Estate and Succession Planning for Family-Owned Agri-Businesses

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What are we going to cover today?

- Just the basics
  - Estate Planning
  - Succession Planning
- We are lawyers, so we will talk about some of the nuts and bolts of the documents and "transactions."

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What are we going to cover today?

- Three questions for each topic:

1. What is it?
2. What are the goals?
3. How do you do it?

What is Estate Planning?

- Planning for incapacity during your life
- Planning for the transfer and management of your assets upon death
- Planning for the care of your family upon death

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Estate Planning: Goals During Life

- Maximize and preserve wealth during lifetime
- Determine who will be responsible for financial and healthcare decisions if you are unable to do so
- Avoid conflict among family members

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Estate Planning: Goals Upon Death

- Transfer wealth at death to intended recipients
- Minimize estate administration expenses
- Reduce or defer estate tax and income tax
- Avoid conflict among family members

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What is Succession Planning?

- Means many things to many people:
  - "Selling" or "Getting Out"
  - Keeping a business "in the family"
  - Retiring
- For Today: Succession planning is the process of planning and implementing the transfer of ***ownership*** and ***management*** of your business, while providing you and your family with adequate retirement income.

Goals of Succession Planning

- Continue the farm for the benefit of younger generations.
- It is estimated that **71%** of businesses fail to survive to the second generation and **87%** fail to survive to the third generation.
- Main reasons for the high failure rate:
  1. Lack of competent leadership and management;
  2. Lack of succession planning; and
  3. Lack of estate planning to minimize income/transfer tax consequences from one generation to another.

Practical Considerations

- Estate and succession planning challenges faced by agri-businesses:
  - Most of estate is tied up in land, buildings, livestock, and equipment (*land rich, cash poor*).
  - Farm operations are leveraged with debt (mortgage on land)
  - Treating children fairly when there may not be many non-farm assets for children that have careers off the farm.
    - One common solution = life insurance

Practical Considerations

- Estate and succession planning benefits for agri-businesses:
  - Financing may be more readily available than in other industries.
  - Strong family desire to transition businesses to younger generations. It's "in your blood."
  - Many farm assets can be valued and are marketable in the event a sale is desired.

Succession Planning "Team"

- Professionals used to create and implement a successful succession pan:
  - Attorney: The attorney has several roles in the succession planning process:
    - Preparation of documents
    - Counselor
  - Accountant: Often has a more constant relationship with the client and his/her involvement is crucial to the success of the succession plan.
  - Business Advisor: Several business consulting firms specialize in agri-business. They can be trusted counselors and add significant value.

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Creating a Succession Plan: *4 Steps*

1. **Goals**: Determine each generation's business goals, family goals, and financial goals.
2. **Management**: Determine who will manage the business, and develop a management team.
   - *Note*: Management and ownership are not the same. Management may be left to one child while ownership is left to all children.

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Creating a Succession Plan: *4 Steps*

3. **Ownership**. Determine who will own the farm and how to transfer the owner's interest in the business to the "new" owner(s).
    - Most owners prefer to leave their farm to those children who are active in the business (the "active" children), but would like to treat all of their children fairly (if not equally).

4. **Estate Planning**. Minimize transfer taxes and prepare an estate plan.

Step 1 - Determining Goals: Business and Family Goals

- What are the owner's business and family goals?
    - Does the owner want to keep the business "in the family?"
    - Does the owner hope to sell to a co-owner or a third party?

- Understand the facts about the owner's business and family situation:
    - Are any family members involved in the business?
    - Are other family members competent to handle significant assets?
    - Does the owner want to treat all family members equally, or just fairly?

- Are there other part-owners of the business?
    - What are the other owners' goals?
    - Do the other owners intend to purchase the rest of the business?

Step 1 - Determining Goals: Financial Goals

- What are the owner's financial needs?
- Many farmers are cash poor, but asset rich. They need cash flow during retirement.
- Can the younger generation afford to purchase the business? Does it cash flow?
- Does the business generate enough income to support the owner and the successors (e.g., his or her children) after financing a purchase?

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Step 2 - Management Succession: Why is this important?

- Many businesses are more valuable than the sum of their assets; they have goodwill.
- The value of the business is dependent on retaining competent management.
- Is the older generation's retirement income paid from the profits of the business? If the business fails, Mom and Dad don't get paid.

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Step 2 - Management Succession: Training qualified replacements

- The older generation will need to groom and train the next generation of managers:
  - Train interested family members
  - Train existing employees
  - Hire new, qualified managers
- Consider a business consultant.

