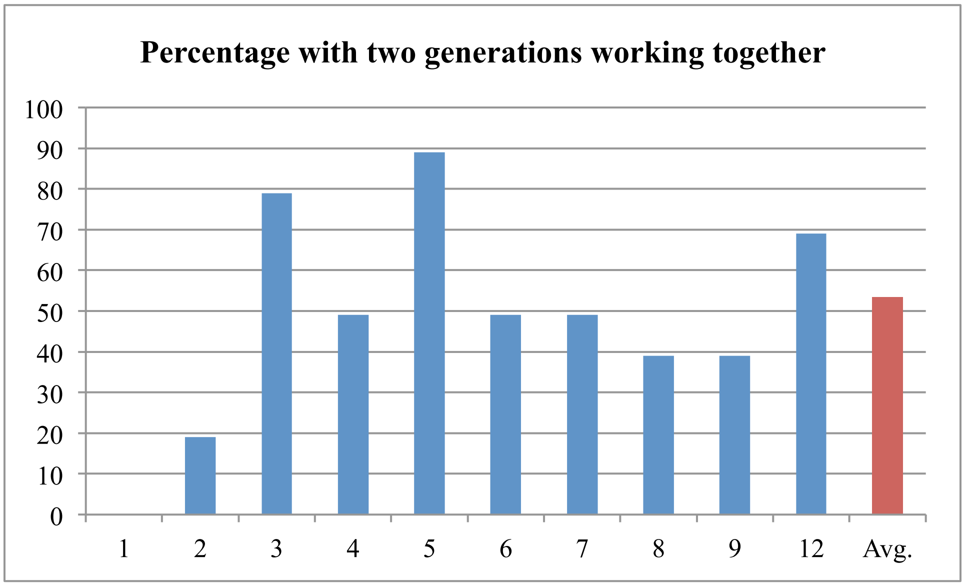


Figure 7

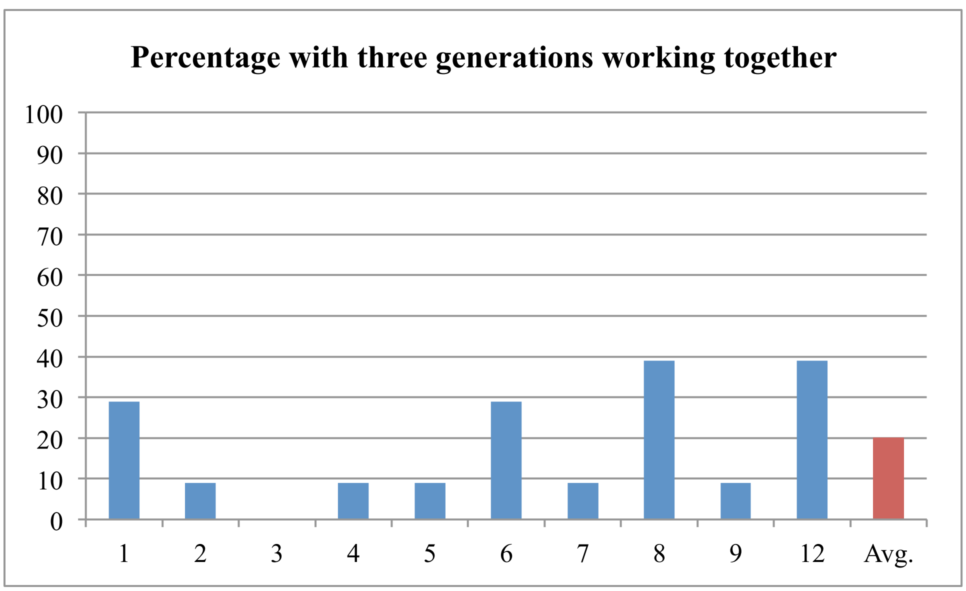
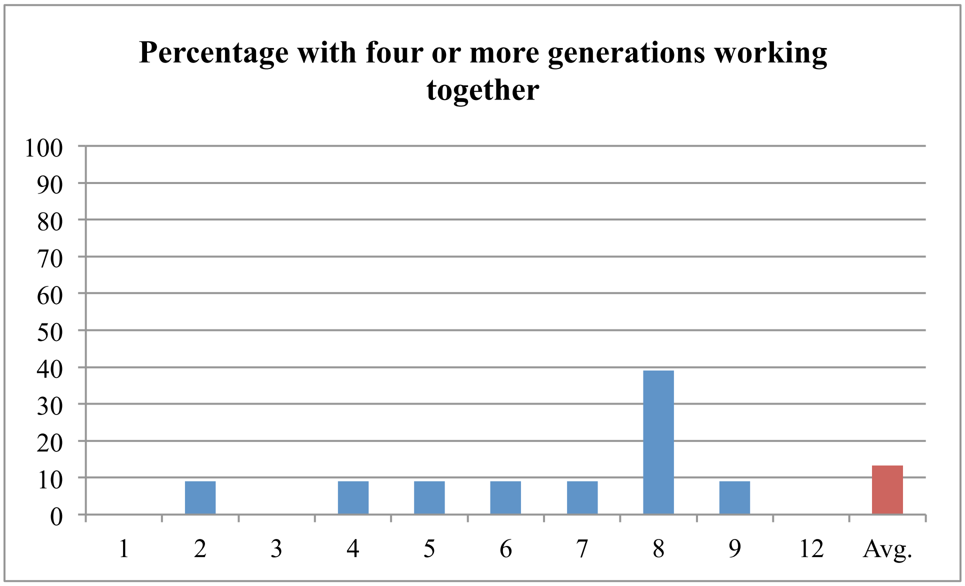


