Successful Succession in a Multi-Generation Business with a Team Approach

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▪ Take Home Message

This talk will examine the steps which farm families can take as they work through this topic of succession planning.

- **Step 1 Discover People's Expectations**

People who own and operate farms say it is important to ask family members what they expect from the business. Goals need to reflect family values and business attitudes of all family members.

- **Step 2 Explore the Options**

With a set of family goals and expectations in place, you can explore your ownership options. Once you have some ideas about ownership methods, you can then examine some business arrangements .

- **Step 3 Build a Succession Plan**

Family business goals, ownership options and preferred business arrangements will all be combined to develop a draft succession plan. The draft plan should outline how management, labor and asset transfer will be handled.

- **Step 4 Check With the Experts**

Your draft succession plan should be shown to experts such as lawyers, accountants, financial and agriculture specialists. Each professional can give you advice on the specifics of your plan and may introduce options you haven't considered.

- **Step 5 Review and Finalize the Plan**

The succession plan should be reviewed and changes made if necessary. A time line and strategy for putting the plan into place should be developed.

- **Step 6 Implement the Plan**

It is now time to shift from planning to action. To help with this step, you need to turn your plans into action in the areas of management, labor and asset transfer. It is best to start with a small, achievable action and get it working rather than taking on too much at once.

Introduction

> *Last summer, we celebrated 100 years of operating our family farm. I can't tell you how satisfying it was to look back on the good times and bad times, and then to look forward to another 100 years."*

....From: *"One Generation to the Next: A Paper for Farming for the Future and CFBM Initiative",* Feb 1996

How do these types of farm families ensure that "success" is part of their succession plan? By planning as early as possible, by fostering open communication with all family members and by carefully considering how the farm business will look in the future. Does this just happen by chance? Certainly not!

The following steps, while only one suggestion, do provide a little more structure to this process of succession planning than just trying to let it happen by chance.

STEP 1 Discover People's Expectations

During this step the family should work on the following types of tasks with the idea that the outcome discussed below will result.

Tasks:

- Find out if any children are interested in taking over the farm.
- Decide whether the family wants to farm together and when the parents no longer wish to farm.
- Calculate whether the farm is financially capable of supporting multiple families.
- Find out what non-farming children expect from the farm.

- Assess the management ability and level of training successor(s) require to manage the farm in the future.
- Decide what is fair to successors and non-farming children.

OUTCOMES: A set of succession goals

Check your goals (personal and business) to make sure they reflect the values and business attitudes of all family members. The goals should reflect the needs of both the retiring and younger generations, whether or not they are farming.

Review the tasks listed and any others in order to ensure your succession goals are complete. The things you learn about yourself and family members should be evident in your goals list.

Check each goal to make sure it is well written. A clear goal will pass the SMAC test. It needs to be specific, measurable, achievable and consistent with your values.

Many families find that the issue of fairness to all children is the most difficult part of succession planning. To help resolve this issue on your farm: plan early, keep communications open among all family members and help your children express their concerns about the plan. You may find that a consultant is helpful during this task if family members have trouble discussing fairness issues.

▪ STEP 2 Explore the Options

Tasks:

- Research the options available for the following:

  ownership/control of land and buildings
  ownership of machinery and equipment
  ownership of inventory (livestock/crops).

- Match business arrangements to your family business:

  sole proprietorship
  joint venture
  partnership
  corporation

- Examine management roles for all individuals.

- Discuss labor allocation and skill development.

- Research the option for financing the transfer of assets.

OUTCOMES: Identified options for ownership of assets and the business arrangement that suits both generations

Most farm families grapple with the trade-off between providing a retirement income for the parents while allowing successors to acquire land, livestock and equipment at an affordable price. Family members will need to be open and direct with each other to ensure the right choices are made.

Ownership agreements identify who will have control over the business assets and share in any increase in their value.

Business arrangements are an important part of a succession plan. They examine the income sharing options as well as management and labor methods. A family can own separate businesses, operate one unit jointly or have some combination. It is typical for a farm family to train the successor(s) while they gradually set-up a viable land or asset base.

The following discussion taken from "*Ownership and Farm Transfers . . Issues for Multi-family Businesses*", Alberta Agriculture, Food and Rural Development, illustrates the different methods of holding land titles which are available to farm families.

