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**PROBLEMS WITH FARM SUCCESSION:
THE CASE OF SASKATCHEWAN, CANADA**

William J. Brown

University of Saskatchewan

Abstract

The succession planning process should start years if not decades before the transfers take place. Unfortunately most farm couples in the exiting generation have not saved enough money outside the farm business to finance their retirement. They have to rely on the farm assets to generate their retirement income either through sale and/or rental. The situation is complicated further when the exiting generation wants the farm business to pass to the next generation intact and to also be fair to all their beneficiaries. A number of tools were investigated including sale of all assets, sale of livestock and machinery and rental of land, insurance on the exiting generation with non-farming beneficiaries claiming the proceeds, and incorporation of the farm business. The only tool that does not require the exiting generation to lower their retirement income and/or the incoming generation to have substantial off farm income is incorporation.

Keywords: succession, planning, goals, rental, insurance, incorporation

Introduction

Succession planning is about finding the right strategy for handing over or selling your business to someone else, whether it be staff, family, friend or entrepreneur, and being prepared for all that transfer entails (Government of Canada, 2010). Succession planning or lack thereof in the farm business context is a major contributor to the changing structure of primary agriculture throughout the world. A lack of planning causes the exiting generation to require substantial assets from the farm business to support their retirement. This leaves the incoming generation in a financially unviable position to continue on in the business without a substantial amount of off farm income. The result, either immediately or within a few years is one less farm reported in the statistics.

Succession planning, in the context of this paper, is part of personal financial management that should begin years, if not decades, before the transfer takes place. Personal financial management consists of insurance management, debt management, and retirement planning. Insurance management entails securing the proper amount and kind of life, disability and liability insurance that suits the life style and life stage of the people involved and the type and size of farm business. Proper management of any farm business requires that debts be serviceable and kept to a conservative level with respect to assets (SMAa). Retirement planning is affected by the goals and objectives of both the exiting generation and the incoming generation and whether the exiting generation needs to rely on farm assets to finance their retirement.

The paper concentrates on the financial calculations associated with transferring the farm business to the next generation. How do the financial position and the goals of the exiting generation affect the resulting financial position of the incoming generation? The other challenges of succession planning with regards to transferring decision making roles and dealing with the associated emotions of those involved are not discussed. Rather, the paper will follow three hypothetical couples through the succession planning process. These couples are labelled as the mattress investors, the conservative investors and the couple more willing to take on risk. The numbers used apply to Saskatchewan, Canada but the situations are applicable to most developed countries in the world.

Setting Goals and Objectives: What Is Most Important?

There are three major areas of goals and objectives for most people in the exiting generation of farm families when it comes to succession planning. The three main areas are: lifestyle during retirement, have the farm business pass to the next generation intact, and treating beneficiaries fairly. Prioritizing which of these three goals is the most important will dictate the best tool to use in succession planning. Of course, goals and objectives are not usually so discrete and much overlapping can occur. The more overlapping the more difficult it will be to select one approach that will satisfy all the goals and objectives.

Retirement Lifestyle is the Most Important

If lifestyle during retirement is the most important goal, then the cost of the desired lifestyle needs to be calculated and the question of how this money is going to be raised needs to be answered. The so called “ideal” retirement lifestyle of lots of travel, golf, vacation properties etc. can cost a great deal. Let’s assume the exiting generation (husband and wife) have decided they need \$50,000 Canadian Dollars (CAD) per year for the next 30 years (for example, age 65 to 95) in addition to any government payments they may be eligible to receive. How much will they need at the start of retirement to give them \$50,000CAD/year for 30 years? The calculation is rather easy if they put the money in a mattress or sock (a rather big one) and withdraw \$50,000CAD/year for 30 years, it would be $\$50,000\text{CAD} \times 30 = \$1,500,000\text{CAD}$. This method of investing is not very advisable as the money would not make any return and would lose some of its purchasing power to inflation. If the couple were rather conservative investors and invested in bonds or guaranteed investment certificates (GICs) and made 4% on the money, they would need: $\$50,000\text{CAD}/\text{year} \times (1 - (1/(1+.04)^{30})) / .04$ (Uniform Series Present Value) = $\$50,000 \times 17.292 = \$864,600\text{CAD}$. If the couple were more willing to take on risk and invested in stocks or mutual funds and made 9% on the money, they would need: $\$50,000\text{CAD}/\text{year} \times (1 - (1/(1+.09)^{30})) / .09 = \$50,000 \times 10.2737 = \$513,685\text{CAD}$. By comparison, the long term, since 1950, return on 10 year government bonds and the stock market total return index in Canada is 7.01% and 9.85% respectively (Brown). However, in the last 5 years these returns have been 4.07% and 9.27% respectively (Brown)

How Is This Money Going To Be Raised?

