

Planning for Succession

Key Points

- Farm succession planning requires balancing retirement and inheritance needs.
- It is important to consider off-farm investments in order to achieve a more successful outcome.
- Divesting farm assets well before death is the crux of modern farm succession planning.
- The removal of some taxation barriers is favourable for asset transfers, while Capital Gains Tax (CGT) requires careful consideration.

For independent farmers or business people, the ultimate in career satisfaction can be to see the new generation in the business and succeeding. But successful farmers face a challenging test when it comes to succession. In addition to passing on the farm, the older generation usually also has to provide for both retirement and an inheritance for other children. Achieving success on the baton change and afterwards is the focus in this article.

Financial Viability

Business success and financial planning are prerequisites to effective estate planning. It is stating the obvious that the ability to accumulate off-farm investments while maintaining a healthy farm enterprise, dramatically improves the chances. The new generation on the farm must start with a viable enterprise and the retirees must have financial security. If off-farm assets are available for retirement, they can also provide an inheritance for off-farm children.

To rely on sudden extraction of capital from the business, rapidly gets dangerous. In these situations, viability factors (which are constantly changing) have to be carefully considered. Who can say what level of capital will be required to sustain the business into the long term? The more you take out, the more difficult the task of the new generation becomes. On the farm, debts in excess of 25-30% of the asset base (and sometimes even less) can be very difficult to carry. Only the most remarkable track record and prospects see greater debt loads sustained.

Where all the capital is in the business, the planning task is usually harder, as options are more limited. Many farming families succeed from this position, but planning becomes all the more important.

Case Study Dairy farmers Brian & Alison Russell, aged 66 and 63, are finalising plans for their retirement. Their plan is to vacate their home on the farm in favour of their son Tom, whose wife Jenny is expecting a third child. Tom,

who is one of four children of Brian and Alison, has been share farming on the property for some years and lives in a small second home. Tom has gradually acquired the herd of cows while share farming.

Brian and Alison have owned a home in the nearest substantial town for the last 15 years. They purchased it with a 35% deposit and now own it outright. In recent years, rent has easily covered the required repayments. Minor refurbishment of the home is needed. Brian and Alison will move to this house and Brian hopes to work part-time on the farm from there, as long as his health permits.

The farm business has debts of \$180,000 or about 25% of the value of the land, which have mainly been incurred recently to modernise the dairy and purchase extra irrigation water entitlements.

Brian and Alison are receiving quarterly payments due to them under the Dairy Industry Adjustment Package (DIAP) and will continue to do so to assist in funding the early years of their retirement.

In light of the income available to them through the DIAP over the next eight years, they are prepared to give Tom three-quarters of their \$540,000 equity in the farm and to transfer the land to him (free of stamp duty*), in return for a capital payment of \$135,000.00. Tom will also purchase the plant and equipment at the written down value of \$50,000.

Of these funds (which Tom will borrow to provide), Brian and Alison are considering making an undeducted contribution to superannuation, adding to \$85,000 they have accumulated in superannuation in recent years. They will seek the assistance of a financial planner in relation to the ultimate destiny of these funds, which are needed to augment their other income in retirement in a tax effective manner. The remaining \$35,000 will be available to upgrade their house and car.

Tom will owe \$365,000 to the Bank, but will still have equity of about \$550,000 in the total operation, including stock, plant and equipment. He is taking a risk on continued prosperity in the dairy industry, but his prospects are considered reasonable.

In later years, Brian and Alison are likely to qualify for Commonwealth age pensions, as after five years, their gift of capital to Tom will be disregarded for assets test purposes and their income position will decline on expiry of the DIAP.

The survivor of Brian and Alison will leave their estate to the other three, off-farm children.

* Stamp Duty exemption requirements vary from State to State.

Strategy

For a variety of reasons, the modern farmer has the opportunity of divesting farm assets to successors well before death, as in the case study. This strategy is really the crux of modern farm succession planning, driven mainly by the factors of:

- The increasing desire by farmers to enjoy retirement in their old age.
- Avoiding the risk of Family Maintenance disputes over Wills.
- Giving the younger generation the means and incentive to farm successfully during the prime of their working lives.

It is no surprise that farm succession research shows a positive correlation between age and equity in the business, along with an inverse correlation of rising equity and declining productivity. The older the farmer, the more likely that production will be geared to the low level needs of the 'old couple.' Research noted that farming efficiency reached a peak when the one person farm operator was in 'his' thirties and declined progressively thereafter. Even if the peak in productivity may possibly now occur at a higher age, there is great importance in empowering the younger generation to tap the benefits of higher productivity.

