Chapter 6.
Succession Planning

Successfully transferring an agricultural operation from one generation requires transferring both the assets and the management responsibilities. While the estate plan deals with the accumulation, preservation and distribution of assets over a person's life, a succession plan focuses on the shift in a business's management responsibilities from one person to another. The material in this chapter presents points to consider. In the next edition of Passing It On more detailed information will be provided.

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Farm and Ranch Survival Kit

Working Together to Create a Hopeful Future For Family Farms

Issue 4

As a farmer, rancher or small woodlot owner, how do you pass on your business and land resources to your heirs without creating a war zone? This installment of the Farm and Ranch Survival Kit will provide you with the answer to that question as well as many other challenges that arise from passing the farming baton to the next generation.

The authors in this issue stress open communication between generations as the most important element of a successful estate plan. When each generation knows it has a voice in the outcome both will be more likely to pull together to form a win-win arrangement. When communication breaks down, the likelihood of a successful intergeneration transfer is compromised.

To learn the skills it takes to make your estate plan successful, plan to attend our upcoming workshop ***"Passing the Baton: The Art of Handing Over the Farm to the Next Generation."*** You will find the details on page six of this newsletter.

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In This Issue

What to Think About
Before Joining Your Family's Business

Dear Advisor,

I've heard some horror stories about promises made to family members who joined the family business – and then not kept. Any advice before I jump in?

Joining the family's business is never a decision that should be made lightly. The rewards can be great – a clear shot at the top spot, financial security, a chance to work with people you love while building on your family's legacy and more. But the risks are great too---if things don't work out, both the economic and emotional costs can be huge. Blurred lines between family and business roles and goals create complexities than can result in family-rending conflicts and business disasters.

Before joining the family business, members of the younger generation should ask themselves a series of questions. Remember, you are taking a job---and just because it's in your family's business, it doesn't assure that you are making a good career move. Here are some questions to think through:

- **Why am I doing this?** Your answer should focus primarily on business-related reasons. If you are thinking "my family needs me" or "working in the family business will be easier than working elsewhere," we recommend thinking again. You may be walking into an unintentional but painful trap.
- **Does it offer the career I want?** Does it fulfill my personal goals? Do I like what the business does? Will I find the work meaningful and challenging? Before you join the family business you need to think clearly about yourself, your goals and what you find fulfilling. If your family business offers a way to apply your passions to your career, go for it. If not, consider another calling.
- **Can I make a real contribution?** Can I bring meaningful skills, talent, knowledge and experience to the business? Businesses thrive because of value added by each employee and the company as a whole. If you bring real value to the table and the capability to build more, bring it on. Other rationales -- blood, family expectations, ease of getting the job, a sense of entitlement – are not sustainable and lead to trouble

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- **Can I work with my family?** Do we communicate openly, honestly and effectively? Can we resolve conflicts that inevitably will arise? Do I understand that being a "good son or daughter" is different from being an effective manager? Some believe that strained family relationships can be improved by family members working together. More often, the opposite results. If you lack good relations and solid communication, joining the family business can put you in real jeopardy.
- **If things don't work out, am I confident that I have other opportunities and the freedom to seek my fortune elsewhere?** Dependency is a horrible trap and an invitation for abuse. You should be of independent mind – psychologically and economically prepared to leave if frustrations become too great.
- **Do you understand what you are getting into?** A potential successor should enter the family business in response to a specific, formal offer to fill a job that exists. If responsibilities are cloudy or a position is being created for you, steer clear. Conditions and criteria for advancement should be explained, as should the methods for determining compensation and the opportunity to become an owner.

Don't join the family business because of promises or expectations. Plans go awry under the best of circumstances. Even if you inherit a business, in reality you must earn it through work, commitment and contribution. Following in the footsteps of a parent is a tricky and difficult challenge. Know what you are getting into and be thoughtful about the seriousness of the commitment you are making. If you are satisfied you've done your homework and you still want to proceed, you have a shot at a career that combines the best---or the worst---of all worlds.

Craig E. Aronoff, Ph.D. Reprinted with permission of the author from the December 2002 issue of The Family BusinessAdvisor.

Use a Checklist When Planning Your Estate

According to Wayne A Hayenga, an attorney and veteran Texas A&M Extension economist, good estate and financial planning can save you a bundle. A good estate plan can save farm and ranch families thousands of dollars in estate taxes, income taxes and administrative fees.

"Many people only worry about estate planning if they hear of a friend's 'problem' in settling an estate or paying estate taxes," says Hayenga notes. Many farmers wait too long to begin their financial and estate plans.