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Step 2 - Management Succession: Retaining the Managers

- After good managers are trained, it is important to retain them.
- Retention strategies:
  - Employment Agreements
  - Share in the profits of the business
  - Open communication regarding the business and finances, particularly with family

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Step 2 - Management Succession: Retaining the Managers

- **Example**: An advertising campaign by Perdue Farms, Inc., the third largest poultry producer in the U.S. began: "After three generations, the Perdues know more about breeding chickens than chickens do." The purpose of the ads was to introduce 45-year old Jim Perdue to the public as the company's new spokesman. In the first TV commercial, Jim's father, Frank, says that he has bad news for competitors hoping that he will retire, "It's a little breeding project I've been working on for the past 45-years – the result of decades of intensive development." After an appropriate pause, he says, "Meet my son, Jim. He may be even tougher than I am."

Step 3 - Transferring the Business

- Now we will concentrate on designing a structure to transfer the business.

- We will discuss the following methods:
  1. Earning-In / Profits Interests
  2. Sales
  3. Gifts
  4. Combinations of Gifts and Sales
  5. Other transactions (e.g., estate freeze transactions)

Step 3 - Transferring the Business

<u>Preliminary Question:</u>
What will you transfer?

- Many farms are organized as partnerships.
  - Each partner directly owns a portion of the business assets.
- It maybe easier to transfer the agricultural business if it is organized as one or more <u>corporations</u> or <u>limited liability companies.</u>
  - More flexibility.
  - Easier to transfer partial ownership.
  - Enhanced creditor protection.
- <u>Most Common</u>: Two entities:
  - One owns land
  - The other owns the operating business

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Step 3 - Transferring the Business

<u>Buy-Sell Agreements</u>

- Contract among the owners of a business, which sets out what will happen upon the occurrence of certain specified future events
  - *<u>Control</u>*: A typical buy-sell agreement will give the entity, the owner, or both a right of first refusal on certain triggering events.
  - *Protects existing owners from unwillingly becoming business partners will undesirable parties.*
- Can be a separate agreement, or part of an LLC operating agreement or other document.

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Step 3 - Transferring the Business

- Triggering Events:
  - Death;
  - Disability;
  - Retirement;
  - Involuntary Transfers (bankruptcy/divorce)
  - Termination of employment

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Step 3 - Transferring the Business

- Liquidity:
  - A Buy/Sell Agreement can provide a withdrawing family member or their heirs with a market for his or her ownership interest
    - Example. Give owner's estate a right to sell in certain circumstances (e.g., on death or retirement)
  - Make sure the company has a plan to fund a buy-out
    - Life insurance is an option

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Step 3 - Transferring the Business

Option 1 - Earn-In / Sharing of Profits

- Typically, an on-farm child gets an interest in the future profits of the business without being required to contribute any cash to the business (Sweat Equity).
- Older generation does not give up equity.
- May be subject to vesting to ensure on-farm kids remain.
- Granting an interest is not a taxable event if certain conditions met.
- Typically accomplished by granted a special kind of LLC membership interest to on-farm children.

Step 2 - Management Succession: Retaining the Managers

Option 1 - Earn-In / Sharing of Profits

Sample Vesting Schedule

Years of Service	% Vested in Profits Units
0-7	0%
8	10%
9	25%
10	40%
11	55%
12	70%
13	85%
14	100%

Step 3 - Transferring the Business

Option 2 - Sale of Business:

- Basics: Sale of the assets or the ownership interests in the business (e.g., assets, stock, LLC units).
- Who is the Buyer?
  - Other Owners?
  - Family members?
  - Third parties?

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Step 3 - Transferring the Business

Option 2 - Sale of Business:

- Price: The FMV of the business determined.
- Payment: Installment sales are common:
  - Buyer pays the purchase price over time under a promissory note.
  - Interest at the Applicable Federal Rate (AFR).
  - Gives the seller a stream of retirement income.
  - Self-Canceling Installment Notes: Buyer gives owner a promissory note to pay the purchase price. Any remaining payments terminate upon the owner's (or the owner's spouse's) death.
    - Unrecognized capital gain is recognized at death
    - Owner must receive a higher interest rate or larger purchase price

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Step 3 - Transferring the Business

Option 2 - Sale of Business:

- Tax Characteristics:
  - Buyer deducts interest payments.
  - Buyer cannot deduct principal payments.
  - Buyer gets basis in assets purchased.
  - Related parties must charge interest at the Applicable Federal Rate (AFR).
  - Seller pays long-term capital gain tax on many assets.
  - Seller pays ordinary income tax on interest and depreciation recapture.

Step 3 - Transferring the Business

Option 2 - Sale of Business:

- Advantages:
  - A sale provides an income stream for the business owner's retirement needs.
- Disadvantages:
  - Taxable transaction.
  - Buyers' ability to pay may be based on the future success of the business.

Step 3 - Transferring the Business

Option 2 - Sale of Business:

- Transfer Tax Basics:
  - Discount Valuations:
    - Used to depress the value of a business being transferred, for transfer tax purposes.
    - Lack of marketability discount.
    - Lack of control discount (minority discount).
  - Usually determined by appraisals.

