



**20. Farming: The Next Generation  
(Making Transition Actually Happen)**

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**Abstract/Summary**

*This session will review the "nuts and bolts" of bringing another generation into the active management and ownership of a farming operation. Employment agreements, stock options, buy-sell agreements, and entity operating agreements will be reviewed to give the operators an idea of strategies to use. A case study farm will be offered to review a common farming scenario.*



## FARMING: THE NEXT GENERATION

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### BUSINESS SUCCESSION PLANNING



## PURPOSE OF THIS SESSION

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- LOOK AT SPECIFIC EXAMPLES OF FARM OPERATING STRUCTURES THAT COULD FACILITATE SUCCESSION PLANNING
- REVIEW SOME EXAMPLE AGREEMENTS THAT COULD ASSIST IN THE FINANCIAL TRANSITION.



## TYPICAL METHODS OF SUCCESSION

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- DO NOTHING CURRENTLY, BUT PROMISE TO LEAVE FARM ASSETS TO ON-FARM HEIR
- INFORMAL ENTERPRISE TRANSFERS TO NEXT GENERATION, SUCH AS LETTING SON TAKE OVER A PIECE OF RENTED LAND OR GIVING YOUR SON 30 BEEF COWS, WHILE PAYING SON A BASE WAGE ON MAIN FARMING OPERATION



## BEST METHOD OF SUCCESSION

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- ESTABLISH BUSINESS ENTITIES AND FORMAL LEGAL AGREEMENTS TO FACILITATE THE TRANSFER OF MANAGEMENT AND SHARE OF PROFITS TO THE NEXT GENERATION



## KEY COMPONENT DEFINE "FAIR & EQUITABLE"

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- IF YOU SET UP ALL BUSINESS ARRANGEMENTS TO BE "FAIR & EQUITABLE" RIGHT FROM THE START, THERE IS NO REQUIREMENT TO HAVE TO MAKE SPECIAL ALLOWANCES IN YOUR ESTATE PLAN



## ADVANTAGES OF A FAIR & EQUITABLE PLAN

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- FAMILY HARMONY
- SPREAD TAXABLE INCOME OVER MORE INDIVIDUALS AND LOWER TAX BRACKETS
- REDUCE ESTATE TAX IF THE ESTATE TAX IS NOT "FIXED" BY CONGRESS
- CREATE FINANCIAL INCENTIVE FOR ON-FARM HEIR



## ESSENTIALS OF SUCCESSION PLAN

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- PLAN MUST FAIRLY COMPENSATE THE CONTRIBUTION OF ALL PARTIES
- PLAN MUST BE IN WRITING
- REVIEWED BY ATTORNEY & ACCOUNTANT
- INTERFACE WITH ESTATE PLAN OF OLDER GENERATION



## CONTRIBUTIONS

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- LABOR
- MANAGEMENT
- CAPITAL
- LAND BASE
- GOODWILL



## LABOR AND MANAGEMENT

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- PAY A FAIR SALARY (CORPORATION OR SOLE PROPRIETOR)
- SET UP GUARANTEED PAYMENT FOR LABOR & MGT IN GENERAL PARTNERSHIP AND LLC
- ESTABLISH A WAY TO GET PROFIT SHARED BASED ON MANAGEMENT CONTRIBUTION, NOT EQUITY OWNERSHIP



## RETURN ON CAPITAL AND LAND

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- PAY A REASONABLE RATE OF RETURN TO THOSE WHO CONTRIBUTE CAPITAL
- PAY CASH RENT/CROP SHARE ON LAND OWNED BY INDIVIDUALS



## GOODWILL

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- GOODWILL IS DEFINED AS THE ASSUMED VALUE OF THE ATTRACTIVE FORCE THAT GENERATES SALES REVENUE IN A BUSINESS (INTANGIBLE)
- EXAMPLES ARE A STRONG LANDLORD BASE FOR ECONOMIES OF SIZE, NAME RECOGNITION, KDHE PERMITS ON LIVESTOCK OPERATIONS, OR A CONTRACT FOR SPECIFICALLY IDENTIFIED COMMODITIES



## GOODWILL

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- GOODWILL IS GENERALLY IGNORED IN PRODUCTION AGRICULTURE, SO THIS WOULD BE A BONUS TO THE ON-FARM HEIR
- AS FARM GET LARGER, GOODWILL BECOME MARKETABLE