Figure 8



The open ended responses regarding what families should be doing to increase the likelihood of a smooth succession to the next generation were much more uniform and included:

- Transfer management sooner (n=3)
- Communication (n=3)
- Estate planning (n=3)
- Build expert team (n=2)

While the respondents recognized these items as ways to improve the chances of a smooth transition, five of nine responding to the question – Are the majority of your farm clients doing the things you listed? – responded no. Reasons for not implementing these tools included: procrastination, lack of education, deal with it when it happens, control issues and not knowing how to get started.

Conclusions

While the numbers were small, there was a level of consensus found between the reasons farm operations were not creating estate or transition plans in our survey of interested third party participants and the responses reported by Universities. From the information we found there is still a need for educational programming about creating both of these plans and the importance of writing them down, communicating the plan to the family members and not leaving the decisions until after the death of the current generation.

More than just having a plan in place for the transfer of assets, the transfer of knowledge to the next generation about the management of the operation and allowing the next generation more management and decision making opportunities needs to be included in the transition planning process.

Due to the value of the land and other assets involved in an average sized South Dakota farm operation, and the dynamics of each family involved in a farm operation having an estate plan and a transition plan in place can prevent problems at the death of the senior generation involved in the operation. The written plans will aid in a smooth transition to the next generation, in a manner that accomplishes the goals of the family.

Works Cited

Anderson, R. M., & Rosenblatt, P. C. (1985, Spring). Intergenerational Transfer of Farm Land. *Journal of Rural Community Psychology, 6*(1), 19-26.

Duffy, M., & et.al. (2000). Farm succession in Iowa. *Iowa Agricultural Statistics Service*. Iowa, United States of America: Iowa Agricultural Statistics .

Duffy, M., Baker, J., & Lamberti, A. (2000). *Department of Economics, Iowa State University.* Retrieved from www.econ.iastate.edu/faculty/duffy/Pages/farmsuccession.pdf

Fetsch, R. J. (1999). Some Do's and Don'ts for successful Farm and Ranch Family Estate Transfers. *Journal of Extension*, 37.3.

Gessner, H. (2014, November 26). *Sustaining the Legacy 2008-2012.* Retrieved from iGrow A Service of SDSU Extension: http://igrow.org/livestock/reports-to-partners/sustaining-the-legacy-2008-2012/

Glauben, T., Tietje, H., & Weiss, C. (2004, August 1-4). Succession in Agriculture: A Probit and Competing Risk Analysis. *2004 Annual AAEA Meeting*. Denver, CO.

Hachfeld, G., Bau, D., & Holcomb, C. R. (2013). *Farm transfer and estate planning*. Retrieved from University of Minnesota Extension: http://www.extension.umn.edu/agriculture/business/farm-transfer-estate-planning/

Hachfeld, G., Bau, D., Holcomb, C. R., Kurtz, J., Craig, J. W., & Olson, K. (2009). Farm Transition and Estate Planning: Farmers' Evaluations and Behavioral Changes Due to Attending Workshops. *Journal of Extension*, 47-2 (article 2FEA8).