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Step 3 - Transferring the Business

Option 2 - Sale of Business:

- Other Taxes:
  - Real property transfer tax.
    - Carefully check for exemptions.
    - State real property transfer tax on certain transfers of controlling interests in business entities with substantial real estate assets.
  - Uncapping issues.

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Step 3 - Transferring the Business

Option 3 - Gifts:

- Gift: Any transfer to an individual where full consideration is not received in return.
- Federal Gift Tax Rate – Up to 35%
- Exclusions:
  - $13,000 per donor, per donee, each year
    - Can be made to as many donees as the business owner desires.
    - For example, if a husband and wife have 5 kids, each can give each an annual gift of $13,000. This is a total tax free transfer of $130,000.
  - $5,000,000 lifetime gift tax exemption for 2012 (the yearly $13,000 per person exclusion does not offset)

Step 3 - Transferring the Business

Option 3 - Gifts:

- May gift assets or equity interests (e.g., stock, LLC membership units, partnership interests)
- Many opportunities and types of gifts:
  - Give business interests only to children that are "actively" involved.
  - Give voting interests to children who are actively involved, and nonvoting interests to those who are not actively involved.
  - Valuation discounts for gifts of partial interests in the business.

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Step 3 - Transferring the Business

Option 3 - Gifts:

- **Issue**: Many business owners want to make gifts for tax planning purposes, but adamantly refuse to give up voting rights or permit certain family members to participate in the business other than as a silent investor.
- **Gift to Trust**: A business owner can transfer stock to a trust for certain family members and name a trusted colleague as trustee. The family members will receive income from the stock and benefit from its appreciation, but the trustee will vote the stock.
  - A family member who does not participate in the business can be given an income interest for life, with the business interest eventually passing to another family member who is actively involved in the business

Step 3 - Transferring the Business

Option 4 - Part Gift Part Sale:

- Owner may gift some equity interests in a business, and sell other equity interests.
- These "two stage" transactions are common.
- Owner and spouse may gift using annual exclusions and lifetime exclusions, and children may purchase the remaining assets.

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Step 3 - Transferring the Business

Option 5 - Estate Freeze Techniques

- Freeze the value of the older generation's estates.
- Transfer future growth in value to younger generations, without transfer tax.
- Many variations

Step 3 - Transferring the Business

Option 5 - Estate Freeze Techniques

Grantor Retained Annuity Trust

- "Estate freeze" technique
- Owner transfers property to irrevocable trust
- Owner retains an annuity (percentage of the assets).
- The remainder is paid to his or her children
- The present value of the remainder is a taxable gift

Step 3 - Transferring the Business

Option 5 - Estate Freeze Techniques

Grantor Retained Annuity Trust

- The owner's annuity is based upon IRS applicable federal rates, so that the present value is zero (no taxable gift)
- The GRAT is structured as a "grantor trust" for federal income tax purposes
- Use a series of GRATs

Step 4 - Estate Planning

- Estate planning is integrated with many transactions we discussed today.
- Important to ensure that other (non-active) descendants are treated fairly.
  - Leave other assets
  - Life insurance

Step 4: Estate Planning
Lifetime Planning

- General Durable Power of Attorney
- Patient Advocate Designation
- Wills or Trusts

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Step 4: Estate Planning
Planning for Death

- Preparing the right "estate plan"
- Key Questions:
  - What do you own?
  - How should you manage assets?
  - To whom should assets pass?
  - Who will care for dependents?
  - Is your plan efficient?

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Step 4: Estate Planning Planning for Death

Estate Planning Options

- Die impoverished
- Will
- Joint tenancy
- TOD accounts (POD accounts)
- Revocable living trust

Step 4 - Estate Planning

FEDERAL ESTATE TAX:

- Applicability: Applies to every estate. However, most estates do not pay the tax.
- Estate Tax Exemption: $5,000,000
  - $1,000,000 in 2013
  - Gifting and Planning can help reduce the assets held in the estate at death. Thus, the estate tax is reduced.
- Top Estate Tax Rate: 35% (scheduled to increase to **55% in 2013**).

What is a Trust?

- A trust is a relationship in which a person holds title to property subject to an obligation to keep or use the property for the benefit of a another person
- The terms of the relationship are normally described in a written instrument:
  - trust instrument or trust agreement
  - will

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A Trust Involves Three Parties:

- the "Grantor" or "Settlor" (the person creating the trust)
- the "Trustee" (the person who holds the property)
- the "Beneficiary" (the person who benefits from the property held in trust)

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What is a "Living Trust"?

- A trust created during the lifetime of the grantor is called a "living trust" or an "inter vivos trust"
- A trust created upon the death of the grantor (through directions in the grantor's will) is called a "testamentary trust"

Revocable Trust vs. Irrevocable Trust

- A revocable trust may be revoked or amended as provided in the trust instrument
  - The phrase "living trust" typically refers to a <u>revocable</u> living trust
- An irrevocable trust may not be revoked
  - Irrevocable trusts are generally associated with more sophisticated techniques used to reduce estate tax

Thank you!

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