Episode 14—Succession Planning for the Farm, June 4, 2021

Announcer:

The Alabama Crops Report podcast, your trusted information source for Alabama agriculture.

Dr. Adam Rabinowitz:

Hello everyone, and welcome to the Alabama Crops Report podcast. I'm Dr. Adam Rabinowitz, Assistant Professor and Extension Economist with the Alabama Cooperative Extension system.

Dr. Amanda Scherer:

And I'm Dr. Amanda Scherer. I'm an Extension Plant Pathologist, also with Alabama Cooperative Extension. We are excited to be releasing regularly scheduled podcast episodes, with up-to-date information about Alabama crops throughout the year. You'll be hearing from extension personnel from all over the state, with the latest research and management recommendations.

Dr. Amanda Scherer:

How are you doing today, Adam?

Dr. Adam Rabinowitz:

I'm doing really well, enjoying the nice weather that we've had lately.

Dr. Amanda Scherer:

Yeah, this past weekend was actually beautiful. You know, we're recording here today on June 2nd, so we just had Memorial Day weekend, production season is getting into full swing.

Dr. Adam Rabinowitz:

It is quite active for sure. You know, today we we're actually joined by Robert Tufts, who's been here, in Auburn, for quite some time. Robert had taught at Auburn University and the School of Forestry and Wildlife Sciences for 36 years, retired six years ago, but he's currently a visiting professor with the Alabama Cooperative Extension system Farm and Agribusiness management team, and he's also a tax attorney.

Dr. Adam Rabinowitz:

Robert, it's a real pleasure to have you join us today. How are you doing?

Robert Tufts:

I'm doing wonderful, Adam, how are you?

Dr. Adam Rabinowitz:

I'm doing great. Thank you for being here with us.

Dr. Adam Rabinowitz:

So today's topic on our podcast is going to be talking about succession planning. Just real briefly, succession planning is that process of determining your vision for the future of your farm, and farmers really should be thinking about this, and who is the next generation, what they'll implement and be able to implement for the farming vision, and when that transition will occur. There's a lot of documents that need to accomplish this, and it's often something that we don't talk about a lot, and farmers don't think about a lot.

Dr. Adam Rabinowitz:

So really pleased that Robert's here to give us some insight. So Robert, can you tell us a little about what is involved in succession planning?

Robert Tufts:

Sure. So, let's start with the fact that transition is going to occur, whether you plan for it or not, and there are several layers in the planning.

Robert Tufts:

So broadly speaking, there's a financial component. You know, how much income will be available to the retiring farmer or the surviving spouse. There's a management component. Who will manage the farm, and what the

business structure should look like, and there's also an estate planning component, which would be the documents that you need to prepare to effect the transition.

Dr. Amanda Scherer:

So Robert, let's talk about that first component that you mentioned, the financial aspects to succession planting, what factors impact these decisions by farmers?

Robert Tufts:

Well, the first decision is when, and that's usually dependent on the lifestyle expectation of the retired farmer and, of course, that will depend on the income that's available. And I know some farmers plan to die with their boots on, but there's a surviving spouse or maybe some children left that need continuing income.

Robert Tufts:

So when we look at where the income in retirement is going to come from, we have social security savings that the farmer's managed to accumulate, but the biggest source is probably assets that the farmer has accumulated over the years.

Dr. Adam Rabinowitz:

So that's interesting you mentioned social security. Often we think about the, those that are off the farm and in regular jobs, even qualifying for social security benefits. What about farmers, given their state of income and being on the farm? Are they qualifying also for social security benefits?

Robert Tufts:

Sure. So anyone that's self-employed is subject to FICA tax. The problem we see a lot, is farmers try to minimize their income and, of course, a lot of them do that by purchasing new equipment and depreciating it, so they wipe out any actual reportable income. The problem is if you don't have at least the minimum 40 work credits, you don't qualify for social security, and you can get four credits per year, and you have to have in 2021 dollars, you have to have $5,880 of taxable income.

Robert Tufts:

I don't have time to get into a lot of the calculations, but I usually suggest that a farmer and their spouse have some earned income, and the amount this year I would recommend is $996. The reason for that, when social security calculates the benefit, there are what we call two inflection points. So for the first, and by the way we calculate what's called the average indexed monthly earnings, and so what they do is take the 35 best years of earnings, and if you have years of zero, then of course the zero is going to count and bring your average down.

