



# FARM TRANSITIONS

Introduction

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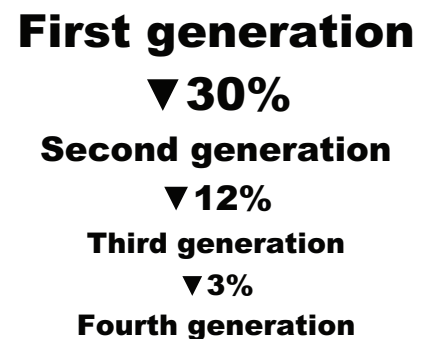
# The Importance of Farm Transition Planning

Legacy. Heritage. Tradition. Values. These words quickly come to mind when one thinks about the importance of passing the family farm to the next generation. For many, the family farm represents the collective work of multiple generations. Regardless of whether a farm's was established in the days of the Oklahoma territory or if it was started last year, though, chances are its owners regard it as more than a mere collection of assets. Farmers and ranchers share a unique connection to their operations, and that connection almost always carries a nearly-instinctive drive to make sure the operation successfully passes to the next generation.

When asked what they would want to happen to their farm after their passing, the vast majority of farmers and ranchers would likely say something to the effect of "I want to keep the farm in one piece and to keep my family farming it." However, the data suggest that farmers, ranchers, and other small business owners are failing in that objective. According to a survey by the Family Business Institute, only about 30 percent of small businesses (including farms and ranches) survive their transition from the founding generation to a second generation, 12 percent survive to a third generation, and only 3 percent survive to a fourth generation.<sup>1</sup>

If farmers and ranchers find the successful transition of their operation so critical, why do we see such frighteningly low success rates of farm transition? What can be done to reverse this trend?

*Figure 1: Generational transition success rates for small businesses.*



## Why do so many farm transitions fail?

Farmers and ranchers often prevail over challenges from drought and machinery failures to market crashes and family emergencies. So why has the problem of successfully transitioning the farm business to the next generation become so widespread? Research from a number of sources suggests it is the result of issues affecting both individuals and small businesses generally, as well as challenges unique to the family farm. One author summarized these challenges into three primary reasons that farms fail to successfully transition from one generation to the next.<sup>2</sup>

*Figure 2: Primary reasons for farm transition failure.*

- 1. Inadequate estate planning**
- 2. Insufficient capitalization**
- 3. Failure to prepare the next generation properly**

A closer look at each of these issues can reveal why your farm transition plan can make all the difference in the future success of your operation.

### A. Inadequate Estate and Retirement Planning

We have all heard the old adage "failing to plan is planning to fail." While parents often cite this to children refusing to plan for the future, many parents would do well to hear it themselves. The successful transfer of an intact farm business from one generation to the next is virtually impossible without a carefully constructed plan, and yet farm families consistently fail to create and follow such plans. A 2007 survey revealed that 55 percent of American adults did not have even a will.<sup>3</sup> Other research suggests that the numbers are far worse

within the agricultural industry with 64 percent of farmers and ranchers having no form of estate plan.<sup>4</sup>

Failing to have any form of estate plan in place clearly influences the issues of insufficient capitalization and failure to prepare the next generation properly, and those influences will be discussed at length in the next subsection. For now, though, we focus on the immediate and significant impacts failing to have an estate plan can have on the very survival of the farm *family*, to say nothing of the survival of its business.

For example, research indicates approximately 80.3% of widowed persons are women.<sup>5</sup> This should pose a concern to farm wives and mothers, as widowed women have a poverty rate between three and four times that of married persons of similar age.<sup>6</sup> Why? In many ways, inadequate estate planning creates hardships for a surviving spouse: the intestate succession process could lead to the complete fractionalization of the farm, leaving an operation of insufficient size to support a surviving spouse as shown below; disputes over how to distribute assets could freeze such assets for significant periods of time; a lack of opportunities for surviving spouse to learn how to manage the assets could result in losses or liquidations; the list goes on and on. A surviving spouse likely will be the first “victim” of a lack of estate planning.

The surviving spouse is not the only likely victim of a lack of estate planning. Children, grandchildren, other relatives, and charities can be the unintended victims of failing to craft an estate plan. To understand all of the potential problems with failing to craft an estate plan, consider Oklahoma’s intestate<sup>7</sup> succession statutes. These are the statutes that govern the distribution of a deceased person’s (called the “decedent”) property. Table 1 illustrates how the Oklahoma intestate succession statutes would distribute property in six different cases.

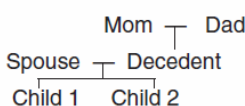
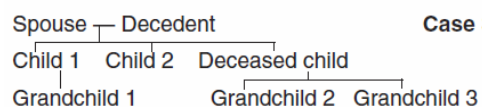
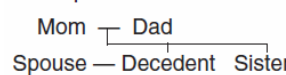
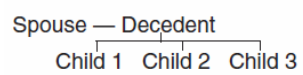
As you can see from this table, the intestate succession statutes may not bring about the result you wanted in a number of cases. For example, any time the decedent leaves surviving children and a surviving spouse, they will always share in the decedent’s property. It may have been the decedent’s intent to leave all the property to the surviving spouse for his or her support, and then for the property to go to the children, but that will not happen without an estate plan. Similarly, it may be the intent of a grandparent that their grandchildren receive property after they die, but if the grandchildren have living parents, the property cannot be passed to them under intestate succession. What if a surviving spouse and children over the age of 18 receive a joint interest in a piece of property? Every party would be entitled to sell their interest and take the proceeds, potentially breaking up an important farm asset and leaving a surviving spouse without sufficient resources to support themselves. One can quickly see that the lack of an estate plan can cause a number of problems.

Closely tied to the issue of inadequate estate planning is the issue of inadequate retirement planning. Many farmers and ranchers fail to see the link between retirement planning and a successful farm transition to the next generation, perhaps because many farmers and ranchers never intend to retire. Surveys among some farm populations indicate 73 percent of farmers plan either to never retire or to only “semi-retire.”<sup>8</sup>

Failing to plan for retirement can have devastating consequences on the financial assets of the farm, meaning hardships for a surviving spouse and little chance of success for a successful transition of the farm to the next generation. For example, a predominant issue for older farm families is the rising cost of medical care. By one estimate, a 65 year old couple will need \$240,000 in liquid funds just to cover their medical expenses to end-of-life.<sup>9</sup> USDA data show the average farm balance sheet is healthy enough to support such expenses overall – with an average asset value of \$1,086,535 and a net worth of \$992,782 as of 2013 (the most recent data available).<sup>10</sup> However, of the over \$1 million in assets held by the average farm, \$987,397 on average was in the form of non-current assets with \$839,219 in land and buildings. Without liquid assets available to cover medical or other expenses, farm families could find themselves having to sell their productive assets and reducing the viability of their farm.

Failing to plan for retirement can have other detrimental effects on the farm’s survivability. While older producers tend to own a great deal of their agricultural land (69 percent of producers over 65 own all the land they farm<sup>11</sup>), they often decrease production or switch to less-intensive enterprises as they age. The average value of sales per farm for producers over 65 years of age is 42 percent lower than that of farmers 45 to 64

**Table 1: Distribution of property under Oklahoma intestate succession laws**

Surviving Heirs		Distribution
Spouse—Decedent	<b>Case 1.</b> Spouse No children No parents	Spouse inherits everything.
	<b>Case 2.</b> Spouse Children Parents	Spouse inherits 1/2 Children share 1/2 (regardless of number of children)
	<b>Case 3.</b> Spouse 2 living children 1 Deceased child 3 Grandchildren	Spouse inherits 1/2 children share 1/2 (1/2 divided by 3 equals 1/6 each) Children of deceased child will divide that share (1/6 divided by 2 equals 1/12 each) Other grandchildren receive nothing.
	<b>Case 4.</b> Parents Grandparents Spouse	Spouse receives all joint-industry property and 1/3 of nonjoint property. Parents receive 2/3 of nonjoint property. If parents are deceased, sister would receive 2/3 of nonjoint property.
	<b>Case 5.</b> Spouse Decedent's children (Not children of spouse)	Spouse receives 1/2 of joint industry property. Children share 1/2. Spouse receives child's share of nonjoint property (1/4 in example). Children each receive share of non-joint property (1/4 in this case).
	<b>Case 6.</b> No relatives	The estate escheats to the state.

\*Joint industry property is property acquired by joint efforts during marriage (including individual salaries). Nonjoint property might include individual inheritances or property owned before marriage if that property is held in separate bank accounts or otherwise maintained as separate property.

years old, despite that their farm size is only 7 percent smaller.<sup>12</sup> The consequence of this “retirement in place” by decreasing productivity of the farm assets can mean the conversion of hard-earned farm equity into living expenses for the current generation occupying the farm. While this might have been the implied “retirement plan” of the founding generation, it can also mean an undercapitalized business remains for the next generation as discussed below.

Some agricultural producers may think they can rely on their farm asset base alone to fund their retirement through the leasing of the assets to the successor generation or to an outside operator. Unfortunately, many farmers and ranchers underestimate the asset base needed to sustain their retirement living withdrawals. Using data from Oklahoma State University’s farm leasing survey, agricultural land can be expected to lease for approximately \$40/acre for cropland and \$22/acre for pastureland<sup>13</sup>; if a farm couple needed \$68,000 as a cost of living withdrawal – the average family withdrawal according to Kansas Farm Management Association records for 2012 – they would require 1,700 acres of cropland, 3,090 acres of pastureland or some combination thereof (and note this calculation assumes no debt is owed on the land). While these numbers do not include the value of machinery or livestock leasing, it should also be noted those investments have at best a ten year leasing horizon without replenishment.

Taken together, these issues can create significant risks not only for the farm’s founding generation, but also

for the viability of any transition plan. As one researcher has observed:<sup>14</sup>

*... [T]he “retirement effect” can be found if a successor is not identified. Operators often slowly disengage from farming by eliminating livestock to reduce labor requirements but continue the cropping enterprises. Eventually, the farmer may opt to let the livestock facilities deteriorate, rent out the cropland, and continue living in the farmhouse in hopes the land will eventually transfer to his or her heirs at his or her death, in spite of the fact the heirs will never farm the land themselves. This process may severely impact the older generation’s retirement income potential, considering that farm business investments may be the only retirement assets. The only way to realize the older generation’s return on investment is to continue farming or sell the farm outside the family at a fair market value, either as a working farm, recreational land, or for development. The other concern with timely identification of a successor is the infusion of Social Security income when the older generation reaches an age to receive benefits. The monthly income from Social Security and the addition of health care benefits through Medicare can provide just enough financial security to allow the older generation to be less reliant on a successful transition to the younger generation. Income from the Conservation Reserve Program can have a similar affect, but goes one step further by taking land completely out of production that might have otherwise been rented to a beginning farmer or a farmer expanding his or her operation.*

In short, a failure to create a well-constructed estate plan can lead to the disruption or outright breakup of the farm business, and failure to plan for retirement can drastically deplete the farm’s asset base, creating serious viability problems for the farm as a going business concern.

## **B. Insufficient Capitalization**

The challenges of inadequate estate and retirement planning flow directly in to the problems of an undercapitalized farm operation. While farmers and ranchers constantly work to plan how their operations will stay ahead of the production challenges of the coming year, they often fail to create intermediate- and long-term business plans for how their operations must grow to sustain the addition of a new generation. Some quick “back of the envelope” math reveals how dangerous this lack of planning can be.

Summaries from two of the nation’s largest farm-management databases suggest that, for operations supported primarily by on-farm income (as opposed to operations where the majority of income comes from off-farm employment), approximately \$600,000 to \$750,000 of gross sales are needed to support each full-time equivalent (FTE) worker on the farm.<sup>15</sup> Based on an average asset turnover ratio of 30 percent, this level of sales requires approximately \$2 million of assets under management. Many farms simply do not have this level of economic productivity or asset base.

The problem becomes magnified when we consider how many people may have to be supported by the farm asset base if another generation is added to the operation. The addition of a generation may mean the addition of an additional full-time employee; it may also mean that the cost of living withdrawals of two families may burden the operation where only one existed before. The other problem posed by the addition of family members to the operation is that farm labor is, to borrow the economic terms, “lumpy” rather than “continuous.” That is, instead of adding fractional amounts of FTEs to the operation, farmers generally can only add labor in integral units of one full-time employee at a time. This may mean significant increases in assets are required to grow the operation to a size capable of supporting the withdrawals of the additional employees. Without a long-term plan to grow the business and its assets, this can create significant problems, ranging from increased financial stress (particularly where debt is used to finance asset acquisition) to compensating added employees at below-market wage rates or a complete inability to add anyone to the operation.

To this point in the discussion of farm capitalization, we have assumed the farm asset base remains completely intact and can be expanded. Frequently, scenarios arise that can significantly reduce the asset base and its ability to support farm family living expenses. One such scenario is the “farm kid / city kid” dilemma. This problem is discussed in several other sections of the handbook, but it is useful here to illustrate why the capitalization of the farm is so important. The “farm kid / city kid” problem is common across many farms and ranches: one or more heirs has stayed on the farm or desires to return and make meaningful contributions to the

operation's growth (hereinafter referred to as "Farm Kid") while one or more heirs chooses to pursue off-farm employment and, although they may have important emotional connections to the farm, they have no intentions of becoming an active member in its operations (hereinafter referred to as "City Kid").

This poses a difficult choice for the founding generation. On one hand, the founding generation likely wants to provide some portion of the farm business to both Farm Kid and to City Kid. Wanting to avoid "unfair" treatment of one child or the other may lead them to conclude the only permissible division of farm assets is equally (often in undivided interests) to both Farm Kid and City Kid. On the other hand, the founding generation also recognizes this will leave Farm Kid with either a diminished asset base (if City Kid chooses to sell his or her share to convert the asset inheritance to cash) or partnered with someone whose economic interests are at best significantly different from their own (and at worst, are completely contradictory to their own).

Many farmers and ranchers choose the first approach. Fearing that City Kid will protest if he or she receives less in overall asset value than Farm Kid, they choose to evade the issue by giving both Farm Kid and City Kid equal, undivided interests in all of the farm's assets. A 2006 FARMTRANSFERS survey of Iowa farmers revealed 40 percent thought the "best" farm estate plan was to divide the assets among all the heirs equally.<sup>16</sup> However, if the objective of a farm transition plan is "to keep the farm in one piece and keep the family farming," then giving the farm to both City Kid and Farm Kid in equal, undivided shares may not be the best option, for a number of reasons. First, City Kid is much more likely to view the farm assets as an investment whose value can only be realized through its sale, while Farm Kid and the founding generation view those assets as critical pieces to a continuing and hopefully growing business.<sup>17</sup> The sale of assets to an outside party means that the farm not only slows or stops its growth; it may be reduced below a viable size. Alternatively, Farm Kid may try to buy out City Kid to consolidate control of the farm assets, but this can expose Farm Kid to significant financial stress if indeed he or she can even secure financing for the purchase given the cash flows or equity position of the farm business.

This dilemma is summarized in the comments provided by a FARMTRANSFERS survey respondent: "My dad spent his entire life paying off my uncles. Now I'll spend the rest of my life paying off my brothers."<sup>18</sup> The farmer went on to note that he was one of three sons and his father had resolved he was going to give the farm in equal parts to all three, even though two of the brothers "were not currently on the farm and had not worked on the farm since they were children." The farmer's father had been in the same scenario, thus placing the current Farm Kid in the position of having to pay off heirs of the previous generation, and of the current generation as well. Put another way, one Cooperative Extension professional has noted "With poor farm transition planning, your family can buy the same farm from itself multiple times!"

If the farm is not sold to an outside interest, but rather Farm Kid and City Kid choose to work together, challenges still remain for both. As someone who holds an "investment" in the farm, City Kid may seek to maximize short-term returns in hopes of increasing distributions to his or her shares ("dividends"). This approach may run in opposition to the interests of Farm Kid, who is more likely to seek a long-term strategy of growth for the business that requires significant reinvestment of returns in the business rather than distributions to owners. Even if City Kid is given "non-voting" or "preferred" stock / membership units, they can still pose significant management issues for Farm Kid. The juxtaposition of these interests creates numerous opportunities for disagreements that, at best, strain family relationships and, at worst, can paralyze the business or tear it apart. For this reason, many farm planning professionals strongly advise against any estate plan that puts farming heirs and nonfarm heirs in an operating business.<sup>19</sup>

Given these potential conflicts, why do farmers and ranchers continually choose to give their farms to Farm Kids and City Kids in equal shares? In the experience of the authors and through abundant anecdotal evidence from other professionals, the answer lies in a fundamental misunderstanding of the concepts of "equal" and "equitable." Though it may seem obvious, these terms do not mean the same thing. "Equal" implies identical treatment, whereas "equitable" implies fairness. If farmers and ranchers would step back and examine the business and personal factors at play in their transition planning processes, many would quickly see that "equal" treatment of their heirs is far from "equitable."<sup>20</sup>

Consider, for a moment, the contributions Farm Kid has made to the farm business. It may be that the past growth of the business may not have been possible without the contributions of Farm Kid, who provided both labor and management (and may have invested significant capital or pledged personal assets as well). Additionally, Farm Kid may not have been compensated at the prevailing market rate for his or her contributions of management and labor. In contrast to the contributions of City Kid (which may have been nothing), it quickly becomes clear that treating both Farm Kid and City Kid equally in the distribution of farm assets is inequitable. As a result, the founding generation may wish to provide more of the farm asset base to Farm Kid, in at least the amount of their “equal” share *plus* the amount of farm growth resulting from Farm Kid’s efforts and contributions.<sup>21</sup> Alternatively, the founding generation could choose to allocate all of the farm assets to Farm Kid, and direct other assets such as cash, retirement investments, or life insurance proceeds to City Kid. Of course, to use this strategy requires assets are available in sufficient quantities to provide what the founding generation views as an equitable gift to City Kid, which in turn requires the kind of long-term retirement planning that seems to be lacking in agriculture. We see again that having a farm with sufficient capitalization is crucial to a successful transition.

### C. Failure to prepare the next generation properly

Farming and ranching are complex, technical enterprises that must work in a risk environment unlike almost any other industry. On any given day, a farmer or rancher must be an animal scientist, agronomist, environmental scientist, engineer, economist, commodity broker, human resources manager... the list goes on and on. Part of the problem in successfully transitioning a farm or ranch to the next generation, then, comes from making sure that the successors have all the skills needed to successfully operate the business. Indeed, the failure of the founding generation to devote significant time and resources in the management and leadership development of the next generation has been cited by multiple experts as a principal cause for the high failure rate of farms, ranches, and other small businesses.<sup>22</sup>

As discussed in section 2 of this handbook, good family communication is critical in preparing the next generation to successfully continue the family farm and ranch business. However, some farm estate or transition plans will place the surviving spouse in the role of manager for the remainder of his or her life. Thus, just as much care should be placed in preparing spouses for their new roles. This can be a challenge even if both spouses are active and engaged partners in the farm enterprises, as now one will have to do the work of two in addition to dealing with issues such as settlement of the estate and their own grief at the loss of the other spouse. If the surviving spouse has not been an active participant in the agricultural enterprises (and note that this may be because the spouse was actively engaged in off-farm employment to support the farm or because the deceased spouse ran the enterprises in a “black box” and refused to share the “how and why” of their management decisions), they face the dual and daunting tasks of keeping the farm operating while the simultaneously try to learn exactly how to meet that challenge.

## How do I start my transition plan?

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First, take pride in the fact you have already started your transition planning process by reading this handbook. You are already well ahead of many others in that you have the courage to take the first steps in your transition plan.

At this point, we should also discuss what is meant by the term “transition plan.” As you have seen from this introduction, poor estate planning can be devastating to the successful future of the family farm. But estate planning alone is not enough. Businesses that successfully transfer from one generation the next frequently start the process years before the death of the founding generation. They identify key goals and milestones, devote time and resources to the development of the people involved (whether employees or family members), and have a plan for how those people will grow into new roles within the business. As a result, the business gradually

transitions from one generation to the next, rather than moving suddenly upon the death of a key person.

That is why we use the term “transition planning” rather than “estate planning” or “business succession planning.” The most successful plans involve elements of both estate and business planning, and thus transition planning is used to show this comprehensive approach.

With that comprehensive approach in mind, this handbook will walk you through the steps of creating and implementing a transition plan for your farm.

**Section 1 – First Steps** will help you do just that: take the first steps towards building your plan. As you know from reading a map, to determine your course, you have to first know where you are, and where you want to go. In this section, we will discuss how to determine where you are today, both in terms of your operation’s finances, and where you stand on your values and goals. The answers to the questions posed in this section will be the foundation for all of your work moving forward with your transition plan.

**Section 2 – Crucial Communications** will prepare you for what many regard as the hardest part of the transitions planning process: communicating with all the stakeholders in your agricultural operation. Many farmers and ranchers avoid talking about their transition plans with those who have a stake in the operation because they are worried about creating conflict, or simply do not want to bring up what they believe is a depressing or distasteful topic. However, in so doing, they frequently doom their plan to failure. A successful transition plan requires open and honest communication with everyone involved. This section will help you overcome the barriers to starting the conversation, help you navigate difficult conversations, and, when it comes to it, how to “fight fair” when disagreements arise.

**Section 3 – Planning for Transition** reveals the very heart of the transition plan: the roles of both the current and future generations involved with the farm, and how those roles will shift in the transition plan. Here, we will map out the human resources needed on the farm as it grows and changes, show how to integrate new stakeholders to the operation as founding members find new roles, and how business entities can be used to facilitate these transitions.

**Section 4 – Estate Planning** discusses the element of transition planning that most people think of first (and perhaps exclusively). Sound estate planning is critical to a successful transition plan, and this section will walk through the considerations involved with a number of estate planning tools, from powers of attorney to trusts. This section also addresses the issues of estate tax planning, which has changed greatly in recent years.

**Section 5 – Putting Your Plan into Action** will help you actually put your plan into action, rather than putting a lot of work into a plan that goes into a binder that is then put on a shelf to gather dust. This section will help you prepare your stakeholders for their next steps, and will also help you periodically evaluate your progress and make revisions if necessary.

*Let’s begin!*

- <sup>1</sup> Family Business Institute, “Succession Planning,” <http://www.familybusinessinstitute.com/index.php/Succession-Planning/>.
- <sup>2</sup> Kevin Spafford, *Legacy by Design: Succession Planning for Agribusiness Owners*, XI (2006).
- <sup>3</sup> Lexis-Nexis, “Majority of American Adults Remain Without Wills” available at <http://press-room.lawyers.com/majority-of-american-adults-remain-without-wills.html>.
- <sup>4</sup> Kevin Spafford, *Legacy by Design: Succession Planning for Agribusiness Owners*, XI (2006).
- <sup>5</sup> Lewis R. Aiken, *Dying, Death, and Bereavement* (4<sup>th</sup> ed., 2001) 327, 328.
- <sup>6</sup> Kathleen M. McGarry and Robert F. Schoeni, Medicare Gaps and Widow Poverty, Michigan Retirement Research Center, Research Paper No. WP 2003-065, available at <http://www.mrrc.isr.umich.edu/publications/papers/pdf/wp065.pdf>.
- <sup>7</sup> “Intestate” simply means “without a testament” as in someone who has not completed a last will and testament.
- <sup>8</sup> Joy Kirkpatrick, *Retired Farmer – An Elusive Concept*, Choices, 2Q 2013, available at <http://www.choicesmagazine.org/choices-magazine/theme-articles/transitions-in-agriculture/retired-farmer--an-elusive-concept>.
- <sup>9</sup> Fidelity.com, “Fidelity Estimates Coupled Retiring in 2012 Will Need \$240,000 to Pay Medical Expenses Throughout Retirement,” available at <http://www.fidelity.com/inside-fidelity/individual-investing/retiree-health-care-costs-2012>.
- <sup>10</sup> USDA Economic Research Service, ARMS Farm Financial and Crop Production Practices: Farm Finances for All Farms: All Survey States, Farm Business Balance Sheet, available at [http://www.ers.usda.gov/data-products/arms-farm-financial-and-crop-production-practices/tailored-reports-farm-structure-and-finance.aspx#.VI8PaTHF\\_9U](http://www.ers.usda.gov/data-products/arms-farm-financial-and-crop-production-practices/tailored-reports-farm-structure-and-finance.aspx#.VI8PaTHF_9U).
- <sup>11</sup> USDA National Agricultural Statistics Service, 2012 Census of Agriculture, Table 69: Summary by Age and Primary Occupation of Principal Operator, available at [http://www.agcensus.usda.gov/Publications/2012/Full\\_Report/Volume\\_1,\\_Chapter\\_1\\_US/st99\\_1\\_069\\_069.pdf](http://www.agcensus.usda.gov/Publications/2012/Full_Report/Volume_1,_Chapter_1_US/st99_1_069_069.pdf).
- <sup>12</sup> Personal communication with Dr. Derrell Peel, Oklahoma State University Department of Agricultural Economics, March 12, 2013; calculations based on 2007 Census of Agriculture Data.
- <sup>13</sup> Damona Doye, Roger Sahs, “Oklahoma Cropland Rental Rates: 2012-13,” Oklahoma Cooperative Extension Service Current Report CR-230 (2013), available at <http://pods.dasnr.okstate.edu/docushare/dsweb/Get/Document-5994/CR-230web08-09.pdf>. It should be noted there is significant variation in these numbers depending upon the region of the state and the type and quality of the land involved; these numbers are used only for the sake of illustration.
- <sup>14</sup> Joy Kirkpatrick, *Retired Farmer – An Elusive Concept*, Choices, 2Q 2013, available at <http://www.choicesmagazine.org/choices-magazine/theme-articles/transitions-in-agriculture/retired-farmer--an-elusive-concept> (internal citations omitted).
- <sup>15</sup> see Kansas Farm Management Association, “Whole Farm Summaries,” available at <http://www.agmanager.info/kfma/>, Illinois Farm Business Association Whole Farm Summaries, available at <http://fbfm.ace.uiuc.edu/>.
- <sup>16</sup> John Baker, “What’s it Worth if You Stay on the Farm?” Presentation at National Farm Business Management Conference, Overland Park, Kansas, June 11, 2013, available at [http://www.agrisk.umn.edu/conference/uploads/JBaker1541\\_01.ppt](http://www.agrisk.umn.edu/conference/uploads/JBaker1541_01.ppt).
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- <sup>18</sup> John Baker, “What’s it Worth if You Stay on the Farm?” Presentation at National Farm Business Management Conference, Overland Park, Kansas, June 11, 2013, available at [http://www.agrisk.umn.edu/conference/uploads/JBaker1541\\_01.ppt](http://www.agrisk.umn.edu/conference/uploads/JBaker1541_01.ppt).
- <sup>19</sup> Darrell L. Duntelman, *Heirs at Odds*, Farm Futures, April 2006, 36.
- <sup>20</sup> A reason that many farmers and ranchers give for choosing the “equal” rather than “equitable” approach is they fear the potential family conflict if City Kid is dissatisfied with their inheritance. This fear is the precise reason why family communication regarding transition goals is so crucial, and will be discussed at length in section 2 of this handbook.
- <sup>21</sup> See John Maday (with David Goeller), *Compensating Your Ranch Heirs*, Drovers, January 2012, 24.
- <sup>22</sup> Kevin Spafford, *Legacy by Design: Succession Planning for Agribusiness Owners*, 53-104 (2006).



# FARM TRANSITIONS

Chapter 1

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## CHAPTER 1: FIRST STEPS

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# First Steps

Arguably, the hardest part of the transition planning process is figuring out where to start. One place to start is to simply create an inventory of what you have to work with in creating a transition plan for your farm. Thus, you can begin by rounding up information not only about the property that makes up your farm, but also the people and intangible assets that contribute to your operation. To help you with this process, consult the Transition Planning Inventory included in the references and tools portion of this section.

## 1.1. Examining the “Core Values” to determine what matters most

Our “value” system (our character, if you will) has been developed based on experiences and exposures over our entire lives. The list of influencing factors includes all of our long history of experiences, education, family upbringing, friends, and religious beliefs or training. In addition, various contemporary influences such as media of all types, books we read, and even our government can influence our values. Our core (strongly held) values influence our beliefs, our attitudes, and ultimately our behaviors, which is why it is important to start the transition thought process by reflecting on not only your own individual values, but how your values mesh with those of the rest of your family business stakeholder team.

Reflecting on values is a difficult exercise. It is often suggested that you begin by thinking about other people that you really respect or admire (your true heroes). Why do you look up to them? Looking inwardly to yourself, what is your proudest accomplishment? What characteristics do you see when you imagine “your best self?” Taking time for various members of your stakeholder team to ponder such questions can begin the process of sorting out what is really important to your team from a big picture, very long-term perspective.

Core values of the team help guide the transition planning process. Some common categories of strongly held beliefs that may need to be considered include:

1. How do the stakeholders feel about various ownership and operational models for the future of the family business, and the process to get to a potential new model? For example, is it important that the business continue after the current management generation retires, and is it important that it remain completely within family ownership and/or management?
2. How important is family consensus regarding the future of the farm, and how important is shared input and decision making?
3. What roles will various stakeholders take in managing the business, and how will they be compensated?
4. What are the perceptions of fairness vs equality as business assets transition to the next generation? How does everyone feel about providing additional assistance to younger generation members who will be actively involved in the family business?
5. Do stakeholders feel strongly about particular products, services, production practices, or social and environmental responsibilities? These are simply examples of categories to think about when reflecting on core values. Business stakeholder teams may add to the list and come up with other categories of issues that are important to them.

It is important to remember that while reflecting on core values will likely begin as an exercise for each individual stakeholder in the business, ultimately agreement will need to be reached on the core values that reflect the consensus of the business stakeholders. These values will guide the rest of the planning process as an overall vision and mission are solidified into more concrete objectives and goals, and ultimately into specific

strategies and tactics for implementation. The questions need to evolve from the individual perspectives, to the “business” perspective, as illustrated in the following table, a process that can be difficult when the business is not used to having multiple stakeholders with significant roles.

**Example of how “core values” need to evolve from individual perspectives to the overall business perspective.**

<b>Individual Perspective “Core Values” Questions to Ponder</b>	<b>Stakeholder Team (The Business) Perspective “Core Values” Questions to Ponder</b>
What is important to <i>me</i> ?	What is important to <i>our</i> business?
What would <i>I</i> like to be?	What would <i>we</i> like to be?
Who am <i>I</i> ?	Who are <i>we</i> ?
What do <i>I</i> want to do?	What do <i>we</i> want to do?
How will <i>I</i> measure activity?	How will <i>we</i> measure activity?
What is <i>my</i> plan?	What is <i>our</i> plan?
How do <i>I</i> implement the plan?	How do <i>we</i> implement the plan?

The “Zeroing in on Core Values” planning tool is included here to help stimulate thought. Individual business stakeholders can jot down thoughts regarding what is very important to them in the various categories listed, or add appropriate categories that capture what is important to them. Two columns are provided to reflect that fact that there may be a recognition that values might need to evolve over time as the business thinks about the long-term. These thoughts from individuals can then be discussed and combined into a set of over-arching core values that reflect the consensus of what is important to the entire stakeholder team as it pertains to the business.

**Zeroing in on Core Values**

<b>Category</b>	<b>Now (Mission Statement)</b>	<b>Future (Vision Statement)</b>
How is the business is managed, owned, and organized?		
How are decisions made?		
Who does the work, how are they compensated, how will that change over a transition period?		
Fairness vs. equality in transferring the asset base to the next generation: how will business operating heirs be treated relative to non-operating heirs?		
What products or services are produced; which production practices and marketing practices are used?		
Social - environmental concerns / responsibilities		
Work – family balance issues		
Other issues:		

## 1.2. Where do you stand financially?

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A detailed financial assessment of the existing business is a critical component of any successful business transition plan. The assessment will address such issues as whether the business has adequate resources, whether the business can pay obligations, and whether the business is the type of profitable and efficient enterprise that you would want to pass on to heirs or successors. This will help determine if the existing business can achieve the objectives and goals that the various stakeholders have in mind, or if changes will need to be made before the transition process can begin. [OCES publication AGEC-790](#) provides more detail and examples regarding the evaluation of financial performance and position.

The financial position and performance of a farm business needs to be evaluated based on the following criteria:

- 1) solvency,
- 2) liquidity,
- 3) profitability,
- 4) financial efficiency, and
- 5) repayment capacity.

*Solvency* measures the ability of the business to pay all debts if the business were to be sold. In general, if the market value of the total assets (things of value owned by or owed to the business) of the business exceeds the amount of debt (financial obligations) owed by the business, then the business is solvent. Common solvency measures assess the “degree” of solvency. Examples include the absolute level of net-worth (equity), the debt-to-asset ratio, and related measures such as the equity-to-asset ratio and the debt-to-equity ratio.

*Liquidity* is a measure of the ability of the business to pay bills in a timely fashion in the short run. For agricultural businesses it is common to measure liquidity based expected sources of cash over the next year relative to bills and financial obligations over the next year. Liquidity is typically measured by either the absolute level of working capital, or by the ratio of current assets to current liabilities (current ratio). Profitability means the level of income the business generates after paying all expenses.

*Profitability* is typically measured over an accounting period (usually a year). Common measures include absolute level of net farm income, rate of return on assets, rate of return on equity, and operating profit margin ratio. Financial efficiency measures the ability to convert inputs to saleable output, or how good the business is at utilizing the inputs and resources it has available.

*Financial efficiency* is directly related to profitability, though it is not the sole driver of all profitability measures. Numerous measures are utilized to relate physical output to various physical and financial inputs. The most commonly utilized measures that can be applied to a wide variety of agricultural businesses include the asset turnover ratio, the operating expense ratio, the depreciation expense ratio, and the interest expense ratio.

*Repayment capacity* is closely related to liquidity, but more specifically provides an indication of the ability of the business to meet debt payment commitments. The absolute measure (known as the capital replacement and term debt repayment margin) and the relative measure (known as the term debt and capital lease coverage ratio) are the most commonly utilized indicators of repayment capacity.

So, what do we do with all this information regarding financial position and performance? By examining trends in measures over time or comparing measures to benchmarks, problems can be identified, mistakes can be corrected or avoided, and strengths can be identified so that opportunities can be pursued. Looking at the trend in key measures over time reveals important information such as whether or not the equity position of

the business is improving over time, whether a liquidity or debt repayment problem is developing, and how consistently profitable and efficient the business has been historically. The farm financial trends worksheet from [OCES publication AGECE-238](#) is included as a starting point for evaluating trends in financial performance. Recent measures can also be compared to benchmarks that have either been established by the business as internal targets, or have been drawn from external sources such as comparative farms or industry standards. Numerous farm management benchmarking data sets are maintained across the U.S., and general industry standards have been established for many of the most common financial measures. An example resource is [OCES publication AGECE-237](#). We have included the benchmark page from that resource in this manual.

The information needed to obtain the aforementioned position and performance measures comes from the two most basic financial statements, the balance sheet (also known as the net-worth statement), and the accrual income statement (also known as the profitability statement). The balance sheet is a systematic organization of everything owned and owed by the business at a single point in time, so it is a “snapshot” of the financial position of the business at that point in time. Assets values are presented from “most liquid” to “least liquid,” and similarly the corresponding liabilities are arranged based on when they are due. Assets that are cash equivalents or are expected to be converted to cash within one year (like grain produced to be sold, for example), and debts that are payable within one year (like an operating note, for example) are classified as current assets and liabilities respectively. Assets that would not typically be sold within a year (breeding livestock, for example), and debts that are not payable with a year (the non-current portion of a land loan, for example), are classified as non-current assets and liabilities respectively. Some agricultural balance sheets also include an intermediate (1 to 7 year) category for both assets and liabilities. This “term-structure” breakdown allows the balance sheet to reveal information about liquidity. The basic accounting identity that is revealed by the balance sheet is that the total value of the assets is equal to the sum of the creditor’s claims (liabilities) plus the owner’s claims (equity), assuring that the balance sheet will reveal information about profitability.

The balance sheet can be prepared based on a market-basis valuation of the assets (fair market value minus selling costs), or based on a cost-basis valuation of the assets (original cost adjusted for depreciation). Each method has advantages and disadvantages. As a general rule, the market-based method is considered most useful for credit analysis and estimating true owner equity, while the cost-based method is considered most useful for evaluating true financial progress resulting from business management decisions over time. It is important that sequential balance sheets be prepared at the same time each subsequent year, and that the same valuation method be used for consistency. A typical farm looks a lot different in June than it does in December, so comparing snapshots over multiple years is most useful if they are prepared at the same time. Accurate inventories of everything owned and owed by the business are essential. An example balance sheet template extracted from [OCES publication AGECE-752](#) is included in this workbook.