Giving much thought--with attention to detail--- is essential in estate planning. Here's Hayenga's checklist of some estate planning tools:

- ✓ Wills
- ✓ Pourover wills
- ✓ Standby trusts
- ✓ Account title review/change
- ✓ Deeds with retained life estate
- ✓ Lifetime planning
- ✓ Declarations of guardian
- ✓ Powers of attorney/escrow letter
- ✓ Management trust
- ✓ Directive to physician
- ✓ Health-care power of attorney
- ✓ Planning for children
- ✓ Guardian
- ✓ Uniform transfers to minors
- ✓ Minor's trust
- ✓ Life Insurance
- ✓ Tax planning beneficiary designation
- ✓ Ownership review
- ✓ Policy review
- ✓ Charitable gifts
- ✓ Foundations
- ✓ Gifts
- ✓ Limited partnerships
- ✓ Split interests
- ✓ Parents' wills
- ✓ Premarital agreements
- ✓ Installment sales

These tools may or may not fit your estate goals. This list can be used as a springboard for conversations with your spouse, business partners, heirs and financial advisors in order to draft your estate plan.

Adapted from information presented during a seminar series by Dr. Wayne A. Hayenga, Texas Cooperative Extension economist and attorney at Texas A & M University.

Consider the "Family Issues" in Farm Ownership Succession

Unless carefully planned, the transfer of family farm ownership to the next generation, especially if the farm has been in the family for several generations, can result in considerable emotional stress among the family members involved. There are many "family issues" which confront farm families in working through this transition. Nevertheless, they must be addressed to prevent disturbing the farm's operation with legal fights. These ownership issues must be discussed by all family members involved and resolved to everyone's agreement for a successful transfer of ownership to the next generation as well as avoiding the personal conflicts and family feuds that often arise.

Role of the Dad Issue: One issue is the fact that Dad is wearing two hats in the farm operation, Boss Hat and Father Hat. When wearing the Boss Hat, Dad is in charge by use of authoritative power. In this role he supervises the adult children as farm employees. When wearing the Father Hat, Dad tends to listen and have a better understanding his adult children's concerns. This presents a difficult task since Dad must know when and how long to be wearing which hat. The adult children must also make the distinction between the Boss and Father roles that Dad plays in the farm business.

Dad needs to compliment that farming adult child and give praise when he or she does a good job. If he criticizes by continuously pointing out mistakes, a negative family working environment soon develops. Dad must treat a farming son/daughter as an adult person capable of making decisions and providing worthwhile ideas. If Dad only wears his Boss Hat, the adult child may feel that he or she is only hired help with no opportunity for any management input and soon lose interest in the farm and leave.

The Issue of Mom Outliving Dad: Another related issue is that fact that Mom may outlive Dad. What if Dad dies unexpectedly before retirement? Will Mom operate the farm as if Dad were still living or will she start making the changes she always wanted but Dad would not allow? Some moms might rent out the farm to a neighbor while other moms would probably sell the farm within a relatively short period of time. How does the farming son or daughter fit into this situation? Will Mom turn over full control to them and let them make the farming decisions? Things can become very complicated if Mom remarries and there is a step-father to contend with. Also consider the fact that some mothers rather than fathers wear the Boss Hat in the family.

The "Who is Family" Issue: Who are considered the "real family members" in the farm family business? Are only the "blood related" family members included in financial business decisions? Do they alone have management authority? Do in-laws even the chance for farm ownership? Are the in-laws treated or even considered as "family" in the farm business? Do the in-laws involved in the farming operation actually have a voice in business matters? Are they allowed to make management decisions? If the in-laws are kept in the dark about the farm and are excluded from business discussions, relationships of trust between family members quickly fail. This can lead to suspicions and a lack of respect for others.

The Issue of Controlling Parents: Many parents actually raise their children to be followers. Children are often expected to do what the parents expect and want. "Work hard and do exactly what you are told, but DO NOT ask any questions" is often the standard rule in some families. Now parents cannot understand why their adult children have no drive or ambition. What is the behavior expected by the parents for the adult children working in the farming business? Do the parents want these children to be puppets or independent thinking adults with their own ideas? Is it the parents' dream for the children to return back home to the family farm or is it the children's dream to farm with Mom and Dad? Children should never feel obligated to return back to the farm when their career interests or dreams lie elsewhere.

The other side of this issue concerns parents who want to help their adult children have a better standard of living. These parents may help their adult children buy their first home or pay for a needed vacation. This may be done with "strings attached," with Mom and Dad expecting something in return for the favor or gift they have provided.

