ASSISTING PROPERTY OWNERS WITH WEALTH TRANSFERS: ANECDOTAL EXPERIENCES FROM THE UNITED STATES AND NEW ZEALAND

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Abstract

Anecdotal experiences are discussed relative to efforts assisting property owners with wealth transfers. The author draws from his work in the United States and while on sabbatical in New Zealand. Initially focus was given to the technical aspects and details of asset transfer: organizational structures, ownership of assets, percentages of annual transfer through gifts, etc. Experience led to a redirection of emphasis in dealing with property owners. Efforts were redirected to hard issues of economics (can the farm afford succession) and to soft issues of management, such as mission and vision statements, articulation of values by the property owners ultimately leading to establishment of goals and plans. The transition of wealth, consistent with owner plans, is then executed incorporating business plans, gifting, sales, and bequests all sensitive to tax constraints if any. The most difficult issue often times, is the gathering around the kitchen table to begin the discussion.

Keywords: wealth/business transfer, taxation, goals

Introduction

To live cash poor and die land rich is often the case with farmers and other primary producers in the rural sector. Generally, as is well known, land acquisition and subsequent appreciation of land creates the wealth of farm families. As commercial farms in industrially developed countries decline in number, but conversely gain in size and scale, transfers to subsequent generations can be a challenge for these families. This paper discusses change in the methods and focus used by the author in assisting farm families with this process. These anecdotal experiences are gleaned from private meetings with farm families across kitchen tables, to public extension meetings conducted as workshops, to address in a broad fashion the issues of wealth transfers (the family farm in many cases).

This discussion includes the following topics: goal setting, economic reality, business structures, tools used to address these issues. Recent emphasis of the author has focused on the “soft” issues of family wealth transfer as compared to “technical” issues. The author discusses his experiences from the perspective of his professional career as an extension specialist in two Cooperative Extension Services in the United States (Kansas and North Carolina) and a six and one half month sabbatical as a visiting farm advisor in Ashburton, New Zealand.

Workshops begin with asking participants three questions: 1) what is your definition of success, 2) what is your definition of succession, and 3) what motivates you (gets you up in the morning), money or the game of business? Often, these questions begin the task of simply talking, listening and learning between family members either attending a workshop or sitting around the family table.

Goal Setting

The simple overriding goal relating to wealth transfers is that it, the accumulated wealth, “goes to my family”. That is simple if one has only one child, and that child desires to continue “the tradition of family farming or the family business". However, reality is much more difficult. Yes, the encompassing goal, with family business transfer is to keep it in the family, but to or with whom in the family? When the author opens the topic of succession planning three general questions are asked. First, what is success; as defined by the participants? A working definition of success, being the root from which the word succession is taken, is necessary for the participants to focus as a beginning to goal setting. Overwhelmingly, in New Zealand (10 locations) and in the United States (8 locations in North Carolina) the author observed that participants listed family values as primary indicators of success. Time with family, to experience family events, to participate in activities of children either at school or extra curricular events such as athletic competition, camping or religious activity was ranked consistently in the top two to three categories. Yes, business success can "afford" the flexibility to allow for these enjoyments. Articulation of financial success was generally rated number five or six on lists created in descending order of importance. This is consistent with results of employee surveys that rank employee satisfaction or motivational inputs where salary or compensation is ranked sixth. The importance of goals, preferably written, allows for the planning, implementation and control of family business activities so that the business owner's definition of success, generally inclusive of family, can be attained.

Formalized goal setting can be difficult; a tool used to formalize the process can aid in the recognition of important issues in the wealth (business) transfer process. Such a tool is illustrated below. The goal setting acronym SMART: where **S** represents **specific**; **M** represents **measurable**; **A** represents **attainable**; **R** represents **rewarding**; and **T** represents **timed,** helps focus the process (author unknown). Other practitioners of farm consultancy use other like words when using this acronym. Articulation of a goal using this methodology may look something like this:

Specific (I want to purchase family farm land)
Measurable (I want to purchase the 100 acre Moore Farm)
Attainable (I can purchase this farm with a 35% down)
Rewarding (Buying "grand dad's" old home place)
Timed (I want to close by September 15, 2007)

Each member of the family, involved in the firm or not, may influence any ultimate outcome of transition planning. It is important for all parties to recognize their individual goals, even if difficult to articulate, in this wealth or business transfer process. For the patriarch, commonly the driving force of family businesses, is there a view point change that needs to be addressed? Namely is there a sense of "being put out to pasture" or is there a recognition of movement to a new phase of life; either being a mentor to the successor(s) or a curmudgeon? For the matriarch, has her family life been one of "nurturing the children" and being "family peacemaker" versus being an esteemed business partner? For the supposed successor(s) is this viewed as an offered opportunity or an entitlement? For non-successor family members is the transfer of family business wealth [possibly disproportionately to successor(s)] viewed with honest recognition of contribution to the past growth of the firm or with envy? Lastly, for this discussion, what about the spouses of the successor generation; are their perspectives received as *bona fide* family members or not included in this process? Attention, therefore, to the permutation of family inputs should lead wise family business owners/managers to be aware of the complexity of the human dynamic of the wealth transition process. Articulation of goals, business and family, should be paramount in the beginning of the process of wealth transition. Operators of these businesses must balance many objectives in the successful transition of accumulated wealth: retirement cash flow, equitable wealth transfer to desired recipients, business successor(s) with sufficient resources to have a chance at success, and a host of other issues.