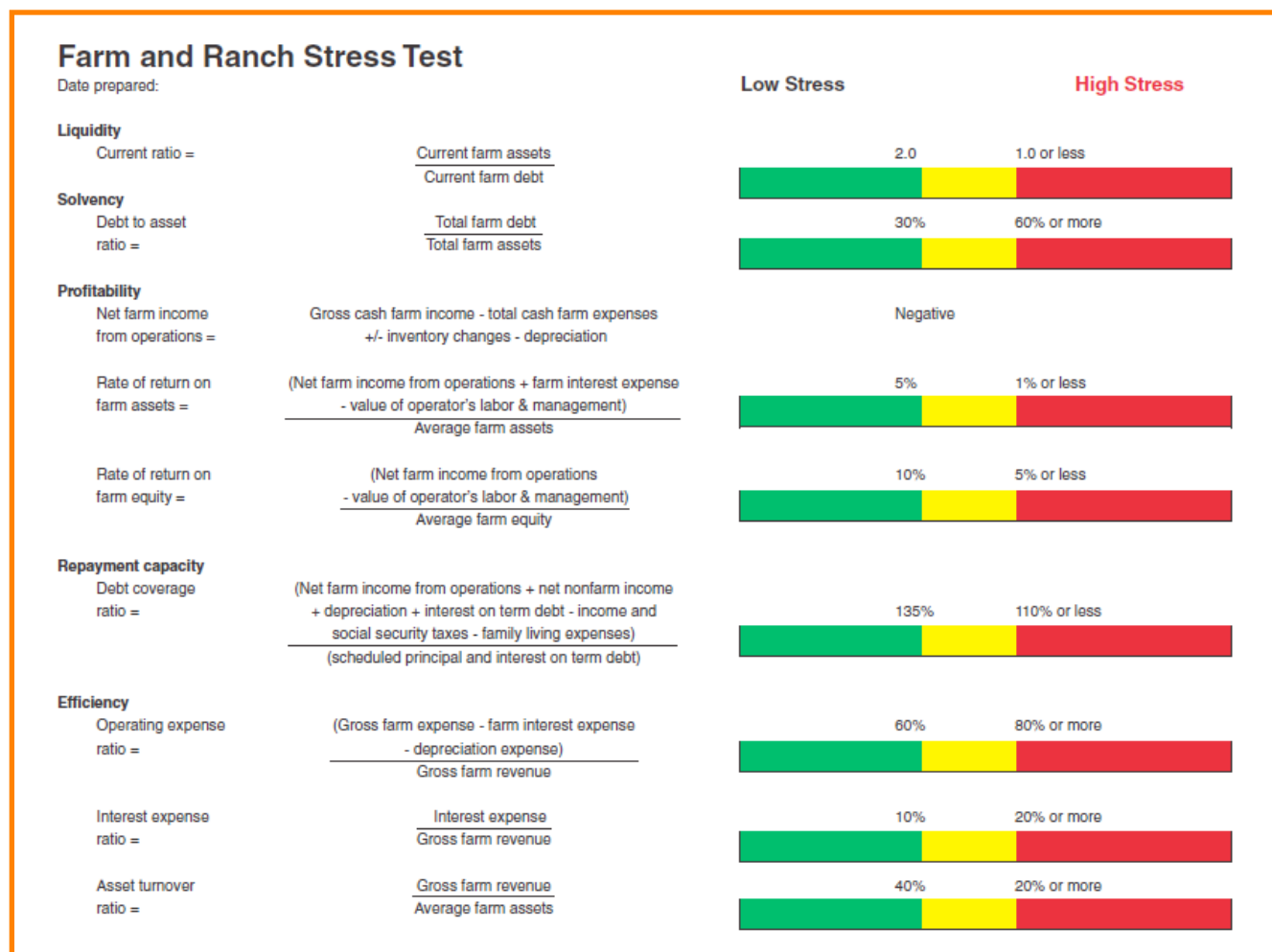
The income statement is a summary of revenues and expenses over an accounting time period (typically a year), and as such it reveals profitability. A critical point to remember is that accrual revenues and expenses are not the same as simple cash inflows and outflows. Accrual revenue represents the true value of anything produced during the accounting period, so it typically includes receipts from commodity sales adjusted for inventory changes that need to be accounted for in determining that true value of production. Accrual expenses represent the true costs of doing business, so it includes operating expenses (including non-cash expenses such as depreciation) adjusted for relevant expense inventory changes. Accrual net income (profit) is the difference between revenues and expenses. An example income statement template extracted from OCES publication AGECE-753 is included in this workbook.

Financial efficiency, repayment capacity, and some other financial indicators, typically combine information from both the balance sheet and the income statement. It is good business practice to develop and evaluate measures at least annually, but this is especially critical when working through the business transition planning process. Be consistent in how information is tracked and evaluated, and utilize the information to improve the business and to facilitate a smooth transition. Be sure to note and discuss reasons for unusual

measures (such as drought, etc.) and discuss ways to work through unusual times. It is important that all stakeholders be involved in the financial evaluation part of the transition process. Here is an example of a tool to monitor financial position and performance trends (taken from [OSU Fact Sheet AGEC-238](#)).

Farm Financial Trends Worksheet						
Year (fill blank with year)	_____	_____	_____	_____	_____	_____
<b>From the balance sheet</b>						
Total assets	_____	_____	_____	_____	_____	_____
Total debt	_____	_____	_____	_____	_____	_____
Total equity = Total assets - total debt	_____	_____	_____	_____	_____	_____
D/A ratio = Total debt/total assets	_____	_____	_____	_____	_____	_____
Credit line balance	_____	_____	_____	_____	_____	_____
Credit card debt	_____	_____	_____	_____	_____	_____
<b>From Tax reports</b>						
Gross income (Schedule F, Line 9)	_____	_____	_____	_____	_____	_____
Interest expense (Schedule F, line 21a + line 21b)	_____	_____	_____	_____	_____	_____
Depreciation expense (Schedule F, line 14)	_____	_____	_____	_____	_____	_____
Repairs expense (Schedule F, line 25)	_____	_____	_____	_____	_____	_____
Net farm profit or loss (Schedule F, line 34)	_____	_____	_____	_____	_____	_____
Interest expense/Gross income	_____	_____	_____	_____	_____	_____
<b>From family financial records</b>						
Family living expense	_____	_____	_____	_____	_____	_____

The following benchmarks for important financial position and performance measures were taken from [OSU Extension Fact Sheet AGEC-237](#).



The following example balance sheet is adapted from the [Kansas State AgManager.info publication MF-291](#) and [its accompanying Excel template](#).

BALANCE SHEET				
ASSETS:				
	January 1	December 31	Average	Notes
1) Cash	\$0	\$0	\$0	
2) Marketable Securities	\$0	\$0	\$0	
3) Accounts Receivable	\$0	\$0	\$0	
4) Fertilizer and Supplies	\$0	\$0	\$0	
5) Investment in Growing Crops	\$0	\$0	\$0	
6) Crops Held for Sale and Feed	\$0	\$0	\$0	
7) Market Livestock	\$0	\$0	\$0	
8) TOTAL CURRENT ASSETS	\$0	\$0	\$0	(Add lines 1 through 7)
9) Breeding Livestock	\$0	\$0	\$0	
10) Machinery and Equipment	\$0	\$0	\$0	
11) Buildings	\$0	\$0	\$0	
12) Investments in Cooperatives	\$0	\$0	\$0	
13) Land	\$0	\$0	\$0	
14) TOTAL NONCURRENT ASSETS	\$0	\$0	\$0	(Add Lines 9 through 13)
15) TOTAL ASSETS	\$0	\$0	\$0	(Add Lines 8 and 14)
LIABILITIES AND OWNER EQUITY:				
	January 1	December 31	Average	Notes
16) Accounts Payable	\$0	\$0	\$0	
17) Taxes Payable	\$0	\$0	\$0	
18) Accrued Expenses	\$0	\$0	\$0	
19) Current Portion: Deferred Taxes	\$0	\$0	\$0	
20) Notes Due Within One Year	\$0	\$0	\$0	
21) Current Portion of Term Debt	\$0	\$0	\$0	
22) Accrued Interest	\$0	\$0	\$0	
23) TOTAL CURRENT LIABILITIES	\$0	\$0	\$0	(Add Lines 16 through 22)
24) Noncurrent Portion: Deferred Taxes	\$0	\$0	\$0	
25) Noncurrent Portion: Notes Payable	\$0	\$0	\$0	
26) Noncurrent Portion: Real Estate Debt	\$0	\$0	\$0	
27) TOTAL NONCURRENT LIABILITIES	\$0	\$0	\$0	(Add Lines 24 through 26)
28) TOTAL LIABILITIES	\$0	\$0	\$0	(Add Lines 23 and 27)
29) OWNER EQUITY	\$0	\$0	\$0	(Subtract Line 28 from Line 15)
30) TOTAL LIABILITIES AND OWNER EQUITY	\$0	\$0	\$0	(Add Lines 28 and 29)

The following income statement example is taken from [OSU Extension Fact Sheet AGEC-753](#).

INCOME STATEMENT				
Business Consolidated Personal	<input type="checkbox"/>	Actual Projected	<input type="checkbox"/>	For the period: _____
<b>REVENUE</b>				
Sales of Livestock Bought for Resale	CF 1	1	_____	
Sale of Livestock Products	CF 2	2	_____	
Livestock Sales (raised)	CF 3	3	_____	

Change in Market Livestock Inventories	BS 6 C	4	_____
<b>Gross Revenue from Market Livestock and Products</b>	(1+2+3+4)	5	_____
Crop Sales			
a.	CF 4	6	_____
b.	CF 5	7	_____
Change in Stored Crops/Feed Inventories	BS 6 C	8	_____
<b>Gross Revenue from Crops</b>	(6+7+8)	9	_____
Ag Program Payments	CF 6	10	_____
Other Farm Income	CF 7	11	_____
Patronage Dividends	CF 8	12	_____
Gain or Loss from Sale of Cull'd Breeding Stock		13	_____
Change in Value Due to Change in Quantity of Raised Breeding Livestock		14	_____
+/- Change in Accounts Receivable	BS 2 C	15	_____
+/- Change in Prepaid Expenses	BS 3 C	16	_____
+/- Change in Cash Investment Growing Crops	BS 4 C	17	_____
+/- Change in Supplies	BS 8 C	18	_____
+/- Change in Other Current Assets	BS 9 C	19	_____
+/- Change in Contracts & Notes Receivable	BS 19 C	20	_____
+/- Change in Investment in Cooperatives	BS 20 C	21	_____
<b>Other Farm Revenue</b>	(sum 10 thru 21)	22	_____
<b>GROSS FARM REVENUE</b>	(5+9+22)	23	_____
<b>EXPENSES</b>			
Purchased Market Livestock	CF 40	24	_____
Car, truck	CF 17	25	_____
Chemicals	CF 18	26	_____
Custom Hire	CF 20	27	_____
Purchased Feed/Grain	CF 22	28	_____
Fertilizers, Lime	CF 23	29	_____
Freight, Trucking	CF 24	30	_____
Gas, Fuel, Oil	CF 25	31	_____
Insurance	CF 26	32	_____
Labor Hired	CF 27	33	_____
Rents, Leases	CF 29	34	_____
Repairs, Maintenance	CF 30	35	_____
Seeds, Plants	CF 31	36	_____
Storage, Warehousing	CF 32	37	_____
Supplies	CF 33	38	_____
Taxes (Ad Valorem)	CF 34	39	_____
Utilities	CF 35	40	_____
Vet, Breeding Feeds, Medicine	CF 36	41	_____
Other Expenses	CF 37	42	_____
Marketing Expenses	CF 38	43	_____
Sale Commission	CF 39	44	_____
+/- Change in Purchased Feed Inventories	BS 7 C	45	_____
+/- Change in Accounts Payable	BS 30 F	46	_____
+/- Change in Ad Valorem Taxes	BS 34 F	47	_____
+/- Change in Employee Payroll Withholding Taxes	BS 35 F	48	_____
+/- Change in Other Accrued Expenses	BS 38 F	49	_____
+/- Change in Other Current Liabilities	BS 39 F	50	_____
+/- Change in Other Non-Current Liabilities	BS 47 F	51	_____
Depreciation Expense		52	_____
<b>Total Operating Expenses</b>	(Sum lines 24 through 52)	53	_____
Cash Interest Paid	CF (40+51+53+66)	54	_____
+/- Change in Accrued Interest	BS 33 F	55	_____
<b>Total Interest Expense</b>	(54+55)	56	_____
<b>TOTAL FARM EXPENSES</b>	(53+56)	57	_____
<b>NET FARM INCOME FROM OPERATIONS</b>	(23-57)	58	_____
Gain/Loss on Sale of Farm Capital Assets		59	_____
Gain/Loss Due to Change in Base Values of Breeding Livestock		60	_____
<b>NET FARM INCOME, Accrual Adjusted</b>	(58+59+60)	61	_____
<b>NONFARM REVENUE</b>			
Wages, Salaries	CF 15	62	_____
Other Non-Farm Income	CF (14+15)	63	_____
+/- Change in Nonfarm Assets	BS (11+12+13+25+26+27)	64	_____
<b>Total Nonfarm Revenue</b>	(62+63+64)	65	_____
<b>NONFARM EXPENSES</b>			
Cash Interest Paid	CF 55	66	_____
+/- Change in Accrued Interest	BS 41 F	67	_____
Depreciation Expense		68	_____
Other Cash Payments	CF 48	69	_____
<b>Total Nonfarm Expenses</b>	(66+67+68+69)	70	_____
Gain/Loss on Sale of Nonfarm Capital Assets & Marketable Securities		71	_____
<b>Total Nonfarm Income</b>	(65-70+71)	72	_____
<b>INCOME BEFORE TAXES &amp; EXTRAORDINARY ITEMS</b>	(61+72)	73	_____
Cash Income Taxes Paid	CF 46	74	_____
Change in Accrued Income Taxes	BS 36 F	75	_____
Change in Current Portion of Deferred Taxes	BS 37 F	76	_____
<b>Total Income Tax Expense</b>	(74+75+76)	77	_____
Income Before Extraordinary Items	(73-77)	78	_____
Extraordinary Items (Net of Tax)		79	_____
<b>NET INCOME</b>	(78+79)	80	_____

## 1.3. Evaluating financial feasibility

---

The previous section provided a discussion regarding evaluating financial position and performance. The other important financial aspect that must be addressed is financial feasibility, or “can we make this happen?” The fundamental difference between the concepts of “are we profitable and in a solid financial position?” and the concept of “can we make this happen?” is an important one that is often overlooked and misunderstood. It is definitely a mistake to assume that just because a business has been historically profitable that it can successfully navigate all of the complex financial obstacles associated with a major change, such as an ownership and/or management transition. The business must also look at several issues of financial feasibility.

The first feasibility concept is one of business size. In this context we are not referring to the obvious issues related to economies of scale and business efficiency, as those issues would show up in the performance indicators discussed in the previous section. Here we are simply examining the level of net income needed from the business to support family living needs and to facilitate needed growth for the future. In many agricultural businesses it is the residual that is left over after paying all the operating expenses, paying the outside investors, and reinvesting some earnings back into the business for growth and expansion that is used to support the primary operators on the farm.

Therefore, the level of net income needed becomes a question of “how many people can the business support?” This often becomes an issue when planning a family business transition because the fact of the matter is that people come in whole units of one, rather than in fractions. For example, if there is a desire for a family from the younger generation to return to the farm in an active role while the more senior generation is not yet ready to fully retire, there is a time period when the business will need to grapple with the issue of how to provide income for another whole person or an entire additional family. There always seems to be plenty of work to do around a farm, which often leads to the assumption that another person can easily be added. From a financial perspective that may not be the case.

For most of our modern commercial agricultural enterprises using modern technology, one person can and certainly needs to generate a lot of productivity. In order to do that, a significant amount of assets are needed. When faced with this issue, questions regarding how much income will be needed and how much of that will come from the farm or ranch business need to be addressed. This becomes the issue of business size. A simple evaluation that utilizes some of the financial performance measures discussed in the previous section can be conducted using the mathematical process imbedded in the following worksheets. Worksheets 1 and 2 help to identify the total net income that the business will need to generate to accommodate the sum of family living needs and equity growth. Worksheet 3 provides the calculations to compute the performance measures needed to plug into worksheet 4. Information to compute these measures is derived from the balance sheet and income statements. Worksheet 4 provides the calculations to estimate the size of the business that will be needed in terms of gross farm revenue, and in terms of the value of the asset base needed to achieve the target level of net income from the business.

### Worksheet 1

#### Spendable Income Plus Growth That The Business Is Expected To Generate

Family Living Expenses		\$	_____
Non-Farm Savings	+	\$	_____
Other Wants or Needs	+	\$	_____
Capital Needed for Farm Growth (from Worksheet 2)	+	\$	_____
Less Non-Farm Income	-	\$	_____
Income Needed From Business	=	\$	<input type="text"/>

### Worksheet 2

#### Growth Worksheet

(A) Current Farm Equity		\$	_____
Real Growth Rate Needed			_____ %
Projected Inflation Rate	+		_____ %
(B) Nominal Growth Rate	=		_____ %
Projected Capital Needed For Growth (A*B)		\$	<input type="text"/>

### Worksheet 3

#### Ratios Needed For The Evaluation

##### Net Farm Income From Operations

Net Farm Income		\$	_____
Gross Farm Revenues	÷	\$	_____
NFIFO Ratio	=		<input type="text"/>
Asset Turnover Ratio			
Gross Farm Revenues		\$	_____
Average Farm Assets	÷	\$	_____
Asset Turnover Ratio (ATR)	=		<input type="text"/>

## Worksheet 4

<b>Business Size Evaluator</b>		
<b>Gross Farm Income Needed</b>		
<b>Income Needed From Business</b> (Worksheet 1)		\$ _____
<b>NFIFO Ratio</b> (Worksheet 3)	÷	_____
<b>Gross Farm Revenue Target</b>	=	\$ <span style="border: 1px solid black; display: inline-block; width: 150px; height: 25px; vertical-align: middle;"></span>
<b>Assets Required To Generate Desired Revenue</b>		
<b>Gross Farm Revenue Target</b>		\$ _____
<b>Asset Turnover Ratio (ATR)</b> (from Worksheet 3)	÷	_____
<b>Asset Base Needed To Achieve Goals</b>	=	\$ <span style="border: 1px solid black; display: inline-block; width: 150px; height: 25px; vertical-align: middle;"></span>

For illustration, assume that a farm has generated an average of about \$50,000 in net income to cover the current operator's family living plus grow the business investment a little bit each year. Also assume that this net income has been generated from an average gross income of about \$250,000 per year utilizing an asset base valued at about \$715,000. These historical facts result in a net farm income from operations ratio of 0.2, and an asset turnover ratio of 0.35. Now assume hypothetically that a transition is being considered where the current operator will semi-retire and live on only a \$20,000 family living draw from the farm, to make way for a young family that will manage the operation for family living draw from the farm of \$50,000, and an additional \$10,000 is assumed to be needed for continued growth resulting in a total \$80,000 net income requirement. Using worksheet 4 and the relevant historical ratios from this business, the new gross farm income target for this farm will need to be \$400,000 per year, and the asset base needed to generate that level of gross income will need to be close to \$1.15 million. Can the business make a one-time jump in size to accommodate these new realities? If this growth is not planned for and the higher levels of family living withdrawals occur anyway, then equity levels are quickly drained from the business to support family living. What if growth cannot occur that quickly? Then other models that include a slower transition, perhaps including more off-farm income may need to be considered. In any case these issues are much easier to grapple with if they are addressed in the planning stages of the transition, rather than in the later stages.

Another feasibility issue is whether or not the proposed enterprises of the farm or ranch will actually make money. Enterprise budgets can be used to answer this question. Enterprise budgets are an organization of revenue projections, expense projections, and profit projections for a single enterprise of the farm. Therefore, the enterprise budget can be thought of as an enterprise specific "income statement" projection, useful for identifying the most profitable enterprises to be included in the whole farm plan and for identifying bottlenecks to overall profitability. Alternatives can be explored and compared before significant resources are committed to the production process. Separate enterprise budgets can be constructed and evaluated for each different crop type and land tenure arrangement, and for each type of livestock enterprise being considered. The format is similar no matter what the enterprise, with the primary difference being that cropping budgets are typically done on a per-acre basis, while livestock budgets are typically done on a per-head basis (though it does not have to be done that way). All cash and non-cash revenues are projected, followed by operating or variable costs, then ownership or fixed costs. Finally, projected profits are calculated as the net return to all resources that were not charged in the budget (usually management and unpaid operator labor). Example budgets and budget


templates are available from a number of different sources, including most Land-Grant-University Extension Services. If the particular budget examples you are utilizing are not already in a spreadsheet template, it is highly recommended that users convert them to a spreadsheet format. This is to simplify the ability to conduct “sensitivity” analysis, or examining best and worst case production or price assumptions through a series of “what if” calculations.

The following is an example generated by the [OSU Enterprise Budget Software](#).

**SAMPLE ONLY.**  
 See [www.agecon.okstate.edu/budgets](http://www.agecon.okstate.edu/budgets) for information on OSU Enterprise Budget Software.

**Dryland Wheat Enterprise Budget - Grain and Graze**  
 1000 acres farmed, 160 acres for this budget

2012 harvest price projection  
 Lo till rotation



				Total
PRODUCTION	Units	Price	Quantity	\$/Acre
Wheat	Bu.	\$ 5.75	31.97	\$ 183.83
Small Grain Pasture	Acre	\$ 48.40	1	\$ 48.40
Other Income	Acre	\$ -	0	\$ -
<b>Total Receipts</b>				<b>\$ 232.23</b>

OPERATING INPUTS	Units	Price	Quantity	\$/Acre
Wheat Seed	Bu./acre	\$ 15.00	2.00	\$ 30.00
Fertilizer	Acre	\$ 58.59	1	\$ 58.59
Custom Harvest	Acre	\$ -	0	\$ -
Pesticide	Acre	\$ 25.61	1	\$ 25.61
Crop Insurance	Acre	\$ 7.00	1	\$ 7.00
Annual Operating Capital	Dollars	6.50%	85.42	\$ 5.55
Machinery Labor	Hrs.	\$ 9.50	0.79	\$ 7.51
Custom Hire	Acre	\$ 4.93	1	\$ 4.93
Machinery Fuel, Lube, Repairs	Acre	\$ 41.10	1	\$ 41.10
Other Expense	Acre	\$ -	0	\$ -
<b>Total Operating Costs</b>				<b>\$ 180.29</b>
<b>Returns Above Total Operating Costs</b>				<b>\$ 51.94</b>

FIXED COSTS	Units	Rate	\$/Acre
Machinery/Irrigation	\$/value		
Interest at	Dollars	6.00%	\$ 7.09
Taxes at	Dollars	1.00%	\$ 1.83
Insurance	Dollars	0.60%	\$ 0.71
Depreciation	Dollars		\$ 12.93
Land	\$/acre	\$ -	
Interest at	Dollars	0.00%	\$ -
Taxes at	Dollars	0.00%	\$ -
<b>Total Fixed Costs</b>			<b>\$ 22.56</b>
<b>Total Costs (Operating + Fixed)</b>			<b>\$ 202.85</b>
<b>Returns Above All Specified Costs</b>			<b>\$ 29.38</b>

Garfield County - North-Central OK

Owner-Operator

Owned equipment

Grain Break-Even (B-E) Analysis			
<b>B-E Yield at \$/bu.</b>	<b>5.75</b>	<b>B-E Price at bu./acre</b>	<b>31.97</b>
Above Operating Costs (Bu.)	23	Above Operating Costs	\$ 4.13
Above Total Costs (Bu.)	27	Above Total Costs	\$ 4.83

Break-even yield is the yield needed to cover costs given the expected price, pasture income, and other income such as government payments. Break-even price is the price needed to cover costs given the expected yield, pasture income, and other income.

Business  
Consolidated  
Personal

Actual  
Projected

# CASH FLOW

Covering the period: \_\_\_\_\_ through \_\_\_\_\_

		Totals	March	April	May	June	July
<b>CASH RECEIVED FROM OPERATIONS</b>							
1	Sale of Livestock Bought for Resale:						
2	Sale of Livestock Products						
3	Livestock Sales (raised)						
4	Crop Sales: Wheat						
5	Ag Program Payments						
6	Other Farm Income						
7	Patronage Dividends						
8	<b>TOTAL CASH RECEIVED FROM OPERATIONS</b>	(Sum 1 thru 7)					
<b>CASH RECEIVED FROM CAPITAL SALES</b>							
9	Non-Real Property						
10	Land, Buildings & Improvements						
11	Non-Farm Property						
<b>OTHER INFLOWS</b>							
12	Wages and Salaries						
13	Other Contributed Capital						
14	Royalty Income						
15	<b>TOTAL CASH INFLOWS</b>	(Sum 9 thru 14)					
<b>OPERATING EXPENSES</b>							
16	Car and Truck Expenses						
17	Chemicals						
18	Conservation Expenses						
19	Custom Hire (machine work)						
20	Employee Benefits						
21	Feed						
22	Fertilizers and Lime						
23	Freight and Trucking						
24	Gasoline, Fuel, and Oil						
25	Insurance						
26	Labor Hire						
27	Pension and profit-sharing						
28	Rent or Lease						
29	Repairs and Maintenance						
30	Seeds and Plants						
31	Storage and Warehousing						
32	Supplies						
33	Taxes						
34	Utilities						
35	Veterinary, Breeding and Medicine						
36	Other Expenses						
37							
38							
39	Cost of Livestock Purchased for Resale						
40	<b>TOTAL CASH EXPENSES</b>	(Sum 16 thru 39)					
<b>CAPITAL EXPENSES</b>							
41	Non-Real Property						
42	Land, Buildings & Improvements						
43	Non-Farm Property						
<b>OTHER OUTFLOWS</b>							
44	Family Living						
45	Income & Social Security Taxes						
46							
47							
<b>SCHEDULED LOAN PAYMENTS</b>							
48	Current Short Term -Interest						
49	-Principal						
50	Non-Real Estate -Interest						
51	-Principal						
52	Real Estate -Interest						
53	-Principal						
54	Non-Farm Loan -Interest						
55	-Principal						
56	<b>TOTAL CASH OUTFLOWS</b>	(Sum 41 thru 56)					
<b>NEW BORROWING</b>							
57	short term						
58	Non-Real Estate						
59	Real Estate						
<b>CASH FLOW SUMMARY</b>							
60	Interest Paid:						
61	Minimum Cash Balance:						
62	Beginning Cash Balance						
63	Inflows - Outflows	(16 - 57)					
64	Cash Position	(Sum 62 thru 63)					
65	New borrowing, Line of Credit						
66	Interest Accrued, Line of Credit	Accrued Interest =					
67	Line of Credit - Interest Payments						
68	Line of Credit - Principal Payments						
69	Ending Cash Balance						
<b>OUTSTANDING LOAN BALANCES</b>							
70	Outstanding Credit Line Loans						
71	Outstanding Short Term Loans						
72	Outstanding Non-R.E. Loans						
73	Outstanding Real Estate Loans						
74	Outstanding Non-Farm Loans						
75	<b>TOTAL OUTSTANDING LOANS</b>	(Sum 64 thru 69)					

A partial budget is another feasibility tool that is often used to fine tune the operation on a day-to-day basis by examining smaller questions. Examples might include “should we harvest our own crops or hire a custom operator?” or “should we sell our calves at weaning or hold onto them for a while in a growing program?” The standard partial budgeting format provides a formal and consistent method for examining the expected profit impacts from proposed alternatives. Only changes in expected revenues and costs are considered in a very organized approach so that the chances of overlooking something or counting an item more than once are minimized. Typically, a proposed alternative way of doing something is compared to the existing way of doing it. Positive financial effects of the proposed alternative are listed on one side of a “T” accounting page as either added receipts or reduced expenses. Negative financial effects of the proposed alternative are then listed on the other side of the tee account as either added expenses or reduced receipts if the alternative were pursued rather than the existing plan. The net expected financial impact is simply the total positive effects minus the total negative effects.

For really significant changes to the business, stakeholders may want to consider developing whole-farm pro-forma financial statement projections, perhaps for multiple years into the future in order to help develop plans to most efficiently utilize the resources available. Budgeting is an important component of planning for smooth farm operations, and is an important component of the development of sound marketing plans as well.

Example Partial Budget Form			
Column 1		Column 2	
Additonal costs	_____	Additional returns	_____
Reduced returns	_____	Reduced costs	_____
A. Total additional costs and reduced returns	_____	B. Total additional returns and reduced costs	_____
Net change in income (B minus A)			

## 1.4. Developing a Farm Game Plan

Strategic planning involves thinking about where the farm or ranch business needs to be positioned in the future. It involves considering what the various stakeholders want to see happen to the business as a whole. It also involves evaluating what skills and resources the business and business participants bring to the table, and subsequently where efforts and resources need to be focused in order for the business to remain competitive into the future.

Historically, for many farms and ranches this planning for the future of the business has been done in a very informal manner. The thought process starts with a consideration of the resource base. Activities and enterprises are then selected to “fit” with the resource base. In many cases, vague objectives and goals remain in the minds of the individual managers or owners. As businesses, including farms, become larger, more complex, and involve more stakeholders there is benefit in replacing this traditional management style with a more strategic and participatory management style. The flow of the thought process for a “strategic” management style is dramatically different. The significance of this difference cannot be over-emphasized, as it dramatically opens

up the scope of possibilities available to the organization. The stakeholders begin with an overarching vision of where they want the business or entity to go. The vision is then focused down to a more concrete mission, which is made workable through well thought out and documented long-term objectives and short-term goals. A strategy is formulated, selecting enterprises and activities that lead to accomplishment and fulfillment of goals and objectives. Specific tasks and tactics are spelled out, and a resource base is assembled (beginning of course with the existing resource base) to implement the plan.

Vision and/or mission statements form the foundation of a strategic management system. Vision is a long-term concept, focusing on where the business hopes to be in the future, and providing guidance for the organization over the long-term. Knowledge and broad acceptance of what it is that the organization needs to accomplish always makes the path more clear. Vision statements often directly reflect deeply held core values such as honesty, integrity, passion for rural lifestyle, concern for the environment, etc. They focus on what is really important, emphasize the future, and can be a unity building instrument to facilitate the planning process. More specific characteristics such as business size and scope, composition and quality of products or services, target markets, and work force composition may also be reflected in the vision statement, or these specifics may be relegated to the mission statement.

The mission statement embodies the broader vision, but is much more specific and focused on the present, rather than the future. A well written mission statement outlines the basic purpose of the business and summarizes what is done, who it is done for, and how the organization conducts itself. The mission statement reflects the true strengths of the overall business. Therefore, in formulating a mission statement it is important to focus attention on the guiding values, principles, and primary roles of the organization to provide direction when making major decisions.

To illustrate the flow from an overarching “vision” to a more focused “mission,” a ranch could have a vision of producing the highest quality beef products possible. More concrete attributes like genetic characteristics, environmental responsibilities, commitment to the community, employee friendly workplace, etc., then need to be incorporated into the mission statement. The process of developing vision and mission statements is as important as the product. Getting input from every stakeholder, drafting statements, getting feedback, revising, and re-writing gets the communication flowing regarding things that really matter. However, due to the abstract nature of the activity, developing vision and mission statements can be one of the more difficult tasks for the farm business management team. Those who expend the time and effort to base their planning activities on a vision and a more specific mission for their organization will find that they provide a solid foundation for the business and provide guidance for day-to-day activities.

Individuals and organizations approach the visioning process differently, however, and a few general guidelines should be kept in mind. Relegate long-term planning activities (visioning) to non-crisis time periods so that attention can be focused on long-term issues. It is critical to discover the expectations of all family stakeholders during the visioning process. This reduces the risk of incorrect assumptions, increases cooperation in creating the plan, and helps to reduce conflict, ultimately resulting in a more effective plan. One danger of written vision and mission statements (and the most common criticism) is that they can quickly become too abstract and all encompassing, making them essentially useless for directing day-to-day management. The most effective way to avoid this pitfall is for the stakeholder team to keep this danger in mind as the statements are being drafted. Keep the purpose and intent of the visioning activity in mind throughout the process: to inspire and direct you and others in the business, not to impress outsiders. In their final form both the vision statement and the mission statement should be relatively brief (a rule of thumb for the mission statement is 100 words or less). There are many ways to begin pulling various stakeholder thoughts and expectations into vision and mission statements. Refer to the points various stakeholders made during the core-values exercise to help formulate vision and/or mission statements, perhaps utilizing generic templates like the following to illustrate and stimulate the thought process regarding “why the business exists,” and “what the business needs to look like in the future.”

*Vision Statement Template: In ten years our business will be providing \_\_\_\_\_. We will be recognized for our ability to \_\_\_\_\_. We are pursuing these activities because \_\_\_\_\_.*

*Mission Statement Template: The mission of \_\_\_\_\_ is to operate a \_\_\_\_\_. This endeavor will provide \_\_\_\_\_. (desired financial results, desired product results, desired family and living environment, desired business transition results, recognition within industry, community, etc.)*

Finally, realize that developing vision and mission statements that are appropriate for your farm or ranch will require a significant amount of time and effort. Spread that effort over numerous family and stakeholder discussions (family meetings).

The next step in the strategic planning thought process (goal setting) helps formalize informal “dreams” into concrete short-term goals and longer-term objectives that support the over-riding vision and mission of the organization. As with the visioning process, the goal setting process is often challenging for agricultural business managers because many have not tried to formalize their abstract ambitions. However, clearly defined written objectives and goals are essential for developing a serious business strategy, as they provide a solid framework for achieving the mission and vision of the organization.

When taken seriously, the goal setting process takes time, a precious commodity for everyone. Goal setting requires creative thinking, discussion and compromise among family and business partners (communication is critical throughout the strategic planning process). It is critical that the objectives and goals build on what is important and flow seamlessly from the over-riding vision and mission of the organization. Well-expressed objectives and goals provide management direction and consistency, and add precision to the decision making process so that resources can be allocated more effectively. Under the terminology convention adopted for this publication (certainly not universal), objectives are more general, have a longer (or undefined) time horizon, and provide overall direction. They reflect what the organization hopes to accomplish over the long-run. They should flow directly from the mission statement, translating it into motion. A widely used acronym for long-term objectives is DRIVE (Directional, Reasonable, Inspiring, Visible, and Eventual). Examples for a farm or ranch business might include:

Increase gross income per acre by an amount of X

Reduce work load by a number of Y man-hours per year

Transfer the family business to the next generation within Z years

Goals, on the other hand, should be specific statements that set a timetable and provide benchmarks for measuring success. Goals translate general objectives into specific action statements. They work on the principles of focusing attention, mobilizing energy, increasing persistence, and developing work habits. The commonly used acronym for short-term goals is SMART (Specific, Measurable, Attainable, Rewarding, and Timed). Examples that directly relate to the previously illustrated example objective might include:

Increase average wheat yield to 42 bushels per acre next year

Contract with a custom operator to put up alfalfa crop beginning this year

Schedule succession planning family meetings each month this year

Goals that are too general and vague provide little direction for the management team. Remember, specific strategies and tactics (production, marketing, financing, and transition plans) need to flow easily from the objectives and goals. To implement the objective and goal setting process, some businesses may find it useful to have each stakeholder or business partner fill out a goal setting matrix like the one illustrated here.

Category	Longer - Term (Objectives – 1, 2,...)	Short – Term (Goals – a, b, ....)
The overall business production enterprises, activities, and production practices	1. 2.	1a. 1b. ...etc. 2a. 2b. ... etc.
Marketing products, services, and our business	1. 2.	1a. 1b. ...etc. 2a. 2b. ... etc.
Financial position, size, structure	1. 2.	1a. 1b. ...etc. 2a. 2b. ... etc.
Environmental, community, and resource stewardship	1. 2.	1a. 1b. ...etc. 2a. 2b. ... etc.
Personal / family family - business interaction family communication	1. 2.	1a. 1b. ...etc. 2a. 2b. ... etc.

The broad array of objectives and goals that various stakeholders bring to the table from this exercise can then be “thinned out” and prioritized, in order to reduce the demands on limited resources, reduce conflicts between business and family activities, and ensure consistency between objectives and goals, and with the overall mission and vision of the organization. Begin by developing a list of long-term objectives that are agreed upon by all stakeholders. Start with the objectives because typically the list of long-term objectives is shorter (and less controversial) than the list of short-term goals presented by various stakeholders. With the list of agreed upon objectives in front of the planning team, separately create a master list combining each stakeholders’ list of short-term goals. Consider the primary resource requirements (money, labor hours, etc.) for each goal. In addition, consider how well each individual goal matches up with other goals, and with other long-term objectives (complementary or conflicting). Numerous meeting and conversations involving all stakeholders will be needed over time to develop a more manageable list of the most important commonly agreed upon objectives and goals for the organization. The goal setting process is iterative. After contemplating prioritizing short-term goals, the management team may find that there is a need to go back and re-visit long-term objectives, or even revise the mission and/or vision statements of the organization.