## EXAMPLE FARM SUB-S CORPORATION

- FATHER (70) AND SON (50) HAVE A SUCCESSFUL FARMING OPERATION WITH 2500 ACRES TILLABLE AND BACKGROUND 1000 HEAD PER YEAR
- ALL OPERATING ASSETS (EQUIPMENT, GRAIN, & CATTLE) ARE IN A SUB-S CORPORATION AND THEY EACH OWN 50 PERCENT OF SHARES IN THE CORPORATION
- ALL FARMLAND IS OWNED INDIVIDUALLY AND CASH RENT IS PAID BY THE CORP



## EXAMPLE FARM SUB-S CORPORATION

- GRANDSON (28) HAS A DEGREE IN AGRONOMY, WORKED OFF THE FARM FOR SEVERAL YEARS, THEN CAME BACK TO THE FARM AND HAS WORKED FOR A SALARY FOR THE PAST TWO YEARS. GRANDPA HAS BEEN SLOWING DOWN, BUT STILL TAKES AN ACTIVE MANAGEMENT ROLE IN THE OPERATION. ALL PARTIES SEE THE GRANDSON TAKING A MORE ACTIVE ROLL IN MANAGEMENT.



## EXAMPLE FARM SUB-S CORPORATION

- GRANDSON HAS NO EQUITY TO PUT INTO THE OPERATION
- THE CORPORATION HAS ESTABLISHED CASH WAGES OF \$25,000 FOR GRANDPA AND \$ 50,000 EACH FOR SON AND GRANDSON BASED ON LABOR CONTRIBUTION, AND THEIR CASH FLOW PROJECTIONS ARE POSITIVE
- HOW CAN THE GRANDSON ENTER INTO THIS BUSINESS ARRANGEMENT?



## SUB-S CORPORATION GRANDSON EMPLOYMENT AGREEMENT

- BASE SALARY OF \$ 50,000
- BONUS EQUAL TO 1/3 OF (CORPORATION "ACCRUAL NET FARM INCOME" AFTER ALL LABOR EXPENSE LESS 4 PERCENT RATE OF RETURN ON SHAREHOLDER EQUITY AT THE BEGINNING OF THE YEAR). 1/3 WILL BE REDUCED BY ANY STOCK PURCHASED BY THE EMPLOYEE, SO THAT STOCK OWNERSHIP AND BONUS EQUALS 1/3.



## SUB-S CORPORATION GRANDSON EMPLOYMENT AGREEMENT

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- A CORPORATION IS LEGALLY BOUND TO KEEP ALL CASH DIVIDENDS EQUAL BASED ON THE NUMBER OF SHARES OWNED
- BONUS COULD BE "COMMODITIES IN LIEU OF WAGES" TO AVOID SE TAX



## SUB-S CORPORATION STOCK PURCHASE AGREEMENT

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- EXECUTE AGREEMENT WHICH GIVES GRANDSON THE RIGHT TO PURCHASE EQUAL NUMBER OF SHARES THAT ARE CURRENTLY OWNED BY GRANDPA AND DAD OVER TIME.
- THIS WOULD MAKE THE 3 EQUAL PARTNERS WHEN THE GRANDSON IS FINISHED BUYING SHARES.



## SUB-S CORPORATION STOCK PURCHASE AGREEMENT

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- GRANDSON WOULD USE THE "BONUS" TO PURCHASE NEWLY ISSUED CORP STOCK, WHICH WOULD ALSO HELP THE CORPORATION CASH FLOW SITUATION.
- PURCHASE PRICE EQUAL TO FMV LESS THE ACCRUED BONUS AND DIVIDENDS PAID SINCE THE FIRST OF THE YEAR.



## SUB-S CORPORATION EXAMPLE BONUS CALCULATION

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- ACCRUAL FARM INCOME AFTER WAGES = 190,000
- BEGINNING CAPITAL OF SHAREHOLDERS = 1,000,000 @ 4% RATE OF RETURN IS 40,000
- 190,000 LESS THE CAPITAL CHARGE OF 40,000 EQUALS 150,000 X 1/3 = 50,000 BONUS



## SUB-S CORPORATION EXAMPLE BONUS CALCULATION

- GRANDSON TAKES THE \$ 50,000 BONUS IN COMMODITIES IN LIEU OF WAGES, PAYS THE TAX DUE OF APPROX \$ 10,000, THEN PURCHASES \$ 40,000 OF NEWLY ISSUED CORPORATE STOCK
- OTHER TWO SHAREHOLDERS TAKE \$ 70,000 EACH AS A DIVIDEND