For family business owners one of the most difficult decisions to be addressed and ultimately made is asset distribution to heirs. This decision must include who gets what; when they get it; and finally, how do they get it. It is the author's observation that this question is the most difficult because of the emotional component often drives objectivity out of the window. Workshops have enjoyed a measure of success in bringing light to the difficult questions families must address. Observations of workshop participant groups indicate that questions can be raised in the supported environment of others dealing with the same or similar issues. After discussion of the emotional topics a transition is made to the feasibility topic: what is the affordability of the present business enterprise regarding wealth transfer or succession?

Can the Family Business/Farm Firm Afford a Successor?

Importantly, when addressing the family objective of continuity of the family business, the issue of affordability, or more pointedly, the economic reality of successful family wealth (business) transfers must come into play. Increasingly, in production agriculture, business owners must address the question, are they the managers of a commodity production unit within the context of a the "national farm" (Lisa Jack, NCSU guest lecture March 29, 2007), or, are they entrepreneurial mangers within the primary production sector striving to differentiate their products produced for either market niches or niche markets. The family business/farm must continue to be profitable and sustain the families that it supports. As parents live longer, the demands on cash flow are increased if there are no off-farm income sources such as social security payments, equity investments or pensions. David Kohl, Virginia Tech professor emeritus, indicates that businesses in the primary sector must plan to grow five to six percent per year for business sustainability. If the firm's income is to support more than one generation, the growth factor may indeed need to be higher to allow for continuing success. Therefore, analysis of firm profitability and capital structure can provide fundamental groundwork in the success of wealth (business) transfers. This analysis can be performed by the accounting/tax professional engaged by the firm. Further, use of production and economic benchmarks by various categories: scale, farm business type, capital, etc. can provide family business owners with direction as to feasibility of the transfer. Likewise, the successor to the farm business can begin to chart the path of success as they see it with the resources that are available to yield the profit necessary to afford the transition. Obviously, if the elder generation has made off-farm investments and thereby has an income stream to fund its retirement needs, chances of the success of wealth transfer is heightened. The author observed this to be the case in both the United States and in New Zealand.

Tax Considerations and Business Structures

Both the United States and New Zealand have their law rooted in English Common Law. The expression and practice of each country's national law and state laws for the United States differs by cultural and structural construct of their respective jurisdictions. Each country has laws governing taxation policy and business ownership; however New Zealand's tax laws are wealth-transfer friendly.

The author observed that in New Zealand, tax laws made wealth (business) transfers easier to accommodate family goals of business succession. Namely, New Zealand does not have a capital gains tax and presently, by statute, the estate tax rate is zero. (NZ Inland Revenue) Therefore, parents wishing to "cash up" can sell the family business to the successor generation with little to no tax cost. Upon death, if cash remains in the decedent's estate, it can be transferred to beneficiaries with little to no transfer cost as well. (NZ Inland Revenue) The absence of these two taxes allow for New Zealand family-owned businesses to be "offensive", relative to business succession and for providing income to the former business operators.

In contrast, the United States taxes capital gains as income but at a preferential capital gains tax rates. Presently 15 percent is the maximum marginal tax rate on capital gains. (Internal Revenue Service) Farm businesses selling depreciable capital goods such as tractors must recapture any depreciation taken in prior years at ordinary income tax rates, the maximum rate of which is 35 percent. (Internal Revenue

Service) Further, the United States has an estate tax (wealth transfer) of 45 percent for estates which have assets valued greater than US $2,000,000. In the United States estates of US $2 million or less do not pay federal estate tax, though some estates may pay estate or inheritance tax to the revenue or taxation department of the individual State in which the decedent lived. These two tax issues are important to farm business managers in the United States as they must be “defensive” in their wealth transfer strategies. Frequently, for many farm business owners, these two taxes establish a large disincentive to wealth transfers and can require large cash outlays by the decedent’s estate to pay these taxes upon transfer. Regardless, plans should be developed by business owners for this taxing potential as part of the wealth transfer process. Ultimately then, for farm business owners in the United States, the tax consequence of wealth transfer will occupy a greater role than for their counterparts in New Zealand as plans are developed.