## 1.5. Wants, Needs, Expectations, and Fears Exercise

Farm and ranch families often find it difficult to express all of their concerns when a successor plans to return to the farm family business. It is often most difficult for individual family members to discuss their concerns with other family members. This exercise is designed to help families explore their deepest feelings regarding the transition process. Every stakeholder, including fathers, mothers, successors and their spouses, and siblings or others who may have either an emotional or a financial stake in the family business needs to answer the following questions:

- 1) What do we *want* to have happen when our successor returns to the farm family business?
- 2) What do we *need* to have happen when our successor returns to the farm family business?
- 3) What do we *expect* to have happen when our successor returns to the farm family business?
- 4) What do we *fear* will happen when our successor returns to the farm family business?

After each individual stakeholder answers all four questions, the stakeholders need to openly discuss the individual desires and concerns openly.

## 1.6. Internal and External Factors

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Large businesses often engage in a strategic planning exercise that has long been advocated by business schools and management consultants known as a “SWOT” analysis, or an examination of the Strengths, Weaknesses, Opportunities, and Threats of the business. You may not consider yourself a large business; however, conducting a SWOT analysis is an important step to keep a business competitive, and is especially useful when the business is facing significant change.

Strengths and weaknesses are associated with the internal workings of your farm, and are things that are generally within the control of the business. Skill set, machinery compliment, and how the business is financially structured are just a few examples that would be considered “internal factors,” things the business can control that might put them in a better or worse competitive position than others in the industry. Opportunities and threats are associated with external forces that can impact the business. External factors are important to consider so that strategies can be considered that will manage the impacts on the business. Things beyond your control that are happening in your community (zoning regulations, for example), your geographic area (persistent drought, for example), or around the world (expanding markets, for example) are sources of opportunities and/or threats. Businesses planning for any type of a transition would be well served to engage in some form of a SWOT exercise. Facilitating discussions regarding the following questions, and perhaps incorporating the results of those discussions into a SWOT matrix is one way to begin this thought process.

1. Identify two internal strengths (what the business does well). How important are these strengths to the overall competitive advantage of the business, and what (if anything) is the business doing to maintain this advantage?
2. Identify two internal weaknesses (what the business does not do well). How important are these weaknesses to the overall competitive advantage of the business, and what (if anything) is the business doing to improve on these weaknesses?
3. Identify one external opportunity that the business might consider taking advantage of. How important is this opportunity to the future of your business, and what (if anything) is the business doing to take advantage of this opportunity?
4. Identify one external threat that the business might face in the future. How important is this threat to the future of your business, and what (if anything) is the business doing to respond to this threat?

In each quadrant of the following SWOT matrix, stakeholders can develop strategies and responses to deal with strengths, weaknesses, opportunities, and threats as they intersect.

SWOT Analysis: Subject			
		Positive	Negative
Internal	Strengths		
	Weaknesses		
External	Opportunities		
	Threats		

## 1.7. Selecting and Engaging Your Professional Team

As you have no doubt gathered from this section (and as you likely will from the sections to follow), the transition process can be complicated, even intimidating. That is why creating a team of knowledgeable professionals will be crucial to succeeding in the process – it is simply not possible to know everything one needs to know to navigate the process by yourself. Writing this workbook required a team of experts, and you need one too.

As you begin the transition planning process, consider adding the following professionals to your transition team:

Professional	Emphasis Area
Accounting professional	Determining farm's current financial performance; evaluating feasibility of alternative business arrangements/enterprises to implement transition plan
Tax professional	(If different from accounting professional) Evaluate income and estate taxation implications of transition plan alternatives; suggest transaction structures to minimize tax liabilities incurred by transition plan chosen.
Attorney	Suggest transactions and entity structures needed to accomplish transition objectives; draft legal documentation needed to implement transition plan
Production consultants	Aid in evaluation of transition plan alternatives and feasibility of alternative operational structures
Investment advisor	Aid in formation of retirement investment goals and selection of appropriate investment vehicles to accomplish goals; aid in crafting of benefit plans for employees if needed
Human resources advisor	Aid in development of position descriptions for all involved in farm operation, both currently and after implementation of transition plan; consult on training programs and other actions needed to acclimate stakeholders to new roles
Mediator / family communication specialist	Facilitate transition meeting discussions; aid in gathering stakeholder input for transition process; provide continuing support in discussions to implement selected transition plan

This list is just a beginning. You may find other professionals in addition to these are needed. Do not be afraid to engage whatever professional assistance is needed. The transition process is one of the most important things you will ever do for your farm, so secure all the assistance you and your family need to make the best possible decision.

What if you have identified the need for a professional, but don't know how to select one? While it is impossible to ensure you have always found "the best" professional, there are a number of steps you can take to help you find a good fit.

1. **Ask around:** Seek out others who have gone through the transition process and ask for their experience with the type of professional you seek. Their encounters with similar professionals may suggest who to seek, and perhaps also who to avoid.
2. **Use professional association directories:** Almost all professional associations maintain directories of their members, and may even provide search features on their websites that allow you to select a professional based on their areas of specialization (such as agriculture) and their location (such as a specific county or city).
3. **Interview the professional:** Once you have narrowed your search to handful of professionals, schedule a meeting or telephone call to interview them. You would insist on an interview for someone working for you on the farm – this person will be working for you as well, just in a different capacity. Prepare a list of questions for the professional, such as their amount of experience in the specific area you need, and don't settle for vague answers. "Oh yes, we do estate planning work for farmers and ranchers" is not enough. What proportion of your practice is in that area? Have you provided presentations or written on that topic? What training have you received in this area? Have you worked with professionals in other disciplines (this is important as the best professional team will work well with all other members of the professional team)? The point of your questions is to reveal how well equipped the professional is to address *your* specific needs.
4. **Ask for references, and follow up:** During your interview, be sure to ask for reference clients you can contact to determine how the professional performed with real clients. Of course, the professional will only provide reference clients he or she feels would provide a good reference (although you may be surprised); don't be afraid to ask those clients for the names of other clients you can contact (or "indirect references").

This may be the most important information-gathering step in the process.

5. **Check professional credentials:** Most professionals are subject to a board, association, or other organization that accredits and/or licenses the professional and maintains records of any disciplinary actions taken against its members. For example, attorneys are regulated by state bar associations, accountants are regulated by state accountancy boards, financial planners may be governed by the Securities and Exchange Commission or the Certified Financial Planners® Board (depending on their specific advising activities), and so on. Ask your professional for their governing board information, and contact the board to determine if the professional's license or other credentials are in good standing, and if there is any pending or past disciplinary action regarding the professional.
6. **Ask for a written engagement agreement:** “Get it in writing” is something you’ll see multiple times in this workbook, and it holds true here as well. When you think you have narrowed your search to the professional that fits your needs, ask them for a written engagement agreement that spells out the following details:
  - a. Who is the client: in transition work, multiple family members may be involved with the professional. Clearly spell out who is “the client” – in other words, for whom is the professional working? You, or the business as a whole? This can be a critical point, specifically with attorneys and accountants, as they have very specific ethical obligations with respect to their clients that can affect their ability to work with and disclose information to other stakeholders.
  - b. The scope of work – what specific tasks will the professional perform for you?
  - c. Deliverables – what specific products will the professional provide to you (such as a financial analysis report, a will, a set of corporate documents, etc.)?
  - d. Confidentiality – what will the professional do to protect the confidentiality of the information you provide to them? Will a “non-disclosure agreement” or other confidentiality document be needed to protect trade secret information or other information that should not be disclosed to other parties?
  - e. Payment terms – how will you be billed for the services provided by the professional? Will a “retainer” or other advance payment be required? Will you have an opportunity to review bills as the process goes on? Will you be billed on an hourly basis, according to a fee schedule, or on some other basis?
7. **Involve other stakeholders where appropriate:** Some professionals may be working specifically for you, and in such cases you are certainly within your rights to select the professional by yourself. If the professional will be working extensively with other stakeholders, though, you may want to seek their input. The best professional team will be able to interact well with all your stakeholders.

## 1.8. Conclusion

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As you complete this section of the workbook, you’ve seen a number of the fundamental questions you have to ask about your operation as it is today before you start planning for its future. Hopefully, these questions will not only jump-start your transition process; they will also help you focus your thought about how your operation runs and help you engage all your stakeholders. And speaking of engaging stakeholders, that will be the focus of Section 2!

# FARM TRANSITIONS



Chapter 2

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# Communicating Effectively

## 2.1. The Importance of Communications in the Transition Planning Process

Family farm managers are entrepreneurs, and therefore frequently are “doers” rather than “talkers.” However, a successful farm transition requires open, candid, and frequent communication with all farm stakeholders. In fact, research by leading business experts suggest there are three factors that correlate significantly with family business longevity: (1) frequent family meetings, (2) strategic planning, and (3) active boards of directors for the family business.<sup>1</sup>

While communication is one skill often ignored by farm and ranch families, the list of benefits it provides is too extensive to ignore.

1. Study after study shows good communication is vital to improving the performance of the farm business in the “here and now,” as well as improving chances for success in implementing your transition plan.
2. Strong communication has the potential to significantly strengthen family relationships.
3. Open, candid communication can help obtain buy-in for the transition plan from farm stakeholders with very diverse interests.
4. Secretiveness, whether actual or perceived, can cause resentment or even active opposition to the transition plan. Conversely, opening up succession talks avoids or reduces thoughts that the process was secretive or manipulative.
5. Communication is the vehicle for informing stakeholders about how the succession process works and how the decisions forming the transition plan are to be made.
6. Open lines of communication can help identify and train the management successors for the farm business.
7. Engaging multiple generations in the communication process can help document and preserve the history of the farm business.
8. Well-conducted family business meetings portray the farm as a professionally run business, which encourages better professional behavior among all involved.

Better communication among your farm stakeholders is something that must take place many times each day, in many different environments. However, as you begin your transition planning process, you will likely start the communications process in the form of family meetings.

A common perception is that business meetings are a “waste of time.” This perception likely stems from historical experiences involving poor meeting practices. Family business meetings can be a very effective tool to facilitate communication, coordinate work flow, and improve decision making.

Depending on the business, very different types of meetings may be needed at different times, and involving different subsets of the business stakeholder team. In situations where several individuals are coordinating work efforts during a busy time, regular staff meetings may be needed to line out task responsibilities for the day, week, etc. in order to keep the day-to-day functions of the business running smoothly. This may involve an informal 10 minute planning meeting first thing in the morning, or a specific time allotted at the start of each week. Managers involved in the daily activities of the business, and employees involved in the operations would be key participants. Periodic management meetings to discuss resource issues, establish priorities, and assign responsibilities may also be needed. These meetings would involve the

management team of the business. Every farm and ranch business will need to determine the appropriate mix of these “tactical” type meetings, depending on the complexity of the operation and the number of managers and employees involved.

The primary focus of this discussion is on the need for, and implementation of, longer-term strategic discussions that involve the full array of stakeholder interests (all of the people with ownership, managerial, or emotional interests in the family business). Most families underestimate the importance of these types of meetings, as shared decision making and effective communication are primary keys to successful family businesses.

The framework for conducting successful big-picture family business meetings must be established ahead of time. Below are some important issues to consider as you plan your meetings:

1. How will we start the conversation?
2. Who will be invited to participate?
3. Who will facilitate the conversation?
4. What will be discussed?
5. When will meetings be held?
6. Where will meetings be held?
7. How will meetings be conducted?
8. How will decisions be made?
9. How will a record of the meeting decisions be maintained?

## 2.2. Starting the Conversation

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Perhaps the most difficult part of the farm transition conversation is simply starting it. By definition, the term “transition” means change, and change is almost always scary for many of us. In “the way things are” (*i.e.* the status quo), the farm stakeholders likely know what to expect, how to react to other stakeholders, how to behave, and have a good understanding of the “rules” (both spoken and unspoken) about the farming operation.

Even discussing the possibility of change through creating and implementing a transition plan can make many stakeholders uncomfortable since it may throw all of these “known” factors into question. Changing the course of the farm operation can require individual change, and that requires everyone to evaluate a number of factors about themselves, including:

1. Their perception of their own control over the operation
2. Their attitude regarding change
3. Their core values
4. Their knowledge and skills (and their willingness to develop them)
5. Their work habits
6. Their emotional and physical health
7. Their feelings regarding other stakeholders’ roles and investment in the farm

Since the transition process may challenge some or all of these very central ideas, some (or many) stakeholders may be reluctant to even engage in the conversation, and this is a very common response to the prospect of significant change. How can we engage these reluctant participants? There are three potential avenues to examine

1. **Information:** First, if stakeholders do not see a need to change, they may not feel any need even to discuss the possibility of it. Providing objective sources of information that support the need for transition planning may help people come to the conversation on their own. Using objective information helps communicate the need for the planning process is real while, at the same time, showing you are not trying to steer the process with information biased only to your point of view. This is also a way of inviting other stakeholders to share their own information, which is an important step toward establishing a good environment for communication, as discussed next. This workbook and the references it provides can be a starting point for providing this information.
2. **Environment:** All the facts in the world will not matter unless all the stakeholders feel there is an environment in which they can safely share their thoughts and feelings. Without such an environment, no one can freely contribute to “the pool of shared meaning.” The pool of shared meaning for any group is the collection of information that has been shared by the participants and upon which all the parties hold some measure of agreement. The larger the pool, the more meaningful information the group has upon which it can act; conversely, the smaller the pool, the more difficult (or even impossible) it becomes to create meaningful decisions. Later you will see how you can work to create a safe communications environment for all farm stakeholders.
3. **Communication skills:** Better communication skills start with you. Starting with you is the best way to ensure both effectively conveying meaningful information and creating an environment in which all stakeholders feel safe in sharing their thoughts and feelings. With an improved set of communication skills, you will be better able to engage reluctant stakeholders and put the overall communications process in motion. This section and its references provide a number of ways that you can improve these critical skills.

Throughout the rest of this section, ways to create a safe communications environment and to improve communication among all stakeholders will be presented.

## 2.3. Engaging the Farm Stakeholders

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Any conversation about the future of the farm operation must necessarily involve all those who hold some stake in it. How can we identify these stakeholders, and what do we need to know about them to engage them in the transition conversation?

### 2.3.1. Who are the farm stakeholders?

It is important that all stakeholders be involved in making the major decisions affecting the business. One of the first questions that arises is: who are the “stakeholders?” Consider three categories of family business stakeholders. The first two are obvious, and include anyone with either a financial *investment* (financial stakeholders) or significant *managerial* (management stakeholders) role in the business. This would include the farm owners and those that participate in the day-to-day operations of the farm. The third category includes those with an *emotional* stake in the business (emotional stakeholders). In the case of farms and ranches, these could be individuals who spent their youth on the farm years ago, and perhaps return periodically on vacations or family holidays, but who are not currently directly involved in a financial or managerial role. It seems that for farms and ranches, the emotional ties run deeper than they do for other family businesses, and it is often this set

of stakeholders who feel overlooked in the business transition planning process. Note that farm family members likely occupy two or three of these roles simultaneously.

## **2.3.2. Understanding Stakeholder Perspectives**

### **2.3.2.1. The value of diversity in farm decision making**

It is difficult for one to truly relate to and understand the decision making process of others who have different personality styles than their own; however, it is especially hard when one is not even aware of the different personality styles with which one is dealing. One suggestion for facilitating communication is for all the stakeholders to develop a more complete awareness of both their own personality style and the other personality types that are involved in their operation. Numerous tools are available and have been successfully utilized to accomplish this task including but not limited to profiling exercises such as “Real Colors” ([www.realcolors.org](http://www.realcolors.org)), or the Myers Briggs (MTBI) exercise ([www.myersbriggs.org](http://www.myersbriggs.org)). The authors’ experiences in working with farm and ranch families involved in a transition is that the stakeholders actually enjoy discovering more about their own personalities, and the characteristics of the personalities of the other stakeholders. Thus, this type of exercise can create multiple benefits for the transition process.

Personality styles to a large degree dictate the way in which individuals communicate, and the way in which individuals make management decisions. For example, some individuals are comfortable making significant decisions “on the fly” and actually enjoy the feeling of accomplishment that comes from making decisions. Others avoid commitments and have extreme difficulty in making even decisions of small consequence. Some stakeholders in the family business may make decisions based on significant research and fact finding, while others are prone to let the opinions of others drive their decision making process. There may be stakeholders who are very much bound by history and tradition in their decision making process, and others who make each decision based on well-defined goals and objectives.

Large corporations have long recognized the value of diverse perspectives in making critical business decisions. Similarly, when farms can capture different personality styles and thought processes, they can often create better decisions through the diversity of options created by engaging all the farm’s stakeholders.

### **2.3.2.2. Understanding generational differences**

Almost by definition, farm transition discussions involve groups of stakeholders from different generations. It is important to remember that each generation comes to the table with a different set of life experiences, and to a large degree a different set of values, as well as alternative ways of looking at the world in general, and business in particular. Characteristics of the various generations that are still significantly involved in family businesses today have been well studied and documented.<sup>2</sup>

Sociological research has shown that the characteristics discussed tend to be “modal,” among the respective generations, meaning that such traits are more likely among a plurality of that generation than other traits. This is *not* to say that *all* members of that generation share those traits. To do so would be akin to saying that every Oklahoman is a Sooner fan and every Kansan a Jayhawk. The authors would vigorously assert that is *not* the case. Thus, while this discussion is meant to provide awareness of the traits one is *likely* to encounter in dealing with individuals of that generation, it should not be taken to guarantee such traits will be encountered. Keen attention to the individuals in the conversation is vital.

In production agriculture, the reality is that the senior living generation (those born from about 1920 through the end of World War II in 1945), maintains control of a large percentage of the business assets (and in many cases the management) on farms and ranches today. Many of these individuals experienced the great Depression, the Dust Bowl, and several significant wars so they grew up in difficult times and developed a strong work ethic. Traditional value systems and the importance of extended family are deeply instilled. Their perception is that strong leadership moves people and organizations forward, so the command and control

organizational system is a perfectly acceptable way to run the business, and subordinates should accept decisions made by the leaders, sometimes without question or any need of leadership to explain how or why things are done the way they are.<sup>3</sup>

The “Baby Boomers” (generally considered to be those born between 1946 and 1964) experienced the Cold War, the civil rights and women’s movements, and the Vietnam War. They question the integrity of leadership, and evolved with a very career-driven mentality to prove their worth. They expect to work hard, but also expect to be compensated fairly, and their perception of family is more nuclear than extended. From a business perspective, they expect broad participation in leadership and decision making.

The Generation X’ers (born from 1964 to 1980) experienced the introduction of personal computers, MTV, and Operation Desert Storm. Many grew up with single, or AWOL parents (*i.e.* as “latchkey kids”) in an era of rapid change. They developed a sense of family among friends and a survivor mentality. Their perception of family includes more of a blend of biological and friendship relationships. From a business perspective they tend to be self-reliant, non-committed to organizations, and unimpressed with authority.

Finally, Generation “NeXt” (sometimes called the “Millennial” generation) was born after 1980 and grew up experiencing numerous violent public events, including the Oklahoma City bombing and the Columbine massacre (made all the more terrifying given its setting in a school). These individuals also grew up with very busy, over-planned agendas. They are incredibly technologically adept, and they view their parents as advocates for their views, feeling somewhat entitled to much of what they desire. Their sense of family likely includes more un-related friends than it does actual relatives. From a business perspective they have not yet developed a commitment to work (or schedules for that matter), and they have little understanding of those who are less technologically savvy than they are. They expect immediate responses because they grew up in a completely connected world. Numerous authors have written extensively on the “NeXt” generation, and have indicated that they are perhaps more different from previous generations than any generation ever studied extensively.<sup>4</sup>

The point of this discussion is that examining and understanding generational differences is an important part of facilitating effective business communication. One fairly simple suggestion for business stakeholders is to go to their local library and check out a sample of the wealth of literature on the subject of generational differences. The important point to remember is to choose resources that are fairly recent, so they include the youngest generations that will be involved in the discussions.

## 2.4. The Who, What, When, Where, and Why of Family Meetings...

Regularly meeting together as a family to discuss business issues can help focus the communications of the stakeholders on important business decisions such as a business transition. In fact, even in the context of day-to-day operations most family businesses underestimate the usefulness of family business meetings. A few simple guidelines will greatly enhance the effectiveness of family business meetings.

### 2.4.1. The “who” of the transition meetings

To some extent, the agenda of the meeting (discussed in the next subsection) may dictate who needs to be at the meeting. As a general rule, anyone who has any legitimate reason to care about the decisions to be made at the meeting needs to be invited. For the “big picture” discussions regarding the transition of your farm business, that list may be fairly extensive, including current owners and managers, successors, off farm siblings, spouses, and perhaps key employees. Questions often arise regarding the inclusion of off farm sibling spouses, and the answer may depend on the situation. It likely will boil down to a judgment call regarding whether or not they would contribute constructively, or would generate conflict. As one expert observed, “[family members] will hear about the proceedings anyway, whether they are present or absent.”<sup>5</sup> Once a decision is made the

rule would be to either invite all or none. Depending on the agenda of the meeting, advisors from outside the business may be invited to participate.

Your family meeting might also benefit from having a facilitator present. The facilitator is responsible for defining the ground rules and structure of the meeting, assuring that the discussion sticks to the agenda that was established prior to the meeting. He or she manages the process, helps keep track of major points, and directs the recording of the meeting. In addition, the facilitator manages the discussion by keeping the meeting focused, constructively resolving conflicts and shifting the communication if needed. The facilitator has a difficult task because emotions are often high, and at times the facilitator must assist parties in expressing their ideas without seeming to take sides. Different businesses utilize different models for choosing the facilitator. In some cases it is appropriate for one stakeholder to facilitate all to the business meetings for a period of time. Sometimes an outside neutral party facilitator, such as a trained mediator or a family communications expert, is needed. In other cases stakeholders take turns in the facilitator role, which may be a good way to develop leadership, conflict management, listening, and speaking skills.

## **2.4.2. The “what” of the transition meetings**

Someone needs to be responsible for circulating a draft agenda ahead of each family meeting. Once in the routine, the agenda for subsequent meetings can be discussed at the current meeting; however, getting started can be difficult. Stakeholders can begin by circulating issues or questions to identify issues that are most important.

If your farm stakeholders are not in the habit of meeting routinely, chances are an initial meeting will be crucial to establish some of these fundamental points, which may form the basis of your first meeting agenda.

1. Is there existing family conflict that must be resolved before discussions can move ahead?
2. Do big picture issues such as core values, vision, and mission need to be ironed out?
3. Are there concerns about the roles of stakeholders with respect to
  - a. ownership,
  - b. business participation,
  - c. compensation, or
  - d. responsibility?
4. What do the stakeholders envision the farm business looking like in the future?

The first family business meeting will need to be initiated by one or more of the primary stakeholders of the business.

After the first family business meeting, a good place to start is the record from previous meetings. Assign one stakeholder the task of assembling an agenda in advance of each meeting that provides an outline of what important business topics will be discussed. The agenda should be prepared interactively with input from a broad range of stakeholders (something that is easy to do with modern technology), and the final version should be distributed to each stakeholder well in advance of the scheduled meeting, along with any support materials that are necessary.

Unless your business is considering an extended family business retreat (discussed later), it is advised to keep the list of topics and issues to be covered at any one meeting short enough that it is projected to take no more than a couple of hours to cover. Nobody likes extended meetings, and there can be a real danger of information overload if too many issues are brought up at one time. If possible, schedule more frequent

meetings of less duration.

The last agenda item for any family business meeting should be a brief discussion regarding the next meeting. Confirm the date, time, and place for the next meeting. If you are rotating facilitators, decide who will facilitate and at a minimum briefly summarize proposed agenda items and discuss any stakeholder subsets that particularly need to be involved. Finally confirm how the draft agenda will be formulated and circulated.

### **2.4.3. The “when” of the transition meetings**

The “frequency” of strategic family business meetings will depend on the business itself and the complexity of the issues it is facing, and the schedule may change depending on the time of year, or the immediacy of the issues being addressed. Decide on a schedule ahead of time, whether it be once a year, quarterly, monthly, monthly during the “off” season, etc., and once a schedule has been agreed upon resist the temptation to postpone scheduled meetings. If a specific date has to be cancelled, re-schedule as soon as possible so that the family stays in the routine. It is essential that these strategic planning sessions be viewed as an important use of stakeholder time.

It is important to schedule these meetings at times that are convenient for all parties so their input can be provided (as discussed above). This means taking into account many of the seasonal impacts of stakeholder schedules, whether they are related to the production cycles of the farm (such as planting, cultivation, harvest, calving, etc.) or off-farm issues such as seasonality of off-farm employment activities or children’s and families’ activities.

Commonly, families are tempted to hold these meetings during holidays such as Christmas or Thanksgiving simply because these represent times when the entire family is all together. However, this can be problematic. At best, these holidays are times when the family should be together celebrating and enjoying each other’s company without the stress of business issues that may be a source of conflict. At worst, the holidays may already be a stressful time, and the addition of a potentially difficult conversation may worsen the situation. The better course is to separate the transition conversation into its own event. Not only does this avoid the potential conflict with holiday activities; it also impresses upon the stakeholders that it is an important event worthy of individual attention.

### **2.4.4. The “where” of transition meetings**

Regularly scheduled, shorter meetings likely will need to be held close to the business headquarters simply due to time constraints and logistics, so decisions have to be made regarding their location.

For planning meetings and other “big picture” meetings where it is important that everyone feel comfortable openly sharing their thoughts and feelings about potentially sensitive topics, a neutral location can be critical. Mom and Dad’s kitchen table may be a familiar environment, but it also comes with a very strong, established power hierarchy. In this environment, children may be very reluctant to openly share because Mom and Dad hold all the power there. This can cripple the conversation. Therefore, try to pick a neutral location where everyone feels comfortable voicing their opinions.

Not only is it important that everyone feels emotionally comfortable in the meeting space; it is important that the environment be physically comfortable as well. A quiet space free of distractions with comfortable chairs, space to write and record ideas, and refreshments can be important amenities.

It is also important to keep distractions and interruptions to a minimum. Make sure the day-to-day activities for the meeting time have been delegated to someone else or taken care of in advance (and note – since it may be important for the person who handles those activities to be in the meeting, outside help may have to be hired on a temporary basis). Make arrangements for the care of any children who will not be participating in the meeting. Mobile phones and other communication devices should be put somewhere they can be reached in an

emergency, but not so accessible they are a source of distraction.

Some families have had success with “rotating” the meeting location around to various places. Many local Extension offices, local restaurants, community buildings, schools, and churches have meeting rooms that can be used for such discussions, especially if non-busy times are chosen. The important thing to keep in mind is to create a safe environment to have conversations about important issues.

As a final thought on family business meetings, periodically a very powerful type of family business meeting along the order of an extended family weekend retreat (somewhere away from the family business) is warranted. Sometimes due to schedules, distances, etc. it is necessary to spend an extended time working on big picture issues that involve a lot of stakeholders or really tough decisions. This is where a weekend family retreat away from the business at a hotel, park lodge, or other getaway location may be beneficial. Families might even find it useful to request an outside advisor to serve as a facilitator for part of the meeting. If these types of retreats are being considered, be sure to incorporate family fun time and schedule plenty of breaks to back away from the discussions. These breaks can be important times to gather one’s thoughts and to “process” the meeting discussions, which can lead to insights about how to proceed. Obviously, most family businesses will not be able to do this very often, but at the right stage of the transition planning this type of focused attention to a big picture issue could be very rewarding.

### 2.4.5. The “why” of transition meetings

To an extent, the entirety of this workbook has underscored the “why” of transition meetings. To state the “why” in one short statement, though, it is because effectively communicating with all stakeholders in a safe and open environment is absolutely essential to making good decisions that will impact the future of your farm business. Beyond the critical nature of good family meetings and the communication they facilitate to the transition planning process, they also give you a competitive advantage over other operations. In the words of one expert:

*Only a small proportion of American families own and run their own businesses. And a much smaller percentage ever holds a family meeting as a constructive way of addressing important issues. By simply beginning the family meeting process, the family has distinguished itself. And family members are giving themselves a potentially powerful advantage in grappling with the pressures, privilege, and responsibilities of ownership.<sup>6</sup>*

Organizational performance research underscores the fact that the highest performing organizations excel at communication. Thus, these meetings and the opportunity they provide not only to communicate but to improve at communicating, can make a tremendous difference in how your farm performs. Or, as stated by another expert, “[i]s it possible that an organization’s performance could hang on something so soft and gushy as how individuals deal with crucial conversations? Study after study suggests the answer is yes.”<sup>7</sup>

## 2.5. The “how” of transition meetings, and the rules of engagement

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Early in the process, the stakeholders need to agree on some fundamental ground rules for meeting conduct and decision-making.

1. What are the attendance and preparation expectations?
2. What are the specific roles and expectations of the facilitator?
3. How will we ensure respect for opinions and promote honest and courteous communications?
4. What will be the rules for sharing information discussed at the meetings with outsiders?

These, and other basic family communication ground rules will help validate the process and preserve stakeholder harmony. Criteria for decision making revolve around what is most important to the stakeholder group as a whole. Is it short-term financial impact, longer-term financial impacts or growth, or is it other core family values that will steer the discussion and decisions.

Organizations have several options for how decisions will be finalized. These options frequently fall in to four categories:

1. Command – the stakeholders have no involvement in the decision; it is handed over to someone else (a decision-maker) and then stakeholders follow his or her lead
2. Consult – Decision-maker gathers ideas, evaluates options, make a choice, then informs those affected
3. Vote – best suited to situations where efficiency is the highest value and you're selecting from a number of good options. Should not be used when team members don't agree to support whatever decision is made.
4. Consensus – should be used with high-stakes and complex issues or issues where everyone absolutely must support the final choice.<sup>8</sup>

In choosing which method to use, consider who genuinely wants to be involved in the decision, who will be able to contribute meaningful information, whose cooperation is needed, and how many people is it worth involving?<sup>9</sup>

Someone needs to be responsible for documenting the discussion and what decisions were made at each meeting. This obviously can help minimize later “selective recall.” In addition, because succession planning can seem like such an insurmountable task due to all the issues that need to be addressed, meeting records can serve as a motivator to document that decisions are actually being made and that the business is planning for forward movement. Thus, for each meeting, designate someone to be responsible for taking notes of the discussion (perhaps on a copy of the original agenda), copying those notes or minutes, and distributing copies to each stakeholder.

### **2.5.1. Creating a safe communications environment**

As discussed previously, a “safe” environment is crucial to effective communication. Part of creating a safe environment is creating a sense of trust among all stakeholders. A basic element of open communication is trust. A history of honesty, courtesy, kindness, and fulfilling commitments tends to build trust in a relationship, while betrayal, disrespect, and threats tend to tear down trust.<sup>10</sup> Relationships in which the level of the “trust bank account” is high will be able to handle difficult discussions about important issues like family business transition in a much smoother fashion, again reinforcing the importance of starting the process early and working on the transition over the long haul.

Trust, or mutual respect is an absolutely critical element to creating a safe communications environment. Without that safe environment, meaningful communication is impossible, and the entire purpose of the meeting is rendered moot. Put another way, in a safe environment, one can say almost anything, but in an unsafe environment, nearly everything said is taken in the most negative light.<sup>11</sup>

Given the importance of safety, how can it be established and maintained? First off, to have a safe environment, it is critical to establish two conditions. First is mutual purpose: all of the participants must understand that the point of the conversation is to arrive at a solution that can benefit all parties. This is a precursor to the conversation – without it, the stakeholders have no incentive to participate in the conversation at all. Second is mutual respect (or trust): all of the stakeholders must feel that they have the respect of the other stakeholders. Mutual respect is a continuation condition – without it, a conversation will simply stop, or explode in to a conflict. As it has been said: “respect is like oxygen: if it's there, no one thinks about it, but without it, it's all anyone can think about.”<sup>12</sup>

Safety is so important that it must constantly be monitored. If anyone feels unsafe in the conversation, it is time to stop and reestablish a safe condition. How can you tell when someone feels unsafe? Frequently they fall into one of two states: “silence” – in which they stop participating in the discussion, or “violence” - name calling, yelling, making threats, or attacking. Learning to spot these responses is a skill in itself, because when someone moves to silence, our instinct is simply to overlook them, and when someone moves to violence, our instinct is to fight back. Both of these responses are counterproductive. Instead, we have to train ourselves to objectively examine the conversation and realize that both the silence and violence responses are symptoms of an unsafe environment.

Thus, it is to our advantage to learn how to recognize these symptoms:

1. Silence – avoiding meaningful participation
  - a. Masking (sarcasm, sugarcoating)
  - b. Avoiding (moving completely away from sensitive subjects – changing the topic)
  - c. Withdrawing (pulling out of the conversation altogether)
2. Violence – trying to overwhelm other stakeholders
  - a. Controlling (coercing others to share your perspective)
  - b. Labeling (putting people into a stereotype so they can be dismissed)
  - c. Attacking (directly attacking others involved in the conversation)<sup>13</sup>

When someone demonstrates these symptoms, avoid the temptation to take them personally. Rather, recognize them for what they are – a signal that someone feels unsafe. Stop the conversation and take steps to help restore trust and respect.

First, do not overlook the value of an apology. Understand what an apology is: a statement that sincerely expresses your sorrow for your role in causing or not preventing pain or difficulty to others. You do not have to apologize for having beliefs, values, or perspectives that are different from someone else, but you should also realize that *the way those beliefs, values or perspectives are shared* may cause hurt feelings. Second, contrast what your intent actually was in a statement versus what may have been perceived by others (“I didn’t mean that our livestock operation isn’t important – I meant to say we might want to consider other enterprises as well.”). Third, work to underscore the mutual purpose at play (“I think we all agree that we’re trying to arrive at a plan for the farm that benefits everyone involved. Let’s focus on a true win-win.”). <sup>14</sup>

If someone still feels threatened and refuses to engage in the conversation, consider using this approach:

1. Ask to get things rolling: directly ask the person for their input. They may feel that their opinion is not valued or that they have nothing to contribute; asking can help restore their confidence.
2. Mirror to confirm feelings: explain your perception to the other person to get their take. For example: “You haven’t been saying much during this conversation. Is that because you don’t feel comfortable sharing your point of view?”
3. Paraphrase to acknowledge the story: once someone has shared why they are withdrawn, restate what you have heard to ensure you understand correctly. “You said you don’t feel comfortable sharing your opinions because you’re worried we have already committed to a different approach. Is that right?”
4. Prime the discussion – take your best guess at what the other person is thinking or feeling as a means of starting the discussion of the true nature of the problem. “Is the reason you’re withdrawn because we have made you feel like you don’t have something important to add?”<sup>15</sup>

## 2.5.2. Basics of effective communication

It is important to remember some basic realities regarding interpersonal communication, particularly as it relates to family business communication. First, many people are surprised to learn that communication in general involves much more than spoken words. In fact, most communication research suggests that the total message in an average conversation consists of approximately 7% words, 38% tone of voice and other verbal signals, and 55% body language and non-verbal messages.<sup>16</sup> This serves as a gentle warning to both farm families, and those working with farm families, that communication is a *complex* interaction and carefully chosen words are only part of the process.

Bearing these considerations in mind, consider the following pointers as you balance both the content of your words and the way in which you deliver them:

- Remember to focus on the positive, and be mindful of what's best for the farm and family as a whole.
- Spend a brief moment thinking about the bigger picture before saying anything. Think, *then* speak.
- Bring up topics in the context of “I” or “we,” in order to avoid the perception of blaming the other person. For example, “when the combine broke down in the middle of harvest, I felt very out of control and did not know what to do,” might be a more effective way to open a conversation about how to move forward than “when *you* broke the combine in the middle of harvest it created a real crisis for the whole farm.”
- Actively listen. Watch the reactions of people while they are talking, and ask questions to clarify meaning. This not only assures that the message is received clearly, but also shows the speaker that you are genuinely focused on their message at the moment.
- When it is your turn to speak, if it is important, say it more than once, and ask questions to ensure that others understand your meaning. As you are speaking, try to read the impact you are having on the listeners. Are they tense, or are they relaxed? What is their body language telling you?

## 2.5.3. When the conversation becomes difficult

Even if you have worked tirelessly on developing flawless communication skills and have deployed those skills with perfect execution, the conversation may become heated. Someone may say something that seems utterly irrational, becomes offensive, or takes a position that seems beyond understanding. Which such a thing happens, you must have a degree of objectivity. Step back, and ask yourself “why would a reasonable, rational, decent person have the perspective they do, or say the thing they just said.” If we can put ourselves in the other person's shoes, we might have a chance at determining why they might have taken such a position. We might also understand that in a difficult conversation, we might confuse our emotions about an issue with the facts about the issue; indeed, when we are passionate about an issue, it is amazing how our emotions may feel like facts, making us wonder how it is even possible for someone to feel differently than we do.