Ownership of Land and Buildings

It is worth noting that the real issue is usually about **control** over land and not its actual ownership. The word control is one which most people find rather strong. To many people, however, having control over their land is critical. Who has the say as to whether it will be sold, mortgaged or leased is important. When parents have worked for and are depending upon the land for their future income or financial security, they may feel uncomfortable about giving up control.

Over time, however, the parents' need for and want of control changes. It may be unnecessary to have the same control over each piece of land to achieve financial security. Likewise, children eventually want some control over land because they too are concerned about their families' future and land forms a major part of their security.

Several types of land ownership arrangements are possible. The amount of control they offer ranges from total control to none at all, with many degrees in between. Family members may require only sufficient control over the asset to ensure that it cannot be sold, mortgaged or leased without their agreement. Shared control with a spouse or with children is often the solution.

Individual Ownership

Fee simple is the legal terminology for an individual having the ownership of land in their own name. No other person or entity has any legal right to the asset unless by way of a separate legal agreement (except by way of the Dower right for spouses on the home quarter and the matrimonial property act in the case of marriage breakdown). The land may be used in the owner's business or be rented or leased to a business.

The person with ownership has complete control to do what he/she wants with the assets including selling, giving, mortgaging or leasing. If an owner requires income from sale of the asset in the future, then they should keep the ownership to themselves.

Pledge the Land as Security

If the parents want to help their children but do not want to give any of the titles to them, they may permit the child to use the land title as security for the purchase of their own land. Parents must realize they may lose the land they have pledged or be forced to pay out the mortgage to get the land back.

In many farm businesses, the purchase of additional land by the child is a good means of involving them in the business but permitting the parents to retain their property for retirement or estate planning. This option gives control of the asset to a third party, a mortgagor, but the owner has the say over what the original terms and conditions are.

Joint Ownership of the Title

Under this arrangement two or more individuals own the assets jointly. None of the owners are able to sell, mortgage or rent the land without everyone's agreement. There are two types of joint ownership.

Joint Tenants

With this type of joint ownership, the individuals share the asset equally while alive, but upon death the survivor has total ownership. The one who lives the longest ends up owning the entire asset. The owners are not able to leave their share in their will because their share does not go to their estate upon death. It goes directly to the surviving owners.

If parents want land given to a child returned to them rather than going to their child's spouse, this arrangement would work, because the joint tenancy would revert to the parents automatically if the child dies. The spouse could be protected with other assets or life insurance.

Tenants-In-Common

Under this form of joint ownership, each person owns a specified percentage while alive and their share goes to their estate upon death. They are therefore able to will their share to whomever they wish including their spouse.

Life Estate Title

This option provides the parents with Control over the right to income and/or use of buildings for life through a life estate title. Their child has the right to ownership through a second title called a remainder-man title. The parents however have given up the ownership control with its right to sell, mortgage or lease.

The remainder-man title created for the child gives them ownership control over the asset. While the life estate titles are in effect, however, the child does not have control over the right to income and/or use of buildings and usually will find it difficult if not impossible to sell or mortgage the title. If the remainder-man title is sold or mortgaged it does not affect the life estate title which remains in effect for the life of the person(s) who have it.

The life estate title can only be removed by the person named on the title or at the time of their death.

Sale with Mortgage or Agreement for Sale

A child can purchase a land title with a mortgage placed against it and made payable to the parent. The parent can either take the yearly payments or let them go into arrears. (Be careful not to forgive debt because the amount of principal forgiven would be taxable income in the hands of the child). In this kind of transaction, the parents can take what money they need at present for living. If they do not need the payments, they could give them to other children as an advance on their estate.

If the child wishes to sell the property, any balance remaining must be paid off including any arrears and interest on arrears. In this way, the parents can have some protection against a gift being sold. This would be applicable in the case of a marriage breakdown where the title was to be transferred or sold.

The same type of protection could be achieved with an agreement for sale being registered instead of a mortgage. The child has the property provided they fulfill the agreement. If the child cannot fulfill the agreement, the parents have legal recourse to get the property back.

Transfer to a Partnership or Corporation

Another method of sharing control over land is to transfer it to a partnership or a corporation and then share the ownership of the business. This will not solve many of the problems that are evident with shared control and may create more problems than before.

Partnership

When assets are owned by a partnership, they are in effect owned by the business. The assets will however remain in individual or joint names. While the name or names on titles will not be changed to the partnership, the asset is formally transferred to or purchased by the business. In this case the person or persons named on the titles does not directly own the assets, but rather a partnership interest in the business.