Business ownership structures used in the two counties are similar. Nuances exist relative to application and legal construction that may have operational implications for preferred ownership structures between the two countries. But for the purpose of this discussion, the structures used in both countries are flexible tools for wealth transfer. Fractional ownership can be transferred to the successor(s) with transfers of family-corporation stock shares or ownership interests of limited liability companies or partnerships. Business continuity, an assumed family goal, can be facilitated by partial transfer of ownership interests over time. However, the use of gifts as part of a transfer process is available in both countries but expressed differently.

In the United States an annual gift exclusion of US $12,000 per donee is available to use as a business ownership transfer mechanism. In practice, the Internal Revenue Service allows a discount for minority interest and non-marketability of closely held companies ranging from 20 to 38 percent from the interest’s fair market value. (Internal Revenue Service) Business owners with a relatively long planning horizon may transfer US farm businesses to accomplish family goals.

In contrast, New Zealand has a total gift limit of NZ $54,000 (2005) per year. Donors may choose to gift this amount to one or several donees. Similar to the United States, business owners with longer planning horizons can transfer wealth to successors. The major difference between the two countries gifting allowances is that in the United States gifts of an annual tax free amount can be made to unlimited donees, while in New Zealand there is an annual total amount that can be gifted to a donee(s). For owners of businesses the task of planning for the transfer of business wealth must in some way address any tax consequences of the transfer process. These tax issues often become psychological obstacles bringing the transfer process to a crawl or full stop.

Workshop Tool: A Case Farm for Small Group Discussion

Use of a case farm is a successful way for large and small groups to address the issues of goals, which family member gets what, how, and when balanced by economic reality and tax considerations of wealth transfer. The use of a case study in the farming context allows for participants to identify with a common issue, wealth transfer of family businesses, but in a not threatening and personal way (disclosure of personal financial data). The case study can be constructed with “red herrings” for highlighting issues that may occur in family businesses or to force recognition of “life events” that demand non-traditional plans, such as a child born late in life and the only one that truly desires to be the successor farmer, but is to young to carry on when parents want or need to exit farming. An example of such a case farm is included in the appendix to this paper.

As a part of the workshop in which wealth transfer of farm businesses is the focus, the case farm tool is used to discover strategies that can be explored by the participants in the workshop with their own personal plans. In the following sections the author discusses observations relative to the workings of the small groups. When conducting these workshops, the author splits the attendees into small groups of no more than 6 persons. Further, these groups are segregated to separate family members so that each person is able to express personal opinions without familial influence. Additionally, when possible, the author segregates participants by sex, attempting to have at least one female-only small group. After a group discussion period, each group reported to the entire workshop the group's suggestions and observations of the case farm. Obviously groups often reported the same or similar suggestions to succession and wealth transfer issues. However, each group would typically identify a unique discussion point.

Male Participants

The point of the exercise was to come to some conclusion or group consensus formulating a plan for succession based on the given facts in the case farm. Observations made of the small group dynamics, in which male participants were either the entire population or majority of the group; indicate that the males try to "farm" themselves into a solution or out of the perceived problem. The males were driven by their drive to produce product. To be fair, a few groups both in New Zealand and the United States did investigate and pose ideas utilizing the capital resources as a means to continue to generate income through passive means such as rents or restructuring the asset portfolio to include off-farm opportunities to generate income. Overwhelmingly, the males exhibited sharper financial analysis skills across all groups. New Zealand participants seemingly were more willing to exploit off-farm business opportunity ideas (using farm-based equity) than their counterparts in the United States. The proposed solutions coming from the male groups did recognize the difficulty of the process, but the males generally left themselves in the picture of "running the business", thereby deferring action on succession.

Female Participants

At four of 18 workshops, two each in New Zealand and the United States, sufficient numbers of participants were female to allow for female-only groups. Observing these groups produced an interesting contrast with the all male or male dominant groups. First the females tended to follow more closely the charge of the activity to seek succession strategies relative to wealth transfer in the case farm. Second, the women were more apt to define "fair" as equal, but struggled with the concept of "fair" as it related to the case farm scenario. Small female groups vocalized this difficulty to the entire workshop group; the men likewise concurred, but did not spend as much time on this issue in their small groups. Third, the author observed that in three of the four female only groups, understanding of financial statements, basic business operations planning, and estate and wealth transfer issues was greatly lacking. These observations raised questions regarding intra-family communications and transfer of knowledge: business, production or otherwise among spouses or partners. Since women generally outlive men this lack of understanding by the likely surviving spouse or partner may have grave consequences for successful business and wealth transfers in the rural sector.