Robert Tufts:

But going back to the why the 996, basically social security will pay back 90%. In other words, if you have close to a thousand dollars a month, you'll get back $900 a month in social security benefits. So that's the first inflection point.

Robert Tufts:

So anything over the 996, social security only pays 32% on that, on the amounts above 996, up to $6,002. Anything over 6,002, you only get 15%.

Robert Tufts:

So I recommend that to get the 90% payback, that farmers have some earned income. Obviously, if they have an off-farm job, that may take care of it, they may not have to worry about farm income, but you really need to make sure you earn the 40 work credits.

Robert Tufts:

Health insurance is going to be a really big deal. If you don't qualify for social security, then you miss the qualification for Medicare. You can still get Medicare if you don't have the 40 work credits, but it will end up costing more.

Dr. Adam Rabinowitz:

So just to make sure that I've got this right about that $996 of earned income, you're saying that can be off the farm, but can also be on the farm as well?

Robert Tufts:

Correct. So 996 is kind of the best return, and it's any earnings that you report as social security earnings.

Dr. Adam Rabinowitz:

Great. That makes sense.

Dr. Amanda Scherer:

Robert, you also mentioned, aside from social security benefits, you mentioned savings as an additional source of income and just for just the general public, a lot of that comes into play in our own retirement 401ks, IRAs, but I'm curious, how farmers have to think about these things differently from maybe the rest of the workforce, and what are your thoughts and advice for farmers when establishing these types of savings accounts?

Robert Tufts:

Anyone that's self-employed can basically put together a retirement program. The big problem that I see with most farmers though, is they don't put a lot of money into savings. They reinvest their money back into their

farm, but obviously if you are going to try to pass the farm along to the children, you probably need some kind of savings to live on.

Robert Tufts:

So as a self-employed individual, the farmer can certainly have an IRA or a 401k. There are other types of plans, if he has employees that he wants to include in those. One of the big problems today with the saving side of it is, is the market volatility. So stock market's at an all time high, but is there a bubble there? Is it going to drop again? We've seen it go up and down recently, you know, the 2007 and '08 timeframe, and most people now, unlike [inaudible 00:08:48] employees that have a defined benefit program, most people have what's called a defined contribution program, so you have whatever money you have, and then you've got to do the planning to make it last.

Robert Tufts:

So I certainly would recommend working with a financial planner to at least come up with some kind of estimate of how much income your savings will generate and, of course, when you retire and what your life expectancy is will determine how long your savings might last.

Dr. Amanda Scherer:

I definitely imagine that for farmers, it can be tough to accumulate a lot of savings, because they have these long wishlist of things that they want to do or purchase for their farm, so I can see how that could be a challenge for a lot of producers in our area.

Dr. Adam Rabinowitz:

So you talked about social security benefits, savings, but that leaves assets now, as the third one that you mentioned before, as a source of income for farmer retirement. Can you elaborate on that?

Robert Tufts:

Sure. So as I just mentioned, farmers tend to put more of their money back into land and equipment, than they do savings, and so that means that probably going to have to sell those assets to generate retirement income.

Robert Tufts:

So, obviously the farmer would love to pass the farm down to his children, but he may not be able to do that, because got to generate some kind of income in retirement.

Robert Tufts:

One thing that farmers don't always consider is the income tax applications of selling the assets, so the farmer may have purchased the land say for $500 an acre 30 years ago, now it's worth 4,000. That means when the farmer sells the land, he would have a taxable gain of $3,500 per acre, and the tax rate could be as high as 25

percent. So for married individuals filing jointly, the capital gains tax is only 0% on the first 80,800. Then it goes up to 15% on the amount of both 80,800 bit less than 5,016, and then it goes to 20% on the amount over 501.

Robert Tufts:

You know, going around doing workshops, I hear stories every once in a while, and I had this one farmer had kind of a sad story. He was retiring in December, and a couple of years earlier, he had deferred his crop income to January to save on taxes, and so then he had to continue deferring his income. So now he's retiring in December. In January, he sold his equipment for a million dollars, and he got his million dollar crop payment. So now he's looking at $2 million of ordinary income with no offsetting expenses, and at the time, he was at the 39.6 federal rate and 5% state, so he lost almost half of his million dollars just to taxes.