## SUB-S CORPORATION LAND SUCCESSION

- GRANDPA ESTABLISHES AN LLC WHICH OWNS ALL HIS REAL ESTATE OUTSIDE THE CORPORATION
- LLC EXECUTES A LONG-TERM LEASE TO THE SUB-S CORPORATION
- LLC EXECUTES A BUY-SELL AGREEMENT WHEREBY NON-FARM HEIRS WILL BE PAID OFF AT FAIR MARKET VALUE, BUT MUST FINANCE THE SALE WITH A 10 YEAR CONTRACT AT THE MINIMUM IRS INTEREST RATES. ONLY CURRENT LLC MEMBERS ARE ELIGIBLE TO PURCHASE THE UNITS.



## CORPORATE DIVISIVE REORGANIZATION

- SPIN-OFF A PORTION OF ASSETS INTO A SUBSIDIARY CORPORATION
- EACH SHAREHOLDER TRADES HIS  $\frac{1}{2}$  OF STOCK IN ONE CORP FOR THE OTHER SHAREHOLDER'S  $\frac{1}{2}$  OF THE OTHER CORP, SO EACH ENDS UP OWNING 100 % OF HIS OWN CORP
- IRC SECTION 355



## DIVISIVE REORGANIZATION CASE STUDY FARM

- TWO BROTHERS(AGE 54 & 52) OPERATE A SUCCESSFUL CASH GRAIN OPERATION THAT FARMS 4000 TILLABLE ACRES AND EACH OWN 50% OF THE CORPORATE SHARES
- EACH BROTHER HAS A SON WHO WOULD LIKE TO TAKE MORE ACTIVE MANAGEMENT IN THE OPERATION AND THERE IS AN OPPORTUNITY TO PICK UP ADDITIONAL FARMLAND TO RENT.



## DIVISIVE REORGANIZATION CASE STUDY FARM

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- THE BROTHERS HAVE CONCERNS ABOUT THE ABILITY OF THE COUSINS GENERATION TO GET ALONG AND FIND IT DIFFICULT TO DO THEIR OWN ESTATE PLANNING WITH THE STOCK OWNERSHIP IN THE OPERATING ENTITY INTERTWINED WITH EACH OTHER.



## DIVISIVE REORGANIZATION CASE STUDY EXAMPLE PLAN

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- OLD BROTHERS CORP SETS UP A WHOLLY OWNED SUBSIDIARY(NEW CORP INC.) AND TRANSFERS ½ OF ASSETS AND DEBT INTO NEW CORP INC.
- BROTHER #2 TRADES HIS STOCK IN OLD BROTHERS CORP FOR 100% OF THE NEW CORP INC. STOCK.
- THIS LEAVES BROTHER #1 OWNING 100% OF OLD BROTHERS CORP AND BROTHER #2 OWNING 100% OF NEW CORP INC.



## DIVISIVE REORGANIZATION CASE STUDY EXAMPLE PLAN

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- EXECUTE A BINDING AGREEMENT TO DIVIDE OUT THE RENTED FARMLAND BETWEEN THE TWO CORPS, WITH RESTRICTIONS OR COVENANTS NOT TO COMPETE IN REGARDS TO EXISTING LANDLORDS.
- FSA PAYMENT LIMITATION BENEFITS
- JOINT EQUIPMENT OWNERSHIP AGREEMENTS BETWEEN THE TWO CORPS



## PARTNERSHIP/LLC CASE STUDY FARM

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- FATHER IS 60 YEARS OLD AND IS FARMING 3000 ACRES OF TILLABLE LAND WITH SEASONAL HELP
- SON IS 32 YEARS OLD AND HOLDS A FULL TIME JOB IN TOWN, BUT ALSO WORKS 20 HOURS A WEEK FOR HIS FATHER FOR AN HOURLY WAGE.



## PARTNERSHIP/LLC CASE STUDY FARM

- SON'S FATHER-IN-LAW IS RETIRING FROM FARMING IN THE SAME COMMUNITY AND WOULD LIKE TO SEE HIS SON-IN-LAW OPERATE HIS OWNED LAND AND LAND HE HAS RENTED, WHICH TOTALS ABOUT 1500 TILLABLE ACRES.
- SON WOULD LIKE TO GIVE UP HIS OFF-FARM JOB AND FARM FULL TIME WITH HIS FATHER.
- THE CASH FLOW PLAN LOOKS GOOD, INCLUDING UPGRADING EQUIPMENT TO FARM HIS FATHER-IN-LAW'S GROUND