Harris, J. e. (2012). The impact of farm succession decisions on the financial performance of the farm. *Economic Research Service or the U.S.D.A, AAEA, CAES, & WAEA Joint Annual Meeting.* Economic Research Service.

Hoppe, R., & Banker, D. (2010). *Structure and Finances of U.S. Farms: Family Farm Report.* U.S. Department of Agriculture, Economic Research Service.

Janssen, L., Killivan, K., & McMurtry, B. (2014, May 29). South Dakota 2014 Agricultural Land Values and Cash Rental Rates. *Economics Commentator*. Brookings: South Dakota State University.

Kansas State University Extension and Research . (2015, February 2015). *Transition Planning: 12 Steps.* Retrieved from www.agmanager.info: http://www.agmanager.info/farmmgt/planning/MF3074.pdf

Kelley, D. H. (1975). The Farm Corporatopm As an Estate Planning Device. *Nebraska Law Review*, 217-261.

Marshalls, J. e. (2006). The Paradox for the Family Firm CEO: Owner Age Relationship to Succession-Related Processes and Plans. *Journal of Business Venturing 21*, 348-368.

Mieke, C., & Huylenbroeck, G. V. (2008, August). The Succession Effect Within Management Decisions of Family Farms. *12th Congress of the European Association of Agricultural Economists-EAAE*. Ghent, Belgium: Ghent University/Department of Agricultural Economics.

Mishra, A. K., & El-Osta, H. (2008). Effect of agricultural policy on succession decisions of farm households. *Review of Economics of Households*, 351(1): 133-152.

Mishra, A. K., Durst, R., & El-Osta, H. S. (2005, April 1). How Do U.S. Farmers Plan for Retirement? United State of America.

Mishra, A., El-Osta, H. S., & Saleem, S. (2010). Succession Decisions in U.S. Family Farm Businesses. *Journal of Agricultural and Resource Economics*, 133-152.

Mishra, A., Johnson, J., & Morehart, M. (2003, September 21-23). Retirement and Succession Planning of Farm Households: Results from a National Survey. Salt Lake City, UT.

Nerlove, M., Razin, A., & Sadka, E. (1984). Investment in Human and Nonhuman Capital, Transfers Among Siblings and the Role of Government. *Econometrica*, 52 (119-1198).

Olson, K. D., Kurtz, J. N., Holcomb, R. C., Hachfeld, G. A., Craig, W. J., & Bau, D. B. (2009). Farm Transition and Estate Planning: Farmers Evaluations and Behavioral Changes Due to Attending Workshops. *Journal of Extensions*, 47.2.

Parson, R., Ruhf, K., Stevenson, G., Baker, J., Bell, M., Epley, E., . . . Keller, J. (2010). *Research Reprot and Recommendations from the FarmLASTS Project.* CSREES.

Pesquin, C., Kimhi, A., & Kislev, Y. (1999). Old Age Security and Inter-Generational Transfer of Family Farms. *Eur. Rev Agr. Econ*, 26, 1 (19-37).

Pitts, M. J., Nussbaum, J. F., Kaplan, M. S., Fowler, C., & Becker, J. C. (2009). Communication Barriers to Family Farm Succession Planning. *Journal of Extension*, 59-79.

Shalk, S., Mishra, A. K., & El-Osta, H. S. (2010). Succession Decisions in U.S. Family Farm Businesses. *Journal of Agricultural and Resource Economics* , 35(1):133-152.

Thomas, C. (2013, August 14). *Farm Transition Planning: Are You Ready for the Unexpected?* Retrieved from Ag Web: http://www.agweb.com/article/farm_transition_planning_are_you_ready_for_the_unexpected/

United States Department of Agriculture (USDA). (2014, May). *http://www.agcensus.usda.gov/Publications/2012/Full_Report/Volume_1,_Chapter_1_St* *ate_Level/South_Dakota/sdv1.pdf.* Retrieved February 20, 2015, from http://www.agcensus.usda.gov/.

Vallabh, & Chatrath. (2008, February 1). *Rural Finance Learning Center* . Retrieved from http://www.ruralfinance.org/fileadmin/templates/rflc/documents/102901122-1130.pdf