Summary

The purpose of these extension workshops was to assist or prod participants into beginning the process to think about, discuss and formulate or review personal plans toward successful wealth/business transfers. The case farm is a useful tool to help participants, male and female, to recognize issues similar to their own circumstances, without disclosure, and begin the conversation. Men, driven by their production work ethic, attempted to produce the case farm out of the perceived problem solvable by more profit. Women tended to express solutions that were nurture focused, as being equal in distribution of wealth to heirs, regardless of the business implication. An observation of the female groups indicated that understanding of business analysis and production practice was lacking on the part of female participants. If this observation is indeed true, then future extension work needs to be developed to assist with broader understanding of these topics.

The overall goal, to bring owners and operators and their spouse or partners of rural and farm businesses together to discuss and explore transfer of wealth/business issues was accomplished. Several participants left with knowledge confirming already established plans, or, those that needed to begin the process left with lines of communication open, but knowing that conversation must continue for ultimate success.

Appendix: Case Farm Example

Case Farm: Dusty and Bumpy Furrow

Dusty (51) and Bumpy (48) have three children: James (25), Jennifer (23) and Timothy (14). Dusty and Bumpy have been in contact with their farm advisor about doing a farm succession/transition plan. They provide information (see supplement) from which to make a frame work for the decision making process.

James is entering medical school and has no interest in the farm. Jennifer is interested in farming as she is a recent graduate of an Eastern State University, but is in a budding relationship with a Californian who lives on a cotton farm in the southeastern part of California. Tim is really keen on farming in his father's footsteps. Dusty and Bumpy are in somewhat of a quandary.

Family living expenses: $65,000 per year
Life Insurance: $15,000 per year

Annual family car capital cost: $8,500

Aid to James in med school: $10,000
Aid to Jennifer $5,000

Dusty and Bumpy remember the struggles that the family had when Dusty's father died unexpectedly in a bar room brawl (he was truly an innocent bystander as he was asking for directions…). Dusty had to buy out his siblings and only in recent years has had the means to develop the farm. Dusty feels that he was taken advantage of and doesn't want that to happen with his children. Bumpy wants to treat all the kids equally. Dusty is not so sure seeing some issues can not be resolved, but recognizes a plan needs to be in place. At 51 years of age, Dusty does not want to be on the farm every day as he currently is doing, he and Bumpy want to be able to take planned holidays.

They have come to seek advice as to options they should consider.

Farm Financial and Production Factors
NC Crop Farm Example: Dusty Furrow

YEARS

Physical Production Factors	1	2	3	4	5
Farm Area (acres)	1766	1766	1766	2150	2150
Effective Farm Area (acres)	1,501	1,501	1,501	1,850	1,850
Cattle: head	98	98	98	115	115
Crop area: acres	1,370	1,370	1,370	1,685	1,685

Financial Factors	1	2	3	4	5
Cotton Income	$154,852	$138,936	$164,350	$158,560	$185,625
Corn Income	$53,394	$44,777	$38,659	$51,503	$42,367
Cattle Income	$34,096	$38,965	$45,975	$69,850	$77,625
Wheat Income	$15,685	$10,768	$18,680	$24,350	$27,680
Soybean Income	$36,785	$39,757	$42,568	$61,536	$72,652
Other Income	$4,377	$5,369	$3,726	$5,782	$5,354
Gross Farm Income (GFI)	$299,189	$278,572	$313,958	$371,581	$411,303
Farm Working Expenses (FWE)	$171,658	$165,373	$193,894	$246,070	$258,750
EBIT (Excluding Depreciation) (Earnings before Interest and Taxes)	$127,531	$113,199	$120,064	$125,511	$152,553
Fertilizer & Lime/a	$72.48	$114.97	$169.60	$43.97	$292.24
R & M /a	$26.24	$41.80	$49.00	$56.45	$44.52
Animal health/head	$4.56	$4.36	$3.77	$3.96	$4.47
GFI/a	$199.33	$185.59	$209.17	$200.85	$222.33
FWE/a	$114.36	$110.18	$129.18	$133.01	$139.86
EBIT/a	$84.96	$75.42	$79.99	$67.84	$82.46
Cotton GI/ total acre	$113.03	$101.41	$119.96	$94.10	$110.16
Corn GI/total acres	$38.97	$32.68	$28.22	$30.57	$25.14
Cattle GI/total acres	$24.89	$28.44	$33.56	$41.45	$46.07
Wheat GI/total acres	$11.45	$7.86	$13.64	$14.45	$16.43
Soybean GI/total acres	$26.85	$29.02	$31.07	$36.52	$43.12
Other Income / total acres	$3.19	$3.92	$2.72	$3.43	$3.18
Depreciation averages $17,000 per year					

Balance Sheet

Land: 1112 a at $2,150/a		$2,390,000
Equipment:		$250,000
Irrigation:		$250,000
Livestock:		$105,000
	Total Assets	$2,995,000
Non-Current Debt		$950,000
Overdraft (Operating loan)		$50,000
	Total Liabilities	$1,000,000
	Equity Position	$1,995,000