Dr. Adam Rabinowitz:

That is a scary situation there, that something like that can happen. What kind of advice do you even have for somebody that that's facing situations like that?

Robert Tufts:

The first thing I would say is, a year or two before you get into something like that, consult with a CPA or a tax attorney, because there are some things you can do. I wrote an article on this a couple of years ago, and it's got a couple of different strategies that you can use to minimize that. I hate to get into a lot of detail, but one of the ways, on the depreciation, form an LLC, and then let the person that's going to buy you out, buy into the LLC, and then basically you retire part of your interest annually for the next several years, and so that would give you a way of minimizing or reducing taxes.

Robert Tufts:

So there are some things you can do, but it's one of those, we need to look at what you've got and what you're planning on doing, and so a good tax attorney or accountant could probably help you minimize the amount of tax you would owe.

Dr. Adam Rabinowitz:

Sounds like good advice. Appropriate planning, and consulting the right experts.

Dr. Amanda Scherer:

Robert, now that I feel like we've given a good background on some of the financial things to think about for succession planning, earlier on, you mentioned that second component, which involves, who is taking over the farm and then how will it be managed? I imagine that this will involve some tough decisions for producers, depending on how many people are involved, how many children they have, and what their thoughts are. What is your advice for producers or what's your thought on this second component?

Robert Tufts:

I do an estate planning for landowners workshop, and I always start IT off with a question. So if husband and wife leave the 300 acre farm to their three children, and of course they leave it equally. How many acres does each child have? The answer is 300, because the only way to leave things equally to children, is to leave them an equal interest in each asset, and what that ends up doing is creating joint ownership and joint management.

Robert Tufts:

The problem that I see is most farming families have one or more children that are interested in farming, and one or more children that don't have an interest in farming. They've gotten married, they've moved to town, they have another job, maybe they would rather have a new house than a one-third interest in the farm, so it's not a good idea to force children with different goals to work together.

Robert Tufts:

So if the children can't agree on the use of the property, the only remedy is partition, and it's a court proceeding, or partition can be done voluntarily, but it's almost never done voluntarily because nobody can agree on who gets what. But partition means to physically divide, if possible, and if it's not physically able to be divided, so if it's 300 flat acres of crop land, yeah, we can probably divide that evenly, but if it's 40 acres with a house and a pond and some pasture and some trees, no way to divide that equally.

Robert Tufts:

So if you can't divide it equally, then it will be sold, and one of the problems, of course, with physical division, if the parcels are too small, then maybe they're not enough to generate the needed income, and if you force the sale, the price may be so high that a family member cannot afford to purchase the land.

Robert Tufts:

This is one of those, when the court says we're going to sell it, you got to show up with cash. The court's not financing anything, so the alternative to doing that would be to create a business entity or a trust that would hold the land, so the children that are interested in farming could lease the land from the entity. The non-farming children would get the rental income as their share, so this would ensure that the land would be available to the family for farming, and it would generate some income for the children, but it would prevent the non-farming children from forcing the sale, and it would also provide creditor protection for the land.

Dr. Adam Rabinowitz:

So developing a business entity or a trust, does that actually then survive the individual farmer?

Robert Tufts:

That's the whole point, of course, is having an entity that will survive past the farmer's life, so the business entity wouldn't give the children the most flexibility, and hopefully the farmer has identified one or two children that

have the interest and aptitude for farming, and he has mentored those children by passing along his knowledge that he's gained over the years.

Robert Tufts:

So the farmer should have a vision for the future of the farm, and hopefully convey that to the children, and ideally the farmer would have one or more family meetings, where he discussed with the children what his vision is, and how he hopes to accomplish it, and who will help him. When you're thinking about a family meeting, you need to understand that the in-laws, the daughter's husband, has a fair amount of influence on your daughter, and so they probably need to be included in these conversations.

Robert Tufts:

And then, after you have the family meeting, maybe the farmer has to change his vision, so the one thing the farmer has to understand on the business entity, once he has gone, the children are in control, so if they do not understand the plan and agree with it, they may completely change the use of the land, or even sell the land that the farmer managed to accumulate over his lifetime.

