BlackmanSpargo
Rural Law

Succession Planning for Dairy Farmers
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Introduction

My experience of succession planning is almost exclusively limited to the rural sector, and particularly the dairy industry.

In the rural sector, the term "succession planning" refers to the process by which farm assets transfer to the next generation. In the districts in which I practice, most of the clients wanting succession plans comprise a generation of farmers who are married and who have had no assistance from their parents in acquiring a farm. I describe this group as first generation farmers. Notwithstanding this fact, I would assess the average net value of the joint assets as between $4,000,000 and $10,000,000.

This paper will examine the trends, the objectives and the legal structure options, concluding with a recommendation on how a successful, resilient and flexible succession plan is created.

Trends

In the last 10 to 15 years the rural sector has been characterised by:

1. On the whole a stronger commercial approach to the farming business, which has led to

2. A focus on endeavouring to increase production and/or reduce costs, which has led to

3. A preference to increase the average size of farms to achieve that objective rather than to reduce costs, which has led to

4. A decrease in the number of farms, especially in the dairy industry, which has inevitably led to

5. A significant increase in debt funding, with the banks willing to continue to lend in the rural sector, which has led to

6. A situation where demand has clearly outstripped supply, which has led to

7. A significant increase in the value of dairy farm assets, especially Fonterra shares and land, which has led to

8. A significant increase in the equity value for the farmer, which has in turn led to

9. A paradigm shift for an increasing number of farm owners to prefer succession to eventual sale, and the demand that arises from this has resulted in

10. A limited availability of good commercial advisers specialising in a full range of the issues relevant to the farming family and especially to farm succession.

Elements of a Good Succession Plan

When a farming client visits me to discuss succession planning, you can be assured that the succeeding child and the parents and hopefully other close members of the family have spent many long hours discussing whether succession is desired by the family and how it should be done. Frequently they propose a plan and want confirmation from their lawyer and the accountant that it will work. In some cases they have implemented the plan and it has been a disaster and they need help to unravel the problem to get the plan back on track.

In order to ensure that a flexible and resilient plan is implemented and we start off on the right track, I go to the white board and list, in order of priority, the following clear and vital elements to a good succession plan, namely:

1. Needs.
2. Financial security.
3. Control.
4. Fairness.
5. A flexible and workable plan.

Under each of these items I discuss the importance of each element and explain that each of these elements is in order of priority.

Needs

The issue for most farmers surrendering ownership of land is an emotional one. Farmers, irrespective of their ethnicity, see themselves as guardians of the land and their "mark" is made by leaving the land in a better state than when they acquired it.

It follows that succession of the family farm to a child is a significant and emotional issue. However, succession is rarely more important than the harmony of the close family unit and understanding and empathising with the client at the emotional level is an important element of a successful succession plan. It will take the family a lot of hard work over months, sometimes years, to feel comfortable about the plan. The family relies on its professional advisers to identify and understand how to meet these emotional needs.

This usually means working first with the parents (your clients) to ensure there is a common understanding of the desire for succession and then to involve directly or indirectly all of the close family members. In other words, the family should buy in to the plan because it is fair, and properly achieves the family's goals and not necessarily one child's personal vested interest.

In my experience this involves some patience and a willingness and skill to educate the client on the features of the succession plan and how it meets their needs and the needs of their family. This is an approach which, in my view, is rarely in evidence when farmers form trusts.

Financial Security

It is vital that the succession plan guarantees that the parents are financially secure. A large loan to the succeeding child, upon demand without interest and with no prospect of being repaid, is not financial security to the parents. In order to achieve financial security, the family needs to ensure that:

(a) The plan is financially viable to both the parents and the succeeding child. It is all but impossible, without significant off-farm assets, to achieve succession of a 3,000-stock unit sheep and beef property. Particularly with the current schedule for lamb, it is not possible to provide for two families (the parents and the child's family) out of the income generated from that farm. Any arrangement for the child to assist or take over the farming of that property is not, and could not ever be, a succession plan. It is a misnomer. If the family thinks that succession will be achieved, then they are all going to be disappointed.

(b) The parents have control of the income for so long as they wish and can afford to pay the succeeding child the current market rate for the work undertaken by that child.

(c) The parents have an investment plan which maps out their current and future financial needs and builds in contingencies to ensure that their needs - a loan to the other children, an overseas trip, or upgrading the kitchen - are all affordable.

(d) The succeeding child understands the long-term financial sacrifice that he or she and his or her family will be undertaking as a result of the need to, as a first priority, secure the financial position of the parents. Often, the parents need to be told emphatically that their financial security is the first priority because there is a tendency of parents to subjugate their needs to the needs of their children.