Sometimes, it is difficult to have this level of objectivity. In such cases, remember the value of simply taking a break from the conversation. A brief recess can help cool emotions and give everyone a chance to breathe (both literally and figuratively).

As we try to bring everyone back into the discussion and build agreement, consider the “STATE your path” approach proposed by Patterson, Renny, McMillan, and Switzler:

1. **S**hare your facts – facts are the least controversial, most persuasive, and the least insulting. Begin your path with facts to which everyone involved can agree. If you can't agree on facts, use the ABC method
  - Agree – many times in a disagreement, there is consensus on the vast majority of the facts, and disagreement on just a few. Find the common ground

- Build – If the other person is missing facts, don't tear them down for being wrong. Build on their facts with additional information.
  - Compare – rather than just accusing the other person of being wrong, compare your paths to see now they differ.
2. **T**ell your story: Show people how you went from your facts to the meaning you gave those facts
  3. **A**sk for others' paths: invite them to share the meaning they have given to the facts
  4. **T**alk tentatively: frame your view of others statements to clarify meaning rather than as absolute facts ("Based on these facts, I think what is happening is..."). At the same time, though, don't completely disclaim the legitimacy of your view or fake tentativeness.
  5. **E**ncourage testing: sincerely invite others to challenge your point of view. If others won't do so, play devil's advocate with yourself to show others you can in fact see other perspectives.<sup>17</sup>

### 2.5.4. Moving from conversation to action

Family business transitions are difficult, especially when there are numerous stakeholders involved. View family business meetings as an opportunity for stakeholders to work together for the success of the business. The earlier a business begins facilitating difficult conversations, the more likely conflicts can be resolved and family values, traditions, and history can be preserved. Stakeholders will learn more about the business, and more about themselves through enhanced communication. Conflicts will arise, but the focus becomes constructively resolving those conflicts to ultimately build stronger businesses, and stronger families. In addition the process can help develop leadership skills throughout the organization, and sends a message to others such as employees and business partners that the business is committed to the future.

Everyone can benefit from a reminder to work at good communication skills every day. Practicing good communication skills habitually when engaged in day-to-day interactions will most certainly increase the likelihood that good skills will rise to the surface when the conversations are more critical.

## 2.6 Conclusion

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Many farmers and ranchers think they are too busy to engage in the types of family discussions presented in this chapter, or that those conversations are not critical to the success of the family business or its transition to the next generation. However, both an overwhelming amount of research and the experiences of countless professionals underscore that such conversations are absolutely vital not only to the success of the transition process, but the success of the business itself.

Remember that there will eventually come a time when the conversation must move to action. Do not be content to have a good conversation about your transition plan; commit to do something with the information you have developed. At the end of each meeting, have a clear plan for following up. Assign everyone who participated in the meeting with specific tasks. Be specific in spelling out exactly what the stakeholders are to achieve, and by when it must be completed. Finally, establish how you will follow up – create a system of accountability that everyone agrees to follow.

## For More Information:

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Craig E. Aronoff and John L. Ward, Family Meetings: How to Build a Stronger Family and a Stronger Business

(2011).

L.C. Lancaster and D. Stillman. *When Generations Collide* (2002).

Kerry Patterson, Joseph Grenny, Ron McMillan, Al Switzler. *Crucial Conversations: Tools for Talking when Stakes are High* (2d Ed. 2012).

“Real Colors” ([www.realcolors.org](http://www.realcolors.org))

Myers Briggs (MTBI) exercises ([www.myersbriggs.org](http://www.myersbriggs.org))

## ENDNOTES

<sup>1</sup> Craig E. Aronoff and John L. Ward, *Family Meetings: How to Build a Stronger Family and a Stronger Business* (2011), 4.

<sup>2</sup> See L.C. Lancaster and D. Stillman (2002). *When Generations Collide*. New York : Harper Collins.

<sup>3</sup> W. Strauss and N. Howe (1991). *Generations*. New York: Quill.

<sup>4</sup> See M. Taylor, 2006. *Generation NeXt comes to college: 2006 Updates and Emerging Issues*. In *A Collection of Papers on Self Study and Institutional Improvement, 2006 Vol.2*, ed. S.E. Van Kollenburg, 99-107. Chicago: The Higher Learning Commission. See, also, J.M. Twenge (2006). *Generation Me*. New York: Free Press.

<sup>5</sup> Craig E. Aronoff and John L. Ward, *Family Meetings: How to Build a Stronger Family and a Stronger Business* (2011), 52.

<sup>6</sup> *Id.* at 54.

<sup>7</sup> *Crucial Conversations: Tools for Talking when Stakes are High*. Kerry Patterson, Joseph Grenny, Ron McMillan, Al Switzler (2d Ed. 2012), 11.

<sup>8</sup> *Id.* at 181.

<sup>9</sup> *Id.* at 183.

<sup>10</sup> D. Hofstrand (2007). “Making Family Business Decisions.” Iowa State University Ag Decision Maker Fact Sheet C4-72, available at <https://www.extension.iastate.edu/agdm/wholefarm/pdf/c4-72.pdf>.

<sup>11</sup> *Crucial Conversations: Tools for Talking when Stakes are High*. Kerry Patterson, Joseph Grenny, Ron McMillan, Al Switzler (2d Ed. 2012), 56.

<sup>12</sup> *Id.* at 76.

<sup>13</sup> *Id.* at 58.

<sup>14</sup> *Id.* at 82.

<sup>15</sup> *Id.* at 162.

<sup>16</sup> See, e.g., A. Mehrabian (2008). “Communication without Words.” In C. David Mortensen, *Communication Theory*. Transaction Publishers. Piscataway, NJ.

<sup>17</sup> *Crucial Conversations: Tools for Talking when Stakes are High*. Kerry Patterson, Joseph Grenny, Ron McMillan, Al Switzler (2d Ed. 2012), 136, 170.



# FARM TRANSITIONS

Chapter 3

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# Planning for Business Succession

## 3.1. Planning for retirement

An important component of the succession planning process revolves around the “retirement” of the exiting generation. We often hear the comment that “there is no such thing as a retired farmer,” and there are certainly plenty of examples to back that up. However, planning for all the aspects of retirement – in whatever form it takes – will definitely smooth the family business succession process. One critical question to be answered is how soon the exiting generation plans to begin the retirement process. Often succession plans begin to take place early, and there may be a time period of several years where the exiting generation is still very much involved in (or even in charge of) the operation. In fact, that model would be consistent with a planned and phased-in management transition process. Keep in mind, however, the income realities discussed in the financial section regarding how large the business might need to be in order to financially support additional families if the senior generation is not ready to begin to cut back on both responsibilities to and income withdrawals from the business. Alternatively, the senior generation may desire to partially retire when successors begin to take on responsibilities. Yet another possibility is the “clean break” scenario in which the reins are handed over “all at once” and the business becomes the successors’ to run immediately and the senior generation fully retires.

In any case, serious thought needs to be given to the following issues:

1. How does the exiting generation envision retirement? This involves such issues as the degree of involvement in the helping with the operation and management of the farm, where they desire to live, and what other hobbies or interests they may want to pursue in order to remain active.
2. How much income will they need, and what sources are available to provide that income?
3. What will their expenses look like, and how might they change as they phase into retirement and over time?

The exiting generation needs to honestly anticipate or think about their desired retirement lifestyle. Are they interested in travel, volunteer work, or devoting time to Church related activities. What hobbies or interests are they interested in pursuing? Is it important to them to maintain involvement and decision making control over the farm? Take some time to think through these questions as you work on the succession plan.

Next, consider the sources of retirement income that will be available, and how long those income sources will last. The good news is that people are on average living a long time into retirement. The bad news (financial pun intended) is that people are on average living a long time into retirement. For example, recent data suggest that for a healthy 65 year old couple, there is a 75% chance the at least one spouse will live to be at least 86, there is a 50% chance that at least one spouse will live to be 91, and there is a 25% chance that at least one spouse will live to be 96. The point is retirement income sources may need to last a long time. Potential income sources during retirement include continued wage income from part time or spousal employment, social security income, income from farm assets, savings and investments, or pension income from prior employment. Continued wage income should, in most cases, be considered a short-term income source, often used as a transition while perhaps helping the younger generation get established.

Retirees can elect to begin receiving social security benefits at age 62. The amount of the monthly benefit drawn increases each year that retirement is delayed up until age 70, and wage and self-employment earnings do not count against social security benefits after age 65. These regulations make the decision regarding when to begin drawing social security a bit complicated, but the general rule is that if a person is healthy and can afford to wait it is generally more beneficial over the long run to wait until at least age 65 to begin drawing on social security benefits. A word of caution is in order for individuals who have been self-employed for a significant portion of their career. For some reason (that is hard to understand for those who work in the farm economics

field) business managers have long been tempted to minimize reported social security earnings (net farm incomes) for tax reporting purposes in order to minimize taxes. The massive difference between true accrual calculated management profitability and net farm income often reported for taxation purposes is a topic for another time, but suffice it to say that the ability to perpetually understate true profitability for social security reported earnings works against the accumulation of social security benefits. Put simply, minimizing Social Security taxes paid over a lifetime will also minimize the amount of Social Security benefits available. Check your earnings and projected benefit record periodically at [www.ssa.gov](http://www.ssa.gov) to get an idea of your historical social security contributions and what that might translate into in the form of benefits.

Retiring farm owners and operators sometimes mistakenly assume that the business will continue to support them in retirement. Keep in mind that the “operator return” portion of what your business has historically been generating will now likely need to go to someone else.

In retirement the income from farm assets generally comes in two forms, sale or rent/lease. A consideration if you are thinking about selling land or equipment to fund retirement needs is the issue of capital gains and/or income recapture. If the sale price of an asset is more than the tax basis in the asset, then taxes will be owed, reducing the net amount from the sale.

Long-term family wealth accumulation can be enhanced by carefully evaluating which assets to sell between generations, and which assets to transfer through an estate. For depreciable assets such as machinery and breeding livestock, leasing may be a good alternative in the short run; however, keep in mind that these assets wear out and will need to be sold or replaced at some point. Leasing can provide a mechanism for slowly working the next generation into the ownership of the depreciable assets, with the incoming business operators purchasing replacements for those assets as they wear out and are sold by the retiring operators over time. At that time, the leasing income from that particular asset goes away; this poses a financial situation that must be planned for in advance.

Leasing or renting non-depreciable assets such as land provides a common form of steady income for retired farmers. Keep in mind the “rent to value” for agricultural land is fairly low, so in order to generate a significant amount of rental income a large dollar amount of agricultural land must be owned. In addition, any debt payments to be made on land that is not already completely paid for need to be considered.

Other retirement income sources such as employer-sponsored pension plans or investments such as savings accounts, CD's, bonds, or investment accounts also need to be considered. For these sources, time is money. The sooner you start saving the more money you are likely to accumulate. Add up all the potential sources of retirement income, and evaluate the degree of diversification for your particular situation. Statistics show, in general, retired farm operators rely somewhat more on income from business (farm) assets, and somewhat less on income from traditional retirement accounts and social security than average retirees, which is certainly understandable given their life devotion to building up the farm business. That does, however, make conventional retirement planning tools (and rules of thumb) used for non-business-owning retirees less applicable.

Finally, think about a realistic spending plan. Will you still be involved in the farm, and therefore need to consider farm expenses and/or perhaps capital investments well into retirement? Consider family living needs and how those might change as you get into retirement. Don't forget inflation influences. At 2% inflation, in approximately 35 years it will take twice as many dollars to pay the same bills as today, but if inflation were to increase to an average of 4% the time it takes to double the dollar requirements is reduced to about 18 years. Remember, health and health insurance costs become a larger share of the total expense pie as we get older, and those costs have risen at a rate much higher than the general rate of inflation in recent years. Depending on your situation, it may be appropriate to consider tools such as long-term-care insurance and life insurance (see discussion in section 4.6.1)

Develop a retirement budget based on retirement income and spending projections so see if the

retirement you have in mind is possible. Common mistakes that can lead to retirement shortfalls include planning too late, miscalculating how much income will be needed or the level of retirement expenses, and failing to protect assets late in life.

Following is an example retirement planning budget, available from TIAA-CREF (available at [https://www.tiaa-cref.org/public/pdf/advice-planning/tools-calculators/A125820\\_budgeting\\_worksheet.pdf](https://www.tiaa-cref.org/public/pdf/advice-planning/tools-calculators/A125820_budgeting_worksheet.pdf)).

Essential budget items	Per month	Discretionary budget items	Per month
<b>Household expenses</b>		<b>Household expenses</b>	
Mortgage/rent	\$	Home improvement	\$
Utilities/cable/internet	\$	New purchases	\$
General maintenance	\$		\$
Household supplies	\$		\$
Property tax & insurance	\$		\$
Credit card debt payments	\$		\$
<b>Meals</b>		<b>Meals</b>	
Groceries	\$	Dining out	\$
Beverages	\$	Entertaining	\$
Essential entertaining	\$		\$
<b>Personal care</b>		<b>Personal care</b>	
Clothing	\$	The extras	\$
Products/maintenance	\$	Products/maintenance	\$
<b>Healthcare</b>		<b>Healthcare</b>	
Medicare/supplemental insurance	\$	Other out-of-pocket insurance	\$
Out-of-pocket payments	\$		\$
Dental	\$		\$
Eye doctor/glasses	\$		\$
Other essential expenses	\$		\$
<b>Transportation</b>		<b>Transportation</b>	
Car payments/auto insurance	\$	Discretionary travel	\$
Maintenance and fuel	\$	Vacations	\$
Taxes, registration, etc.	\$	Upgrades	\$
Essential transportation costs	\$	Other	\$

Essential budget items	Per month	Discretionary budget items	Per month
<b>Leisure &amp; hobbies</b>		<b>Leisure &amp; hobbies</b>	
Essential spending	\$	Discretionary spending	\$
Gifts and holidays	\$	Gifts and holidays	\$
<b>Tax considerations</b>		<b>Tax considerations</b>	
Charitable contributions	\$	Charitable contributions	\$
Income tax	\$	Gifts	\$
Other	\$	Other	\$
<b>Miscellaneous</b>		<b>Miscellaneous</b>	
	\$		\$
	\$		\$
	\$		\$
	\$		\$
	\$		\$
	\$		\$
<b>TOTAL ESSENTIAL</b>	<b>\$ 0.00</b>	<b>TOTAL DISCRETIONARY</b>	<b>\$ 0.00</b>

## 3.2 Who's in charge?

Organizational structure is one of the three primary “structures” of the business.<sup>1</sup> Organizational structure, sometimes referred to as leadership structure, is the framework within which decisions are made within the organizations. Lines of authority and responsibility need to be clearly established, with each stakeholder having a clear understanding of the various leadership and responsibility roles within the organization, and how those roles will change over the course of the transition. The most successful decision-making authority transitions are usually done through a gradual process, though sometimes, unforeseen events trigger a much faster transition. Successful large businesses often devote several years to the selection and preparation of management successors.

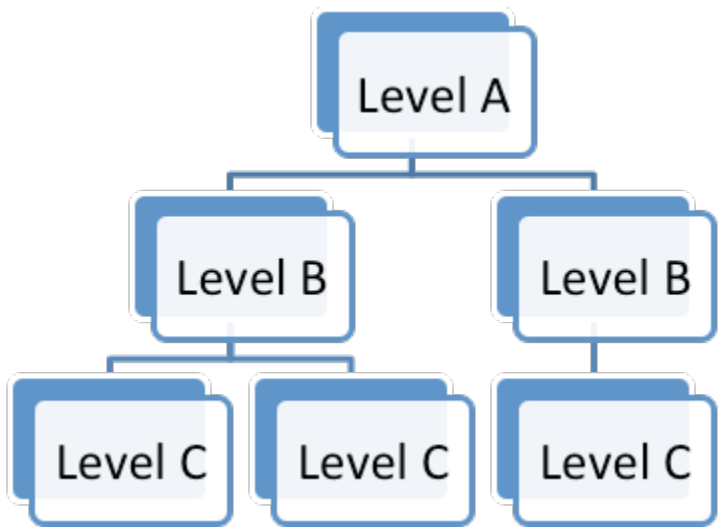
Family businesses need to agree on what type of organizational structure they want to evolve out of the transition. Options include the traditionally common command and control structure, where decisions are all made by one, or a very few, key individuals. This system provides order and security, but may impede the organizations ability to respond to evolving opportunities. This top-down model works best for smaller businesses where there is someone with very strong leadership and decision-making skills. On the other end of the spectrum, some businesses seem to be organized as somewhat of a bureaucratic system, where responsibility and decision making is very spread out and so many approval layers are required that nothing seems to get done. Under this type of a system, an agricultural business might find it very difficult to make progress and respond to evolving opportunities. In the middle would be a hybrid organizational structure where day-to-day decisions are spread among several managers or even employees who have the authority to make decisions, and along with that are willing to accept responsibility. At the same time the big decisions remain under the purview of the top decision maker or makers in the organization. No one organizational structure will fit every farm family business, so as the transition planning process takes place the advantages and disadvantages of various alternatives need to be discussed in the context of the overall vision and mission of the organization.

With the exception of the sudden transitions that are triggered by unforeseen events, most business successions follow a transfer time line, where ownership, decision-making authority, and income sharing arrangements move through the phases of testing, commitment, establishment, and withdrawal of the senior generation.

- **Testing:** During the testing phase, the successors may only be working for a wage or wage-incentive compensation plan, may only be sharing or leasing assets from the senior generation, and may be somewhat limited in decision making authority. This phase may be necessary to see if the business is a good fit in terms of commitment, skills, and interests for the successor and his or her family.
- **Commitment and establishment:** During the commitment and established phases the successor progressively acquires more of an ownership interest in the assets of the business, takes on more management and decision-making authority (and responsibility), and the compensation plan changes along with the responsibilities and ownership interests in the business.
- **Withdrawal:** The withdrawal phase is where the senior generation turns over the reins of the business to the successor, but may maintain varying degrees of ownership interests.

Questions always come up regarding the length of time that should ideally be allocated to each of the phases of the transfer time line. The answer, of course, it depends on the situation. The scenario to avoid, however, is the one where the various stakeholders, especially the successor, do not know what the transfer time line is and do not see any progress being made along the process. Imagine the frustration that develops when a young couple returns to the farm under the understanding of becoming the family business successor, and finds themselves still stuck in the testing phase of the transfer time line working for a wage (often below market wage rates, under the “someday son this will all be yours compensation plan”), gaining no ownership interest in the business, and being given no decision making authority after several years of working in the business. Having had no discussions regarding the transfer time line, they (especially the spouses) lose faith in the process and become frustrated, often causing disharmony among the family.

So, what can family businesses do to smooth the organizational structure transition of the business? Once again, it boils down to communication. As part of the succession planning process, have open, honest discussion among all the stakeholders about management transfer plan. We suggest the following exercise as a starting point. In a family meeting environment (discussed in Chapter 2), provide each stakeholder with two blank pieces of paper (or use front/back of one sheet). Have each stakeholder portray their perception of the current decision making (organizational) structure of the family business on one sheet.



```

graph TD
    A[Level A] --> B1[Level B]
    A --> B2[Level B]
    B1 --> C1[Level C]
    B1 --> C2[Level C]
    B2 --> C3[Level C]

```

### Our Farm Organizational Structure

Today \_\_\_\_\_

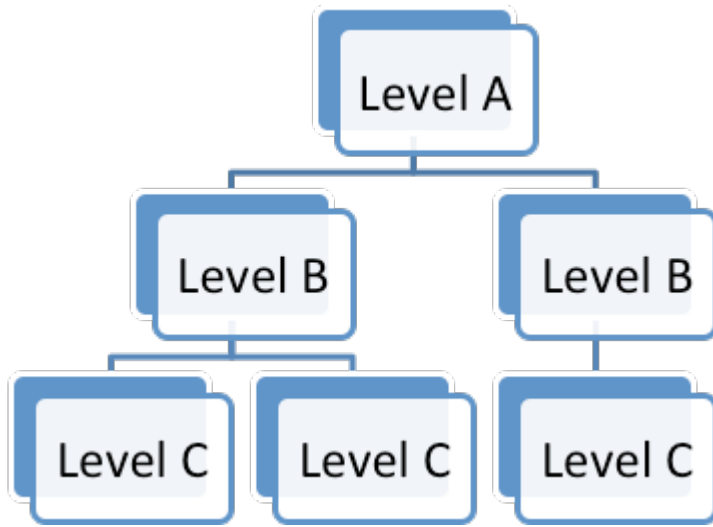
On your worksheet, graphically depict the current organizational (decision making) structure of your business. Fill in names, specific responsibilities, money spending authority, etc., for each significant stakeholder or stakeholder group.

Then, ask them to portray their perception of what the organizational structure of the business should look like at some chosen time in the future (two years, five years, ten years, etc.) on the other sheet. Use these simple tools to begin discussions regarding the development of the projected management transition time line.

### Our Farm Organizational Structure

Future \_\_\_\_\_

On your worksheet, graphically depict the organizational (decision making) structure of your business as you see it at the specified future date. Fill in names, specific responsibilities, money spending authority, etc., for each significant stakeholder or stakeholder



This simple exercise will help begin the process. Once you have these two pictures (what the organization looks like today versus what it will look like in the future), you can then develop a plan to prepare successors with the necessary leadership skills to move from where each individual is now to where they need to be.

## 3.3. Human resource evaluation

People are an essential resource for any business. People are needed to do the daily work, to manage, and to plan, among other things. The skill sets required for each function of business management and operation are different, though some individuals may possess skills that match more than one function. Relative to other resources, labor is somewhat unique in that it cannot be stored for future use. As a part of the transition process, it is important to document who is involved in the current business and what roles they play, what skills are needed (and what skills the business potentially lacks), and how the human resource situation might change over the course of the transition.

Begin with a simple list of all the people currently involved in the operation and positions they fill. This might include a brief description of the duties and responsibilities required for each enterprise and activity of the farm, and how those labor and management requirements are being filled. These needs may be very seasonal in nature, so think in terms of task that need to be done, as well as the timeline within which the work needs to be accomplished. Don't overlook the general management and coordination of the entire operation in this assessment process. You could develop a "human resource diagram" much like the decision making diagram from the previous section to visually portray the current human resource situation for the business.

This examination may reveal critical shortfalls in the current human resource mix, or may reveal that there are times of the year when there appears to be an excess of labor available. It is not just about "hours of labor available" but also how well-suited the various stakeholders are for the roles they are currently filling in the operation. We suggest both a "self-assessment" on the part of the current workforce, and a manager's assessment of each individual currently involved in the operation to gauge the fit between current skills and interests and the duties currently being performed.

For the self-assessment, have each person involved in the operation seriously consider his or her own skills, abilities, and interests. Do they enjoy working and/or living on the farm? What do they enjoy or look forward to the most? How do they feel about conflicting farm and family demands on their time? Do they enjoy certain production activities such as crop production, livestock production, or machinery management, or do they enjoy management activities such as record keeping, marketing, or planning? Key managers in the business

should also conduct their own human resource assessment, consisting of an evaluation of the skills, interests, and abilities of each person involved in the operation. A list of criteria like the following could be utilized, and don't forget to have various members of the management team evaluate each other so that everyone in the operation is included.

<b>Person</b>	
Skill/Trait	Comments (Assessment, self or by others)
Crop Production Management	
Livestock Production Management	
Machinery Management and Repair	
Technology Adoption and Aptitude	
Financial Management	
Marketing Management	
Personnel Management	
Organizing and Scheduling	
Creativity and Innovation	
Decision Making	
Logical Thinking	
Communication /Listening	
Overall work ethic	
Other	

These assessments will provide critical information to facilitate discussions among stakeholders regarding the human resource situation, and will provide background information as transition plans evolve.

The focus will then change to questions regarding who will be leaving or joining the operation and the mix of skills and abilities that will change. Plans can be made to either develop the skills that will need to be replaced, or to begin seeking outside expertise in those areas. One fact of life on the modern farm with the increasing technology and complexity in the industry is that it is much more difficult to fill all of the necessary roles on the farm with one individual. The modern farm will likely require a management team where skills are spread around among several stakeholders. As a part of the transition process, develop job descriptions to help focus on the skills needed and the qualifications of various individuals to fill those roles. Begin developing the necessary skill set in the successor team early so that the transition process can proceed smoothly.

## 3.4. Beginning Farmer Issues and Bringing New Stakeholders into the Operation

As discussed throughout this workbook, transition planning means creating a path forward both for the existing members of the farm business, as well as creating roles for new members. Part of this process may include helping the current members understand the capabilities of those who will be joining the business. Another part will be selecting tools to integrate these new members and facilitate the transfer of management, ownership, and economic participation in the business. This subsection will present tools for both groups to accomplish their goals

### 3.4.1. Presenting your farm experience through a farm resume

The competition for basic resources in agriculture is always intense. It is especially important for beginning farmers to help distinguish themselves from competitors. A farm resume is a tool that can help a farmer to market themselves and their operation. Much like a traditional resume designed to help convince a potential employer that they should hire someone, a business resume (farm resume) is designed to convince others that they should be interested in doing business with the farm.

Important points that could be emphasized in a family farm resume might include information about the family itself, goals and objectives (or even the broader vision of the business), and specific experiences, skills, and history associated with the business. Also one might elaborate on unique equipment, technology, or farming practices that position the farm to be more efficient, productive, or resource friendly. Knowledge in important areas such as risk management or farm program implementation may also be pointed out. Focus on characteristics or resources that outside stakeholders would find appealing. It might also be appropriate to include references, such as current landlords or others who have an interest in your business. Keep the farm resume short and to the point, and make it an attractive easy to read document.<sup>2</sup>

### 3.4.2. Transactional tools for changing roles

There are a wide array of transactions that can be used to help beginning farmers and ranchers begin their ownership and/or management of farm assets. Three primary tools are discussed here: the buy/sell agreement, the leasing of assets, and installment sales.

#### 3.4.2.1. Buy-Sell Agreements

The process of transitioning the current business to the next generation will often result in the creation of a new entity with multiple owners. For example, a limited liability company (LLC) may be formed with the founding generation holding a significant majority of the ownership units with an agreement that units will be sold and/or gifted to the successor generation over time. However, unexpected events can happen. In order to make sure the new entity structure survives an unexpected death such as the a shareholder death, departure, disability, or divorce, a buy-sell (buyout) agreement should be drafted to take care of the business in such contingencies.

A buy-sell agreement is a legally binding agreement between the owners of the business clarifying who can buy the departing individual's share of the business and at what price this transfer will occur. The agreement should also explain the events that will trigger a buyout of an individual. These could be a partner's death, disability or incapacity, divorce (in which the ex-spouse would get a portion of the business as a settlement – this can point to the need of both a buy-sell agreement and a pre-nuptial agreement), bankruptcy or foreclosure on debt secured by business assets, or desire to exit the business.

It is important to keep in mind that the reason for transition planning is to keep the business viable for

future generations. Proper planning is needed to make sure that an external event does not destroy these plans. It is much easier to determine the provisions of the buy-sell agreement before the transition takes place versus after everything is in full operation and then try to fix it.

### **3.4.2.2. Leasing of Assets**

Frequently, the incoming generation is “cash poor” and the older generation needs cash to cover the revenue foregone by exiting the farm business, as well as retirement expenses. Leasing of assets by the older generation to those that are entering the business often aids in this cash flow problem for both groups. Leasing business assets does have some income tax consequences depending upon the lease contract and the assets being leased.

A lease may be categorized as a rental of property (an operating lease or tax lease) or an acquisition of property (a capital lease or conditional sales contract) financed through a lease agreement. If the lease agreement transfers essentially all ownership rights and risks to the lessee, there is an acquisition of property occurring as specified in the lease contract. If ownership rights and risks do not transfer to the lessee, the lessee is simply renting the property. The distinction must be made when accounting for the asset on the books of both parties.

A capital lease is an arrangement that is termed a lease but has the qualities of a purchase. This is why this type of lease is sometimes referred to as a conditional sales contract or a lease-purchase agreement. The lessor may then be considered a dealer who also sells assets or a lender financing the lease. The lessee takes possession of the property and is usually responsible for repair expenses. The lessee is also required to make periodic lease payments which are similar in amount to loan payments that would be required to purchase the asset during the term of the lease. The lessee acquires an ownership interest in the property and also incurs a liability for the principal amount which was financed.

The Farm Financial Standards Council (FFSC) recommends the application of four rules to which are used to determine if a capital lease exists. If any of the four rules apply, a capital lease exists for the lessee and the asset must be capitalized and depreciated in the same manner as if it had been purchased, which can have important tax implications for both the lessor and the lessee.

1. The lease transfers ownership of the property to the lessee by the end of the lease term.
2. The lease agreement contains a bargain purchase option. In this case the lessee has the option to purchase the property at the end of the lease term for an amount which would be significantly less than the value of the property at that time.
3. The lease term is equal to 75 percent or more of the estimated economic life of the property.
4. The present value of the lease payments at the beginning of the lease term is equal to or greater than 90 percent of the fair market value at that time.

If none of the above four rules apply, the agreement is an operating lease. The asset is rental property and the lease payments are treated as operating income by the lessor and operating expenses by the lessee. In addition, ownership of the leased assets does not change.

An operating lease is much simpler to establish and the tax treatment of the payments by both parties is less complicated. In an operating lease the lessee treats the payment as an operating expense and the lessor reports the payment as income. Since the lessor retains ownership of the assets, depreciation deduction is also retained by the lessor.

There is also one tax issue that occurs when only machinery and equipment are leased. In this situation,

the assets are personal property and the IRS considers the lessor of personal property to be in the business of leasing which results in the payment being subject to self-employment tax. To avoid this self-employment tax situation, real property (land and buildings) are the only asset leased or the land, buildings, machinery and equipment are all leased as one unit that is in one agreement.

For additional information refer to fact sheets [AGEC-935: “Capital Leases”](#) and [AGEC-940: “Tax Aspects of Leasing.”](#) You can also find numerous leasing resources at [www.aglease101.org](http://www.aglease101.org) and [www.aglandlease.info](http://www.aglandlease.info). Be sure to discuss the options of leasing with your tax advisor.

### **3.4.2.3. Installment Sale of the Farm**

The decision to retire from farming may lead to the desire to sell the assets and invest the proceeds which are to be used as a retirement fund. Usually the sale of a farm business involves the disposition of farm land, machinery, equipment, marketable inventory plus all the remaining tools of the trade. Special tax rules apply to the sale of depreciable assets and the land that is sold under an installment contract. The sale decision may result in a large income tax liability if all the farm assets are sold in one tax year.

The use of installment sale contract simply means that the income from the sale will be received over a period of two or more years. Therefore the use of an installment sale for a farm liquidation allows for the sale proceeds to be taxed in the year that the payment is actually received. An installment sale is a tax management strategy that can be helpful for the seller to manage taxable income.

In order to fulfill the requirements of an installment sale, the buyer may be obligated to make future payments under a deed of trust, note, land contract, mortgage or some other evidence of indebtedness. It is necessary to properly record the debt, transfer ownership, and charge a reasonable interest rate on the note. The minimum interest rate that must be charged to avoid the “sale” being regarded as a “gift” by the IRS can be found with the help of your tax professional.

The main benefit of an installment sale is that the seller is able to spread the tax resulting from the gain on the transaction over the life of the contract. In addition, the buyer is able to obtain immediate possession of the property. The buyer also does not have to go through the process of acquiring a bank loan or other traditional financing.

A drawback of using an installment sale for all the farm assets occurs with the sale of depreciable assets. Depreciation taken on machinery, equipment, buildings, purchased breeding livestock, and any other depreciable asset must be recaptured as ordinary income in the initial year of sale. This can create a problem in the situation where the sale proceeds received in that year are not sufficient to cover the tax liability.

The sale of non-depreciable assets using an installment sale contract works well. Since there is no depreciation to be recaptured, only the gain from each annual installment is taxable. Therefore an installment sale of land and raised breeding livestock can help manage the income tax liability resulting from the sale since both of these assets are not depreciable.

An installment sale will spread the seller’s income tax liability over multiple years. However it does create risk to the seller in the event that the buyer fails to make good on the contract. Sellers need to evaluate the credit worthiness of the buyer before entering into a sale agreement. In the event that a buyer defaults, the seller may have additional costs of foreclosure and repossession of the property. Be sure to seek proper legal counsel when considering an installment sale.

## **3.5 Business Entities**

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The term “business entity” refers to an organized business that exists, at least to some extent, separately

from its owners. Often, people think of a business entity as something only used for large corporations, but business entities can be used for any size of operation. Business entities can be important tools for business succession. In this subsection, a variety of business entities and their characteristics are presented. Then, using a family farm example, the use of the various entities as transition tools (and the tax consequences of those choices) explored.

As the discussion proceeds, it will examine four basic entity forms: the sole proprietorship,<sup>3</sup> the general partnership (including general and limited partnerships), the corporation (including “C corporations” and “S corporations”), and the LLC.

### 3.5.1. Forming the Entity

Sole Proprietorship: There really is no formation process for a sole proprietorship. Whenever a person starts a business activity without forming any other type of business entity, a sole proprietorship is created. There are no filing requirements necessary to start a sole proprietorship, although if the person operating the business wants to use a trade name, they will need to file a “trade name registration” or “Doing Business As” (DBA) registration.

Partnership: Partnerships require some form of “partnership agreement” among the people forming them, though the requirements for the partnership agreement are very low. All that is needed is for there to be evidence that one or more people intended to engage in some sort of business activity together. That being said, it is a good idea to carefully think through the partnership agreement (including what each partner will contribute to the business, how items of income and loss will be allocated among the partners, how decisions will be made, etc.) and to put the agreement in writing.

In a general partnership, there is no need for a government filing to start the partnership, although, as with the sole proprietorship, a DBA filing will be needed if the business will be using a trade name. On the other hand, creation of a limited partnership does require the filing of a registration form with the Oklahoma Secretary of State. This is because (as discussed below) a limited partnership has at least one “limited partner.” In exchange for the limited partner’s liability protection, the limited partner must register with the Secretary.<sup>4</sup>

Corporation: Both C corporations and S corporations must register with the Oklahoma Secretary of State. The filing made with the Secretary is called the Articles of Incorporation. In addition to the Articles of Incorporation, a corporation must also have a set of bylaws. These bylaws should cover the classes of shares the corporation can issue, the officers of the corporation, how decisions will be made, the rights and obligations of shareholders with respect to the corporation and each other, what happens if the corporation decides to end its business, etc. The owners may also consider restrictions on who can be a shareholder and/or whether the corporation or the other shareholders will have the right (or obligation) to buy the shares of another shareholder if they choose to sell their shares.

LLC: LLCs must also register with the Oklahoma Secretary of State. The filing made with the Secretary is called the Articles of Organization. In addition to the Articles of Organization, the owners of the LLC should create an operating agreement for the LLC. The operating agreement addresses the same issues as the bylaws of a corporation although, as discussed in the following sections, LLCs have much more flexibility in many aspects of the business than corporations do.

### 3.5.2. Liability

Sole proprietorship: The owner of a business operated as a sole proprietorship is personally liable for all of the liabilities of the business. For example, say the sole proprietorship is a custom wheat harvesting business. While harvesting wheat, a fire starts on the combine. The fire spreads to the field and eventually damages several nearby buildings. If the owners of the buildings sue the sole proprietor and win, not only are all the business

assets (such as the harvesting equipment) at risk; all of the owner's personal assets such as his or her home, vehicles, and savings are also at risk. This is referred to as "unlimited liability" and is often a reason that people operating businesses chose a limited liability entity such as a corporation or LLC.

Partnership: In a general partnership, all of the partners have unlimited liability. While someone suing the partnership is generally required to take the partnership assets first to satisfy their claim, if those assets are not enough, they can then take the personal assets of the general partners. Further, partners also have what is called "joint and several liability." This means that if someone sues the partnership but one of the partners manages to evade the suit, the remaining partner is liable for the entire amount of the judgment in the suit. That partner can, in turn, sue the other partner(s) to contribute their "fair share" but if the other partners cannot be found or successfully sued, there is no recourse for the partner that paid the full amount of the suit.