Corporation

Corporations can own assets in their name. They are a separate legal entity with the right to hold, buy or sell assets. Here, the corporation owns the assets and the individual(s) in turn own the corporation.

Transfer the Title

Situations may exist where the parents require no control over an asset. In this case they can transfer the asset to the other family with or without remuneration. Once the title or ownership has been transferred, there is no legal recourse if the original owner wishes to regain control.

There is no need and it is unlikely that the degree of control over all assets will remain the same over time. The combination of individual assets, type of control and time creates many combinations that provide for a phased transition from one family to another. Some may remain totally under the control of the owner for life while others change over time. This will vary depending upon the needs and desires of both parties.

Ownership of Machinery and Equipment

Machinery can be owned in many different ways, but it is not covered by titles as land is. The following are some methods of machinery ownership that multi-family businesses may consider.

Individual Ownership

If one person owns the equipment, that person has total control and gets to take the depreciation and capital cost allowance. The owner may decide whether it is sold or traded. Any proceeds from the machinery sales go to the owner.

Some farmers look upon machinery as forming a part of their retirement fund. In this case they will need total ownership and should take care to understand the legal and tax consequences of its sale.

Joint Ownership

As with land, machinery can be owned by more than one person. When two or more persons own a piece of equipment they all have a right to any income from its sale, all must agree on its sale or trade, and all must agree on its use. Any depreciation or capital cost allowance will be taken by the individuals in the same proportion as their ownership. Because each individual depreciates their own share, they do so independently.

One of the biggest issues with joint machinery ownership occurs when the use is not proportionate to the ownership. It is necessary but often difficult to come up with an agreement for offsetting this use. This may not be as big an issue with parents and children, but if more than one child is involved or children from a number of families are involved, this can be a difficult problem. One solution is to transfer all machinery to the business.

In parent/child operations, the parent will often transfer the ownership of machinery to the child over time. This can be done in many ways, from outright gift to sale. Often machines are transferred when they are traded for replacements. The parent may give the old one to the child, or sell it for the undepreciated capital cost allowance. The child adds the trade-in difference and owns the new one. This will result in a slow transfer between generations with minimal tax consequences.

A second way to transfer ownership of machinery to the child is to exchange it for a machinery use agreement. The child agrees to farm some or all of the parents’ land for a specified time period in exchange for ownership of the machinery.

Owned by the Business

The machinery may be transferred to or purchased by the business rather than by the individuals. In this case a partnership or corporation could own the machinery and the individuals own an interest in the partnership or shares in the company. The business will take any depreciation or capital cost allowance before the profits are split to the individuals. This eliminates the opportunity of the partners to take capital cost allowance individually.

One other way to own the machinery is through a machinery partnership or corporation. In this case the business only owns the machinery and would rent it to the farming individuals. This rent could be on a use basis such as per acre or hour, or any other agreement that would be fair. Care should be taken to examine the tax and legal consequences of these machinery businesses. This allows the families to operate separate businesses but to share the expenses incurred for machinery. Not all machinery needs to be transferred in this manner. Possibly only the larger, expensive pieces would be operated through the partnership or company.

Ownership of Inventory (Livestock and Crops)

Inventory may be owned by one individual, several individuals or by a business. While there are no titles, animals may be identified and registered, but usually the bills of purchase will determine their ownership.

Often families have planned to use the proceeds from livestock sales as retirement income. This can be done by phasing down slowly year by year to spread out both the income and the tax. It is worth noting that many farm families pay more tax as they are phasing out of farming than while they are fully operational. Because of this, cattle income is often taxed at a fairly high rate.

If the livestock will be transferred to a child, they may be sold over time or given to the child. It is important to note that if cattle are given to the child, the parents have to add the market value of these animals to their yearly taxable income. Because of this, animals are often transferred over time under some form of income share. The child may receive a percentage of the offspring, including any replacements, while the parents receive their share of offspring and take any culls. In this way the child builds up their herd, the parents reduce theirs and very little money has had to change hands.

Inventory of livestock or crops can be transferred to a partnership or company in exchange for partnership interest, shares or loans. The shares or partnership interest could then be transferred to a child over time. Carefully check the tax and legal considerations first.

▪ STEP 3 Build a Succession Plan

Tasks:

- Prepare a management plan:
  - management skills
  - management functions
  - management roles
- Develop a labor plan.
- Design an Asset Transfer plan:
  - ownership of land and buildings
  - ownership of machinery and equipment
  - ownership of inventory

OUTCOMES: A first draft of a farm succession plan detailing management, labor and transfer plans.