## PARTNERSHIP/LLC CASE STUDY ENTITY PLAN

- A GENERAL PARTNERSHIP IS ESTABLISHED – 50/50 PROFIT INTEREST EACH – GP IS USED PRIMARILY FOR FSA PAYMENT LIMITATION BENEFITS
- FATHER CONTRIBUTES FARM EQUIPMENT AND GRAIN TO THE PARTNERSHIP
- FATHER SETS UP A LAND OWNING LLC – WITH BUY/SELL PROVISIONS
- RENTAL AGREEMENTS ON ALL FARM LAND ARE SIGNED BETWEEN THE LLC AND THE PARTNERSHIP



## PARTNERSHIP/LLC CASE STUDY PARTNERSHIP AGREEMENT

- GUARANTEED PAYMENT OF \$ 50,000 EACH FOR LABOR. THIS CAN BE ADJUSTED IF FATHER STARTS TO SLOW DOWN.
- PARTNERSHIP PAYS CASH RENT ON FARMLAND OWNED BY FATHER
- CAPITAL GUARANTEED PAYMENT OF 4% OF FMV CAPITAL AT BEGINNING OF YEAR IS PAID NEXT.



## PARTNERSHIP/LLC CASE STUDY PARTNERSHIP AGREEMENT

- ANY PROFIT ABOVE THE GUARANTEED PAYMENTS WILL BE DIVIDED 50-50 BETWEEN THE PARTNERS.
- REQUIRE CASH DISTRIBUTIONS OF 30% OF TAXABLE INCOME ABOVE GUARANTEED PAYMENTS, SO THAT PARTNERS HAVE THE CASH TO PAY TAX.
- BUY/SELL AGREEMENT EXECUTED
- REQUIRE SECT 754 ELECTION



## BUY/SELL LIQUIDITY LIFE INSURANCE

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- HIGH COMMISSION/HIGH COST
- CONSIDER SECOND TO DIE POLICIES ON A MARRIED COUPLE TO CHEAPEN PREMIUMS
- KEEP THE LIFE INSURANCE DECISION AT THE INDIVIDUAL LEVEL INSTEAD OF ENTITY LEVEL
- MORE IMPORTANT TO HAVE ON THE YOUNGEST GENERATION/KEY MANAGER



## BUY/SELL LIQUIDITY TERM PAYOUTS

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- 10 OR 15 YEAR PAYOUT AT MINIMUM IRS RATE
- ALLOWS OFF-FARM HEIRS THE ABILITY TO CONVERT ASSETS TO CASH
- ON-FARM HEIRS DO NOT HAVE TO BORROW FUNDS FROM OUTSIDE SOURCES



## BUY/SELL LIQUIDITY

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- FARM RETURN ON EQUITY COULD BE MUCH HIGHER THAN RETURN ON LIFE INSURANCE – KFMA RETURN ON EQUITY 3 YEAR AVERAGE OF TOP 25% OF FARMS IS 17.48%
- COMPOUNDED VALUE OF A 20 YEAR, \$ 20,000 ANNUAL INSURANCE PREMIUM AT 15% IS \$ 2,048,800



## BUY/SELL AGREEMENTS VALUATION METHODS

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- LOCK BUYOUT AMOUNT INTO AGREEMENT AND PERHAPS CHANGE EVERY 2-3 YEARS (MEDICAL PRACTICE)
- FAIR MARKET VALUE DETERMINED AT DATE OF TENDER OF OWNERSHIP UNIT, BUT SET METHOD OF CALCULATION (FARM)



## SUCCESSION PLANNING SEMINAR EXAMPLE DOCUMENTS ATTACHED

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- EMPLOYMENT AGREEMENT
- STOCK PURCHASE AGREEMENT
- BUY/SELL AGREEMENT FOR LLC UNITS OR CORPORATE STOCK



## SUCCESSION PLANNING RESOURCES

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- [www.agtransitions.umn.edu](http://www.agtransitions.umn.edu)
- USE TO DOCUMENT AND PREPARE A WRITTEN SUCCESSION PLAN
- CAN ALLOW REVIEWERS TO EDIT YOUR PLAN ON-LINE



## SUCCESSION PLANNING RESOURCES

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- IOWA STATE UNIVERSITY EXCEL SPREADSHEET
- USE TO DETERMINE CONTRIBUTION OF ON-FARM HEIR AFTER-THE-FACT
- AVAILABLE FROM KSU EXTENSION UPON REQUEST



## PRESENTED BY

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