The retiring couple has at least 3 major ways to raise this money: they can save and invest the money over their life time, they can sell all or part of the farm business, or they can sell the machinery and livestock and rent the farmland out. In 2007 the average Saskatchewan farm family had \$36,090CAD in off farm investments (AAFC). It is obvious therefore that the average Saskatchewan farm family is not saving for their retirement but rather relying on the farm assets to finance it. However, if they had saved and invested the money over their life time they would need to save $(\$1,500,000\text{CAD} - \$36,090\text{CAD})/30 = \$48,797\text{CAD}/\text{year}$ for 30 years to get the required \$1,500,000CAD needed if they use the mattress approach. If they were conservative investors and realized a 4% return they would need: $(\$864,600\text{CAD} - \$36,090\text{CAD}) \times .04 / ((1+.04)^{30} - 1)$ (Sinking Fund Deposit) = $\$828,510\text{CAD} \times 0.0178 = \$14,748\text{CAD}/\text{year}$. If the couple were more willing to take on risk and invested in stocks or mutual funds and made 9% on the money, they would need: $(\$513,685\text{CAD} - \$36,090\text{CAD}) \times .09 / ((1+.09)^{30} - 1) = \$477,595\text{CAD} \times 0.0073 = \$3486\text{CAD}/\text{year}$. If this last couple started saving 10 years sooner, thereby saving for 40 years, they would need to save: $\$477,595\text{CAD} \times .09 / ((1+.09)^{40} - 1) = \$477,595\text{CAD} \times 0.003 = \$1,433\text{CAD}/\text{year}$. The above calculations show a clear advantage of using a form of investment vehicle that suits your risk preferences, and increasing the length of time to save for retirement.

The average farm in Saskatchewan, Canada in 2009 had Assets = \$980,706CAD, Debts = \$191,092CAD, and Equity = \$789,614CAD (SMAA). Selling all or most of the farm works for the couple willing to take on more risk (stocks or mutual funds realizing 9%), but the conservative

investing couple (bonds and GICs realizing 4%) and the mattress investing couple will not have enough equity in the farm to cover their desired retirement income.

Selling the machinery and livestock and renting out the farm land will also not work for all three couples. The average farm in Saskatchewan, Canada has only about 26.5% of their assets in machinery and livestock and cash rents have historically been only about 4.5% of the current value of the farm land (SMA, United States Department of Agriculture (USDA)). Once the debt is paid off after the machinery and livestock are sold there is only: $(\$980,706\text{CAD} \times .265) - \$191,092\text{CAD} = \$68,795\text{CAD}$ left for retirement. Even if it were invested at 9%, it would only generate: $\$68,795\text{CAD} \times .09 / (1 - (1/(1+.09)^{30}))$ (Capital Recovery Factor) = $\$68,795\text{CAD} \times 0.0973 = \$6,694\text{CAD}/\text{year}$. The land rent generated would be: $(\$980,706\text{CAD} \times .735) \times .045 = \$32,437\text{CAD}/\text{year}$. This would leave all the couples at least: $\$6,694\text{CAD}/\text{year} + \$32,437\text{CAD}/\text{year} - \$48,797\text{CAD}/\text{year} = -\$9,666\text{CAD}/\text{year}$ short of their annual retirement income goal.