Taxes

The further reduction of taxation barriers to the transfer of the family farm is one of the most notable achievements of the political process for farmers in recent years. The abolition of probate and gift duties, followed early this decade by the elimination of stamp duty on family farm transfers, firstly in Victoria and successively elsewhere, have removed nasty planning obstacles for farmers. The introduction of capital gains tax was against this trend, but its impact is usually far less severe. There are still extensive pre-CGT holdings in farms.

Whether assets were acquired before or after the introduction of Capital Gains Tax, its impact on a succession plan has to be carefully considered. In farming or business, assets will often be better managed and developed, when in the hands of the current managers, so an apparent incentive to keep pre-1985 assets exempt from CGT by leaving them in current ownership, often isn't of significant planning value. Further diminishing this consideration are the significant CGT concessions now available to small business of:

- The 15-year asset exemption for retirees.
- The 50% reduction for an individual's active assets.
- The retirement exemption for asset sale proceeds rolled into superannuation.
- The roll-over option for non-retirees who acquire replacement assets.

Income tax factors can usually be managed at the time of succession, but the role of the tax consultant is critical and should be duly recognised and fully utilised.

Social Security

In situations where significant capital can't realistically be made available to fund retirement of the senior generation, family farmers frequently rely on social security for a substantial proportion of their retirement incomes. Their willingness to accept a low income in retirement, often on the promise of assistance where necessary from the farm, does much for the prospects of the continuing farmers. The younger generation of farmers faces the same pressures as the rest of the community to fund their own retirements, as they are unlikely to be able to rely on social security to the extent that some of their parents and grand-parents have.

Farmers should be aware that Centrelink has a Forgone Wages policy, which deems the younger farmer to have acquired a capital interest in the property through wages forgone over any period. A statutory declaration is required for evidence.

The new social security 'Integrity of Means Testing' rules announced in the 2000 Federal Budget relating to private trusts and private companies, also now need to be taken into account by advisers. Families operating private trusts and companies need to plan to remove obstacles to eligibility well in advance of a planned pension application.

Family Involvement

The planning process needs the participation and understanding of both generations of farmers. Avoiding the issue is a particularly easy trap for the older generation, especially where there has been no tradition of retirement.

For the younger generation, the need to secure the future makes the process easier and the sooner this occurs, the greater is the likelihood that they'll have the incentive to compete successfully in the tough modern environment.

How to involve off-farm children in the planning process is an issue for most families. Ideally, they need to be involved to gain an understanding of what is intended, but the extent to which they can expect to influence the final outcome must be limited. If they have a sense of good will towards the farmers and an understanding of the particular challenges faced by them, this will help the process. Engendering a good family atmosphere is often a high wire act.

Case Study: Brian and Alison Russell knew for some years that Tom would be their sole successor on the farm. They have always downplayed the prospect of the non-farmers having an equal inheritance. Brian and Alison have alerted their other son and two daughters to the details of the proposed arrangement and they are pleased for their parents and to have indications of their expected inheritances. Although with some tensions along the way, they have come to terms with Tom ultimately owning the farm.

US researchers have put these issues succinctly, arguing that continuity of the farm "is dependent upon a parental sense of obligation and commitment towards a son wishing to farm and the support and co-operation of siblings for the sibling who farms."

The Future of the Business

Succession provides a great opportunity for planning as to the future structuring of the farm business entity. The range of assets held in most businesses, give good opportunities for a range of holding options. Among the competing considerations as to asset holding options, such as tax, control and management, succession and insolvency protection, practicality and ease of administration can easily be disregarded, but should not be.

The discretionary family trust, whether testamentary (by Will) or inter vivos (by Deed), was widely hailed in recent years as the best vehicle for the holding of family business assets, whether they consisted of land or otherwise. In the case of farmers, a limiting factor to this, was the situation of the family home and its two hectare curtilage.

Historically, the farm business alone was often conducted by a trust, with the land held in personal names. This may remain a trend in the future, given the 50% CGT concession for active assets held by individuals and the emphasis of other concessions on the ultimate retirement of the main individual players.

The recently announced and pending New Business Tax System legislation, will transform the climate affecting family discretionary trusts, which with the advent of such reforms as entity taxation and the profits first rule, will be used far differently than in the past. In short, focussing on the tax position, Trusts retain many attractions for income, particularly offering the ability to accumulate income after payment of the newly lowered corporate tax rate. However, taking account of capital gains considerations, they are now somewhat less attractive as vehicles to hold significant capital assets, such as farms.

Conclusion

For farmers aiming to keep the family business going, succession planning is of critical importance. The prospect of seeing the plan executed and in operation should be rewarding, but can also be difficult because of resistance to relinquishing the controlling aspects of the operation. As one researcher puts it: "where the fresh ideas and enthusiasm of the children are not allowed to influence business policy, there can be a slowing down or stagnation of the business; delaying involvement in management is to reduce the next generation's motivation, confidence and competence to take decisions."

This information is not to be relied upon as a substitute for professional advice related to specific circumstances.