Vesting of control

The parents rarely feel comfortable giving control and ownership to the succeeding child all at once. Such an approach does not accord with the natural and gradual progression of passing over ownership and control of the property over time. Farmers are genuinely close to the land and it is, in my experience, largely the physical demands and rigours of the job that lead them to the inevitable conclusion that it is time to pass the torch. From a legal and financial point of view, the gradual passing of control (both of the day-to-day operation and the legal ownership) as and when the parents dictate is by far the best option as it meets their emotional and financial needs.

There are degrees of control and they need to be discussed and agreed upon between the parties. There is operational control, management control, financial control and legal control. If these aspects of control are wrested from the parents too soon, then it can lead to disenchantment and unhappiness in the family. A good succession plan relies on understanding that control should only be given away as and when the parents dictate. Passing ownership with control is better but not at all mandatory. It is better because it is not fair to the succeeding child for him or her to have day-to-day and management control without the benefits of ownership. Otherwise, the succeeding child is nothing more than a tenant farmer with no real prospect of succeeding to land ownership and growing capital. Ownership is synonymous with income, but control is not.

Given the emotional value placed on control and stewardship of the land, I place the issue of control as a second priority. After all, meeting the emotional needs of the parents is of vital importance to a good and successful succession plan.

Fairness

In my experience, this issue is the most hotly debated topic amongst the family.

I endeavour to explain, often to the relief of the client, that fairness does not necessarily mean equality. That is to say, it is a subjective test and one which ultimately must be determined by the parents. Often a client will feel a moral or an imagined legal obligation to make equal provision for all of the children, including the succeeding child. I explain to them the limitations imposed by the Family Protection Act, having regard to the value of the assets in the estate or the value of the capital in the trust; often in the range of $4,000,000 to $10,000,000.

Adequate provision can be made to each and every one of the children, but with a greater contribution to the succeeding child in order to ensure the viability of the succession plan. The opinions and feelings range greatly, but in order to ensure the succession plan is viable, flexible and operable, it is important that the succeeding child starts as soon as possible to acquire small portions of the farm. Having in place a company/trust structure that allows the succeeding child to gradually acquire the farm creates a plan which permits the children to be treated equally if this is a prerequisite by the client.

A Flexible and Workable Plan

Given the current environment, with the high value of land and the traditionally poor return on that capital, the best way of achieving the objectives referred to above (namely, financial security to the parents, vesting of the control at the appropriate time and fairness to the other children) is to create a living succession plan. This involves, during the remaining life of the parents, the gradual purchase of farm assets over a considerable period of time. The suggestion that the parents can sell the farm to the succeeding child in one transaction is almost always destined to fail and, regrettably, the failure inevitably impacts mostly on the parents and often the surviving widow.

A good legal structure provides a viable solution. In my experience, it doesn't really matter how much time the family spends on devising the succession plan that endeavours to meet their objectives; unless the legal structure is a proper one, then the succession plan has little chance of real success.

At the other end of the spectrum, it is quite unreasonable and manifestly unfair for the child to continue to work on the farm property on wages and find at the end of his or her career that the farm is sold and he or she only receives an equal share of the value of the property.

In order to avoid these extreme outcomes, it is important to do all the things necessary to devise a plan but, most importantly, it is vital that the legal structure can cope with and meet the needs of the whole family.

Without any doubt, the best legal structure for succession planning is a company trust structure.

Comprehensive Legal Structure

Estate and succession planning is but one of a number of issues that need to be considered when looking at a farmer's current legal structure, determining the adequacy of that structure and whether there is a better legal structure.

I will now consider each of these issues which are:

- Tax
- Costs
- Asset protection
- Estate and succession planning

In my view, the advice sought and received on legal structures has been generally rather biased and, in some cases, fickle. On the whole, the banks have avoided the issue of succession planning and the accountants have proposed legal structures driven by financial and tax considerations. Regrettably, a lot of advice from accountants has been to form trusts and transfer the land and buildings to those trusts for reasons of asset protection and without regard to the cost of administration or estate and succession planning issues.

For this reason, especially with regard to the rural sector, this paper provides an opportunity for lawyers to understand the issues and become more involved in legal structures in the rural sector.

I will now turn to consider each of the objectives of a good legal structure.

Tax Planning

Any legal structure should be considered having regard to the farmer always wanting to pay as little tax as is lawfully possible.