Have the Farm Business Pass to the Next Generation Intact is the Most Important

As stated above the only one of the 3 example couples that can meet their retirement income needs by selling the farm is the couple willing to take on more risk and invest in stocks or mutual funds. Let us assume as above, that the retiring couple needs \$513,685CAD from the sale of the farm business to meet their income needs. The incoming generation would have to pay the exiting generation at least this much plus take over the existing debt of \$191,092CAD. The total debt of the incoming generation would then be $\$513,685\text{CAD} + \$191,092\text{CAD} = \$704,777\text{CAD}$. Given the asset value of the farm business of \$980,706CAD, the incoming generation would have a very high debt/asset ratio of $\$704,777\text{CAD}/\$980,706\text{CAD} = 0.72$. Many lenders would not want to lend this much based on the market value of the assets. Also given this farm has only 437 hectares (1,079 acres) of cultivated land that generates on average about \$506CAD/hectare (\$205CAD/acre) in gross revenue with a net income average of \$89CAD/hectare (\$36CAD/acre) (SMAa, SMAb). It should be noted that an allowance for unpaid labor and management and/or living expenses have not been included in the expense calculation. The total net income generated by the farm business annually would be: $\$89\text{CAD}/\text{hectare} \times 437 \text{ hectares} = \$38,893\text{CAD}$. If the incoming generation has to borrow the entire \$704,777CAD at 4% with a repayment period of 25 years, the annual payments of principal and interest would be: $\$704,777\text{CAD} \times .04 / (1 - (1/(1+.04)^{25})) = \$704,777\text{CAD} \times .064 = \$45,105\text{CAD}/\text{year}$. This situation results in leaving the incoming generation with the need for off farm income to service the remainder of the principal and interest payment and cover living expenses.

Treating Beneficiaries Fairly is the Most Important

First of all, treating beneficiaries fairly is not the same as treating them equally. Earlier gifts like tuition fees should be considered when allocating assets between beneficiaries. The value of a university education paid for 10 years earlier is significantly more than the equivalent amount of money that may not be inherited for another 30 years. For example, at 5% annual interest rate, the present value of \$40,000 paid for 10 year ago is: $\$40,000 \times (1.05)^{10} = \$65,156$. Whereas, the same \$40,000 paid 30 years from now has a present value at 5% annual interest of: $\$40,000 \times 1/(1.05)^{30} = \$9,255$. Therefore those beneficiaries that will not receive their inheritance for quite some time should get more to be fair.

The above scenario assumes that only one of the beneficiaries and perhaps his/her family buys the farm business. They pay \$704,777CAD for the farm that has an asset value of \$980,706CAD and thereby inherit equity of \$275,929CAD. It was previously shown above that they cannot cover the principal and interest payment on the loan without off farm income. How then can any other beneficiaries be compensated?

It appears that all the example couples discussed above cannot satisfy both the goal of passing the farm business to the next generation intact and the goal of being fair to all beneficiaries. If the farm business is split fairly between the beneficiaries, none of them would have a large enough farm business to survive without off farm income or and the exiting generation would not have enough to meet their retirement needs. Let's look at the couple willing to take on more risk and invest in stocks or mutual funds and assume they have 2 beneficiaries that they want to treat fairly. In this example, when the farm was sold intact to the one beneficiary that person also received \$275,929CAD of equity. The exiting couple could require the farming beneficiary to pay another \$137,965CAD or half the equity for the farm business and give that money at the time of sale to the other beneficiary. The principal and interest payments of the farm beneficiary would now be: $(\$704,777\text{CAD} + \$137,965\text{CAD}) \times .04 / (1 - (1/(1+.04)^{25})) = \$842,742\text{CAD} \times .064 = \$53,936\text{CAD}/\text{year}$. This situation results in leaving the incoming generation with the need for more off farm income to service the remainder of the principal and interest payment and cover living expenses. This also results in a very high debt/asset ratio of $\$842,742\text{CAD}/\$980,706\text{CAD} = 0.86$ and most lenders would not want to lend this much based on the market value of the assets.

Another potential solution to this problem would be to give some of the land to the non-farming beneficiary, in the hope that they rent it back to the farming beneficiary. It should be remembered that once title is received the new owner does not have to follow instructions from a previous owner as to what to do with the land. So let's assume the non-farming beneficiary receives \$137,965CAD worth of land and rents it at 4.5% to the farming beneficiary. The farming beneficiary now has the same amount of borrowed money as when he/she originally bought the farm from the parents but has \$137,965CAD less in assets. The farming beneficiary also has a rent payment of: $\$137,965\text{CAD} \times 4.5\% = \$6,208\text{CAD}/\text{year}$. This situation again results in leaving the incoming generation with the need for off farm income to service the remainder of the principal and interest payment and cover living expenses. This is better for the farming beneficiary than buying out the off farm beneficiary as in the previous example. However if the off farm beneficiary sells the land out of the family the farming beneficiary will need even more off farm income.