Consider the "Family Issues" in Farm Ownership Succession (continued)

Transfer of Ownership Issue: Who will end up owning the farming operation when the parents retire? Will the parents still retain total ownership after retirement while the farming children keep doing all the work? Which children will have the chance to gain actual ownership? When will this happen or do the parents plan to retain total ownership until their death? What entitlements do the farm children actually have in the business? Have parents already made promises to any of the children? Will the parents honor these promises or have the parents changed their mind without telling anyone?

Non-Farming Children Issue: The most sensitive issue in succession planning is where non-farming children come into play when passing on farm ownership. This issue is hard to discuss because parents often have favorites among their children. In order to avoid the problems of sibling jealousy and resulting grudges, parents must block out their personal feelings of favoritism and devise an estate plan that is fair and equitable to all children and that allows for the farm business to continue. This will require much thought, many hours of discussion by the parents and children together and, if needed, seeking out professional help.

Farm family operations are the most difficult to handle in terms of fairness among all the children since some children worked harder than others and may have contributed more to the parents' farming operation. Also remember that some children care more about the farm while others are only interested how much money they may receive from the parents' farm estate.

Ironically, most parents try to avoid this very issue. There are just too many personal emotions involved. Some parents just assume that their children will work it out later by themselves. This only results bitterness and feuding that can split a family apart for future generations.

Issue of a Fair Selling Price: If the parents decide to sell part or all of the farm to any of their children, what is a "fair selling price" for the farm property. This is particularly crucial to the adult children farming with them who have invested a lot of sweat equity into the operation already. The largest share of the parents' financial investment for retirement is tied up in the farming operation. Nearly all of their assets are farm related. If the parents decide to sell the farm for "top market dollar", could a farming son/daughter ever afford that selling price? It could mean taking on a substantial amount of debt that they will never be able to repay during their lifetime.

Yet on the other side of this issue, the parents cannot afford to just give their farm away or sell at the lowest bargain price. Parents can expect to live a longer retirement and will need a secure financial future for the many years ahead. Working out a fair selling price that provides the parents with a secure financial retirement but at a price that the children can afford is certainly no easy matter. These adult children must begin to gain ownership of farm assets now and to build their own net worth. That way these children are in a position to borrow the necessary loan funds from a lender to finance the purchase of the home farm if the parents decide or are forced to sell.

Summary: It important to have a strategic plan for ownership succession in place for the next generation. These sticky and emotional issues need to be discussed among family members since avoiding these issues can have disastrous consequences later. Parents must have a clear vision of the future of their family farm business and then be willing to discuss their ideas with the children who plan to return back home.

Dr. Ron Hanson is a professor of Farm Management and Agricultural Finance in the Department of Agriculture Economics at the University of Nebraska-Lincoln.

Ten Rules of Transition Management

The issue of family business generational transition is a major topic of discussion as farm businesses position themselves for success. Growth is the primary reason why businesses fail, and this is because of under-capitalization, inadequate preparation in human relations and communications, and insufficient income generation. Sixty percent of all farm and small businesses that enter bankruptcy were profitable in previous years. The following are some rules that are generally used in successful business transitions.

Rule 1: Revenue/Net Income
Bringing in a new partner takes an estimated $150,000 to $250,000 in gross revenue, or $40,000 to $70,000 of net profit for a successful business transition. Violate this rule and you set yourself up for guerilla warfare, where family members or partners fight over scarce resources (including net income) to meet their standard of living.

Rule 2: Three-to-Five-Year Rule
Agricultural business transitions are twice as likely to be successful when the family member or potential business partner works for someone else for three to five years. Allow them to make mistakes with someone else's money! A recent study found that the farm businesses that allowed entering partners to work for others for three to five years found their business to be four times more profitable. A college education is not part of this experience; however, military and summer work experiences are part of the experience base.

Rule 3: Six-Year Rule
If a new partner is brought into the business, make sure you allow him/her to move into management and decision-making within six years. Farms and businesses that fail to do so are twice as likely to have an unsuccessful business transition and are less profitable. This past winter in a seminar in Wytheville, an 85-year-old gentleman, after the seminar, indicated that he needed to turn the books over to his boy. Well, his boy was 65 years old! The old adage is you either teach or share with the younger generation, or you destroy the business.

Rule 4: Ripple Effect
When making changes to a growing business, you should over-estimate capital needs by at least 25 percent to avoid being short on working capital due to unexpected costs. For example, if you need $200,000 to expand the business, then $250,000 should be estimated and used to determine whether or not the growth is financially feasible. It is also wise to over-estimate the time needed to complete the change by 25 percent.