You will see from the legal structure options that follow that there are a limited number of structures available to a farming business. The structures are:

1. Sole trader or partnership.
2. Limited liability company.
3. Trust.

Clearly, for income tax purposes it is important to understand the different regimes of income tax for each of these entities. They are:

Sole trader or partnership	$0 to $38,000 - 19.5 cents in the dollar $38,000 to $60,000 - 33 cents in the dollar Over $60,000 - 39 cents in the dollar
Limited liability company	A flat rate of 30 cents in the dollar but with imputation credits attached to dividends distributed to shareholders.
Trust	A flat rate of 33 cents in the dollar from 1 April 2008 unless trust income is distributed to beneficiaries in the year in which it is earned, in which case the tax is the individual tax rate to that beneficiary, unless the beneficiary is under 16.

Any good legal structure will ensure that:

- Most primary income will be streamed to a trust at a flat rate of 33 cents, or a company at a flat rate of 30 cents.
- To the extent possible, income is paid to the shareholder or beneficiary at the lowest marginal rate of 19.5 cents.

Tax planning should also consider tax on death and the possible introduction of a tax on wealth.

As already suggested, it seems improbable that death duty will be reintroduced but this is still a consideration. The ultimate decision is one for the politicians, thus creating a degree of uncertainty with respect to this issue. On balance, it is more likely that a capital gains tax will be introduced, if indeed a wealth tax is ever introduced during the period of your client's effective business life. As a general rule, company and trust structures can provide better and more effective tax planning for wealth tax than individual ownership.

Costs

The issue of costs and legal structures is twofold; namely:

1. The cost of moving from a current structure to a new structure, and
2. The ongoing administrative costs of a new or current structure.

Deciding whether the current structure is better or worse than any other structure will involve not only whether a proposed new structure is better in isolation, but also the cost of getting there. It is always important, in considering these issues, to involve the accountant and the lawyer. The cost of proper professional advice is expensive. The expense is compounded by the inevitable tax cost of transferring assets from one legal entity to another. Accordingly, unless succession is an issue, restructuring is often seen by the farmer as too expensive, especially when they already have a trust.

The cost of administration of the existing structure and the cost of administration of a new structure is also an important factor. Clearly, a husband and wife partnership owning all assets is a simple, cost-effective and inexpensive structure. This can be contrasted with a structure comprised of a partnership, a trust and a company which can be very expensive to administer, both financially and legally. There is also the emotional cost to the farming client who struggles to come to terms with complex multi structures of this kind.

In every case the cost/benefit of the current structure and any new structure is an important consideration.

Asset Protection

The use of trusts to protect assets is highly effective with regard to the following risks:

1. A flexible estate plan to ensure that the assets vest, either directly or beneficially, in the right members of the family.

2. The assets vest beneficially in their children's testamentary trusts, to protect those assets from the premature death of a child or the unintended effects of the Property Relationships Act.

3. Protection from an attack under the Family Protection Act or the Law Reform (Testamentary Promises) Act.

The Plan

From a lawyer's perspective, effective estate and succession planning for farming clients is all about legal structures. Although MAF and AgResearch consider succession planning as a key and vital issue to the rural sector, there is very little material available on this important topic.

MAF Policy Technical Paper 97/4A entitled "Issues of New Zealand Farm Succession: The Study of the Intergenerational Transfer of Farm Business" (June 1998) provides a comprehensive discussion on issues associated with succession planning but does not (and in reality could not) define any of the solutions from a legal perspective.

The solutions lie in a close examination of each client's needs, an understanding of the issues referred to herein and an understanding of the options available, having regard to the long-term emotional and financial needs of the farming family. Legal structures are an important and vital ingredient to any effective estate and succession plan. The success of any such succession plan is also dependent upon those farming families having a clear succession vision and a real commitment by the family as a whole to make it happen.

However, farming families with this clear goal in mind are not themselves capable of determining proper legal structures and therefore are dependent upon their professional advisers. It is quite wrong, but it occurs not infrequently, for the farming family's professional advisers to simply implement the instructions of the family without fully considering the options.

Company with Trust Shareholder

This legal structure assumes a limited liability company owning all trading assets, namely land and buildings, farming shares, livestock and plant and machinery, with the shares being owned initially by the husband and wife discretionary trust and then, in due course, by the succeeding child's trust.

The issues are:

Tax Planning

The new company tax rate at 30 cents in the $1.00 allows the company to reinvest capital in the company with 3 cents in the $1.00 tax saving. With the individuals holding a small number of shares, income can be stripped to the individuals as working directors at 19.5 cents in $1.00. The balance of the profits can be paid as a dividend to the majority shareholders, the Trust, and stripped down to the beneficiaries if a lower rate is available. However, the tax rate for a trust is still 33 cents in the $1.00 and 3 cents in the $1.00 will be paid if that dividend income is retained in the trust as income.