Another potential solution to this problem is for the farming beneficiary to get the farm intact while financing the exiting generation's retirement and to buy insurance on the exiting generation with the non-farming beneficiary being the beneficiary of the insurance proceeds when the parents pass on. The results would be similar to those of buying out the exiting generation outright but would also have the additional cost of the insurance premium. Recall that the non-farming beneficiary's share of the equity was \$137,965CAD. The premium for \$100,000CAD worth of term to 100 life insurance for a 65 year old non-smoking female, which would be cheaper than for a male, is \$213.48CAD/month or \$2,561.76CAD/year (Life Quotes.ca). However the non-farming beneficiary will have to wait: $86.6 - 65 = 22$ years on average, as this is the current life expectancy of a 65 year old Canadian woman, to collect their inheritance (Canadian Business Online). In order to have the same amount as the farming beneficiary the insurance coverage would have to be raised. At 5% annual interest rate the value of the insurance coverage at life expectancy would be: $\$137,965\text{CAD} \times (1.05)^{22} = \$403,584$ in 22 years. The premium for \$400,000CAD worth of term to 100 life insurance for a 65 year old non-smoking female is \$854CAD/month or \$10,248CAD/year (Life Quotes.ca). The two beneficiaries could agree to ensure the exiting generation at somewhere between the two amounts. This situation again results in leaving the incoming generation with the need for off farm income to service the remainder of the principal and interest payment and cover living expenses.

The problems expand exponentially as the number of beneficiaries increase. Even with only one beneficiary, only the more risk taking couple can make it work and the farming beneficiary family would have to have substantial off farm income. Two or more beneficiaries can work but the off farm income would not only have to cover all the living expenses but also more of the principal and interest on the loan.

If All Three Objectives Are Important

If all three objectives are equally important it is next to impossible to meet all of them without long term planning. If retirement saving has not been done a possible solution could be to incorporate the farm business. The farming beneficiary would still have to purchase the farm business from the exiting generation to finance their retirement and take over the debt. The exiting generation would then transfer a controlling interest in the farm business, at least 51% of the voting shares, to the farming beneficiary. The non-farming beneficiary would receive the other 49% of the shares which represent close to half the farm business equity. Once this is accomplished the farming beneficiary controls the decisions in the farm business and does not have to worry about neither the non-farming beneficiary selling the land out of the family, as shares in a family farm corporation usually cannot be sold out of the family, nor the regular payment of rent. Compensation for shareholders is usually in the form of dividends which come from after tax profits. Therefore, dividends do not have to be paid in years of low or negative profits. However, if the farm business is consistently profitable and dividends are not paid out, minority shareholders can appeal to the corporations act and perhaps get a remedy (Ellyn).

If there are more than two beneficiaries, the farming beneficiary could receive all the voting shares for complete control, but there would have to be a category of non-voting shares to be transferred to all the beneficiaries. These non-voting shares would represent the equity in the business and if divided equally among the beneficiaries would leave the farming beneficiary with less and less of the equity as the number of beneficiaries increase. However the farming beneficiary would have complete control over the farm decisions, including compensation to labour and management (himself/herself) and the payment of dividends, to all shareholders. The question remains as to whether the farming beneficiary would be willing to take on the responsibility of working and managing the farm business, while receiving a smaller equity position.

Conclusions

The succession planning process should start years if not decades before the transfers take place. Unfortunately most farm couples in the exiting generation have not saved enough money outside the farm business to finance their retirement. They have to rely on the farm assets to generate their retirement income either through sale and/or rental. The average farm in Saskatchewan, Canada does not have enough equity to support a \$50,000CAD/year, 30 year retirement unless the exiting generation takes on some risk and invests the money in stocks or mutual funds. Therefore the exiting generation will have to lower its retirement income goals. If not, the incoming generation will need substantial off farm income to service the loan payments and cover their living expenses.

The situation is complicated further when the exiting generation wants the farm business to pass to the next generation intact and to also be fair to all their beneficiaries. A number of tools were investigated including sale of all assets, sale of livestock and machinery and rental of land, insurance on the exiting generation with non-farming beneficiaries claiming the proceeds, and incorporation of the farm business. The only tool that does not require the exiting generation to lower their retirement income and/or the incoming generation to have substantial off farm income is incorporation. Incorporation has the potential of dividing ownership and management so that the farm business can stay intact and be managed by one beneficiary and his/her family but be split fairly between the beneficiaries on an ownership bases. Incorporation does not solve all the problems of farm business succession but it is a tool that could be used more often.

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