Rule 5: Don Shula Rule
Many managers and owners stay too long before turning over the business. The optimal time for ownership and management of a business is 30 to 35 years. Owners and managers who fail to heed this rule run into the trap of continuing to do "business as usual" without changing for the times. In order for managers to maintain the cutting edge, they must either follow this rule or surround themselves with new members who will bring renewed energy and new resources into the business.

Rule 6: You Can't Treat All Children Equally, But You Can Treat Them Fairly and Equitably
One of the most profound challenges in estate planning and transition management for farm businesses today is what to do with children who move away from the business. Usually, they have little interest in the operation. When the parents die, the business interests of the children who have moved intensify because proceeds from the estate can be used to pay off mortgages or fund their children's college educations. The most successful transition plans have the business assets transferred to the child managing the business, and insurance policies to cover estate settlement costs and cash settlements for children who are not interested in the business. This strategy allows the children involved with the farm to continue to function without requiring them to buy out the non-farm children's shares, and also have sufficient cash to pay estate settlement taxes. This strategy is simple and objective.

Rule 7: Non-Business Spouse
An increasing challenge in businesses is incorporating the non-business spouse into the family and business management process. Many more families are finding this incorporation a challenge because there are more non-business or non-agricultural spouses, and that these spouses frequently do not understand erratic business schedules, time management, and prioritization problems that can occur. An operations agreement including time expectations, goals, responsibilities, and accountably can resolve many of these issues.

Rule 8: Getting Out of Business
A plan that covers dissolution of the business is critical in establishing a family business transition. Included in such a plan is an operations agreement, a buy/sell agreement, and a time line for an orderly transition. Partners who are not willing to discuss these issues often find that getting out of business is more difficult than getting into business.

Rule 9: Transition Team
All businesses need to have a list of advisors or a transition team. This team includes a lender, a lawyer, an accountant, a financial planner, both spouses, and all partners. Annual team meetings with all members present are critical. Outside professionals need to be placed on retainer rather than on an hourly fee structure.

Rule 10: The Nike Principle
Just do it! The biggest concern with family business transition plans is procrastination. Day-to-day matters frequently take priority over the planning process. A transition plan often takes two to three years to formulate, and must be updated at least twice a decade.

Written by David M. Kohl, Alex White, Dixie Reaves, and Amanda Wilson, Farm Management Update, June 1996
Visit Virginia Cooperative Extension "Ten Rules of Transition Management," http://www.ext.vt.edu/news/periodicals/fmu/aaec-310.html

Succession Planning Workshop Slated

Few challenges facing family forestland owners, farmers, wine-makers, and other land-based family businesses are more important than the issue of passing the business and its supporting land base on to the next generation. As part of the Farm and Ranch Survival Kit Project, OSU Wasco County Extension Serivce, WSU Klickitat County Extension Service and Columbia Gorge Community College are sponsoring a workshop on February 2, 2006 to help families dealing with the challenges of passing the farming baton to the next generation.

Today, 95% of Oregon's small landowners are 65 or older making family succession planning all the more critical.

"Based on the average age of farmers and ranchers right now, the next decade is going to see a huge transfer of land resources to the next generation," says project coordinator, Cheryl Williams-Cosner. "Passing property from one generation to the next can be an emotional experience."

For families, the real challenge may not be technical issues, but communication. Lawyers and accountants are skilled at dealing with the technical aspects of moving assets between Mom and Dad and Son or Daughter through the use of business and legal tools. But without informed decision makers, family emotions may prevent honest, open communication. This alone can prevent families from being able to pass their land on to the next generation intact.

The OSU Wasco County Extension, WSU Klickitat County Extension, OSU Austin Family Business Program and Columbia Gorge Community College jointly host this forum to explore the human side of estate planning, focusing on ways to maintain family ties to the land from generation to generation. Practical exercises will teach families necessary tools to address tough issues.

Passing the Baton: The Art of Handing Over the Farm to the Next Generation" will be held on Thursday, February 2 from 1-4 pm at Columbia Gorge Community College, Building 2, Room 2.384. Participant costs are $29 per person. To insure your seat, **please pre-register by Tuesday, January 31st with Columbia Gorge Community at 541-506-6011** , 400 East Scenic Dr., The Dalles, Oregon 97058. For more information, contact (541)296-5494 or e-mail Brian.Tuck@oregonstate.edu.

How to Be Fair With Off-Farm Heirs

One of the most difficult questions many retiring farm families face is how to get a young son or daughter started farming while being fair to the off-farm, non-farming heirs. To get a young person started farming in today's economy usually takes a great deal of parental help. This help is usually provided through bargain charges for housing, machine and land rents, interest rates, gifting of assets, supplements, and various other types of help. Unless the young person starts out with a handsome nest egg, parental concessions are needed to get the young farmer successfully started.