Robert Tufts:

So, yes, a business entity is an option. The advantage of a business entity is it has perpetual life. The disadvantage is, once the farmer has gone, now the children are in control.

Dr. Amanda Scherer:

So you're mentioning the farmer's vision and then, I imagine, with multiple children involved, there is a risk where they may not agree with the farmer's vision. So what happens if only one or two of the children do agree with this vision after these family meetings?

Robert Tufts:

Ideally, the farmer gets buy-in from the children but, at the end of the day, the farmer can exercise the golden rule, and that would be, he who has the gold, makes the rules.

Robert Tufts:

The farmer is not obligated to give anything to his children. What the farmer can do again, is create the business entity, and if he has one or two children that have bought into the vision, then he can make them the managers of that business. Remember, we were talking earlier that the business would own the land, and the land would be available for lease by the farming children. The other children could get little rental income, but nobody would be able to force the sale, so they don't get as much as they would if they sold it and divided the money.

Robert Tufts:

So if the farmer can identify one or two of these children and make them the managers, then most likely you would use either a limited liability, limited partnership, or a limited liability company.

Robert Tufts:

So the farmer would create, there's a document that you file with the Secretary of State to create the entity, but there's an internal agreement, so most everybody understands bylaws for a corporation, so that the document that's similar to that, would be a partnership agreement for the limited partnership, or an LLC agreement for the LLC, and in that agreement, he would set out how the business operates.

Robert Tufts:

The big thing was how do we transition management from one generation to the next? So he could appoint these children either as general partners of the limited liability, limited partnership, or managers of the LLC, so that would prevent the other children from interfering with the management of the farm, prevent them from forcing the partition of the land, or leaving the business and taking assets with them, so the children basically get an income interest in the business, but they don't have any management rights ... we're talking about the off-farm children ... so they don't have any management rights. They have a right to dissociate from the business, but there is no requirement that the business pay for their interest if they leave.

Robert Tufts:

So that's why the business entity has good security for the farming children. But again, you have to remember, once the children take over the business and they own it, they can always change the farmer's plan or even sell the land.

Robert Tufts:

The other alternative would be a trust, and in a trust, the farmer would dictate the use of the land. So we would appoint a trustee that would manage the farm after the farmer is gone, but the trustee would actually have to abide by the provisions of the trust. So the trust document would set out how the land is to be used, how the income from the land is distributed, and although the trust will not last in perpetuity, in Alabama, it could last for 360 years, which is probably way further than you can plan for.

Robert Tufts:

So the trust actually has more security in terms of keeping the business entity or the farm, the land, from being lost, due to divorce, creditors, bankruptcy, that sort of thing. So the trust provides more protection for the land, and it gives the farmer the option to specify how the land is used, but it takes a little more thinking to put together the trust, than it does the business entity.

Dr. Adam Rabinowitz:

This is a lot of great information, Robert.

Dr. Adam Rabinowitz:

You talked about the role of social security, savings, assets, even just the structure or the transition of the farm, and where the farmer's vision plays into that.

Dr. Adam Rabinowitz:

One of the things that I learned today, listening and talking with you, is just how complicated succession planning can be for a farmer. How can a farmer really learn more about succession planning?

Robert Tufts:

There are several states that have workbooks that can help you with succession planning. The University of Tennessee Extension Publication 1791, entitled Planning Today for Tomorrow's Farms is a pretty good one. There are other states like Virginia, Oklahoma, several others, that also have these, and it is a topic that I am very interested in, so I will have a two hour Zoom program on succession planning on July 15th at 7:00 PM, and you can go to the Extension web page, and type in succession planning, and it should take you to a little one page description of the program and a registration button, if you're interested.

Dr. Adam Rabinowitz:

And that webpage would be ACES, A-C-E-S.edu.

Dr. Amanda Scherer:

So that ends our time today with Robert Tufts. He is a visiting professor in the Farm and Agribusiness Management team, and is also a tax attorney. I think producers are really going to appreciate that two hour Zoom, just because it seemed a lot to cover just in a podcast.

Dr. Amanda Scherer:

We've really enjoyed having you on today, Robert.

Robert Tufts:

Thank you, Amanda.

Dr. Amanda Scherer:

As always, if we can be of any help to anyone, don't hesitate to reach out.

Announcer:

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