In contrast, the limited partner in a limited partnership has what is called "limited liability." This means the liability of the limited partner is limited to what they have invested in the business. For example, consider the custom harvesting business mentioned in the section on sole proprietorships above. Say that the business was organized as a limited partnership, and that the limited partner contributed \$250,000 to the partnership for the purchase of equipment and payment of other expenses. In this case, when the limited partnership is sued for the damages caused by the fire, and the partnership assets are exhausted, the liability for the limited partner is limited to the \$250,000 he or she invested in the business. If the assets of the business are not enough to satisfy the claims in the suit, the general partner's personal assets will still be at risk, but the limited partner's personal assets are not. This is an important consideration for the limited partner. It is also another reason why the limited partner must be careful not to violate the restrictions on involvement in the day-to-day operations of the partnership, for doing so risks losing the limited liability protection.

Corporation: All shareholders in a corporation enjoy limited liability – only their investment in the business (through their purchase of shares or contribution of assets to the business) is at risk for any liabilities of the business. Corporations are the original limited liability business entity form, as their limited liability was one of the original features of the corporate form when it was established centuries ago. Importantly, though, shareholders can lose their limited liability protection if they fail to respect the boundaries between shareholders and the corporation. One common way this happens is the commingling of personal and business assets, most frequently when shareholders treat the corporation's accounts as their own (making payments that are not salaries, dividends, or documented loans) or vice-versa. Another way limited liability can be lost is when the shareholders fail to follow proper business formalities such as holding regular shareholder meetings, documenting meetings through the recording of minutes, voting on actions of the business, or paying the annual fees for the corporation's filing with the Secretary of State. These actions can enable parties suing the corporation to "pierce the corporate veil," meaning they can destroy the limited liability protection of the shareholders and can thus claim both the corporation's assets and the assets of the shareholders to satisfy their claims.

LLC: As the name "limited liability company" implies, LLCs have the same limited liability features as corporations. Importantly, though, the LLC holds some advantages over the corporation in this regard. For example, an LLC could choose to operate and be taxed like a partnership (even to act as a limited partnership) but all of the members would have limited liability. Thus, it is possible for LLCs to combine all of the liability protections of the corporation but to operate like a partnership if it so chooses. Further, the LLC is somewhat less susceptible to "piercing the corporate veil" since there are fewer formalities required of the LLC than of the corporation. This being said, though, LLC members should still use caution to respect the separateness of the LLC and its members.

### 3.5.3. Entity Ownership

Sole proprietorship: Entity ownership for a sole proprietorship is very straightforward. The sole proprietor of the business is the one and only owner of the business and all of its assets.

Partnership: The partnership is, not surprisingly, owned by the partners. The partnership agreement may specify the contributions of property to business by the partners, and this property may be referred to as “partnership property.” Defining partnership property may be important if the partnership is dissolved, and to some extent if the assets of the partnership are at risk for some liability (though, as discussed below, the risks are different for limited partners in a limited partnership).

Corporation: A corporation is owned by its shareholders. It is important to note the property of the corporation is owned by the corporation itself, not by its shareholders. For example, if a corporation owns a piece of land, the shareholders do not have the right to possession of the land itself. Similarly, the funds of the corporation belong to the corporation and not directly to the shareholders. It is important for the shareholders to respect this separation and not treat corporation property as their own, or vice versa. Failing to do so, or comingling personal and corporation assets can lead courts to rule that the corporation did not exist as a separate entity, thus allowing creditors and others claiming a liability against the corporation to reach the personal assets of the shareholders.

S corporations must have 100 or fewer shareholders. However, in Oklahoma, if any type of corporation (C or S) is going to own agricultural land, it is limited to 10 shareholders unless all of the shareholders are lineal descendants.<sup>5</sup> Other states that limit corporate ownership of farm land include South Dakota, North Dakota, Iowa, Minnesota, Wisconsin, Nebraska, Missouri, and Kansas.<sup>6</sup>

LLC: As with a corporation, an LLC is owned by its members.<sup>7</sup> Property of the LLC is owned by the LLC itself, rather than the individual members. As with corporations, it is important for LLC members to avoid comingling assets. In Oklahoma, if the LLC is going to own agricultural land, the LLC can only have 30 members unless all the members are lineal descendants. Most other states with corporate ownership laws also include LLC’s in the restrictions of those laws.

### 3.5.4. Management and Control of the Entity

Sole proprietorship: Sole proprietors have exclusive control over all aspects of the business.

Partnership: In a general partnership, all of the partners can have the right to participate in all decisions of the business. Partners can, through the partnership agreement, choose one of the partners to serve as a “managing partner” who oversees the day-to-day operations of the business, while all partners share in the “big picture” or strategic decisions of the business. In a limited partnership, the general partner(s) have the right to participate in all decisions of the business. On the other hand, the limited partner(s) cannot participate in the day-to-day decisions of the business; doing so creates a risk that courts would determine them to be general partners and thus lose their liability protection.

Corporation: In a corporation, shareholders have control over the business, but do not directly participate in most decisions of the business. Instead, the shareholders elect a board of directors. The board makes major decisions, chooses when to declare dividend payments to the shareholders, and sets the long-term goals of the business. The board also selects officers for the corporation (who do not have to be shareholders) to manage the day-to-day operations of the corporation. Shareholders still hold ultimate control over the business through their power to vote out officers or directors, to overrule their decisions, or to vote to dissolve the corporation.

LLC: LLCs can choose to be either “member-managed” or “manager-managed.” In a member-managed LLC, all of the members have functions like those of shareholders, directors, and officers in a corporation in that they directly participate in all decisions of the business. This model is typically used only when there is a small number of members who all wish to have an active role in the business. Alternatively, the members of the LLC can choose to be manager-managed; this approach means one or more managers are selected, and function like the officers of a corporation to manage the day-to-day operations of the business. This model is

sometimes chosen by LLCs with many members or when some members do not wish to be part of the day-to-day operations of the business. As with a corporation, the members still retain ultimate control over the LLC with the power to vote out managers, overrule decisions, or to dissolve the LLC.

### 3.5.5. Continuity

Sole proprietorship: There is no business continuity with a sole proprietorship. Since there is no separation between the business owner and the business itself, the loss of the owner means the business ceases to exist in its current form. For this reason, sole proprietorships cannot survive the death of the proprietor, and the sole proprietorship in and of itself cannot be used as an estate planning tool. Sole proprietorships can sell assets and can even transfer clients or “books of business” but doing so dissolves the original sole proprietorship and creates a new one in the purchaser.

Partnership: Partnerships have slightly more of an ability to survive the loss of someone involved in the business than a sole proprietor. Technically, a partnership does not survive the loss of one of the partners, but rather becomes a new partnership. However, for most practical purposes, the partnership is regarded as “surviving” so long as 50 percent or more of the original partnership interest remains in the partnership. If a family-owned business is using the partnership form, it is very important that the partnership agreement include rules governing who can be a partner, including to whom a partner can transfer their interest (if they are even allowed to transfer their interest), if there are certain events that will require them to sell their interest (such as bankruptcy, divorce, inability to participate in the business due to illness, a requirement that a partner’s estate sell the interest if the partner dies, etc.), and if the other partners must approve the addition of a new partner.

Corporation: Corporations can have unlimited continuity if properly constructed. In Oklahoma, the corporation’s articles of incorporation can specify the corporation’s existence as either limited to a set period of years, or to be perpetual (this is the case for most other states as well). The potentially unlimited existence of corporations (as well as LLCs) gives them a significant advantage as a business transition tool. Corporations can add or lose owners simply through the purchase or sale of stock. For large, publicly-traded corporations, this happens thousands of times per day, with no impact to the business. For smaller corporations, though, adding or losing owners can have more of an effect, since the shareholders are likely more directly involved in the business. Thus, for small corporations, it may be advisable to have rules such as those discussed for partnerships governing who can (and who cannot) be shareholders. Corporate law imposes more restrictions on these rules, and requires certain rights for shareholders, than is the case for LLCs, giving LLCs more flexibility in this area. Given this, and the fact that it can be difficult for shareholders in small corporations to sell their shares, the shareholders should consider whether “redemption” or “buy-sell” agreements (discussed in subsection 3.4.2.1 above) should be enacted. These agreements govern how either the corporation itself (in a redemption agreement) or other shareholders (in a buy-sell agreement) will purchase shares in case a shareholder wants or needs to sell them. Such agreements can also be triggered by the death, divorce, disability, or bankruptcy of a shareholder.

LLCs: As with corporations, LLCs can have potentially unlimited existence if properly constructed. This gives them much flexibility as a business transition tool. Just like corporations, LLCs can change members by the purchase and sale of membership units. LLCs do have an advantage over corporations, though, in that they have much more flexibility in setting restrictions on only on who can and cannot be members of the LLC, but also in restricting the transfer of units. While this can be beneficial in crafting an LLC specifically to hold and transfer a family business, it also requires the business members to use extra caution in crafting the operating agreement, along with any redemption and/or buy-sell agreements associated with the business.

### 3.5.6. Salaries, Dividends, and Other Distributions of Income

Please note that a fuller discussion of some of the issues regarding the distribution of salaries, dividends, and other distributions of income can be found in the discussion of the tax implications of the various entity

forms in the following subsections.

**Sole proprietorship:** Salaries, dividends, and other distributions of income are irrelevant to sole proprietorships, as there is no separation between the business and its owner. While the business owner may maintain separate bank accounts and accounting records for the business and his or her personal accounts, the law makes no distinction between the two. As a result, transfers of payments between the business and individual carry no legal consequences.

**Partnership:** Partnerships have some flexibility in allocating payments among the partners. Partnerships can pay salaries to the partners (though care must be used in a limited partnership; remember that a limited partner is not allowed to participate in the day-to-day operation of the partnership). Another payment that can be made to partners is a “guaranteed payment,” which is similar to a salary but is made regardless of the amount of income of the partnership (as opposed to other payments which may depend on both the income of the partnership and the partner’s percentage of ownership in the partnership). Partnerships technically do not have “dividends.” However, partnerships also have the flexibility to distribute the income of the partnership either in proportion to the partners’ percentage of ownership or out of proportion to that percentage. Making distributions out of proportion to the ownership requires language permitting such distributions in the partnership agreement.

**Corporation:** Corporations can pay salaries to their officers, and can also pay stipends to their boards of directors. Salaries are also deductible in the case of C Corporations, since they are taxed as a separate entity, but salaries are not tax-deductible for S Corporations. Unlike partnerships, neither C corporations nor S corporations are allowed to make distributions of income, such as dividends, out of proportion with the shareholders’ ownership. However, corporations can create different classes of stock (such as “preferred” stock and “common” stock). These classes of stock may be treated differently; for example, preferred stock might receive a dividend in some years that common stock does not. However, within each class of shares, each shareholder must be treated the same in proportion to their share ownership.

**LLC:** LLCs can pay salaries to their offices and stipends to boards of directors. The tax deductibility of these payments depends on whether the LLC chooses to be taxed like a C corporation or as a partnership (discussed in subsection 3.5.7.3 below). The ability of the LLC to pay dividends and other distributions of income (and to make such distributions out of proportion to the member’s ownership percentages) also depends on the tax treatment chosen by the LLC. Generally, though, LLCs have more flexibility than corporations in choosing how to make payments to their members.

### **3.5.7. The Business Entity as Farm Transition Tool**

How can a business entity serve as a farm transition tool? As discussed earlier in this handbook, the three reasons so many farms fail to successfully transition from one generation to the next are inadequate estate planning, inadequate capitalization, and a lack of communication and opportunities for those involved with the operation to grow into their new roles. When used carefully, a business entity can help address all three of these concerns.

Business entities can help deal with the estate planning issue by providing another estate planning tool. For example, as discussed below, business entities can be used to help property get an increased tax basis before its contribution to the farm business, thus reducing the future tax liability for the business. Entities can also be used to gradually gift portions of the business to potential heirs without incurring gift tax liability.

Business entities can also help deal with the capitalization of the farm business. Since having a business entity requires a separate set of accounts, it can clarify recordkeeping and make the profitability (or lack thereof) more easily determined. It can also allow for more transparency in how the members of the business invest in it, which can actually encourage additional investment.

Last, but certainly not least, a business entity can create more opportunities for family members to gradually increase their involvement in the farm business. If the founding generation is reluctant to “hand over the reins” to the next generation because they are concerned they don’t have enough management experience to profitably lead the operation, a business entity can create the opportunity to slowly increase the amount of management responsibility the next generation has. Gifting or selling small amounts of stock will increase the investment and decision power the recipient has over time, rather than transferring all of the assets at death, as is typically the case.

To explore how the business entity can be used as a farm transition tool, consider the following example. Ward and June currently operate their farm business as a sole proprietorship with Ward as the sole proprietor. They have three children: Tom, Dick, and Harry. Two of them (Tom and Dick) want to come back to the farm while the third (Harry) has little interest in the farm business but has a sentimental attachment to it. Ward and June have decided that they wish to transition the business and now must consider the types of business entity to select based upon a variety of tax and non-tax items. They are considering a partnership, S corporation, C corporation, or Limited Liability Company.

The assets in the business include land, buildings and improvements, machinery and equipment, and livestock. Their home is on the land, but since it will continue to be their home even as the rest of the assets are transferred in the transition plan, it is to be kept separate. In addition to the issue of how to best transition the farm business to the next generation, the family must also consider the income tax implications for the transfer of the assets to the various types of entities.

### 3.5.7.1 Basic Tax Considerations with Business Entities as Transition Tools

Ward and June must decide what assets they are going to contribute to the entity of choice. The farm’s asset information is as follows:

Asset Description	Fair Market Value	Cost Basis	Accumulated Depreciation	Adjusted Basis
Land	\$3,500,000	\$750,000	–	\$750,000
Buildings & Improvements	\$500,000	\$800,000	\$650,000	\$150,000
Machinery & Equipment	\$400,000	\$700,000	\$400,000	\$300,000
Raised Breeding Livestock	\$350,000	\$0	–	\$0
Purchased Breeding Livestock	\$20,000	\$25,000	\$15,000	\$10,000
Market Livestock	\$80,000	\$0	\$0	\$0
Totals	\$4,850,000	\$2,275,000	\$1,065,000	\$1,210,000

The first item they consider is the land. The contribution of the land into an entity must be carefully evaluated, because it will have some long-term tax implications. The land has considerably appreciated in value since it was purchased for \$750,000 (here, the purchase price is the “cost basis” of the land) and is currently worth \$3,500,000. This means the land has increased in value (“appreciated”) by \$2,750,000 (\$3,500,000 current market value - \$750,000 cost basis = \$2,750,000). If Ward and June were to sell the property right now, they would pay capital gains tax on the \$2,750,000 appreciation (or capital gain) on the property. Capital gains are taxed at much lower rates than ordinary income<sup>8</sup> but the capital gain still represents a tax cost. On the other hand, if Ward and June held on to the property until their death, the property’s cost basis would be “stepped up” to its fair market value at the death of the last party to hold the property. For example, if Ward and June were to die today, the cost basis in the property would be stepped up from \$750,000 to the current fair market value of \$3,500,000. If the property were then sold, there would be no capital gains tax, since the capital gain on the property would then be zero (\$3,500,000 fair market value - \$3,500,000 cost basis).

Now, what if Ward and June contribute the land to a business entity? In such a case, the property would

keep its cost basis of \$750,000 (instead of receiving a stepped up basis at Ward or June's death). If the entity were eventually to sell the property, it would have to pay capital gains tax on the excess of the property's fair market value at the time of the sale over the \$750,000 cost basis. In addition, if the entity of choice is a C corporation, capital gain is taxed at the same rates as ordinary income which is much less beneficial than the capital gain treatment received by an individual. None of this may be a problem if the entity is never terminated or if none of the land is ever sold. However, what if Ward and June keep the land in their name and rent it to the entity, they will have source of income as well as the opportunity to allow the cost basis of the land to be stepped up to market value at their date of death. This will allow the transfer of the land to obtain a significant tax advantage at that time. Ward and June could let their estate plan contribute the land into the existing entity with this higher basis.<sup>9</sup>

If Ward or June contribute assets to a business, they likely will receive an interest in the business in return. As discussed above, once assets are contributed to a business, it is the business that owns them, not the people who own interests in the business. Thus, the tax treatment of the assets contributed and the business interest received are handled differently. For example, say June contributed a piece of land to the business entity that was worth \$250,000 at the time of the contribution, and that the land was purchased for \$200,000. She receives an interest in the business entity valued at \$250,000, and the business entity gets a piece of land with a cost basis of \$200,000. Further, assume that due to the success of the business and the appreciation of its assets, the value of June's interest at death has grown to \$300,000. June's business interest will receive a stepped up cost basis of \$300,000. However, the business' cost basis in the asset June contributed will remain at \$200,000 (June's cost basis in the property at the time it was contributed).

Should Ward and June decide that they need some additional cash at the time the entity is established, they could sell some assets to the entity instead of contributing them for ownership interest. For example, if they sell all of their machinery and equipment to the entity at its fair market value of \$400,000 they would get \$400,000 of cash but would have a tax liability since the assets have been depreciated to the point that the adjusted basis is \$300,000 (\$700,000 cost - \$400,000 depreciated value = \$300,000 adjusted basis). If Ward and June are in the 20 percent ordinary income tax bracket, the sale of all the machinery and equipment will result in a tax liability of \$20,000 due to a taxable gain from the sale of \$100,000 [(\$400,000 sale value - \$300,000 adjusted basis = \$100,000 taxable gain) x 20%]. It is important to work with a tax advisor to evaluate all the potential income tax consequences of the sale transaction.

Partnerships, corporations, and LLCs each carry their own unique tax considerations when family members contribute assets to the business entity. These considerations are discussed with each business form below.

Another tax issue is the self-employment tax. Most taxpayers working for an employer have FICA and Medicare withheld from their wages. The amount withheld is matched by their employer. Consequently, they will receive retirement and medical benefits when they reach retirement age. They are also entitled to disability and survivor benefits. The self-employed individual must pay self-employment (SE) tax to be entitled to similar benefits. This is paid when they file their federal income tax return. The SE tax rates equate to both the employer's and employee's share of FICA and Medicare.

Any income other than salary or wages is "earned income." Therefore, a person operating a farm or ranch they own or rent must pay SE tax on the profits. A person must "actively participate" in the operation to have SE income. Individual taxpayers that are involved in a business entity that is a sole-proprietorship, partnership, an S corporation or an LLC electing to be taxed as a single member LLC, partnership or S corporation will be subject to the SE tax. Individuals that are employees of a C corporation or an LLC electing to be taxed like a C corporation are not subject to the SE tax since the corporation pays the employee's portion of the FICA and Medicare tax due. For more detailed information concerning the SE tax and rules visit the [RuralTax.org](http://ruraltax.org) website using the following link: <http://ruraltax.org/htm/tax-topics>.

### **3.5.7.2. Partnerships as Transition Tools**

The creation of a partnership – specifically a limited partnership – between Ward, June, Tom, Dick, and Harry is one possible solution. A limited partnership would allow the non-farming son (Harry) to have an interest in the business without the issue of his personal assets being at risk. The general partners will include Ward, June, Tom, and Dick but not Harry. Harry would instead be the limited (non-managing) partner. Harry could receive a guaranteed payment from the business or he could receive a share of the profits; since he is a limited partner, his income will not be subject to self-employment tax since limited partners will generally not be participating in the business.

The partnership agreement formed by the family will need to include the terms for the sharing of partnership profits, gains, losses, deductions, and tax credits among the general partners. It will also explain how Harry will benefit from the business. The income generated from the business will be taxed to the partners, not the partnership. Income received by the partnership will be taxed even if the partnership retains the income and does not distribute it to the partners. In addition, losses and tax credits will be passed to the partners as well. The partnership agreement can also provide special allocations of income items such as rent for the land versus ordinary income from the sale of crops or livestock.

When the partners contribute assets to the partnership, the contribution is not a taxable event. For example, consider again June's contribution of a piece of land with a cost basis of \$200,000 (her original purchase price) and a current fair market value of \$250,000. If June were to sell the land to the partnership, she would have a taxable capital gain of \$50,000 (the \$250,000 current fair market value minus her \$200,000 cost basis in the property). However, if she only receives a partnership interest in return for her contribution (that is, she does not receive cash for the sale but only an interest in the partnership), there is no taxable event, and no capital gains tax is owed.

The contribution of machinery, equipment, and the breeding livestock plus the value of any assets contributed by Tom and Dick would then be used to determine the partnership interest for the various parties. It must be noted that no partner would want to own 50 percent or more of the interest in the partnership since the sale, exchange, or estate transfer of the 50 percent partner's complete interest will terminate the partnership.

A partner may acquire a partnership interest by providing services. If the contribution of services allows the partner to get an interest in the assets or capital that has been contributed the partner will be taxed on the value of the interest received but if the contribution of services is to be paid from future profits the taxes are assessed when profits are received as payment.

It is important to work with a qualified accountant when establishing a partnership since the tax law associated with partnerships is extremely complicated. It is also important to work with a qualified attorney to make sure the partnership agreement is drafted properly to ensure that the desires of all the parties involved are met.

Finally, it is important to note that only Harry, the limited partner, has any liability protection through the limited partnership arrangement. Ward, June, Tom, and Dick are all jointly and severally liable for the partnership. It should also be noted that Harry runs the risk of losing his limited partner status if he becomes too involved with the day-to-day operations of the business.

### **3.5.7.3. Corporations as Transition Tools**

Much thought must go into the decision to establish a corporate entity. For the purpose of farm business transitions the discussion will be limited to C corporations and S corporations. Both entities will result in the owners receiving stock representing their ownership. A corporation will also limit the liability of all shareholders unlike a partnership. The creation of a corporation requires the filing of articles of incorporation, the creation of by-laws, and the holding of regular corporate meetings with minutes of those meetings being kept. In addition,

an annual franchise tax must be paid.

Corporate shares, whether C corporation or S corporation shares, can facilitate the transfer of the business from parents to children as well as others such as grandchildren over time. It is quite simple to transfer shares of stock to others since the signing of a share certificate accomplishes the transfer. C corporation stock can be sold, gifted, or inherited as well. Creating a sizable number of shares will make gifting easier as well as making sure that the gifts are below the annual gift tax excludable amount. Further, a large number of shares provides more flexibility to gradually increase family members' ownership over time, giving them the ability to slowly grow into more and more important roles in the corporation.

C corporation: A C corporation is taxed separately from its shareholders. This provides some advantages and disadvantages for tax purposes. One issue is the impact of "double taxation." If the corporation makes a profit, that profit is reported on the corporation's tax return at the corporation's tax rate. Then, if the corporation pays dividends and/or salaries to shareholders, those shareholders report those payments on their personal tax returns and pay tax at their personal income tax rate. Thus, payments to the shareholders effectively have been "double taxed" – once at the corporate level, and again at the individual level. Upon learning this, many people wonder why anyone would choose the C corporation form, but there are potential tax advantages to it. One of the major benefits of a C corporation is that fringe benefits such as health plans and retirement plans paid for the benefit of the employees are deductible by the corporation. To deduct these costs, the corporation must pay reasonable salaries to all employees but the salaries paid are deductible by the corporation, avoiding self-employment taxes. Thus, depending on the circumstances, the shareholders might actually receive more after-tax value by using a C corporation than an entity that is not separately taxed.

If and when the family contributes assets to the C corporation, the contribution of assets will result in the contributor receiving shares in the business. Shareholders can be given voting or non-voting shares. The voting shares can be held by those family members active in the day to day business operations (Ward, June, Tom, and Dick) and non-voting shares to the inactive members (Harry). The shares of stock then represent the ownership by the shareholders.

The contribution of property in exchange for shares of stock does not necessarily result in a taxable exchange. A taxable exchange occurs when the transferor receives shares as well as other property in the exchange. If shares are the only items received, no taxable event occurs. If everyone, as a group, that transfers assets into the corporation controls at least 80 percent of the voting stock and at least 80 percent of all other classes of stock then the basis of all the assets contributed will be the same after the transfer as the basis before the transfer which also ensures that a taxable event is avoided. It is a rare situation where the individual shareholders will not control at least 80 percent both voting and other classes of stock. This rule is most often triggered when one corporation owns another corporation; this is not common in a closely-held corporation as presented in this material.

S corporation: An S corporation avoids the double taxation issue since it is not taxed separately. All the income, expenses, gains, and losses pass through to the shareholders, who report these items on their individual tax returns. Thus, an S corporation is taxed, in effect, like a partnership. For this reason, the use of an S corporation can have an advantage over a C corporation if the business will experience periods of losses (as can happen in agriculture), since those losses can be passed along to the shareholders and deducted from their taxes.

Like a C corporation, the contribution of assets to the S corporation most often results in the contributor receiving shares of stock. However, an S corporation can only have one class of stock, which is common stock. This generally implies that all shares of stock have exactly the same rights for each of the holders. In other words, each share will receive the same distribution of profits in the corporation. Therefore there cannot be any discrimination from one shareholder to another. In our example, this might be problematic since Harry is probably playing a much different role and making different contributions to the operation and growth of the farm than Ward, June, Tom, and Dick.

This common stock can be either voting or non-voting. The voting shares can be held by family members active in the day to day business operations (Ward, June, Tom, and Dick) and the income that is generated will be subject to self-employment tax for those individuals who “materially participate” in the farm business. “Material participation” requires that the individual be actively involved in the production of crops and livestock, take a management role, and be actively involved in the business. The non-voting shares are again received by Harry and his income is not subject to self-employment tax since he is not materially participating in the business.

One issue with an S corporation is the need for more detailed bookkeeping to document each individual’s basis in their stock, document adjustments in their capital accounts, and to determine the tax liabilities associated with their distributions. This is due to the fact that S corporation income is not taxed at the corporate level. All the income, deductions, losses, and gains flow from the entity to the shareholders. The amount of losses and deductions that a shareholder can take is limited the adjusted basis of the shareholder’s stock. A variety of items will increase and decrease a shareholders basis. Therefore it is necessary to do a good job of bookkeeping because income will increase the basis while losses will decrease the basis. Basis is increased when a shareholder contributes cash or other assets to the entity. All of these must be documented and the tax information provided to all shareholders must contain this information as per IRS regulations.

Again, the contribution of property in exchange for shares of stock does not necessarily result in a taxable exchange. A taxable exchange occurs when the transferor receives other property as well as stock in the exchange. If stock is the only item received, no taxable event occurs. If everyone, as a group, that transfers assets into the corporation, controls at least 80 percent of the voting stock and at least 80 percent of all other classes of stock then the basis of all the assets contributed will be the same after the transfer as the basis before the transfer which also ensures that a taxable event is avoided (this is the same 80 percent rule as discussed with C corporations above).

#### **3.5.7.4. LLCs as Transition Tools**

As discussed above, LLCs are very flexible entities. The creators of an LLC can choose to have the entity taxed as an individual (a single member LLC also referred to as a disregarded entity),<sup>10</sup> a partnership, or separately taxed like a C corporation. Thus, an LLC allows for a greater level of flexibility in management, control, income distribution, and taxation than either partnerships or corporations.

An LLC may be most beneficial in the transition of the farm business when it chooses to be taxed as a partnership. This avoids the double taxation issue of a C corporation, the S corporation limitations,<sup>11</sup> and compensation and income distributions can be disproportionate among the various members if they so choose. An LLC’s operating agreement can establish that each individual member can receive specific types of income or payments, receive voting or non-voting rights, and management rights can be reserved for only certain members. The operating agreement can easily be amended as the business transition progresses.

LLCs do not have stock that is issued to owners contributing property; instead, they issue membership units. As with corporations, the contribution of property to the LLC is not a taxable event so long as the member receives an ownership interest instead of receiving other property. Managing members in the LLC will be subject to self-employment taxes.

As with corporate stock, the membership units in an LLC can facilitate the transfer of the business from parents to children and grandchildren over time. It is simple to transfer a percentage of a person’s interest and also keep the value below the annual gift tax exclusion amount. The interest can also be sold, gifted, or inherited as well. Thus, as transition tools, LLCs have virtually all the advantages of corporations, with additional flexibility.

#### **3.5.7.5 Single-Member LLCs with Land and Minerals**

Land and mineral interests can present special challenges in transition planning. Since these assets

can sometimes appreciate significantly in value, the tax treatment of that appreciation is an important factor to consider. At the same time, many land and mineral owners also want to protect such assets from liability risks. The following discussion examines the use of an additional entity – the single-member LLC – to hold assets that would benefit from a step-up in fair market value at the date of death of the owner, and that also require some measure of liability protection.

Before discussing the advantages of the single-member LLC, it is useful to examine the potential problems posed by other entity forms in this context. Using a partnership, corporation, or a multi-member LLC to transfer land or minerals can “trap” the low cost basis of the assets in the entity. If there is a need or desire to sell the assets, the capital gain tax can be significant.

To illustrate the capital gain issue, assume that a 160 acre parcel that was contributed to the entity when it was created is to be sold. The fair market value is now \$2,500 per acre (for a total current fair market value of \$400,000 for the entire 160 acre parcel) and the cost basis of the parcel was \$500 per acre (for a total cost basis of \$80,000). If the property were to be sold, the amount subject to capital gain tax treatment is \$2,000 per acre (\$2,500 current fair market value per acre minus \$500 cost basis per acre) or \$320,000. If the capital gain tax rate for the partners is 20 percent, the amount of tax owed on the sale would be \$64,000.

Now, what if the contributor did not contribute the land when the entity was created, but held it until his or her death and transferred it to the entity as part of his or her estate plan? In this scenario, the property would receive a stepped-up basis to the fair market value at the date of death of the contributor. Assume that the fair market value of the land was \$2,250 per acre at the date of death; this now represents the stepped-up basis of the property. If the partners now sell the land for \$2,500 per acre (and assuming the same 20 percent capital gain tax rate), the capital gain per acre would be \$250 per acre (\$2,500 fair market value per acre minus the \$2,250 cost basis per acre). Now the total amount of tax on the gain would be \$8,000 compared to the \$64,000 without the stepped-up basis.

While holding onto the land until death allows for stepped-up basis, there may be a desire to obtain the liability protection provided by an entity like an LLC. The creation of a single-member LLC (a disregarded entity for tax purposes) allows the land to be held by the parents and still have the LLC’s liability protection. From the standpoint of both income and estate taxes, the assets put into a single member LLC are still controlled by an individual (the transferor) who pays the income tax generated from the assets and also controls them from an estate tax perspective. As a result, the property in the single-member LLC is eligible for a step-up in basis at the date of death.

## 3.6. Conclusion

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Business entities can provide a number of advantages for a farm business, both in and of itself, and in the context of preparing the business for a transition. As this discussion has demonstrated, there are many, many factors to consider in selecting a business entity for the farm business. It is critical to determine what the goals and objectives of those that will be involved in the business as well as the other heirs. The selection of an entity should be thoroughly analyzed with the help of a qualified legal and tax professionals. With careful work, the farm business entity can help preserve the farm business for generations to come.

## For More Information:

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Internal Revenue Service – Business Structures

<http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Business-Structures>

## Small Business Administration – Choose Your Business Structure

<https://www.sba.gov/category/navigation-structure/starting-managing-business/starting-business/choose-your-business-stru>

## Small Business Taxes & Management: Choosing the Best Entity--A Practical Approach

<http://www.smbiz.com/sbfaq023.html>

## Business Entities Journal

<http://store.tax.thomsonreuters.com/accounting/Finance/Business-Entities/p/100200619>

## ENDNOTES

<sup>1</sup> [The other two structures are financial structure \(debt versus equity financing, discussed earlier in section 1\), and legal entity structure, discussed later in this chapter.](#)

<sup>2</sup> [An example of a farm resume template that outlines the approach discussed here is University of Missouri Extension Farm Management Fact Sheet G-420, “Designing a Farm Resume.”](#)

<sup>3</sup> [It could be argued a sole proprietorship is not technically a business entity since it has virtually no existence apart from that of its owner. However, it is useful to contrast the sole proprietorship with the other entity forms, and thus it has been included in this discussion.](#)

<sup>4</sup> [For limited partnership registration forms and procedures, visit the Oklahoma Secretary of State’s website at https://www.sos.ok.gov/business/forms.aspx.](#)

<sup>5</sup> [“Lineal descendants” here means all of the shareholders must be descendants of the same people – for example, all the shareholders would have to be part of the same family of parents, children, grandchildren, great grandchildren, etc.](#)

<sup>6</sup> [See National Agricultural Law Center, “Corporate Farming Laws,” available at http://nationalaglawcenter.org/research-by-topic/corporate-farming-laws/.](#)

<sup>7</sup> [Owners of a portion of a corporation are referred to as “shareholders,” whereas owners of a portion of an LLC are referred to as “members.”](#)

<sup>8</sup> [Capital gains are taxed at rates ranging from 0% to 20% depending on the tax bracket of the taxpayer, compared to rates ranging from 10% to 39.6% for ordinary income.](#)

<sup>9</sup> [This subsection will discuss more considerations regarding land and minerals later.](#)

<sup>10</sup> [For purposes of a farm transition the following discussion will not cover the single member LLC.](#)

<sup>11</sup> [That is, being limited to one class of stock and having no more than 100 shareholders.](#)



# FARM TRANSITIONS

**Chapter 4**

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# Estate Planning

## 4.1. The Role of Estate Planning in Transition Planning

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If you recall from the introduction to this handbook, there are three primary reasons farm businesses fail to successfully transition from one generation to the next:

- Inadequate estate planning
- Insufficient capitalization
- Failure to prepare the next generation properly

As discussed earlier, all three of these causes are linked, but many of the problems of a generational transfer start with the estate plan, or more frequently, the lack of one. The lack of a carefully considered and well-drafted estate plan can cause a number of problems that can either deplete much-needed farm resources or result in its complete breakup at the death of one of the founding members. If no estate plan is in place, the intestate succession rules can result in the division of farm assets among family members whose economic incentives are to simply sell them (and the best price may be offered to someone other than a farm heir). If there is a plan but it has not been discussed with the family and some members wish to contest it, the ensuing litigation can drain resources from the estate and “freeze” assets that could be put to profitable use otherwise. The list of problems potentially caused by the lack of an estate plan could go on and on, but for the purposes of this workbook, some of these considerations are included in the introduction.

At this point, it is enough to say that a sound estate plan is critical to the overall transition plan. Remember – the business succession plan will work to gradually transfer control of the overall business to the next generation. That transfer will obviously require the transfer of the ownership interest held by the founding generation, and this is where the estate plan enters the picture. The estate plan provides the procedure by which the ownership interests held by the founding generation will be transferred either while its members are alive (through lifetime gifts) or after they have passed away (through the estate). Thus, depending on the amount of ownership retained by the founders, the estate plan can be a tremendously important element of the overall farm transition plan.

The following subsections will discuss several of the tools important to every estate plan.

## 4.2. Essential Estate Planning Tools

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When estate plans are discussed, almost everyone’s minds jump instantly to the will. While the will is unquestionably a tremendously important estate planning tool, there are a number of other tools that are vital to managing a number of business and health matters that can arise with the estate.

### 4.2.1. Guardian Nominations

Young people often think estate planning is not a concern for them. However, anyone with children under the age of 18 should consider how to provide for the care of those children until they achieve the age of 18 or older.

One of the most critical pieces for parents to have is a guardian nomination for minor children. This document specifies who the parents would like to have guardianship of their children in the event both parents die. Courts pay a great deal of deference to this instrument when the time comes to grant legal custody of the

children. In Oklahoma, as well as several other states, the court must approve the guardian's appointment and transfer custody of the child to the guardian. The guardianship nomination may be a separate document, but it can also be incorporated into the wills of the parents (and often is).

Selecting a guardian for one's children (commonly called a "godparent") is obviously a tremendously important decision. Parents should discuss the matter thoroughly, considering a number of factors. If grandparents are considered, will they be able to handle the challenges of caring for a young child as they themselves continue to age? What is to happen if the grandparents should pass away before the child is 18 years old? If other family members or non-family members are considered, will they raise the child in accordance with the parent's values, child-raising philosophy and religious beliefs? Will they be close enough geographically to allow other family members to visit for holidays and other special events in the child's life? Should the nominee be married or single? Does the nominee already have children, and what if they eventually have more? Is the nominee capable of caring for the number of children you have?

It is critical to discuss the potential guardianship nomination with the nominee(s). While being nominated as a guardian may be a wonderful honor for the nominee, they may also feel they are not comfortable with the nomination. It is far better to learn this prior to enacting the nomination than after custody has already been transferred. Also, consider nominating successor guardians – someone who will be nominated as guardian in case something should happen to the first nominee.

Another important consideration is whether the estate plan will provide any resources to the guardian for the care of the child. While it is common for the child to receive property from the parents' estates, this property is often held for distribution to the child when he or she turns 18. Additionally, there is no legal requirement for the guardian to support the child out of his or her own pocket. Finally, what about providing funds for college or other educational costs of the child? Parents should consider granting some property of the estate to the guardians or the creation of a "minor maintenance trust" to provide financial resources for the care of the child. There are a number of ways this can be achieved, ranging from a direct gift to the guardian to the creation of a maintenance or special needs trust for the child that makes payments to the guardian. You may also wish to consider whether there should be any compensation directly to the guardian for their efforts

Lastly, it is important that guardianship nominations be kept somewhere they are readily accessible to the nominee and to the parents' attorney. While many such important documents are kept in a safe deposit box, access to the box will be restricted in the event of the parents' death. This can cause problems in getting children into the care of the guardian as quickly as possible. Consider sharing copies of the guardianship nomination with the nominee and with your attorney.