Identifying management roles allows everyone in the business to know who is responsible for the many decisions on the farm. List the management roles on your farm and your team's skills, then decide who will be responsible for each area and how any necessary training will be carried out. This will be your management plan.

Your labor plan will usually unfold as you develop a management transfer plan. But don't take it for granted! Each family member should prepare a labor plan for their areas of responsibility. Depending upon the operation, labour needs can range from only family members to large groups of seasonal or full-time employees.

The asset transfer plan outlines when land and buildings, machinery and inventory will be transferred and how they will be owned. This plan is based upon the options examined during Step 2 of the succession process.

Review the plan to ensure it is coordinated with your management and labor plans.

▪ STEP 4 Check With the Experts

Tasks:

- Contact your professionals to get their advice and comments on your family's plan.

- Get a legal opinion on the plan .
- Discover the tax implications of your plan from your accountant.
- Seek advice on financial issues.
- Check with insurance specialists if insurance is part of your plan.
- Check with your agricultural specialists for their opinion and advice.
- Your lenders will need to be involved when their security is being transferred

OUTCOMES: An understanding of the legal, tax, financial and other implications of your plan and necessary changes.

The goal of this step is to obtain opinions and advice from the experts. People trained in tax, law, farm business management and communications, can provide expert information and options you perhaps did not consider. Take your draft plan with you when you visit these people and prepare a list of questions you would like to ask them.

Most farm families are very concerned about the tax and legal issues involved in their succession plan. You should also consult with financial and insurance specialists as well as agricultural specialists to ensure you have considered all family and business issues in your plan. Their feedback can bring out extra information, resources and alternatives you may not have considered. It's critical to keep the lines of communication open among family members as you meet with the experts, review your plan, access more information and perhaps consider new options. A review of Steps 1 through 3 may be very useful as well.

STEP 5 Review and Finalize the Plan

Tasks:

- Bring all of the family members back together for a final look at the plan.
- Review and discuss the opinions and feedback from all of the specialists.
- Make any necessary modifications to your plan.
- Have everyone review your revised plan for their final ideas and input.

OUTCOMES: A working plan for the transition of the business including family and business goals, management, labor and asset transfers

Review the goals developed during Step 1 of the succession planning process. Has anyone changed their goals or do they feel that clarification or modification is needed? This stage is the foundation for your plan, so don't gloss over people's concerns.

Ensure the plan you are now considering supports and reinforces these goals. The management, labor and asset transfer plans may need some slight adjustment or reworking.

Often, farm families have an idea of what they want to do, even if they have no formal written plan, but they do not take the time to carry out this final review of what is going to happen before they start to make changes. The experts may want to start transferring titles or selling products during this step but if this happens you may loose control of the process.

While immediate action can avoid procrastination, it may not give the family time to all remain on side with changes made for tax or legal requirements. If anyone feels they were not given time to have input into these changes, this feeling can sow seeds of discontent or, worse, can destroy an otherwise sound process.

This step should not be seen as a reason to put off moving forward, but rather as one last chance for everyone to be on side before the process starts.

▪ STEP 6 Implement the Plan

Tasks:

- Put the plan into action.
- Monitor progress through family business meetings.
- Update the plan as required.
- Celebrate your achievements.

OUTCOMES: Action has been taken to start putting the plan in place

Good action planning requires a step-by-step charting of the tasks that family members will need to do in order to achieve each goal of the plan. Short-term goals may require 3-4 tasks over a year while longer-term goals may have a series of 10-20 tasks taking 5 or more years to complete.

Each time part of the action plan is achieved, make sure to celebrate it. People who are working hard to reach goals need to take a breath and congratulate each other for the effort, commitment and value to the team. Some tasks, such as responsibility for the management of a new enterprise, may take considerable energy and effort since people are learning new skills. This is why constant review of the action plan is critical. Use regular family business meetings to discuss progress, achievements, setbacks or changes to the plan.

Teamwork really does help when you are making changes. People working together will be more creative, take greater risks and will stay motivated when the going is tough. This approach reduces the chance of burnout among family members or the shelving of really important plans.

Nobody knows the future, so plan for changes in your succession plan. The plan is only a compass that sets the direction for the business rather than a definite road map. If you find a roadblock, some analysis of other options may show you how to get back on course.