Costs

The cost of transition from partnership or trust to company can be high with transactional costs, valuation costs and tax from depreciation claw back. However, the post-transition administrative costs are low and farming families rejoice in the simplicity of a trading company operation.

Asset Protection

This structure provides limited liability from the trading company and the protection offered by the shares being owned in a trust.

Estate and Succession Planning

There is significant advantage in the flexibility offered by the transferability of shares without triggering any tax cost. This permits the parents the option of selling shares (for cash or with a debt back) to the succeeding child, thus creating a living succession plan which can be implemented over the life of the parents.

Advantages of a Company Trust Structure

Not only does the company structure provide the best succession planning structure, it also achieves the other objectives. It is a good tax structure, especially with the reduction of company tax to a flat rate of 30 cents in the dollar. It provides low administrative costs as only one set of trading accounts is required. It provides proper protection as the company's trading trust enjoys limited liability and the shares in the company are owned by the trust with a significant secured debt from the trust to the company. Most importantly, it provides a perfect structure for long-term succession planning.

Succession with a Company Trust Structure

The great advantage of a company is its flexibility in the transfer of shares to the succeeding child. By transferring shares, the parents are able to sell for cash a small proportion of the total business of the farm to the succeeding child with the following result:

1. The parents receive non-taxed payment to enjoy a higher standard of living and, in many cases, to provide financial assistance to the other children.

2. The child is investing his or her capital in the appreciating asset – land - rather than the livestock and/or plant and machinery, thus protecting the viability of the succession and hedging against the appreciation of the land.

3. By owning even a minority shareholding the child is included as an owner and has a stake in the operation and profitability of the business.

4. The parents, and especially the father, have the opportunity of securing the assistance of a child which provides him with the physical input required as the father gets older, as well as the emotional support, encouragement and enthusiasm of a younger generation. The child is given the opportunity of continuing to purchase shares over time from tax-paid income (and in some cases, an early distribution of his or her inheritance from a loan from the trust) to purchase shares. Over a considerable period of time the shareholding should be significant enough to ensure, on the death of the parents, that the child's succession to the farm is secure, using the shares owned by the child, together with the inheritance from the estate or trust of the parents.

5. If the succeeding child pays cash for the shares, then fairness prevails and none of his or her siblings are able to allege that the farm was "gifted" to the child.

6. Controlled ownership and income increase to the succeeding child as more shares are purchased by that child and thus the parents, as trustees of the shareholding trust, have absolute and complete control over their financial security, financial and operational control over the company, but with an inducement and incentive to sell shares to access capital and ensure the succeeding child successfully gradually takes over the ownership of the farm.

   In that way, the ultimate goal is achieved, namely:

   - The emotional needs of the family are met;
   - The parents' financial position is preserved;
   - The child succeeds to the farm in a viable manner;
   - The estate plan provides fairness to all children.

Other Issues

In structuring a successful succession plan, it is important to give consideration to the following further matters:

1. The appropriateness of the parents setting up a single-purpose inheritance trust for each child. This is a discretionary inter vivos trust. The succeeding child uses this trust to purchase shares from separate property. Such a structure protects the operational viability of the farm as it retains the status of the shares as separate property. It is important to ensure that this trust receives only inheritance property or separate property acquired prior to the relationship or the marriage. It is the parents who generally desire to protect the child's inheritance from the various risks associated with direct ownership of assets, ie the Property Relationship Act.

2. As a consequence of the parents setting up a single-purpose inheritance trust for the child, the child should ensure that the child's relationship property assets are held by the traditional joint trust formed by the child and his or her partner or spouse. In circumstances where there is a partner or spouse, it is strongly recommended that a section 21 agreement is entered into in order to cement the enforceability of the distinction between those company shares which are separate property and those which are relationship property.

3. In my view, and in my experience, a shareholders' agreement between the parents and the succeeding child is desirable, especially at the point in time when 25% or more

of the shares is under the control of the succeeding child. So too, is a contract on commercial terms, between the child and spouse or partner and the company is also very important.

Conclusion

Without question, every farming family has different ideas, different issues and a different approach to the important issue of succession of the family farm. However, without the appropriate legal structures in place, I am concerned that a well-intentioned succession plan will be doomed to failure with the ultimate outcome that the family is destroyed, and with the result that the dairy industry, and the New Zealand economy is the ultimate loser.