#### 4.2.2. Beneficiary Designations

Many investment accounts and employee benefit programs include a provision in their contracts allowing you to designate a beneficiary to receive the value of the investment or other instrument if you should pass away. A "payable on death" ("POD") provision on a bank account is another example. These provisions, called

#### Factors to consider in a guardianship nomination

##### The guardian or guardians

- Age of the guardian
- Marital status
- Current number of children (both yours and theirs)
- Child raising philosophy
- Values
- Religious beliefs
- Location / proximity to other family

##### Who could be a successor guardian

##### Financial support

- Funds for care of child
- Funds for educational expenses
- Compensation to the guardian

##### Arrangements for access to guardian nomination documents

##### Discuss guardian nomination with nominees

“beneficiary designations” are inexpensive, convenient, and effective estate planning tools that are frequently overlooked. Because the beneficiary designations are legally binding contractual obligations, the items they transfer at death do not have to go through the probate process.

If you hold any investment accounts, bank accounts, or benefit plans, ask the institution managing the asset if it has a beneficiary designation. If so, you can use the beneficiary designations to specify a recipient of the asset upon your death. Some designations also allow for “contingent beneficiaries” to be designated. For example, a spouse could be named as a primary beneficiary, and a child named as a contingent beneficiary. In this case, if your spouse dies before you, the child then becomes the primary beneficiary.

Consider what is the best use of the asset. To best achieve the overall goals of your estate plan, who (or what) should receive the asset? If you are trying to arrive at an equitable treatment of off-farm and on-farm heirs, would it be better to designate the asset to an off-farm heir in favor of granting more farm-related assets to the on-farm heir. Since investment accounts may be more liquid (that is, quickly converted to cash with little or no loss in value), would it be better to use them for the payment of estate debts or to give them directly to a specific recipient? There is no right or wrong answer to this question – it is simply one consideration in your overall estate plan.

It is important that you keep records of your beneficiary designations and update them if there are changes in your life. For example, if you execute a beneficiary designation while single and then marry, you may want to update the designation. Any significant change such as marriage, divorce, and the birth or death of a family member means a review of beneficiary designations is wise. Also, if your investment or benefit plan is provided by an employer and you change jobs or retire, you should determine what if any benefits of the asset are still available and adjust both the beneficiary designations and your overall estate plan accordingly.

Since beneficiary designations affect the distribution of property at death, your beneficiary designations need to be carefully coordinated with your overall estate plan to make sure the same asset is not dealt with twice, such as attempting to distribute the asset through both a beneficiary designation and a will or trust.

### 4.2.3. Power of Attorney

Many people have heard of a “power of attorney” but few understand what it is or how it works. Think about a power of attorney in this way: If you need someone to represent your legal rights in court, you hire an “attorney at law” and give them the power to act on your behalf; in the legal matter, they act as you and with your authority. In a similar way, if you need someone to represent you in some other capacity, you can appoint an “attorney in fact” – a person who can act as you and with your authority outside the courtroom.

The power of attorney is, as the name implies, an important power. Essentially, someone who holds your power of attorney is treated as if they were indeed you. This means that, depending on the document that granted them the power, they can execute contracts, buy or sell property, or make payments in your name. Because this is such a significant amount of power for someone to have over the affairs of someone else, you must always carefully monitor whoever you have given this power to make sure they are using it in accordance with your wishes. For this reason, the law automatically revokes the power if the person that granted it becomes

#### Factors to consider in beneficiary designations

Does the investment / benefit plan asset offer beneficiary designations?

Are primary and contingent beneficiary designations available?

Where does this asset fit in my estate plan?

Who (or what) should receive this asset?

When to review the beneficiary designation

- Funds for care of child
- Marriage
- Divorce
- Birth of a family member
- Death of a family member
- Change of job (in the event of employer-provided benefit)

mentally incompetent (that is, the person is deemed mentally incompetent by a physician or is in some other way incapable of understanding what is going on around them).

If a person is deemed mentally incompetent, they are legally incapable of forming contracts or engaging in other business transactions, which frequently means the person's family must to the court and ask for a guardian to be appointed<sup>1</sup> for the incapacitated person. This process can take time, requires the testimony of physician, and may result in the appointment of a guardian other than the one the person would have chosen for themselves. As an alternative, a "durable" power of attorney can be used. Unlike ordinary powers of attorney, a durable power of attorney remains valid even if the person granting it is deemed mentally incompetent. If the power of attorney is comprehensive enough, it may eliminate the need to go through the guardianship procedure. Some people choose to create a power of attorney that is also "springing" which means that it is only activated ("springing" into existence) when the person is deemed mentally incompetent. This means that the power does not exist while the maker is competent, reducing the opportunity for the person receiving the power to do anything against the wishes of the person granting it.

Powers of attorney can be tailored to give the recipient very specific or very broad powers. For example, if you are traveling out of the country but need someone to sign a real estate contract in your absence, you could create a power of attorney giving the recipient only the power to sign that specific contract. Alternatively, if you want to avoid the need for a guardianship in the event you are deemed mentally incompetent, you could grant a durable power of attorney granting the recipient the power to take care of any and all of your business affairs.

Oklahoma and several other states also recognize a health care power of attorney (sometimes called a health care proxy). This power of attorney gives the recipient the power to make health care decisions for the person granting the power if they are deemed mentally incompetent or cannot communicate. This type of power of attorney is discussed in section 4.2.4.1. below regarding advance directives for healthcare.

Clearly, a power of attorney is a significant tool, and you should consider carefully who you would give such a power. Can you trust the person to act in accordance with your wishes? Are they under any financial or emotional stress that could influence their actions? Do they understand your affairs sufficiently to allow them to make quick decisions in your best interest?

As with all the other tools we have discussed, if you grant a power of attorney, you should also consider having contingent powers of attorney should the primary recipient of the power be unable or unwilling to carry out their duties. Additionally, as discussed below, a durable power of attorney may need to reference an advance directive for healthcare or other healthcare documents if they have also been executed.

## **4.2.4. Advanced Directive for Health Care**

As advancements in medicine allow us to live longer and longer lives, we also see an increased number of cases where patients may not have the mental capacity or communications ability to make and communicate decisions regarding their healthcare. Though it is a difficult topic, it is important to consider what you would like to be done with respect to your healthcare options and even what kind of life-sustaining measures you would, or would not, like to have provided in certain medical situations.

Oklahoma recognizes a document called the Advance Directive for Health Care ("advance directive") as a legal tool for people to make their wishes for a number of healthcare situations known. The advance directive can be drafted a number of different ways. [One form provided by the Oklahoma Bar Association](#), incorporates three parts; a health care proxy (sometimes also called a "health care power of attorney"), a living will, and an organ donation directive.

### **4.2.4.1. Health Care Proxy**

A health care proxy is the legal designation of someone to make health care decisions for you if you are

## Considerations for powers of attorney

### The person receiving the power

- Do you absolutely trust the person to act in accordance with your wishes?
- Do they understand your business affairs sufficiently to make decisions (quickly, if necessary) in your best interests?
- Are they under any financial or emotional stress that could influence their actions? What if they come under such stress in the future?
- If the person is unable or unwilling to fulfill the duties of their power, who should be their successor?

### What powers should be granted?

- Real property transactions
- Tangible personal property transactions
- Stock and bond transactions

- Commodity and option transactions
- Banking and other financial institution transactions
- Business operating transactions
- Insurance and annuity transactions
- Estate, trust, and other beneficiary transactions
- Claims and litigation
- Personal and family maintenance
- Benefits from Social Security, Medicare, Medicaid, or other governmental programs, or military service
- Retirement plan transactions
- Tax matters

### Other considerations

- References to advance directive for healthcare or other healthcare documents if executed

diagnosed as incapable of making decisions regarding your medical treatment. This means that physicians can communicate information regarding diagnoses, possible treatments, and the risks of those treatments to the person holding the power of attorney, and that the person can choose a course of treatment as if they were the patient themselves.

Importantly, health care powers of attorney need to be compliant with the Health Insurance Portability and Accountability Act (“HIPAA,” which contains provisions about privacy of patient information) so physicians can share patient information with the person holding the healthcare power of attorney.

In many cases, people may choose a close family member such as a spouse or child to serve as their health care proxy. There are many reasons a family member can be a good choice for a proxy – a family member is likely to be familiar with your values and desires with regard to health care issues, they are often in frequent communication with you, and they may live nearby, making it easier to reach them in an emergency. However, also consider that your health care proxy may have to make some extremely difficult decisions with literally life-and-death implications. Will your family member be able to make those decisions, potentially quickly, and understanding that their duty is to carry out your wishes rather than their own?

Another consideration that often arises with health care proxies is the desire not to show “favoritism” toward one child, resulting in two or more children being appointed as “co-proxies.”<sup>2</sup> Physicians and attorneys have agreed that the appointment of co-proxies can be extremely problematic. First, if co-proxies have been appointed, the attending physician must contact all the co-proxies every time a medical decision must be made. Second, if the co-proxies disagree on how to proceed, medical decisions are delayed with potentially devastating results; at the very least, the physician may have to seek a court order to settle the dispute.

Before contacting the person you wish to serve as your health care proxy, think carefully about your feelings, values, and beliefs about the type of medical care you would like to receive in a broad range of circumstances. Once you have an idea about these concepts, consider who you would want to represent you in making medical decisions should you be unable to make them for yourself. Communicate those feelings, values, and beliefs about a broad range of medical situations with your potential proxy. It may be useful to write a statement of these ideas to provide to your health care proxy.

## Considerations for selecting a health care proxy

Your values, feelings and beliefs regarding health care issues

- How does your faith impact decisions for certain treatments?
- How do your values impact decisions for certain treatments?
- How do you feel about certain treatments?
- What are your feelings about how to balance the risk of certain treatments (including death) with the potential benefits?
- Would you be willing to receive certain treatments given the risks of potential long-term effects such as loss of mobility, loss or impairment of use of a limb, loss or impairment of a sense (sight, hearing, etc.), continuous use of medical support such as kidney dialysis or oxygen, etc.?
- Have you prepared a written statement of values, feelings, and beliefs and provided the statement to

the person you wish to be your proxy?

Choosing your healthcare proxy

- Have you fully and carefully communicated your values, feelings, and beliefs to the person serving as your proxy?
- Is the person willing to accept the responsibility of serving as health care proxy?
- Are you confident the proxy will act in accordance with your feelings, values, and beliefs, even if they conflict with their own?
- Is the person able to make critical decisions quickly?
- Will the person be readily accessible in an emergency?
- Can they travel quickly to be present with you if necessary?
- Have you provided a copy of the advance directive to the proxy?

When it comes time to select a proxy, are you confident the proxy will act in accordance with those feelings, values, and beliefs, even if they conflict with their own? Is there someone you would like to serve as health care proxy if your first choice is unable or unwilling to carry out their duties?

### 4.2.4.2. Living Will

A “living will” expresses your wishes as to whether you want to receive life-sustaining treatment<sup>3</sup> in the event of a “terminal condition,”<sup>4</sup> if you become “persistently unconscious”<sup>5</sup> or have an “end-stage condition.”<sup>6</sup> In addition to these three conditions, you can also specify other conditions in which the living will should apply.

Clearly, thinking about when you do and do not want life-sustaining treatment is difficult, and many people do not execute living wills simply because they do not wish to contemplate what they must contemplate in order to do so. However, failing to execute a living will creates a risk your family will have to make such decisions for you, placing an immense burden on them.

As with the health care proxy, the first step in preparing the living will is to think about your values, feelings, and beliefs with regard to when you would want to receive life-sustaining treatment, and when you would not. Additionally, are there certain types of life-sustaining treatment you would want to receive, but others that you would not? It is important to note that whatever treatments

## Considerations for Your Living Will

Would you want life-sustaining treatments if suffering from the following conditions?

- A terminal condition
- A persistently unconscious condition
- An end-stage condition

What life-sustaining measures would you want and which life-sustaining measures would you not want?

- Cardiac or respiratory resuscitation
- Artificially administered hydration and nutrition (i.e. food and water provided through a feeding tube when you are unable to take them on your own orally)
- Kidney dialysis
- Antibiotics
- Curative procedures
- Diagnostic procedures and surgeries

you do or do not want, the presumption is to give patients palliative (pain management) care to make them as comfortable as possible.

As with all other documents discussed in this section, it is important to discuss your living will with your family so they are aware of it and of the wishes it expresses. Physicians are required by law to follow the directions given in a properly-executed living will, and if they are unwilling or unable to do so, they must transfer the patient to the care of another physician or health care provider willing to comply with the living will. Nevertheless, it is still important that your family understand your wishes to avoid unnecessary conflict or potential delays in implementing those wishes.

#### 4.2.4.3. Organ Donation

Your choice to be an organ donor can be designated on your Oklahoma driver's license; however, you can make a more detailed designation as to specific uses of your organs or specific organs that you wish to donate in your advance directive in a section for "anatomical gifts."

#### 4.2.4.4. Executing and Filing the Advance Directive

Executing an advance directive is obviously a tremendously important legal action. Much as with a will, advance directives have numerous execution requirements to be made legally valid. This serves to both reduce the opportunity for mistake or fraud, and to remind the person executing the advance directive of how important their act is. To have legal effect, the advance directive must be signed by the person making it (the "declarant"). The signature and the advance directive must be witnessed by two people eighteen years of age or older who are not related to the declarant.

Copies of the advance directive should be provided to the person who will be serving as the health care proxy (and any successor proxies) and to your primary care physician. If there is a hospital to which you would likely be taken in a medical emergency, provide the hospital with a copy of the advance directive. Many hospitals will ask if you have an advance directive as part of your admission procedures; be sure to have a copy of the directive with you in such circumstances. It is also a good idea to keep a record of who holds copies of your advance directive; in the event you wish to make changes, you will need to collect the copies of the old directive so they can be destroyed (this minimizes the risk of conflicting copies of your advance directive).

### Considerations for Anatomical Gifts

To what purposes would you want your organs used?

- Transplantation
- Therapy
- Advancement of medical science, research, or education
- Advancement of dental science, research, or education

Do you wish to make a gift of your entire body, or specific organs?

- Lungs
- Liver
- Pancreas
- Heart
- Kidneys
- Brain
- Skin
- Bones / marrow
- Blood / fluids
- Tissue
- Arteries
- Eyes / cornea / lenses

## 4.3. Land Titles

Land titles are often used as an estate planning tool, since they can (in some instances), serve to transfer an ownership right in real property to someone else at death. In this subsection, we will discuss four title forms and their impacts on estate planning: the joint tenancy with right of survivorship, tenancy in common, life estate, and the transfer on death deed.

### 4.3.1. Joint Tenancy with Right of Survivorship

Joint tenancy with right of survivorship (sometimes called simply “joint tenancy” or abbreviated JTWROS) is a form of real property ownership between two or more people. Though the joint tenants do not have to be a husband and wife, spouses often choose this form of property ownership. Parents may also place land into a joint tenancy with a child. Joint tenants do not have to be related, though.

The unique aspect of joint tenancy that makes it appealing for some people as an estate planning tool is its “survivorship” function. Whenever one joint tenant dies, his or her share of the property is redistributed among the surviving joint tenants. For example, if a husband and wife own property in joint tenancy (meaning each currently owns a 1/2 interest in the property), and the husband dies, his share is distributed to the wife as the surviving joint tenant. The wife now owns the entire interest in the property by herself. Consider another example with three siblings – meaning each sibling holds a 1/3 interest in the property.<sup>7</sup> Upon the death of one sibling, their interest would be redistributed to the surviving joint tenants, meaning each now has a 1/2 interest. Upon the death of a second sibling, the remaining sibling would hold the entire interest in the property alone.

Since the law applying to land titles operates to transfer ownership of the decedent’s (person who passed away) property, land in joint tenancy does not have to pass through probate. When one joint tenant has passed away, the survivor(s) must file a certified copy of the death certificate and an affidavit with the county clerk in the county where the real property is located. The affidavit must be notarized and must include the legal description of the real property, the book and page of the joint tenancy deed in the clerk’s records, the date of death of the deceased joint tenant, and a statement that the deceased tenant is the same person identified by the death certificate.

Joint tenancy can be a quick and inexpensive tool to transfer ownership of property at death. There are potential consequences to sharing property ownership in joint tenancy, however. First, a joint tenant can sell or mortgage their portion of the property, which means the other joint tenant can suddenly find themselves with a new fellow tenant. Second, property held in joint tenancy cannot be transferred by will; the survivorship feature of the property already defines who will receive the property when a joint tenant dies. This means that care must be taken not to create conflicts between the provisions of your will and the joint tenancy regarding who is to receive property. Finally, care must be taken not to unintentionally disinherit a family member through the use of joint tenancy. Consider the following example. Ricky and Lucy, husband and wife, have a child, Junior. Ricky and Lucy obtain a piece of property and place it into joint tenancy. Ricky then dies, leaving Lucy with ownership of the entire interest in the property. Lucy then remarries to Oscar, and they place ownership of the property in joint tenancy among themselves. This means that Junior is effectively barred from inheriting the property.

### 4.3.2 Tenancy in Common

Tenancy in common is like joint tenancy with right of survivorship in that it is a way that multiple parties can own the same piece of property simultaneously. However, it is unlike joint tenancy in a crucial way – it does not have a survivorship feature. In other words, when one tenant in common dies, the other tenants do not automatically receive a share of his or her interest. Each share of a tenancy in common is somewhat separate in that each tenant is free to sell, mortgage, or will their share as they choose.

Since there is no survivorship feature to a tenancy in common, it does not really serve as an estate planning tool itself. However, it is mentioned in this section because many people create a tenancy in common by their will, often perhaps unintentionally. Any time property is granted to multiple parties simultaneously, with no other specifications, the law presumes a tenancy in common is created. For example, if Mike dies and leaves a piece of real property “to Greg, Peter, and Bobby” then Greg, Peter, and Bobby have, by default, become tenants in common and each hold a 1/3 share of the property. This may be a perfectly acceptable arrangement, but it should be noted that each of the tenants could sell their interest to a non-related party. Alternatively, if the tenants in common remain together, they must jointly manage the property and handle its revenues and

expenses in proportion to their ownership shares. This can be problematic if the tenants have different views or economic incentives.

### 4.3.3 Life Estate

In a life estate, ownership of real property is given to one person who has the right to possess and use the property for as long as a “measuring life” is alive. Once that measuring life ends, title to the property is then transferred to another party, who receives what is called a “remainder” interest (the person receiving the remainder interest is often called a “remainderman”). For example, Tom could create a life estate in a piece of property for himself and make himself the measuring life, and then create a remainder in Anna. The result of this life estate would be that Tom can possess and use the property for as long as he is alive, and when he dies, the property would then belong to Anna. Note that the measuring life could be someone else; Tom could have created a transfer with a third party as the measuring life. In that case, Tom would get the possession and use of the property for as long as the third party was alive, and upon the death of that third party, Anna would receive the property.

As with a joint tenancy, the title itself creates a transfer of property at death, meaning the property does not have to pass through probate. However, some people chose not to use the life estate as an estate planning tool itself, but rather use it through a will. For example, Tom could execute a will stating that Anna receives a life estate in the real property and that Anna is the measuring life, while giving a remainder to Rob. In this case, Tom’s will would have to go through probate to create the life estate and remainder.

Some people choose the life estate as an alternative to the joint tenancy to avoid creating a form of co-tenancy while they are alive. If Tom creates a life estate in himself and a remainder in Anna, he would not have to share possession and use of the property while he is alive, as would be the case in a joint tenancy with right of survivorship.

Others chose to use a life estate in their will (rather than in life) to give property to one party and then to have that property transferred to another property at the death of the first party. While some people choosing this strategy may think that this restricts the property for at least one generation (that is, they assume the property cannot be transferred until the life estate and remainderman are both deceased), this is not the case – both the life estate holder and the remainderman can sell or otherwise transfer their interests in the property if they choose.<sup>8</sup>

Whenever a life estate is created, it creates a number of rights in the holder of the remainder. If the holder of the remainder sees that the person with the life estate is damaging the property in such a way that it will significantly diminish the value of the property (this is called “waste”) when the remainderman receives it, he or she can sue the life estate holder to stop the waste.

Holding property in a life estate can also add some complexity to the management of the property. Since the life estate holder’s interest goes away upon the death of the measuring life, executing a mortgage, lease, or other transaction with respect to the life estate property will often mean the lender or lessee will want to secure the consent of both the life estate holder and the remainderman.

In order to complete the transfer of title upon the death of the measuring life, the remainderman must file a certified copy of the death certificate and an affidavit with the county clerk in the county where the real property is located. The affidavit must be notarized and must include the legal description of the real property, the book and page of the joint tenancy deed in the clerk’s records, the date of death of the deceased joint tenant, and a statement that the deceased tenant is the same person identified by the death certificate.

### 4.3.4. Transfer on Death Deeds

The “Transfer on Death Deed” (or “TODD”) is a relatively new instrument in Oklahoma, authorized by

a 2008 statute. The TODD was meant to deal with a problem commonly referred to as a “desk drawer deed,” in which the owner of property would execute a deed to another party but would not record it in the county clerk’s office; they would instead store the will somewhere (such as a desk drawer) and instruct the intended recipient to retrieve the deed and record it upon their death. This was intended to keep complete control of the property with the owner until death, and to avoid probate. The problem with this scenario is that the transfer carried out in this fashion would be invalid. With a TODD, however, complete control of the property can be retained by the owner until death, and the property can still be transferred without having to pass through probate.

In many ways, a TODD is much like any other deed in that it must specify the current owner of the property, the transfer on death recipient, and a legal description of the property.<sup>9</sup> Importantly, the deed must be recorded in the office of the county clerk for the county in which the property is located before the death of the owner. Once the owner has died, the person named in the TODD must follow basically the same procedure as used for joint tenancies and life estates: they must file a certified copy of the death certificate and an affidavit with the county clerk in the county where the real property is located. The affidavit must be notarized and must include the legal description of the real property, the book and page of the joint tenancy deed in the clerk’s records, the date of death of the deceased joint tenant, and a statement that the deceased tenant is the same person identified by the death certificate. The affidavit used for the TODD must also state whether the person claiming the interest in the property was married to the person issuing the deed at the time of death.

The TODD has a number of advantages, primarily that it leaves complete ownership of the property with the owner until his or her death. If the owner of the property changes his or her mind and wants to change the recipient of the property under the TODD, or to simply revoke it entirely, he or she only has to file a revocation in the county clerk’s office where the TODD was recorded. Another important advantage is that the property transferred by the TODD need not go through the probate process. At the same time, though, there are other considerations to be weighed before choosing a TODD to transfer title to real property. Since the TODD is a relatively new instrument, the law surrounding it continues to evolve. In fact, the statute creating itself was significantly modified in 2011. Similarly, title lawyers, abstract companies, and title insurance companies are still working to build standards around the TODD-based transfer. Also, property transferred by a TODD comes with “all strings attached,” meaning the person receiving the property takes it with all mortgages, liens, easements, and other encumbrances still attached to the property. Lastly, as with all other estate planning tools, a TODD must be carefully coordinated with other tools to make sure duplicate or conflicting transfers of the property in question are not made.

## 4.4. Wills

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A will may be the first thing that comes to mind when a person thinks about “estate planning.” Wills are probably the best-known estate planning tool, and most people understand at least in part what it is and how it works.

A will is a set of instructions for how to distribute a person’s property upon their death. While this sounds rather simple, it is also immensely important. Given this importance, the law imposes a number of requirements that must be followed for a will to have any legal effect when its maker – called the “testator” – dies.

### 4.4.1. Requirements for Executing a Will

To make a will, the testator must be of legal age (18 years or older), must be mentally competent, and must be free from fraud, duress, or undue influence which might affect will provisions.

Mental competence is somewhat difficult to define. Generally, courts consider factors such as whether the testator recognizes the existence of individuals who would normally be named as heirs (such as a spouse and

children), whether the testator has a reasonable understanding of what property he or she owns, and whether the testator is capable of formulating some plan as to how the estate property should be distributed. There is no requirement that the plan take any particular form or that typical heirs be included as long as it appears that there was some plan and that these family members were not accidentally excluded. Odd behavior and even some mental illnesses may not necessarily invalidate a will if the individual was lucid when the will was written or if the mental problems did not affect the distribution in the will. If there is doubt about the mental competence of an individual who wants to make a will, it may be desirable to obtain a court determination of the individual's competency. Further, this is why many attorneys will make a video recording of the execution of the will that includes a brief examination of the testator to confirm he or she demonstrates the mental clarity necessary to show competence to execute the will.

Even if a person is mentally competent, he or she might still be subject to other factors impairing their ability to execute a valid will. These factors are frequently categorized as undue influence, fraud, and mistake. Undue influence exists when someone exerts influence on the testator causing them to make a provision in the will (or an entire will) they would not have made were it not for the influence. Fraud occurs when someone causes the testator to execute a will by telling them it is some other document, or when someone lies to the testator, causing them to make a different provision in the will (or an entire will) different than they would have made had they known the truth. Mistake occurs when the testator accidentally executes the wrong document or makes an error with respect to the description of a piece of property or a person.

Assuming the testator is mentally competent and not subject to undue influence, fraud, or mistake, he or she can then execute a will. Under Oklahoma law, there are five requirements for a will to be validly executed. The will (1) must be written, (2) signed at the bottom ("subscribed"), (3) the testator has to "acknowledge" or "publish" the will in the presence of the witnesses, (4) the signing must be in the presence of two witnesses who receive nothing under the will, and (5) the witnesses must sign the will.

First, a will must be in writing; oral instructions for how to distribute property will have no legal effect when a person dies.<sup>10</sup> Television and movies have popularized the idea of a video being played at the reading of the will. While such videos are perfectly fine, it must be remembered that the video has no legal effect – only the written document can provide any legally-binding instructions on how to distribute the property of the testator.

Second, the will must be signed by the testator at the bottom. If the testator is physically incapable of signing the will, another person can sign for them so long as they do so at the instruction of the testator. To prevent fraud in the form of someone adding language to the will, the signature must appear at the very end of the will; no provision that affects the distribution of property can appear after the signature, or it will be invalidated.

Third, the testator must "acknowledge" (sometimes called "publish") the will in the presence of two witnesses. This simply means the testator states to the witnesses the document he or she executed was his will. This demonstrates the testator understands his or her actions.

Fourth, two witnesses are required to witness the signature and acknowledgement of the will. The witnesses must be over the age of 18 and legally competent to testify in a court of law. These witnesses must be "disinterested" in the will, which means they do not receive any property in the will. If the witnesses are mentioned in the will, they run the risk of losing anything they would otherwise receive under it. The purpose of this requirement is to ensure the witnesses are unbiased and are not affected by the terms of

#### **Requirements for will execution:**

1. The will must be written
2. The will must be signed at the bottom ("subscribed"),
3. The testator must to "acknowledge" or "publish" the will in the presence of the witnesses,
4. The signing must be in the presence of two witnesses who receive nothing under the will, and
5. The witnesses must sign the will.

the will itself. Incidentally, this requirement is also one of the hazards of fill-in-the-blank or form wills; often, someone using such a form will be doing so at home and will ask those nearby – frequently family members – to serve as witnesses. If they do so, the most the family member could inherit under the will is what they would receive under the intestate succession statutes.

Fifth, the testator must request the witnesses to sign the will. This is called “attesting” to the will, meaning that the witnesses are testifying by their signatures as to observing the fulfillment of the will execution requirements.

Many times, a sixth step will be added to make a will “self-proving.” The self-proving clause is a statement, signed by the witnesses and then notarized, which indicates that the will was properly executed and signed. The use of this clause at the end of the will avoids the necessity of having the witnesses appear in court when the will is probated as long as the will is not contested.

It is possible to execute a will without witnesses, if the will is written, dated and signed entirely in the testator’s own handwriting. Such wills, called “holographic wills,” are valid because the handwriting helps to ensure that the document represents the will of the testator. However, the law is very strict concerning how such wills are created. The will may be invalidated if any portion of the will is typed or not written in the testator’s handwriting. Generally, a formally signed and witnessed will, drafted by an attorney, is recommended. Because oral and holographic wills are subject to strict scrutiny by courts, they create risks which should be avoided. Additionally, since they generally do not involve consultation with an attorney, problems of interpretation and failure to understand the legal consequences of will provisions may result.

#### **4.4.2. The Probate Process**

Making a legally-valid will is only one step in the process. For a will to have any legal effect on the distribution of the testator’s property, it has to go through the probate process once the testator is deceased. The probate process is a legal proceeding in which the court validates the will and empowers the executor to carry out the will’s instructions.

The first step in the probate process is the filing of a probate case in the district court for the county in which the testator’s permanent home was located. Oklahoma law requires individuals who have possession of a will to deliver the will to the probate court or to the executor named in the will within 30 days after they learn the testator is dead. Once the will has been presented to the court, it will validate the will by confirming the testator had the necessary mental capacity to execute the will and that the requirements for the will’s execution were satisfied. This step underscores the importance of self-proving wills, as such wills do not require the witnesses to the will to appear before the court. It is also at this point that those contesting the will may bring their objections (will contests are discussed below).

Next, the court will appoint an executor for the probate. The executor is the person who will act as the representative for the probate estate (that is, all the property handled by the will). The executor’s first task is to create an inventory of all the property owned by the testator at the time he or she died. They must also determine all the debtors of the estate (those that owed money to the testator) and the creditors of the estate (those to whom the testator owed money). Finally, the executor must also preserve and protect the property of the estate until the probate is concluded.

Once the inventory and identification of creditors and debtors is made, the claims of the creditors against the estate and the claims of the estate against the debtors must be settled. Notice of the probate must be mailed to all creditors, and notice must also be posted in the county’s newspaper of record for two consecutive weeks. Any creditors having claims against the property of the estate must make those claims to the court, which will either validate or invalidate those claims. If a creditor’s claim is invalidated, it is essentially void. Also, if a creditor fails to bring their claim to the court for validation, their claim is also invalidated. It should be noted

the validation process is an important advantage of the probate process in that it can clear some liabilities of the estate that could hang over it otherwise. Conversely, if the will were not probated, any heirs who took assets would receive such assets subject to any liens or other encumbrances caused by the debts of the decedent.

Once the creditors of the estate have been handled, the executor submits a final inventory of the estate to the court, along with an accounting. The accounting is essentially a record of all the transactions made between the initial inventory and final inventory. Its purpose is to demonstrate to the court and to those receiving property under the will that all transactions and property have been accounted for, and that there has been no wrongdoing by the executor. Upon approval of the final inventory and accounting, the court will issue a probate decree that allocates the property in accordance with the instructions of the will.<sup>11</sup> This decree is a crucial product of the probate process as it empowers the parties receiving property under the will to have title to that property transferred to them. For example, if someone receives real property under the will, they must present the decree to the county clerk in which the property is located in order to have the property re-titled in their name.

The probate process is the subject of much discussion in estate planning and is often cited by attorneys as one of the reasons people should choose estate planning tools other than wills. Before discussing the potential consequences of the probate process, it is important to underscore that it is not optional if a testator has executed a will –the will *cannot* have any legal effect without the probate process. In many cases, family members wanting to avoid probate will simply act as though they have title to the property given to them under the will, but in fact no title can be transferred without the probate process. This can create title problems for years or even decades after the death of the decedent.

To be sure, the probate process involves time and expense. It requires certain windows of time to be held open for matters such as allowing creditors to file their claims. This means that the probate process must take several months at best to conclude.<sup>12</sup> Since there are a number of legal filings required by the probate process, it will also require significant services from a licensed attorney. The time involved also requires the executor to preserve and maintain the estate, which may involve additional expenses that must be deducted from the estate.

As a court proceeding, the filings made in a probate case are open records, meaning that anyone can access the filings such as the inventory and accountings. Some people may not be comfortable with the public having access to such information.

Another potential complication of the probate process is the limitation of the probate court's jurisdiction. An Oklahoma court only has jurisdiction over property located within the physical borders of the state of Oklahoma. Thus, if a testator owned property in Oklahoma and another state, the will must be probated both in Oklahoma and in the other state.

While most people would regard the previous considerations as disadvantages to the probate process, there are also protections created by the probate process that could be regarded as important advantages. First, as mentioned above, probate cuts off the claims of creditors if they are not filed within a limited time or are invalidated. This can eliminate some liabilities of the testator, and can also be an important protection if the testator was engaged in business or professional activities that might have created potential future liabilities. Second, the probate process can allow for the authorization of a family allowance for the support of the testator's surviving spouse and minor children while the probate is ongoing. This may be useful if estate debts are approximately equal to the total value of the estate. Third, clear title to assets owned by the decedent alone or in some forms of co-tenancy (such as tenancy in common) may not be obtained unless some sort of estate administration is conducted. This is particularly important in the case of real property, bank accounts, and vehicles with title registrations.

### 4.4.3. Will Contests

If someone is unhappy with what he or she has received under a will, they may contest the will. Note, though, that “I’m unhappy with what I got under the will” is not a grounds in and of itself to contest a will – testators generally have the right to grant whatever property they want to whomever they want. Rather, someone contesting a will must successfully prove that there was some sort of flaw in the process of enacting the will. Generally, this will come down to proving that there was something that interfered with the testator’s ability to prepare the will (such as lack of mental capacity, undue influence, duress, or fraud, as discussed above) or the will was improperly executed (for example, the witnesses received something under the will, the will was not properly attested, etc.).

The effect of successfully contesting the will is that either a portion of the will or the entire will is invalidated, which means either part or all of the testator’s estate will pass to his or her heirs according to the intestate succession laws. This means the only people who have legal standing to contest a will are those who would be entitled to receive something from the testator’s estate under the intestate succession laws, such as a surviving spouse, children, siblings, parents, etc.

To discourage anyone from pursuing a will contest, some testators will include a “no-contest” clause in the will. This clause states that anyone who contests the will is automatically disinherited. Thus, if anyone initiates an unsuccessful will contest, they will receive nothing under the testator’s will. It should be noted, though, that if the will contest is successful, it negates not only the will but also its no contest clause. Additionally, the no-contest clause cannot defeat certain statutory protections for family members like surviving spouses.<sup>13</sup>

While no-contest clauses can discourage heirs from contesting the will, experience suggests the better course simply may be to communicate with your family about the goals and objectives you seek to accomplish with your will. Human nature leads people to react negatively to some surprises; if your family members understand your intentions and have had a chance to express themselves (as discussed in Section 2 of this workbook), they may be much less likely to protest when it is time for your estate plan to be implemented.

### 4.4.4. Considerations in Drafting Your Will

A whole workbook could be written about the considerations you should weigh in writing your will. This discussion will cover some of the most important points. Remember to always talk through all considerations with an experienced estate planning attorney.

#### 4.4.4.1. Inventory

The importance of an inventory has already been covered several times in this workbook, but it is a point worth repeating here. Obviously, a very thorough inventory of all your property is a critical starting point for crafting your will, as you need to carefully coordinate your will with all of your other transition planning tools in distributing all your property. However, you also need to consider other elements in this inventory, such as people. It may seem odd to inventory people, but you need to create a list of everyone in your family to make sure no one is unintentionally omitted.

One mistake sometimes made is to fail to include one’s child in the will. This can arise in two situations: first, when someone makes a will and then has a child afterward, or when someone apparently unintentionally leaves a child out of the will. If the child was born after the execution of the will, Oklahoma law provides the child with the share of the testator’s estate they would have received under the intestate succession statutes. If it appears the child was unintentionally omitted (that is, there is simply no reference anywhere within the will as to the child), the same provisions hold as for a child born after the will.

If someone wants to disinherit a child, they must explicitly mention the child in the will and state they are to receive nothing. Otherwise, the executor and the probate court are left to determine whether the testator intentionally or unintentionally omitted the child.

You should also include anyone or any entity who is not a family member that will receive property under the will.

Lastly, you will also need to create an inventory of important documents to make it easier for your family to locate those documents in the event of your passing.

#### **4.4.4.2. Executor**

As discussed above in subsection 4.4. regarding the probate process, the executor is the person who represents the estate in the probate process and is responsible for preserving the value of the estate until it is distributed.

Since the executor has to maintain the estate until the probate is completed – and the process may take a considerable amount of time – it is important that the executor have the knowledge needed to properly maintain the assets of the estate. If the bulk of the estate consists of farm assets, the executor needs to have sufficient knowledge and/or experience to successfully manage a farm operation. He or she should also be familiar with your particular operation. It may be advisable to spend some time “training” your executor to make sure they can successfully manage not only any farm operation, but your particular farm operation.