Non-farming heirs often leave the farm in their late teens for careers elsewhere. Most parents are concerned with being fair to all of their children at estate settlement time. Fairness, however, may not mean equal treatment of heirs.

Reasons farmers give for unequal treatment of heirs at estate settlement time include these:

- Off-farm children received a college education, a down payment on a house, or other compensation, so may get less at estate settlement time.
- The farming heir helped create part of the final estate of the parents by actively contributing to the parents' business over the years, so may be entitled to more.
- Parents want the farm to "stay in the family." Consequently they are willing to give more to the heir whose goal is to stay on the farm.
- Farming heirs are getting delayed compensation for work performed in years when they were underpaid.
- Farming heirs may attend to the physical and business needs of the parents in their declining years. Non-farm heirs may not be there to help.

Here are several methods farmers have used to transfer assets unequally but, in their minds, fairly:

- They have made gifts of various items to farming heirs to get them started farming. For example, livestock, machinery, tools, buildings, house use, etc.
- Some parents have sold assets at bargain prices and terms to farming heirs during their lifetime.
- Some parents have paid a fair wage to children and those wages have been used to purchase assets from parents.
- Parents have written buy/sell agreements with farming children, committing to exact sale prices, terms, and timing of payments on farm properties. These agreements are binding on off-farm heirs and provide the farm heirs a guarantee that they can buy property at an acceptable pace and price.
- Farming heirs can purchase life insurance for parents with funds gifted from parents. This money is then used to pay insurance premiums. This method provides money to buy out off farm heirs at the time of the parents' death.
- Life insurance can be purchased by the parents, and make the off-farm heirs the beneficiaries. In these cases, farm heirs get farm assets and off farm heirs get the cash generated by the insurance.
- Some parents have established a living or testamentary trust. It establishes that the farm heirs have the right to purchase farm assets at predetermined prices, terms, and conditions from the trust over a number of years.
  The parents' will can be used to equalize previous distributions to heirs. The will may make special provisions to fit the situation.

If the farming heir or any heir has received earlier compensation, they may now get less than other heirs.
Off-farm heirs may be willed cash, non-farm assets or remote land holdings, while "base operation" farm assets are willed to farm heirs.
Farming heirs may be given greater consideration for contributions made to parents over the years.

It is a good practice to involve all heirs in the transfer process and to communicate to all heirs the final plans for distribution and transfer of assets. This communication should be done prior to your death so farming heirs are not left in an embarrassing position of trying to explain your actions.

Transferring the Farm Series: #9 Erlin J. Weness

Resources

Websites and Internet Resources:

Succession Planner. *Linda Kirk Fox, University of Idaho*
http://agecon.uwyo.edu/RiskMgt/FinancialRisk/FINANCIALDEFAULT.htm

Protecting the On-Farm Heirs. *Erlin J. Weness, University of Minnesota Extension Service, 1994*
http://agecon.uwyo.edu/RiskMgt/FinancialRisk/FINANCIALDEFAULT.htm

Estate Planning for Families with Minor Children. *A.M. Morrow, Oregon State University Extension Service, June 1998.*
http://agecon.uwyo.edu/RiskMgt/FinancialRisk/FINANCIALDEFAULT.htm

Software

Quicken Family Lawyer *by Intuit Software*

Quicken Family Lawyer is a program that comes with the Quicken Suite 99. Older, stand alone versions may be purchased by searching eBay using the keywords Quicken Family Lawyer. This software enables the user to write a simple will and develop a checklist of estate planning activities. It does not take the place of the advice from a qualified attorney. To learn more about downloading Quicken Family Lawyer visit the following website:
http://web.intuit.com/support/quicken/docs/w_qfl_99.html

Books and Print Resources

Carkner, Richard, W. and Willett, Gayle S. ***Estate Planning Basics for Washington Farm and Ranch Families****. Extension Bulletin 1231, Department of Agriculture Economics, Washington State University, Pullman WA*
Available at http://farm-mgmt.wsu.edu/PDF-docs/misc/eb1231.pdf

Succession Survival Kit. Austin Family Business, Oregon State University, Corvallis

Available by ordering online at http://www.familybusinessonline.org/resources/workbooks.htm or mail Austin Family Business Program, College of Business, 201 Bexell Hall, Corvallis, OR 97331-2603 or fax 541.737.5388

Watch For These Topics in Upcoming Issues!

How do successful farm direct marketers do it?
Are you OVER insured?
How do you handle taxes when you sell the farm?