Since the executor is charged with protecting the interests of everyone who will receive property under the will, the law considers the executor a “fiduciary,” which means they are held to the highest standard of care in their actions and must protect the interests of the people receiving property under the will even if that means placing their own interests after them. As a result, those who will receive property under the will watch the actions of the executor with extreme scrutiny. The actions of the executor may be challenged if a potential heir feels he or she has not acted in the heir’s best interest. These challenges can be stressful for the executor and can drain resources from the estate.

Since the executor is a fiduciary and is, at least for some time, entrusted with managing property that will eventually be given to others, the default under Oklahoma law is to require the executor to post a bond with the probate court to ensure they properly fulfill their duties. While this bond can provide additional protection for the potential heirs, it can also increase the costs of the probate. As a result, many people include a provision in the will to waive the executor’s bond requirement.

Because of the challenges faced by the executor, you may want to compensate the executor with a fee. If so, the fee needs to be carefully described in the will, as the fee itself may be challenged by heirs.

What if the person you have selected as an executor is unable or unwilling to fulfill their duties, or even dies before the testator? For example, many people name their spouse as an executor, but what would happen if both spouses die at the same time, as in an automobile accident? This means there is no executor unless a “successor executor” is named in the will. A successor executor may be wise, as this provides increases the odds that someone chosen by the testator will be available to carry out their wishes.

While *successor* executors may be a prudent will practice, there can be challenges with naming *co*-executors. Frequently, a parent – not wanting to show “favoritism” to any one child – will name all of his or her children as co-executors of the will. If there will be more than one executor at a time, extraordinary caution must be taken to both spell out the specific responsibilities of each co-executor, and also to provide for what will happen if the executors cannot agree to a decision in any areas where they share responsibility. Co-executor arrangements frequently cause delay in the probate process. Consider whether it would be more prudent to have one executor with a line of successor executors. As the proverb states, “there is a reason ships only have one captain.”

As you can see from these factors, an executor faces many demands. While many testators select a family member to be an executor, there may not be a family member possessing all the qualifications to be a successful executor. The testator may also anticipate the probate process to be charged with emotion, and may worry selecting a family member could strain family relationships or be unduly stressful to the family member chosen as executor. In such cases, the testator may want to consider selecting someone outside the family as an executor, such as an attorney or accountant. This can provide an executor who is “above the fray” and may reduce the opportunity for family conflicts. If a non-family executor is chosen, some form of compensation will be likely, and the bonding requirements for the executor should also be examined.

#### **4.4.4.3. Care of Minor Children**

Subsection 4.2.1. above discussed many of the factors to consider in selecting a guardian for minor children, and all of those factors hold true if the guardianship nomination is included in the will rather than in a stand-alone document. If both you and your spouse include a guardian nomination provision in your wills, it is extremely important that the wills mirror each other in that regard to avoid potential conflicts if both of you should die at the same time.

Also as mentioned in subsection 4.2.1., you may want to make a number of provisions for your children in your will. If you want to create a fund to provide the guardian with resources for the care of your child, or if you want to place restrictions on when your child can receive the property (such as an age over 18), you may need a trust. If the trust is created in your will, it is a “testamentary trust” and there are several varieties of such trusts. The considerations surrounding your testamentary trust are discussed in more detail in subsection 4.5. below.

#### **4.4.4.4. Handling Real Property**

For many farm families, real estate makes up the largest proportion of assets, and thus the bulk of the property handled by the will may be in the form of land. While an inventory of property is hugely important, it is absolutely critical in the case of land. This is because how the land is owned dictates not only how it is handled in the will, but also *if* it can be handled in the will. For example, a will cannot transfer an interest in property owned in joint tenancy with right of survivorship, owned in a life estate, or subject to a transfer on death deed; the title to the land itself already dictates what happens when any of the joint tenants dies. Conversely, a tenant in common is free to will their interest in the property. In short, it is critical to know the title status of any property to be distributed by the will.

Another critical piece of information to consider is the importance of the property to the farm operation. Clearly, it is important to coordinate the distribution of property under your will with your overall farm transition plan to make sure the farm business has access to the property it needs for its operations.

Once you have gathered the necessary information about your real property, you should consider whether the will should give the property to one person or entity, or whether multiple parties will share it in some form of co-tenancy. For the factors to weigh in determining the form of co-tenancy to choose, see subsection 4.3. above.

Another factor to weigh is how long you want the recipient to hold the property. If you wish them to have it forever, they can simply receive the property outright (a title called “fee simple absolute”). If, however, you want to place restrictions on the length of ownership, a number of other title forms can be used. For example, if you want someone to receive the right to possess and use the property for as long as they are alive, but you then want to dictate who receives the property after them, you could use a life estate (discussed above). You could also place the property into a testamentary trust that gives the recipient the benefit of the property while they are alive, and then instruct the trust to distribute the property to someone else after their death.

Some testators want to attach conditions to the property, such as prohibiting the sale of the property to

someone outside the family or requiring the land only be used for farming. There are land title uses that can be created by the will (such as “fee simple determinable” or “fee simple subject to a condition subsequent”) to carry out these objectives, but it should be noted that these titles are frequently contested by heirs, and that courts examine restrictions on the transfer of property with great scrutiny. The better means of accomplishing these goals may be to place the property in some form of trust. Remember, as previously discussed, wills generally “do their job” of distributing property and then go away. Since wills are given legal force by the probate process, there is little they can do to enforce restrictions once that process is concluded.

Finally, your will should include provisions for how the executor needs to handle the scenario in which the will gives a specific piece of property to a specific person or entity, but that piece of property is either no longer in the estate (*i.e.* it was transferred by the testator before he or she died) or has to be used to handle a debt of the estate.

#### **4.4.4.5. Handling Personal Property**

As with land, some personal property such as vehicles and equipment may be vital to the operation of the farm operation, and the handling of these items in your will should be carefully coordinated with your overall farm transition plan. Also, remember that the probate process will be vital to the transfer of legal title to the intended recipient, since the probate decree must be presented to the appropriate state agency to accomplish the title transfer.

There may be significant assets that are equally important to the farm operation that do not have titles, such as livestock, stored crops, etc. With these items, careful descriptions and information about where they are kept should be included in the will and in the inventory documents kept for your family.

Experience has shown the value of personal property is not necessarily tied to the importance of the property in the eyes of some family members. Frequently, larger disputes arise out of who receives a family heirloom such as Grandma’s engagement ring or Grandpa’s antique tractor than financial assets of much greater monetary value. It may seem counter-intuitive, but managing disputes over personal property may “head off” much greater problems that could cause family members to challenge the overall estate plan. Thus, a discussion over what objects hold importance for which family members should be part of your family conversation, as outlined in Section 2.

If you plan to give specific items to specific people, those instructions must be included in your will; simply telling a child or grandchild that an item “is yours when I die” will not suffice, and can lead to exactly the kind of family disputes discussed above. In these cases, you may want to include a specific list of items and their recipients as an appendix to your will. If this list needs to be updated, such an update can be accomplished by executing a will amendment or “codicil” without the need to execute an entirely new will.

If you intend to allow parties to select what items of personal property you want, the procedure for how they make these selections must be specified. Some people establish an order of selection (*i.e.* Person 1 selects the items he or she wants, then Person 2 can choose from what remains, and so on). Others create an auction within the estate, whereby eligible persons bid on the objects they want and the funds from the auction go back into the estate for distribution in accordance to the will. In any case, establishing rules for selection can help minimize conflicts among family members.

Regardless of the value of the objects, remember that, for a number of reasons, the distribution of those objects must be handled in writing as part of the will.

Lastly, as with real property, the will should include instructions for the executor in the event that a specific gift of personal property to a specific person or entity cannot be accomplished because the item is not part of the estate or because it must be used to satisfy the debts of the estate.

#### 4.4.4.6. Handling Debts of the Estate

One of the items people often overlook as they prepare their inventories prior to crafting their estate plan is debt. Under Oklahoma law, and the law of most other states, the debt of a testator does not go away at death. As noted above in the discussion of the probate process, creditors that do not properly present and validate their claims risk being dismissed, but those claims that *are* validated must be handled by the estate. If the assets of the estate are insufficient to pay off all of the validated debts, the assets distributed by the will remain burdened by the debts even in the hands of their respective recipients.

To avoid passing burdened assets to those receiving them under the will, your will should contain a plan for paying off any claims against the estate. Some people purchase life insurance specifically for this use. If this is the approach you choose, work carefully with your insurance provider and attorney to make sure the “owner” and beneficiary of the policy are properly selected to accomplish this goal, and include provisions in the will specifically identifying the policy to be used for debt payment. Also include provisions for how excess proceeds (if any) from the policy should be allocated. Other people may identify financial assets such as investment accounts, bank accounts, certificates of deposit, or other such accounts as assets to be used for the payment of debts.

You should also consider provisions for what assets should be liquidated by the executor in the event that the assets specifically identified for debt payment are not enough. These provisions need to include plans for what should happen if the executor has to sell property that has been specifically given to someone.

#### 4.4.4.7. Wills for Married Couples

Often, married couples want wills that “mirror” each other. There is certainly nothing inherently wrong with this goal. Challenges can arise, though, when the spouse wants to include provisions in the will altering its provisions (frequently drastically reducing the amount of property given to the spouse) if they alter their will without the consent of the other spouse.

First, remember that Oklahoma law requires a surviving spouse must receive at least half of the joint industry property acquired by the couple during marriage, unless the spouse agreed to waive that right in an enforceable prenuptial agreement.

Second, each spouse has a completely independent legal right to dispose of their separate property through a will as they see fit. Put another way, spouses are free to have completely separate wills and do not have to obtain any form of consent from the other spouse to dispose of their separate property. Since there is no law that automatically connects the wills of spouses, if they want to “link” their wills, they must generally form a separate legal agreement to do so. This results in what are sometimes called “contractual wills.” Such an agreement frequently specifies what changes (if any) to one spouse’s will require the consent of the other spouse, along with the changes that will be made to the wills if such a change is made without consent. The agreement may also restrict what the surviving spouse may do with the property.

Although such contractual wills can work, they are also frequently subject to attack after the death of one spouse, and courts view such contracts with great scrutiny. A trust may be a better means of accomplishing the same goals. Further, a contractual will requires a very clear agreement with the attorney drafting it, as it requires the attorney to simultaneously engage two clients (both spouses). This means a new set of ethical guidelines are imposed on the attorney.

#### 4.4.4.8. Dealing with Contingencies

As you have gathered from this lengthy discussion of wills, there are many issues to be considered in crafting your will. One of the biggest challenges in drafting a will lies not in deciding what you want to happen if everything goes as planned, but rather what should happen if things *do not* go as planned. Your will should contain provisions for how the executor should handle the distribution of your property under a number of

contingencies.

One of the most emotionally difficult contingencies to consider is what should happen if someone in your will dies before you. Unfortunately, it is also one of the most critical contingencies to address. How should the distribution of property in your will be changed if a spouse, child, or other heir passes away before you?

What should happen if someone is unintentionally left out of the will? For example, what happens if a child is born after the will is made? The birth of a child will prompt many people to amend their will, but should your will include automatic changes in the event a child is born and the will is not amended? Also, grandparents should consider provisions for what happens when a new grandchild is born. Though it may sound odd, grandparents should also consider defining who is considered a “grandchild.” For example, in handling intestate succession and the interpretation of wills, adopted children are considered indistinguishable from biological descendants, but would the grandparent want the same consideration? What about step-grandchildren?

Should the will’s provisions be altered if the testator is divorced? Oklahoma law automatically deletes gifts in favor of a divorced spouse, but the testator may want to handle some of these changes differently than specified in the statute. What if someone receiving property under the will gets divorced, especially if they divorce one of the testator’s heirs?

What if a piece of real or personal property to be given to a specific person or entity is no longer part of the estate? Should an alternative gift of some kind be made to that person or entity?

It is important to spend time working through as many contingencies as possible with your estate planning attorney. Since it is almost impossible to address every potential scenario, it is important to include some flexibility in the will to allow the executor to achieve the intent of the testator in the event the unforeseen comes to pass.

#### **4.4.4.9. Making Changes to the Will**

Wills should be periodically reviewed to determine if any changes should be made. As mentioned above, it is particularly important to consider making changes to a will when significant family changes occur such as births, deaths, divorce or marriage. Other gradual changes in circumstances, such as children reaching the age of 18, the advancing age of guardians, changes in the property owned by the testator, or changing needs of heirs may also create a need for adjustments in the will.

One method of changing a will is to write a new will that includes a statement revoking all prior wills. If the new will does not include such a statement, the court may try to implement both wills to the extent the provisions are not totally inconsistent. This can lead to considerable confusion, and potentially costly court conflicts that may reach a different result than the decedent intended.

If only a few changes are desired, another alternative is to draft a will amendment, or “codicil” to the original will which states the desired changes. The codicil must be signed and witnessed with the same formalities as required for a will. Additional codicils may be added as additional changes are required. Use of codicils is a fairly common method of modifying a will, but if quite a few changes are made over time, it may eventually be desirable to draft a new will.

Generally, it is not advisable to make changes on the face of an existing will by crossing out old terms or writing in new terms. Attempts to make such changes may actually invalidate the will and probably not accomplish what the testator intended.

Finally, remember that any codicil to a will must follow the same execution requirements as the will itself.

#### **4.4.4.10. Limitations of Wills**

Though this section of the workbook has covered several limitations of wills, some bear repeating here.

First, remember wills only control distribution of property that is included in the estate. Property held under certain types of ownership is not included in the estate and thus is not affected by will provisions. For example, property owned in joint tenancy with right of survivorship automatically passes to the surviving joint tenant at death and is not distributed under the will. Similarly, a life estate interest in property automatically terminates at death. If property is owned as tenancy in common, the decedent's share is transferred by will and the other owners continue to own their respective shares.

Life insurance proceeds may or may not be transferred by will depending on who is named in the policy as beneficiary. Generally, life insurance proceeds will not be affected by will provisions unless the estate is named as beneficiary in the policy or all the named beneficiaries are no longer living.

Wills may not take precedence over a prenuptial agreement which promised the surviving spouse a certain share of the estate. Wills also may not be used to exclude a spouse from inheriting at least as much property as the spouse would inherit under state statutes if there was no will (see previous discussions of the spousal election). If the will leaves less than the designated spousal share, the spouse may choose to accept the share designated in the will or may instead demand an intestate share specified under state statutes. There is no similar requirement that children receive anything under the will.

## 4.5. Trusts

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### 4.5.1. What is a trust?

In its simplest terms, a trust is an arrangement whereby one party holds legal title to property and another party has the right to the benefits from that property. In the context of estate planning, a trust is almost always established with a separate legal entity as the party holding the property along with a trust document containing instructions for how that property is to be managed.

For example, Jane Smith wants to create a trust to help her achieve her estate planning goals. She establishes a separate legal entity – the Jane Smith Living Trust – and transfers ownership of some of her property to the Jane Smith Living Trust. At the same time, she prepares a set of instructions regarding how the trust is to manage the property it now owns. That set of instructions binds the trustee (discussed in the next subsection) as to how he or she can manage the property and how they are to distribute income or property from the trust.

One important factor to remember with trusts is that once property is transferred to them, the trust is the owner of the property. The separate ownership of the property by the trust is critical to many of the estate planning benefits of trusts, but it can also add some complexity to managing the property.

### 4.5.2. Parties involved in the trust

Every trust must involve at least three parties: a trustor, a trustee, and a beneficiary. It must also involve trust property.

The *trustor* is the person who creates the trust and transfers the ownership of property to the trust. In the example above, Jane Smith was the person who created the Jane Smith Living Trust and transferred property to it. Thus, Jane is the trustor of this trust.

The *trustee* is the person who represents the trust, manages the property owned by the trust, and makes distributions of income or property from the trust. Since the trustee is charged with managing property for the benefit of others, they are also called a *fiduciary*. Serving as a fiduciary carries a number of responsibilities as discussed below.

The *beneficiary or beneficiaries* is the person or people who receive benefits from the trust property. Most often these benefits are distributions of income from the trust property or gifts of the trust property itself. However, other trust benefits may also be given, such as the use of the trust's property.

*Trust property* is the property given to the trust, and may also be called the trust's *corpus*, or *principal*. If this property is capable of generating revenue such as rents, dividends, or other payments, such revenue is usually called *trust income*. The tax basis of property transferred to a revocable trust remains the same as the trustor's basis since the assets are still under the control of the trustor (since the trust is revocable). Consult your tax professional to discuss any potential tax effects of transferring property into a trust.

Quite frequently, one person may simultaneously hold all three roles. If Jane creates the trust and contributes property to it, she is the trustor. If she puts herself in charge of managing the property, she is the trustee. And if she provides income from the trust property to herself, she is a beneficiary. Many people using the trust as an estate planning tool use this arrangement. As discussed below, though, there may be several reasons for selecting other trustees and beneficiaries.

### 4.5.3. Types of trusts

By some estimates, there are over 40 different kinds of trusts in use today. Why so many? Numerous very specific trusts have been designed over the years to achieve very specific objectives, usually with respect to minimizing estate taxes while achieving some other goal such as the care of a spouse or the education of a child. Selecting the specific kind of trust is a tremendously important decision that should be made with the help of a tax professional and attorney.

For the purposes of this discussion, though, we will simply focus on two very broad categories of trusts: trusts enacted while the trustor is alive, called *living* or *inter vivos* trusts, and trusts established after death through the decedent's will, called *testamentary* trusts.

Living trusts have two main subcategories: revocable and irrevocable. A *revocable* trust, as the name implies, can be revoked (abolished) by the trustor. Many people choose to use a revocable trust because of the flexibility it provides; if the trustor decides he or she no longer wants the trust to hold the property, they simply revoke the trust and bring the property back to themselves. Revocable trusts can also be modified without being abolished as well.

An *irrevocable* trust cannot be revoked or abolished by the trustor – once created, it must stand until the terms of the trust document dictate it is dissolved. The trust document will also contain restrictions on what input, if any, the trustor can have on the management of trust property and distributions from the trust. Generally, the terms of an irrevocable trust cannot be modified. Irrevocable trusts are frequently used to manage estate tax liability for individuals who own more property than the federal estate tax exemption amount; placing property into irrevocable trusts can reduce the amount of the person's estate. Other people use irrevocable trusts for Medicare planning, and still others use them to protect assets from potential creditors of beneficiaries (called *spendthrift* trusts). It should be noted that if someone creates a revocable living trust and the terms of the trust provide that the trust can survive their death, the revocable trust becomes irrevocable at their death.

A *testamentary* trust is a trust established by the will of a testator. There are many reasons a testamentary trust may be chosen: to provide for the care of a spouse and/or children, to hold property for minor children until they are legally capable of owning the property themselves, to restrict the transfer of property for a length of time, for example. Importantly, though, testamentary trusts require that the decedent's will go through the probate process in order for the trust to be created.

The potential consequences of choosing among these types of trusts are discussed later in this subsection.

## 4.5.4. Considerations in drafting the trust

As with many of the topics in this workbook, entire books have been written about how to create a trust and all of the considerations involved. Thus, this discussion will be limited to six major areas of concern: who will be the trustee, who will be the beneficiaries, how long will the trust last, what are the rights and responsibilities of the trustee, how beneficiaries can use trust income and principal, and the timing and amount of distributions to beneficiaries.

### 4.5.4.1. Selecting a trustee

Careful thought must be given to every aspect of creating a trust, but there may be no more important consideration than selecting a trustee. As discussed above, many people creating living trusts make themselves the trustee for as long as they live. In such situations, it is safe to say the trustee has the full faith and confidence of the trustor. However, selecting oneself as trustee may not always be the obvious choice. Further, if the trust is to serve an estate planning role after the trustee has died, another trustee will have to take control. Thus, in almost every situation, at least some consideration must be given to having someone other than the trustor serve as the trustee.

First, should the trustor also be the trustee while he or she is alive? The appropriate choice of trustee will vary, depending upon the purpose of the trust and the goals, interests and management skills of the trustor. If the purpose of the trust is to achieve certain tax avoidance advantages, it may be necessary to give control of the trust to another party. The trustor may also want to secure a trustee who is interested and experienced in management of the particular assets that make up the trust (such as someone adept at managing real property or stock investments if either of those types of assets make up much of the trust property). In short, trustors should be aware that they have the option to select another trustee other than themselves, even while they are alive.

Second, what does the job of trustee involve? As mentioned above, the first job of the trustee is to manage the trust property. That requires someone with the knowledge, experience, and ability to handle the types of assets that make up the trust. If the majority of the trust assets are farm assets, a trustee must be able to competently manage agricultural operations. Beyond the basic competence to manage the assets, though, as fiduciaries, trustees are held to the same standard of care in investing trust assets as a prudent, intelligent person would use in managing his or her own affairs. They must consider both the probable safety and the probable income of the decisions they make. They are not permitted to speculate with trust assets. Unless the trust instrument permits it, the trustee may not buy trust property or sell property to the trust or lend trust funds to himself or commingle trust funds with his own individual funds.<sup>14</sup> When selecting a trustee, consider whether he or she would be capable of satisfying all of these requirements. Also, be aware that any beneficiaries of the trust will watch the actions of the trustee with great scrutiny, since their financial interests are directly affected by the decisions of the trustee. In some family situations, this may mean a trustee outside the family or an institutional trustee may be desirable to avoid emotional entanglements for the trustee's decisions.

Third, if a trustee outside the family is named, should an institutional trustee be selected? Many banks and other financial institutions have trust departments and offer trust management services. A fee is generally charged for those services. One advantage of using a corporate trustee, such as a bank, is that the bank probably employs individuals who are experienced in trust management, with access to professionals that may specialize in managing different types of assets such as farm operations or investments. A disadvantage of using a corporate trustee is that the trustee fees may significantly diminish trust income or principal depending on how they are structured.

Fourth, who should be chosen as a successor trustee? A *successor trustee* is a person or institution who steps into the role of trustee when the initial trustee can no longer perform their duties. If the trust is a living trust that the trustor wishes to use for estate planning purposes and the trustor also serves as trustee, a successor trustee is absolutely critical, since the trust must have someone available to manage it after the death

of the trustor. In virtually every trust scenario, it is a good idea to select a successor trustee in the event that the primary trustee is unwilling or unable to fulfill their duties. It may also be desirable to name a secondary trustee if an institutional trustee is named since the bank or other institutional trustee may eventually cease to exist. Further, regardless of whether an institution or individual is named as the successor trustee, consider having an additional successor, just in case the original successor is also incapable of fulfilling their duties.

Fifth, should co-trustees be named? Many times, parents naming their children as trustees or successor trustees do not wish to treat their family members any differently. Thus, they name all of their children or siblings as co-trustees and give them equal powers (with some parents going even further to require that all of the co-trustees must agree on a decision before it is implemented). While trustor's intentions may be good, this arrangement can frequently cause problems for the management of the trust. First, do all of the co-trustees have the management capability needed to successfully manage the trust property? Second, are the management styles (which are often dictated by personality styles) of the co-trustees compatible? Third, does the trust contain provisions about what is to be done when the co-trustees cannot agree (*i.e.* "tiebreaker" provisions)? Experience indicates that the appointment of co-trustees frequently causes more problems than it solves.

As a final consideration, always discuss the appointment of the trustee with the person selected. The job of trustee is a difficult and demanding one, and you should feel confident that the trustee is willing and able to fulfill their duties when needed.

#### 4.5.4.2. Naming beneficiaries

Every trust must have at least one beneficiary. With living trusts, the trustor frequently makes himself or herself one of the beneficiaries so long as he or she is alive. However, when the living trust is intended as an

### Trustee Considerations

#### For any potential trustee

- Do they have sufficient experience in managing the trust's assets?
- Do they have the time to handle trust management along with their other responsibilities (off farm employment, etc.)?
- Are they capable of handling responsibilities of being a fiduciary?
- If this is the trustee's first time in that role, do they fully understand their rights and responsibilities?

#### Family member?

- Spouse, child, grandchild
- Will there be emotional stresses associated with the role of trustee and with the decisions made to other family members who are beneficiaries of the trust?
- Will the family member be paid for their services as trustee? How will that compensation be viewed by other family members who are also beneficiaries?
- Will the trustee have a bonding requirement / waiver of liability to beneficiaries?

#### Non-family member individual?

- Has the potential advantage of reducing family conflict / emotional stresses
- How will the trustee be compensated?
- What is the level of comfort and trust with the individual both with trustor and with the beneficiaries?

#### Corporate or institutional trustee?

- What is the compensation structure for the trustee?
- Are there provisions for the assignment of trustee duties in the event the corporation or institution is purchased or dissolved?
- Does the institution have experience in managing the type of assets in the trust?
- What provisions govern "self-dealing" issues (for example, if the trustee is a bank, can trust deposits be held by the bank)?

#### Other trustee considerations

- Should a successor trustee (or multiple successor trustees) be named?
- If co-trustees are named, what provisions will be used to break deadlocks?

estate planning tool or when a testamentary trust is used, the trustor may need to take additional considerations into account.

One such situation would be a trust that continues to hold property after the trustor's death, with instructions to distribute income to the trustor's grandchildren. Should "grandchildren" only mean grandchildren that were alive at the time of the trustor's death, or should it include grandchildren born after that point? What must a "grandchild" do to prove their status to the trustee?

Another consideration is whether someone should "step into" the position of a beneficiary should they die. If, say, a son or daughter dies, should their shares of distributions from the trust then go to his or her children?

Yet another situation when the beneficiaries may not be certain comes when the trustor retains – or gives to a trustee – the right to designate the beneficiaries who will receive the benefits of the trust. This right is called a power of appointment and may be exercised after the trust is created. Retention of a power of appointment provides flexibility by permitting the grantor to postpone decisions regarding distribution until some point in the future when he or she may have more information about the needs of potential beneficiaries.

In the end, it is important to think through who you would like to receive income and/or property from the trust, as well as to think through all of the possible contingencies that might come into play with respect to those beneficiaries.

#### **4.5.4.3. Duration of the trust**

Trusts can have a wide range of durations before they must be terminated. If someone is using a trust solely to avoid probate, they may define the trust to last only until shortly after their death, with the trust to be terminated as soon as it distributes its property to the beneficiaries. On the other hand, someone may want their trust to last for multiple generations. In Oklahoma and several other states, a law called the "Rule Against Perpetuities" states that a trust cannot last forever, but must instead be terminated within a period defined as any life in being at the time the trust was established plus an additional 21 years.<sup>15</sup> For example, if Jane had a grandchild alive at the time she established her living trust, and she chose to make that grandchild a beneficiary of that trust (even if the grandchild was not initially a beneficiary, but rather became a beneficiary only upon some later event such as the death of his or her parents), the trust could remain in effect for 21 years after the death of that grandchild.

The duration set for the trust is largely a function of the objectives of the trustor. If, as mentioned, the objective is simply the avoidance of probate, the trust need only last long enough to make the distribution of trust property after the trustor dies. On the other hand, if the objective is to provide income to the trustor's family for as long as possible, the trust duration would likely be set to the maximum length allowed by the Rule Against Perpetuities. When creating a trust, consider both the objectives and the needs of the beneficiaries; in certain circumstances, it may be wise to define the duration of the trust by the lives of some beneficiaries, with provisions in the trust providing instructions in case beneficiaries do not die in the order anticipated by the trustor.

#### **4.5.4.4. Rights, powers, and responsibilities of the trustee**

Certain rights, powers, and responsibilities are implied to all trustees, and a well-drafted trust will often explicitly include these in the trust document. However, the trustor may desire the trustee to have additional powers the law will not imply.

One common issue is what types of investments the trustee can make with trust property. As mentioned above, the trustee is generally held to the standard of a prudent, intelligent person would use in managing his or her own affairs. Some investments may be riskier but provide much higher returns – should the trustee be allowed to pursue such investments? Can the trustee invest only in savings bonds and certificates of deposit,

or can they invest in international growth stock funds? There are broad range of investments, and the trustor should consider how much risk the trustee may seek in managing the trust assets.

Another power that must be made explicit is the power to buy or sell trust property. The general assumption is the trustee is to deal with the property placed in the trust by the trustor. Should the trustee have the power to sell some trust property to generate additional funds in certain circumstances, such as to pay for the medical expenses of a beneficiary who has had a significant illness? Conversely, if the trust is managing farm assets and a piece of land that would enhance the productivity of the farm becomes available, can the trustee purchase the property to add it to the trust? Can the trustee mortgage trust assets to make such a purchase? Can the trustee lease or sell mineral interests associated with trust lands? These are all questions, and any other extraordinary transactions or other contingencies that must be addressed by the trustee should be addressed in the trust document.

The trustor may specify in the document creating the trust that the trustee will not be held to some or all of the duties, restrictions and liabilities which would otherwise be imposed or may designate additional restrictions and liabilities. If too many restrictions are placed upon the trustee, it may be difficult to find someone who is willing to serve as trustee, or the trustee may find it difficult to accomplish the goals of the trust. On the other hand, the duties and restrictions normally imposed by statute are designed to protect the interests of the beneficiary and insure that the trustor's objectives are achieved.

#### **4.5.4.5. Uses of trust income and principal**

Unlike a will that distributes property through the probate process and then goes away, a trust can retain the power to supervise the distributions of property it makes. Thus, a trustor can specify how beneficiaries use the distributions they receive. A trustor can specify that distributions be used solely for the beneficiary's educational or medical expenses, to purchase a home, or for "maintenance of the beneficiary in the custom and lifestyle to which they are accustomed (meaning the beneficiary receives enough distributions to maintain, but not improve, their lifestyle). In some cases, a "special needs trust" may be established to provide for the long-term care of a beneficiary with specific physical or mental health needs, with the amount of distributions tied to those expenses. As mentioned below, distributing only trust income may not be enough in some circumstances; some events may trigger the sale of trust property or the gift of the property directly to provide a larger distribution to a beneficiary. Trustors should think about whether they want to place any restrictions on the use of any distributions made to the beneficiaries, taking into account the additional burden placed on the trustee to enforce those restrictions and the costs to the trust of such enforcement.

#### **4.5.4.6. Timing and amount of distributions**

The trust document should contain instructions for the trustee as to when distributions of trust income and/or trust property are to be made. In some cases, these may be defined by specific dates or periods, such as when a beneficiary turns 18 and can legally receive income or property himself or herself, or to make distributions of trust income to a beneficiary on an annual basis. Other distributions may be based on events rather than scheduled times, such as when a beneficiary starts college, gets married, wants to buy a home, start a farm, or has a critical need caused by illness or other emergency. Regardless of whether the distribution is triggered by a specific time period or event, the trust document should clearly instruct the trustee when such distributions are made.

An important factor that is sometimes overlooked is when to make distributions of income or property to young people. Although a person is legally capable of receiving income or property at the age of 18, some young people have not developed the judgment or experience to care for such gifts at that age. In many cases, trustors may instruct that the distributions are not to be made until the young person is 21, 25, 30, or even older, when they feel confident the beneficiary can properly handle the distribution.

By the same virtue, the trust document should also define the amount of distribution to be made to

the beneficiaries. Some distributions may be defined by a specific dollar amount, and if so, the trust should also include contingency instructions in case the trust does not have enough income to fund that amount. Alternatively, the trust may specify a distribution as a percentage of the trust's income for the period in question. In either case, the trustor should be sure the payments will not drain trust resources too quickly for the trust to accomplish all of its goals. If the trustee has been given the power to sell trust property or give it directly to a beneficiary for a large expense (such as a medical emergency or other major expenditure), the trust should also include instructions for what property is to be used for such purposes, if the beneficiary's future distributions are to be held or otherwise affected, and what to do if the distribution will affect the distribution to other beneficiaries.

#### **4.5.5. Advantages and disadvantage of the trust as an estate planning tool**

Trusts have been heavily promoted for years as an estate planning tool. Trusts can be tremendously flexible estate planning tools, posing significant advantages. At the same time, though, trusts have limitations just like any other estate planning tool.

##### **4.5.5.1. Advantages for trusts as estate planning tools**

The foremost advantage of trusts in the minds of many estate planners is the fact that assets held by the trust do not have to go through the probate process to be distributed. In many cases, this can save both considerable time and expense compared to the probate process.

The separate ownership and management of trust assets also means that property can be held and managed for minor children until they reach a desired age (as discussed in section 4.5.4.6. above). However, the trust arrangement can also minimize the need for appointment of a guardian in case a beneficiary is over the age of 18 as well. For example, if the vast majority of the trustor's assets are in the trust, most of the business affairs of the trustor can be handled by the trustee. This could effectively avoid the need for the appointment of a guardian for the trustor. If the trustor was also the trustee, though, this arrangement is only effective if a successor trustee was named in the trust document.

Trusts carry another advantage in the confidentiality they provide relative to the probate process. While probate is a case filed in open court (giving the public the ability to access records such as the will, the estate's inventory, and the decree of distribution), there is no such public disclosure with a trust. The trust document itself may remain confidential. However, it should be noted that the transfer of titled property into the trust (such as real estate) requires filing in the appropriate public records offices. Still, many people feel more comfortable with the level of confidentiality provided by a trust than that provided by probate.

Trusts are also difficult to contest. While someone unhappy with what they receive under a will can attack the several execution requirements of wills or the mental capacity of the person making the will, there are far fewer points of attack available in a trust. In essence, someone contesting the validity of the trust can only attack the mental capacity of the trustor or the execution of the trust (which is simply a contract, with far fewer requirements than a will). Additionally, courts show great deference to the terms of a trust, and are very reluctant to modify the terms of a trust unless extraordinary circumstances dictate otherwise.

##### **4.5.5.2. Disadvantages for trusts as estate planning tools**

Trusts do have aspects that detract from their effectiveness as estate planning tools. First, if an individual other than the trustor, or an institution, is named as the trustee, trustee fees must likely be paid. Depending on the revenue productivity of the assets in the trust, the effectiveness of the assets' management, and the structure of the fee, the trustee fee may in some cases be a significant draw upon the trust's resources. At the same time, though, one must weigh this against the cost of probate administration. Some estate planners consider the use of a trust as "front loading" the costs of distributing property at death by paying the majority of the costs in advance, while they regard a will and the probate process as "back loading" those costs.

Trusts also add some complexity to the management of the trustor's assets while alive. Remember, the trustor does not hold legal title to the assets placed in the trust; the trust does. This means the trustor cannot deal directly with the assets; they must act through their role as trustee (if the trustor is also the trustee) or by requesting the trustee to act on their behalf.

As with all estate planning tools, a trust must be carefully coordinated with all other estate planning tools to make sure no conflicting transactions are triggered, and to make sure the most efficient and effective tool is used for each item of property.

Finally, even the most comprehensive and well-managed trust does not eliminate the need for a will. Frequently, people who thought their trust handled all of their property at death neglect to place a recently-purchased item into the trust. When they die, not only is the trust powerless to handle that item; it must also go through the intestate succession process if no other estate planning tool acts on it. Thus, even if a comprehensive and far-reaching trust is in place, a will is still needed to round up any property not already in the trust and place it there. Such wills (often called "pour-over wills") still must go through probate, but once probated, they enable the trust to do its job of handling the property.

## 4.6. Life Insurance

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Life insurance is financial planning tool with numerous applications to estate planning. Typically, people think of life insurance as a means of providing income for a surviving spouse and dependent children, and this is certainly an important use. However, there are several other ways that life insurance can play a crucial role in supporting the successful transition of farm assets.

### 4.6.1. Types of Life Insurance

There are dozens of types of life insurance policies, and as with most topics in this workbook, entire books have been written about the topic. To keep things relatively simple, this discussion will focus on two categories of life insurance policies: term policies and permanent policies.

Term policies are purchases for a specific number of years, and as the name implies, provide insurance coverage for a defined term. For example, a ten-year term policy will pay the policy amount if and only if the insured party dies within that ten-year period. If the insured party dies after that period, the policy pays nothing. Term life insurance is typically much less expensive for young purchasers and generally provides more dollars of death benefit per dollar of premium paid than permanent life for young people; however, term life becomes much more expensive the older the insured party becomes.

Permanent policies stay in effect throughout the life of the insured party up to a specified age (frequently 95 years). This means that, unlike term policies, permanent policies pay the policy amount whenever the insured party dies, up to the specified age. Conversely, permanent policies can be much more expensive in terms of dollars of death benefit per dollar of premium paid for young people, though they can also be much less expensive as the insured party ages. In some cases, permanent policies can also accumulate a residual value (sometimes called cash value or surrender value) accessible through withdrawals or loans. It is because of this cash value accumulation that some people regard life insurance as an investment vehicle, although many financial analysts suggest any form of life insurance is best used as an insurance tool only rather than as an investment tool.

As you can see from the differences between term and permanent policies, several factors will influence the choice of which tool is right for you and your estate planning objectives. For many young families, term coverage may have important cost benefits, but for older families, permanent coverage may be needed for the transition objectives they hold. As with all estate planning tools, work closely with your professional team to

determine which insurance policy best meets your objectives.

## **4.6.2. Uses of Life Insurance in Estate Planning**

There are numerous ways life insurance can be used to facilitate your estate planning goals. Before purchasing a life insurance product, though, complete your inventory and financial analysis as outlined in Section 1 of this workbook, and work closely with your accountant, tax professional, and financial advisor to make sure you select the best and most cost-effective tool for your purposes.

### **4.6.2.1. Care of dependent children and surviving spouses**

As mentioned in the introduction to this subsection, perhaps the first use of life insurance thought of is to provide support for any surviving dependent children and a surviving spouse. If you have minor children (or adult children with special needs) who depend on you for care, it is crucial to conduct a financial analysis to determine if enough assets remain to provide for their care until they can become self-sufficient. This may mean providing not only for their care until they are 18, but providing for college education as well. Life insurance proceeds may be an asset directed by your estate plan to any trusts established for your children and/or for their care while in the custody of a guardian (see sections 4.4.4.3. and 4.5.4.5. above). Providing financially for a surviving spouse is an important consideration also, since the surviving spouse will be managing a household (or perhaps even farm operation) without the income provided by the deceased spouse.

### **4.6.2.2. Payment of final medical expenses**

While you may have one or more medical insurance plans to cover the majority of your medical expenses, life insurance may be an important supplement to medical insurance. Medical expenses continue to increase at a rate in excess of inflation, and these costs can be drastically increased when someone dies at the end of a prolonged illness. Life insurance can provide a buffer in case there are medical expenses not covered by medical insurance plans, eliminating the need to “dip into” the other estate assets.

### **4.6.2.3. Debt retirement**

As referenced in section 4.4.4.6., your debts must be handled by your estate in some way or another, and if not paid, they continue to burden the assets of the estate even in the hands of the parties that eventually receive them. Many times, the vast majority of farm assets consist of land or machinery crucial to the farm's operations. Land is generally not considered a liquid asset (meaning it cannot be quickly converted to cash) and frequently is directed specifically to heirs under an estate plan. The heirs may also need the machinery of the estate to operate the estate assets. Thus, even while your farm may have a strong net worth, life insurance may provide the financial liquidity necessary to pay the debts of the estate without having to sell estate assets for those debts.

### **4.6.2.4. Estate administration costs**

Administering even the best-planned estate under the best circumstances incurs some expenses. Administering a highly-contested estate takes far more resources. To avoid the loss of estate assets to these costs, some people purchase life insurance plans specifically to cover estate administration costs.

### **4.6.2.5. Liquidity for operations**

Depending on the amount of liquid assets held by the farm operation, an additional infusion of cash may be needed to maintain the operation during the administration of the estate. This is particularly true if there is any possibility some assets required for the operation may be “tied up” by the administration process or if the distribution of those assets is contested.

### **4.6.2.6. Estate taxes**

Estate taxes can take a significant portion of the estate if the estate is large enough to exceed the amount

of the federal unified credit (see subsection 4.6.2.6. below). In some cases, people may purchase a life insurance policy specifically to cover their anticipated estate tax liability. This strategy can be very effective, but must be carefully coordinated with an estate tax professional and attorney; if the policy is not carefully constructed, it could actually increase the estate tax liability by enlarging the estate.

#### **4.6.2.7. Second marriages**

If someone has children from a previous marriage, he or she may not want to force those children to operate the farm with a surviving spouse who is not their parent. Life insurance could be used provide an asset to care for the needs of the surviving parent while giving the farm assets to children immediately. Such an arrangement might minimize the opportunity for conflicts between the surviving spouse and children.

#### **4.6.2.8. Handling asset allocation among on-farm and off-farm heirs**

At a number of points in this workbook, we have discussed the conflicting interests of on-farm and off-farm heirs. In many cases, parents do not want to treat their children unequally, which often results in giving joint interests in farm assets to off-farm and on-farm heirs. This can often lead to the off-farm heirs selling their interests to the on-farm heirs, or even to an outside party. Such transactions can place financial stress on the on-farm heirs and deprive the farm of needed assets. However, life insurance provides a handful of options to alleviate these situations. In the most straightforward application, parents can purchase life insurance plans and make the off-farm heirs the beneficiaries of the plans. While the off-farm heirs may not receive precisely the same amount of asset value as on-farm heirs who receive farm assets, the allocation of the life insurance proceeds to the off-farm heirs may be much less disruptive to the farm operation. Conversely, if parents chose to grant joint interest in the farm assets to on-farm and off-farm heirs, the on-farm heirs could purchase life insurance plans on the lives of the parents to provide proceeds that could be used to purchase the interests of the off-farm heirs if such a transaction should become necessary.

#### **4.6.3. Final considerations in using life insurance as part of the estate plan**

Regardless of the life insurance product(s) you purchase, work closely with an accountant, tax professional, accredited financial planner and estate planning attorney to determine who should be the owner of the policy, who will be named the beneficiary, how the policy should be funded, and the instructions needed through the will, trust, or other estate instrument to make sure the insurance proceeds are properly directed to their intended uses.

## **4.7. The Estate Tax**

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One of the most frequently cited objectives in estate planning is “minimization of estate and gift taxes.” One should always bear in mind, though, the economically optimal objective might be better stated “maximization of after-tax wealth transferred.” Knowing some of the key estate and gift tax rules can help in evaluating your current situation and in selecting strategies to maximize the wealth transferred.

Before we begin our discussion of the estate tax, it is important to note Oklahoma abolished its estate tax effective on January 1, 2010. Thus, the only estate tax that remains for Oklahoma residents is the federal estate tax.

#### **4.7.1. Calculating the federal gross estate**

The federal estate tax is a tax on all the property owned or controlled (for example, through a power of appointment) by a deceased person. The laws governing the federal estate tax were significantly modified by the American Taxpayer Relief Act of 2012 (2012 ATRA), which modified the estate tax for decedents dying and

estate transfers made after December 31, 2012. One such change was the estate tax exclusion, i.e. the amount of estate value that can pass without estate taxes. This amount was set at \$5,000,000 and indexed for inflation each year thereafter. For 2015 the estate tax exclusion is \$5,430,000. The maximum estate tax rate was increased from 35 to 40 percent for deaths and transfers in 2013 and future years.

The calculation of the federal estate tax starts with determining the decedent's "gross estate." The gross estate includes all real and personal property, whether tangible or intangible. These properties include the following:

- All death benefits under life insurance policies on the life of the decedent owned or controlled by him or her, or payable to his or her estate and cash values of all life insurance policies owned by him or her on lives of others.
- Lifetime gifts are no longer included in the gross estate (although the taxable portion will be included in the tax base for estate tax computations).
- Property over which the decedent held a general power of appointment.
- Property given away during life in which the decedent retained some control or a life estate. Revocable trust assets are included because the deceased retained control until death.

The property must be appraised at its fair market value, or if the executor of the estate elects, certain qualified property may be appraised at its current use value. Current use values for qualified property and the current market value will be discussed later in section 4.7.3. Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to sell or buy.

The completion of the estate tax return is generally overseen by the executor of the decedent's will.

#### **4.7.2. Taxing Joint Tenancy Property**

Generally, the value of all joint tenancy property is included in the estate of the first joint tenant to die, except for the proportion the executor can prove was contributed to its acquisition by the surviving joint tenant and/or as a gift by a third party to the credit of the surviving joint tenant. If the surviving spouse and the decedent were the only joint tenants, only one-half of the value of the joint tenancy property will be included in the estate. If the joint tenants are not spouses, the amount each party contributes to the purchase of the property will be what each person uses as their ownership interest for estate tax purposes. For example, say Tom provides \$300,000 and Harry provides \$200,000 to the purchase of the property. Their value for estate tax purposes would be \$300,000 basis for Tom and \$200,000 basis for Harry.

As result of the marital deduction, property held jointly by spouses with rights of survivorship does not trigger any estate tax in the estate of the first spouse to die. Technically, only one-half of the jointly held property would be included in the estate, and that one-half would be excluded by the marital deduction. For example, Husband and Wife purchase a property for \$100,000. One-half of the value belongs to each; that is, Husband has a basis of \$50,000 and Wife has a basis of \$50,000. At Husband's death, the fair market value of the property is \$250,000. When Husband's joint tenancy interest passes to Wife at Husband's death, her basis in the property is now \$175,000 (\$50,000 contributed by her + husband's \$125,000 [half of the total value of the property at death]).

### 4.7.3. Current Use Value

In some cases, farm land could have a market value significantly higher than its value for farm use. For example, in an area near a town or city, residential development might be near the farm, and land might be worth several thousand dollars per acre for residential development, while the revenues produced by farming the land alone would not support nearly that price. Thus, in some cases, valuing the land in its “current use” could reduce the value of the estate (and thus the amount of estate taxes paid). The executor may elect to value real property devoted to farming or other closely-held business at its current use value rather than market value if certain conditions are met. Contact your tax professional to determine whether current use valuation would be a benefit to your specific situation.

### 4.7.4. Computation of the Taxable Estate

The taxable estate is the gross estate less deductible expenses such as:

- Funeral expenses
- Estate administration expenses
- Claims against the estate, such as the decedent’s debts
- Taxes accrued but unpaid at the date of death
- Loss from fire, storm, and theft (casualty losses) not compensated by insurance or claimed as a deduction in a prior income tax return
- An unlimited marital deduction is allowed for property that passes to a surviving spouse. The executor may even elect to have certain life interests qualify for the marital deduction. See the discussion below on marital deduction for more detail.
- The amount of transfers to charitable, religious, and similar institutions approved by IRS

After the taxable estate is determined, the includible taxable gifts are added to the taxable estate before referring to the tax tables to determine the amount of the estate tax.

Once the value of the taxable estate is determined, it is reduced by the estate tax exemption amount (for 2015, the amount is \$5,430,000). The exemption amount for this and previous years is shown in Table 1 below. Functionally, this means for decedents dying in 2015, no estate tax is owed if their estate had a value of \$5,430,000 or less.

**Table 1**

<b>For decedents dying in year</b>	<b>Federal Estate Tax Credit</b>	<b>Equivalent Exemption</b>	<b>Federal Gift Tax Credit</b>	<b>Equivalent Exemption</b>
2012	\$1,772,800	\$5,120,000	\$1,772,800	\$5,120,000
2012	\$2,045,800	\$5,250,000	\$2,045,800	\$5,250,000
2014	\$2,081,800	\$5,340,000	\$2,081,800	\$5,340,000
2015	\$2,117,800	\$5,430,000	\$2,117,800	\$5,430,000

#### 4.7.4.1. Marital Deductions

There is an unlimited marital deduction for decedents, meaning the value of any property transferred to the decedent’s spouse is deducted from the value of the gross estate. The decisions on the use and amount of

marital deduction will vary with the size of the estate and the unified tax credit. Given the current “portability” rules (discussed in the next subsection), fewer estates will find it necessary to use the marital deduction for the purposes of managing estate taxes.

#### **4.7.4.2. Portability of the Deceased Spouse's Unused Exemption**

“Spousal portability” means the ability to take the unused estate tax exclusion amount of the first spouse to die and add it to the surviving spouse’s exclusion amount. The 2012 ATRA made this ability a permanent part of federal estate tax law.

The estate tax law defines the applicable exclusion amount as the sum of the basic exclusion amount and, in the case of a surviving spouse, the deceased spouse’s unused exclusion amount. For 2015 each spouse’s basic estate tax exclusion amount is \$5,430,000 and this provision allows the spouses to combine their individual exclusion amounts for a maximum exclusion of \$10,860,000 (should both spouses pass in 2015).

Consider this scenario: Husband passes in 2011 and the value of the estate is \$4.25 million. There is an unused amount of \$750,000 from the husband’s estate that can be used for the wife’s estate (the 2011 estate tax exclusion was \$5.0 million). In 2015, the wife passes and the fair market value of the estate is now \$6.0 million. The heirs can use her \$5.43 million exclusion (the exclusion amount for 2015) plus \$570,000 of the Husband’s \$750,000 in unused exclusion, thus avoiding estate tax.

The amount of deceased spouse’s unused exemption is available to the surviving spouse only if the executor of the deceased spouse’s estate elects portability of the unused exemption amount on a timely filed estate tax return for the deceased spouse. An estate tax return must be filed to elect portability even though an estate tax return would not otherwise need to be filed.

#### **4.7.5. Federal Gift Taxes**

For gifts made in 2015 and thereafter the annual exclusion has been increased to \$14,000 per recipient (this amount is indexed for inflation, but only increases by \$1,000 increments). With gift-splitting (that is, the gifting of property by husband and wife), spouses may transfer \$28,000 per recipient per year without gift tax.

Also, an unlimited gift tax exclusion is allowed for amounts paid on behalf of a donee directly to an educational organization for tuition and to a health care provider for medical services.

For a gift in trust, each beneficiary is treated as a separate person for purposes of the exclusion. The annual exclusion is not available for gifts of future interests such as a remainder interest in a trust or life estate, except for gifts to minors in trust or under the Uniform Gift to Minors Act.

Gifts given within three years of death generally will not be included in the deceased donor’s estate (the taxable portion of gifts would be included in the tax base for estate tax computations). However, gifts with retained life estates, transfers effective at death, revocable transfers, transfers of general powers of appointment and transfers of life insurance will be included in the estate. The three year rule was retained for redemption of stock to pay estate taxes, special valuation of certain farm property, extension of time to pay estate tax, and for determining property subject to a lien for taxes.

An unlimited marital deduction is permitted for gifts from one spouse to another and the law exempts all such transfers from gift tax filing requirements. However, gifts between spouses within three years of death must comply with the requirements listed above for gifts given within three years of death.

Gifts to charitable organizations and other institutions specifically mentioned in the regulations may also be deducted from the gross amount of gifts given (they are nontaxable gifts).

Usually, gifts must be complete and permit the recipient to use the property immediately to qualify for the exclusions. If the owner retains certain powers or control over property, it may be taxed as a gift and also in the estate at death. In such cases, however, credit may be allowed on the estate tax return for gift taxes paid.

Normally, the basis of property transferred in an estate is adjusted to its fair market value at the donee's death. However, the basis of appreciated property acquired by gift within one year of donee's death is not adjusted to its fair market value at date of donee's death if it is returned to donor or donor's spouse.

Gift tax returns are to be filed and gift taxes are to be paid on an annual basis. The due date for filing the return and payment of the tax for gifts made during the year is the next April 15.

Oklahoma gift taxes have been eliminated for all gifts made since January 1, 1982. No Oklahoma gift taxes have been imposed on gifts between spouses since September 6, 1975.

#### 4.7.6. "Stepped up" basis in property

Although not actually an estate tax issue, it is important to note that the tax basis in property transferred through an estate will be "stepped up" as a result of that transfer. For example, say Owner purchased a piece of property for \$100,000. Currently, the fair market value of that property is \$500,000. If Owner were to sell the property today, she would pay capital gains tax on her capital gain of \$400,000 (\$500,000 current value - \$100,000 cost basis = \$400,000). Now, say that Owner died and in her will gave the property to Daughter. Thanks to "stepped up basis," Daughter does not have the owner's original \$100,000 cost basis in the property, but rather gets a "stepped up" basis that is the fair market value of the property at the date of the decedent's death (in our example, \$500,000). If the daughter were to sell the property in six months for \$525,000, she would only owe capital gains tax on \$25,000 (\$525,000 current value - \$500,000 stepped up basis = \$25,000 capital gain).

The principle of stepped up basis does not affect estate tax liability, but does impact the potential tax liability of heirs who may sell the property after the death of the decedent. Be sure to consult your tax professional to discuss how your particular estate plan can take advantage of this principle.

## 4.8 Conclusion: Discussing the Estate Plan with Your Family

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Although this workbook devotes an entire section to discussing your farm transition plan with your family, it bears repeating here: maintaining good communication with your family as you develop your estate plan can provide a number of important benefits. Two crucial benefits stand out.

First, such communication can help guide your planning efforts. Knowing the hopes and expectations your family holds with regard to the farm operation provides you with important information that may impact your decision about how to allocate assets in your estate plan.

Second, people tend to react negatively to surprises if they perceive the "surprise" information as negative. For example, consider a scenario in which parents have decided to give all of their farm assets to an on-farm heir, and to give financial assets not related to the farm to an off-farm heir. Although the off-farm heir receives a substantial amount of value, it is not as much as the on-farm heir. Without good communication in advance, the off-farm heir may perceive this as a bad surprise, and motivated by negative emotions, could attempt to undermine the estate plan. Whether the heir's attack is successful, it will likely add significant time and expense to the estate plan, to say nothing of the emotional damage it might cause to the family. While many people wish to avoid conflict in life by not discussing their estate plans, they must also consider the fact that after they are gone, they can do nothing to repair the damage caused by conflicts arising from the plan. If these potential conflicts can be identified and dealt with in life, there is a much greater chance of family unity for years to come.

## For More Information:

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Neil Harl, Farm Estate and Business Planning (18th Ed., 2014)

<http://www.amazon.com/Farm-Estate-Business-Planning-Edition/dp/0967785693>

The Estate Planning Center – Keeping the Family Farm in the Family

<http://tlcplanning.com/FamilyFarmsALastingLegacy/KeepingtheFamilyFarmintheFamily.aspx>

The Farmland Information Center – Farm Transfer and Estate Planning

<http://www.farmlandinfo.org/landowner-options/transfer-your-farm>

Oklahoma Cooperative Extension Service Circular - Estate Planning: A Simplified Guide for Oklahoma Farm and Ranch Families, <http://pods.dasnr.okstate.edu/docushare/dsweb/Get/Document-3593/E-726%20web.pdf>

Oklahoma Cooperative Extension Service Fact Sheet - Trusts: Uses and Considerations

<http://pods.dasnr.okstate.edu/docushare/dsweb/Get/Document-2478/AGEC-771web.pdf>

Oklahoma Cooperative Extension Service Fact Sheet – Probate

<http://pods.dasnr.okstate.edu/docushare/dsweb/Get/Document-7334/AGEC-773web.pdf>

Oklahoma Cooperative Extension Service Fact Sheet – Wills: Requirements and Considerations

<http://pods.dasnr.okstate.edu/docushare/dsweb/Get/Document-7336/AGEC-782web.pdf>

Oklahoma Cooperative Extension Service Fact Sheet – Developing an Estate Plan

<http://pods.dasnr.okstate.edu/docushare/dsweb/Get/Document-9249/AGEC-793-2014.pdf>

## ENDNOTES

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<sup>1</sup> In many ways, the appointment of a guardian for a mentally incompetent adult is similar to the appointment of a guardian for a child under the age of 18.

<sup>2</sup> The issues arising with co-proxies are not limited to siblings in that role; any time co-proxies are appointed, many of the same issues will arise.

<sup>3</sup> “Life sustaining treatment” is generally defined as “any treatment that is designed to prolong life and delay the moment of death and includes, but is not limited to, cardiac or respiratory resuscitation, artificially administered hydration and nutrition, kidney dialysis, antibiotics, curative procedures, most diagnostic procedures and surgeries except those to relieve pain or symptoms. It is presumed that every person would want palliative care which relieves symptoms and promotes comfort but is not designed to extend life.” Jan Slater, “Oklahoma’s Remarkable Law Regulating End of Life,” 85:26 Okla. Bar J. (2014).

<sup>4</sup> “Terminal condition” means an incurable and irreversible condition that, even with the administration of life-sustaining treatment, will, in the opinion of the attending physician and another physician, result in death within six (6) months. 63 Okla. Stat. § 3101.3 (12).

<sup>5</sup> “Persistently unconscious” means an irreversible condition, as determined by the attending physician and another physician, in which thought and awareness of self and environment are absent. 63 Okla. Stat. § 3101.3 (7).

<sup>6</sup> “End-stage condition” means a condition caused by injury, disease, or illness, which results in severe and permanent deterioration indicated by incompetency and complete physical dependency for which, to a reasonable degree of medical certainty, treatment of the irreversible condition would be medically ineffective. 63 Okla. Stat. § 3101.3 (4).

- <sup>7</sup> Property law dictates that all joint tenants have equal fractional shares in the property. Compare this to a tenancy in common, in which it is possible for all of the tenants to have different fractional shares in the property.
- <sup>8</sup> It should be noted, though, that if the life estate holder sells or otherwise transfers his or her interest, that transaction does not affect the remainderman's interest. If, for example, the life estate holder (who, for the sake of this example, is also the measuring life) sold his or her interest, the purchaser would only own the right to possess and use the property while the life estate holder was alive; as soon as the life estate holder died, title to the property would go to the remainderman.
- <sup>9</sup> Oklahoma provides a statutory form for the transfer on death deed at 58 Okla. Stat. § 1253.
- <sup>10</sup> Under Oklahoma law, there is only one circumstance in which an oral will is considered legally valid. A person in military service and in fear of immediate death related to the military service can make an oral statement as to how he or she wants to distribute property. The estate cannot exceed \$1,000 and cannot include real estate. At least two witnesses must be able to establish not only that an oral will was made, but also the contents of the will. Consequently, oral wills have very little practical usefulness.
- <sup>11</sup> The decree may deviate from the will's instructions if some property was required to pay the debts of the estate, or if provisions in the will have been invalidated for some reason (see section 4.4.3. regarding will contests).
- <sup>12</sup> Oklahoma has a statutory procedure that allows for small estates (with less than \$200,000) to go through a process called "summary administration" which proceeds much more quickly than a full probate proceeding. See 58 Okla. Stat. §§ 245 – 247.
- <sup>13</sup> See 84 Okla. Stat. § 44 providing the "spousal election" to take one-half of the joint industry property acquired while the couple was married. Courts have held "no contest" clauses cannot override the spousal election. See *Matter of Estate of Zarrow*, 688 P.2d 47 (Okla. 1984). However, pre-nuptial agreements can override the spousal election.
- <sup>14</sup> However, banks acting as trustees may obtain approval to maintain common trust fund accounts in which funds from several trusts are combined and used by the bank in the same manner as deposits in other accounts. This permits the bank to minimize the costs of managing small trust accounts. In such cases, the bank still has a duty to keep records of the status of each trust and to account for the administration of each trust to the beneficiaries.
- <sup>15</sup> See 60 Okla. Stat. § § 31 and 175.47. The case of *Pipkin v. Pipkin*, 370 P.2d 826 (Okla. 1962), however, held the rule against perpetuities did not apply to the trusts if the trustee had the full power to sell or transfer the trust assets.



# FARM TRANSITIONS

**Chapter 5**

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# Putting Your Plan into Action

## 5.1. Do we have what we need?

In this section we ponder the question: does the business have the resources that it needs to get where it needs to be? We have already broached this topic in some areas including the overall size of the business, and in some discussions regarding the human resources. Here we address the issue in more detail and provide a few simple tool suggestions. Resources to be considered include land, equipment, buildings, financial assets, community support and services, and people.

Begin the process by describing the resources currently available, perhaps by category. This is not an exercise in putting together a value inventory, where the resources are simply listed and assigned a dollar value, but rather an exercise designed to zero in on the contributions of the various resources to the productivity and overall efficiency of the business. Therefore, the focus of this inventory process needs to be on the productivity and usefulness of each resource to the business. Think about the contribution to the goals, objectives, mission, and vision of the business. This evaluation helps match the resource base with production plans, and how those plans might need to change over the course of a transition.

The evaluation begins by detailing a multi-year plan of operations for the business, spelling out on paper what the business plans to produce over the course of the next few years. This is especially important if significant changes will be taking place. This will set the stage for considering the resources that will be needed to facilitate the production plans. We suggest keeping an open mind and considering all options when changes to the resource base (in any category) need to be made. Current resources may need to be disposed of in order to facilitate the acquisition of a set of resources that are a better fit for the future production plans.

The land resource warrants significant attention in any discussion aimed at agricultural producers, since it is considered to be the “base” resource for most agricultural operations, and it is considered to be scarce and costly to obtain in most agricultural situations. Inventory the current land resource beginning with the obvious legal and common descriptions. Utilize GIS maps or satellite photos to assist in the evaluation. For each property, describe the current ownership and/or tenure arrangement, and document any considerations regarding how that arrangement is likely to change in the foreseeable future. Also document any legal restrictions such as zoning, etc. that might limit the scope of the use of that parcel for business purposes. If the land is owned by someone else, the land owner may also impose restrictions on the use of the land. Consider buildings, improvements, water availability, climate, and other overall productivity factors as you focus on how each piece of land currently available to the business matches with the long-term production plans of the business.

Often, it is determined that additional land will need to be added to the operation to facilitate the transition (and just to keep up with normal growth trends in the industry). Like most other resources, land can be acquired through either ownership or leasing. This is a decision that needs to be weighed very carefully, as there are advantages and disadvantages to various land tenure arrangements. Ownership brings with it certainty of control, complete management and use flexibility, and the opportunity to benefit from the investment aspect of land ownership. However, from a financial perspective land purchases have historically had a significant “cash flow” problem, in that agricultural land does not generate enough cash net returns to make payments on any significantly leveraged purchase arrangement. Therefore, land purchases can create significant financial strain on a business in a transition, and as such careful consideration needs to be given to not only the “profitability” aspects of a proposed purchase, but also to the “financial feasibility” aspects as well. On the other hand, in most geographic areas, the rental market for agricultural land is extremely competitive, with several “good” operators in line for any rental opportunities that become available. Consider ways that your business can become very

innovative in “selling itself” as the tenant of choice in your area. Think about factors that are important to the land owners you may want to attract as potential stakeholders in your operations. Some may value primarily the financial returns potential, so for those you find creative ways to highlight the financial returns that you feel you can generate for them. Others may value opportunities to participate or be involved in certain activities such as harvest, so consider mechanisms to facilitate that involvement. You may want to develop landlord newsletters, web pages, or social media outlets as mechanisms to keep land owner stakeholders well informed.

Machinery, facilities, and breeding livestock make up the next largest category of resources for a typical agricultural business, at least in terms of dollar value. Much like the initial evaluation of the land resource, this inventory begins with a list and description of all equipment, buildings, facilities, and breeding livestock currently in the business. Again, the focus is not on dollar value but rather on productive capacity, usefulness, and fit with the overall production plan of the business. For machinery and facilities document such characteristics as age, state of repair, useful remaining life, and match with future needs for production and expansion (could be a ranking on a scale of “excellent” to “poor” for example. Similarly, for breeding livestock document at least a summary of the average age, quality characteristics, and productivity potential. A worksheet like the following might assist in the process.<sup>1</sup>

Many options exist for acquiring resources like machinery, buildings, and facilities. For machinery the list of options includes purchasing (new or used), cooperation or sharing arrangements, hiring work done on a custom basis, leasing equipment, or short-term rental arrangements. Keep in mind that the capacity of modern agricultural machinery is huge, and the reliability is greatly improved from several years ago. At the same time, the price tag is large as well. In order to justify ownership of modern equipment, it must be spread out over a large amount of hours or acres. When planning for the equipment needs of an agricultural business in transition stakeholders must look for opportunities to utilize owned equipment fully, or they must consider alternative ways of acquiring machinery services.

For buildings and facilities that are permanently or semi permanently fixed to a real estate resource, the options for acquisition are somewhat more limited for obvious reasons. Since these resources can tie up large sums of capital, time spent seriously evaluating future needs and plans for acquiring will be well spent.

Breeding livestock is most typically acquired through purchase, though it is not uncommon in many situations for there to be a lease arrangement in place between two individuals. Breeding livestock lease arrangements are a good way for the exiting generation to transfer ownership of a breeding herd to the incoming generation slowly over a period of years.

After summarizing existing resources, future production plans, and the overall transition timeline, plans can be made for making changes to the resource base and acquiring additional resources. Thinking through a couple of alternative acquisition strategies for major items using a template such as illustrated here (worksheet 5.2) can provide direction for the process and will hopefully help your organization to ultimately make better acquisition decisions.<sup>2</sup>

Chapter 1 provided a detailed discussion regarding the evaluation of the financial resources of the farm, and methods for looking at the financial aspects of implementing the transition production plan. Along with the “mechanical” aspects of financial evaluation and planning outlined earlier, don’t forget to assess the ability and willingness of various business stakeholders to take on risk. As part of the resource evaluation and planning process constantly monitor credit worthiness and maintain a list of potential funding needs and sources.

The “community” resource compliment includes such things as access to markets that are relevant for what you are currently or planning to produce, labor availability and competition, support services, and professional service availability. This is likely the one resource category that you cannot change (at least not very much), so planning involves figuring out how to best manage your operation in the community environment that you find yourself in.

## Worksheet 5.1

### Describing Current Physical Assets

#### Buildings - Structures

Item	Size or Capacity	Condition	Value	Match with Future Production Plan

#### Machinery – Equipment (Crop Production)

Item	Size or Capacity	Condition	Value	Match with Future Production Plan

#### Livestock - Equipment

Item	Size or Capacity	Condition	Value	Match with Future Production Plan

#### Breeding Livestock

Item	# of Head	Condition	Value	Match with Future Production Plan

## Worksheet 5.2

## Thinking Through Resource Acquisition Alternatives

[illegible]

Finally we come to the category of “human” resources. Human resources are unique in that each person is different in many regards, labor is necessary to utilize the other resource categories, and for the most part labor cannot be stored. Begin the process of the human resource inventory and plan by developing a business workload calendar that clearly summarizes what tasks and functions need to be accomplished, the timeline when those tasks and functions need to be done, and the amount of time required. A worksheet similar to our example worksheet 5.3 may be helpful in that process.<sup>3</sup> Next, summarize the individuals currently available in your stakeholder team and the amount of time they are willing and able to commit to the business. Consider each individual’s skills, abilities, and interests that match up with the tasks that need to be done.

### Worksheet 5.3

#### Workload Calendar

Hours/Quarter				
Tasks	1 <sup>st</sup> Quarter	2 <sup>nd</sup> Quarter	3 <sup>rd</sup> Quarter	4 <sup>th</sup> Quarter
<b>Operating</b>				
<b>Sub Total</b>				
<b>Management</b>				
<b>Sub Total</b>				
<b>Marketing</b>				
<b>Sub Total</b>				
<b>Other</b>				
<b>Sub Total</b>				
<b>Overall Total</b>				

It may be helpful to develop a diagram of your human resource situation (what are the various responsibility and reporting connections) to graphically portray your business human resource situation. The idea is to gain a clear understanding of “who is on your business bus” and “what seat are they in”. The current workload calendar needs to be supplemented with future production plans to consider the match between workload estimates and other needs, and the human resource compliment that will be available or will need to be assembled. Questions such as “will anyone who currently works in our operation be leaving”, and “will any new people be joining our operation and if so what skills will they bring to the table” need to be considered. This process will help identify human resource “gaps” that will need to be filled. Then, like with the other resources, a well thought out acquisition strategy can be developed that considers the skills needed to move the business forward through the transition. If this sounds like developing job or position descriptions, it is. While a relatively small percentage of even the best run farm and ranch businesses have well documented job descriptions for important positions in the business, we argue that position descriptions are an essential part of this planning process. Among other things, well written job descriptions help to define the various roles within the organization, provide a benchmark for accountability, and provide an objective basis for performance evaluation. While many believe that job descriptions are only for “non-family” roles within the business, they can also help avoid common pitfalls when bringing family members into the business. By focusing specifically on the skills that are needed in the business, a position description will help avoid the temptation to bring somebody into the operation (and start paying them) just because they are family, and not because there is a legitimate opening in the business that can be filled by that particular person. There are often serious misconceptions regarding skills and abilities that can be sorted out by utilizing job descriptions. Furthermore, when an individual is considering phasing out of the business, a position description provides a detailed checklist regarding what skills will be needed to fill that void, and what timeline and training strategies can be employed to bring someone into that role if considering an existing business stakeholder, or what acquisition strategy needs to be employed if there is a need to find someone currently outside the business to fill that role. Without going into a lot of detail here, any job description should provide detail regarding the specific job duties, responsibility, and authority, broken down by functional area (operations, management, planning, etc.). Qualifications should be listed, as well as the work environment within which the various tasks will take place and who the person will report to (where the position fits within the organizational structure of the business).

As we have outlined above, in principle the human resource compliment should be evaluated just like any other category of resources to see if the current workforce responsibilities need to be redefined, if current resources need to be replaced with resources that are a better fit, or to see if other resources can be substituted for labor, or vice-versa. In practice, this is a very difficult process to implement objectively, especially in a family business. Disagreements about decision making authority, and jealousy among stakeholders is simply more pervasive in family businesses due to the difficulty in separating the family, ownership, and operational roles that each stakeholder simultaneously plays in the family business.

The point of this entire resource evaluation and planning exercise is two-fold. First, has your business exhausted all the possibilities for improving efficiency from the existing resource base? Second, is there a combination of under-utilized resources that might create an opportunity that has not yet been considered? Only through a comprehensive evaluation and planning process that considers all alternatives available can the business zero in on these efficiency question, and maintain a high level of resource use efficiency through a transition or major change in the business.

## 5.2. Preparing your stakeholders to move forward

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As you may recall from Section 2, keeping in constant communication with your stakeholders is crucial to developing a transition plan with sound “buy-in” from everyone involved. Now, as you begin to implement your transition plan, you will need to “cash in” on that buy-in as those stakeholders now prepare to move into the new

roles to which the transition plan will call them.

As you move toward the implementation phase of your plan, you can help prepare your stakeholders by thinking about what skills they will need relative to the skills they have now. Will additional training or experience be needed? How can that training or experience be provided in a way that is affordable? How much time does the stakeholder have to prepare for their role? What can be done if there is a gap between the time the training or experience can be obtained and when it is needed?

These matters are important regardless of the transition plan you have chosen, but it is also critical that you prepare at least one (if not more) stakeholders for what should be done in the event of your death. To some extent, these questions are similar to those in the preceding paragraph, but with more urgency. Would the person who needs to step into your role in the event of your sudden, accidental death have the experience and expertise needed to take over quickly and with a minimum disruption to the operation of the farm? Would they have access to the funds and equipment they need to continue the farm operation? Do they have relationships with the vendors, consultants, and professionals you rely upon in the operation (and if not, how can those relationships be developed)? Talk through all these points with the person who would be your successor in such an event, ask if they have questions, and help them work through the preparations needed.

Another step that can aid your successor in the event of a sudden death of a manager is to have a clear, plain-English plan for what should happen in the event of that death. Include step-by-step instructions for what needs to happen with the farm operation, as well as what needs to happen with regard to the farm operation, as well as to the estate of the deceased person. Include directions on where to find needed resources, who to ask for help, a list of records to keep (including where to find your current inventory for the operation), and a list of the kinds of tasks and decisions that can be made without any assistance, what can be done only with the help of a professional (such as an accountant or attorney), and what can be done only with the permission of the court or some other legal proceeding (such as actions that require approval of the probate court).

These conversations may be difficult, but should the information be needed, they will also be immensely valued by the entire family.

## 5.3 When is the right time for a checkup on the transition plan?

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You've worked hard to develop your transition plan, and feel good about what you have accomplished. That's the good news. The challenge is that your transition plan will need continuing care to remain effective. A number of events can require revisions to your plan. These include:

- Birth of a new family member
- Death of a family member
- Marriage of a family member
- Divorce of a family member
- Disability of a stakeholder
- Acquisition of an asset of significant value
- Sale or other disposition of an asset with significant value
- Major legal change (such as a change in taxation, estate, or business entity laws)

Any of these occurrences can change the effectiveness of your plan in achieving your goals. Further, even if none of these changes occur, your plan should be evaluated on a regular basis. Ideally, your plan should be reviewed each year in the context of your family's annual business meeting (though such meetings should occur more than annually) to determine the progress that is being made toward your transition goals; this will also help you determine if any modifications or revisions should be made to the plan.

## 5.4. Conclusion

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Remember, the payoff for all the work you and your family have invested in your transition plan is the successful implementation of the plan. Don't be content to have a good plan that gathers dust in a binder on the shelf – you'll have to invest as much (if not more) effort in implementing your plan as you did developing it!

### ENDNOTES

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<sup>1</sup> Adapted from Worksheet 2.3 in "Building a Sustainable Business: A Guide to Developing a Business Plan for Farms and Rural Businesses", Minnesota Institute for Sustainable Agriculture.

<sup>2</sup> Adapted from Worksheet 4.14 in "Building a Sustainable Business: A Guide to Developing a Business Plan for Farms and Rural Businesses", Minnesota Institute for Sustainable Agriculture.

<sup>3</sup> Adapted from Worksheet 4.18 in "Building a Sustainable Business: A Guide to Developing a Business Plan for Farms and Rural Businesses", Minnesota Institute for Sustainable Agriculture.