You Can Bet the Farm on It: 6 tips to Ensure a Successful Transition to the Next Generation

BY: Samantha K. Wolfe, Esquire, LL.M. in Taxation

My dad grew up on a dairy farm in Maryland. He lived with his aunt and uncle and helped out on their farm. He still complains about the two a.m. milking's and loves to say that my sisters and I don't know what work is because we never had to milk the cows before going to school. He regales all of these stories with that mischievous glint in his eye, and I know he loved it. Since before I can remember, my uncle was sick with Parkinson's disease. When he died in the early 1990s, my Aunt Katherine decided it was time to talk about what would happen to the farm when she passed away. She knew how much my dad had loved living on the farm and wanted to make sure that the legacy would go to my dad upon her death. It was important to her to transition the farm to my dad in the best way possible.

I remember sitting at our dinner table listening to my dad and Aunt Katherine hash out all the details. They were on the right track to implementing a proper business succession plan. They had great intentions to pull off a seamless transition, but through a series of bad circumstances and some bad advice from Aunt Katherine's attorney, the business succession plan never got off the ground. My dad really doesn't like to talk about it. He says he paid too much money in taxes, and nothing was accomplished.

If you take a step back, you can learn a lot from my dad's circumstances. If I had known then what I know now, if my dad had asked me to create his business succession plan, I would have asked six basic questions. I'm sure these six questions would have sparked additional questions, but these six questions would have started the wheels turning and would have laid the foundation for a successful succession plan.

Question #1: Why is a business succession plan needed?
When my dad and Aunt Katherine met with the attorney, the attorney didn't ask what was most important to my dad and Aunt Katherine. There was no plan. If the attorney had asked my dad what he and Aunt Katherine wanted to accomplish, my dad would have said to transfer the farm to him while paying the minimal amount of tax. The attorney could have mapped out the steps that needed to be taken to accomplish that goal.

A major component of a successful business succession plan is identifying the future decision-makers. In my dad's case, he has a brother that lives out-of-state and a sister, neither of whom spent a lot of time working on the farm. Aunt Katherine wanted to ensure that my dad had the ability to make the decisions regarding the farm since he had invested so much in its success. To maintain healthy relationships between siblings, it would have been helpful for the attorney working with Aunt Katherine to include not only my dad, but also his brother and sister in the discussion about the transition of the farm to the next generation.

Because of the complexities involved with business succession planning, the emotional facet is often overlooked. It is important to remember that you need to consider not only the mechanics of the transition, but also the emotional ramifications.

Question #2: What mechanism should be used to facilitate the business succession plan?
When most people think of a business succession plan, they think of a buy-sell agreement, but a buy-sell agreement is only one of the ways to transition a business.

A few options to transition a business include outright gifting, including a specific bequest in a Last Will and Testament; patterned gifting to gradually transition the business to the next generation; gifting to different types of trusts; or the use of a buy-sell agreement.

The simplest business succession plan is to either gift the business outright or include a provision in a Last Will and Testament specifying who will receive the business upon the death of the current owner. Experience has taught me, however, that the simplest plan is not always the best plan. Remember, it boils down to whether the business succession plan accomplishes the goals of the current owner and the future owner.

In my dad's circumstances, the attorney heard my dad when he said he wanted to keep the business succession plan simple, but the attorney missed the part where my dad and Aunt Katherine stressed that most importantly, they wanted to transition the farm to my dad while minimizing the tax consequences for both my dad and Aunt Katherine. Additionally, it would have been helpful for the attorney to have explained that there is more than one type of tax and an option to reduce one type of tax may increase the tax liability for a different type of tax.

In general, most people want a simple business succession plan, but more importantly they want a successful business succession plan. My guess is that most clients will forfeit the simple plan in favor of the more complex plan if it meets all of their goals. On the flip side, we try never to plan more complex than it needs to be.

Question #3: How will the business transition occur?
This question sounds much more difficult than it is. The question should really be: "Is the business being gifted to the next generation or will there be a sale?" In my dad's situation, Aunt Katherine determined that my dad had already paid her for the farm through the years of work he had done on the farm. She generously wanted to give my dad a part of the legacy he had helped to create. In Aunt Katherine's situation, she had other assets that she was going to give to my dad's siblings. In some situations, there may not be other assets for the beneficiaries; there may only be the business to pass on to future generations. Remember to consider the ramifications to every member of the family. How does the sale or gift affect each individual?

Question #4: How will the business transition be funded?
If the business will be gifted to the next generation, this question is obviously not needed, but if there will be a buy-sell agreement or a sale, this question is vital.

Typically, with a buy-sell agreement, the transition is funded with life insurance. Even if there is not a buy-sell agreement in place, if the business is transitioning to the next generation through a sale, then consider a source to fund the sale. Also, consider whether the sale will occur in a single transaction or through a structured sale. Does there need to be some sort of payment plan?

In my dad's situation, Aunt Katherine had other assets in her estate that could have provided some funds to facilitate a purchase of the farm. I have met with many clients where this is not the case, so one of the purposes of the business succession plan is to identify how to actually accomplish the transition.

Question #5: What will trigger the transition of the business?
Think the three Ds—death, divorce, and disability. There can be other triggering events but those are the big ones to consider.

A proper business succession plan needs to address what will trigger the transition or the start of the transition. The majority of the clients I meet with have considered transition upon death, but not many have considered what will happen to the business if a business owner becomes disabled or divorced.

During the last year of Aunt Katherine's life, her physical health was not good. She wasn't able to perform many of the day-to-day tasks on the farm, but she had the experience and knowledge to advise my dad when he was making decisions; so, although the attorney did not draft the business succession plan to address what would happen if Aunt Katherine would become disabled, in my dad's situation he probably wouldn't have wanted her disability to trigger the transition of the farm. If, however, the circumstances had been different and Aunt Katherine hadn't had the mental capacity to participate in the decision-making process, it may have been more beneficial for Aunt Katherine's disability to trigger the transition of the farm. For example, if my dad had needed more assistance with manual labor on the farm, it would have been a drain for him to have to continue to pay Aunt Katherine when she was not contributing to the operation and management of the farm. Dad may have needed those funds to hire someone to help him with the physical labor.

A nuance of the disability trigger is what happens if one of the business owners needs long-term care. Typically, this issue is addressed in the governing document (the bylaws, operating agreement, or partnership agreement), but most of the clients I meet with have not addressed this issue, so we incorporate that into their business succession plan. A business succession plan should address the situation where one of the business owners needs long-term care and should indicate if the business interest is an available asset to help pay for the costs of long-term care.

Question #6: What assets does the business own?
This is my favorite question to ask during a business succession planning meeting because, in my experience, it is such a game changer. I can almost guarantee that if I am meeting with business owners to discuss their goals for their business succession plan, at least one of the business owners will tell me that one of their major goals is to minimize tax during the business transition, and rightfully so. Business owners are very intelligent individuals; that is one of the reasons they are successful, but sometimes they come into our law firm with tunnel vision. They see one particular type of tax and are so focused on that tax that they miss the orange flag alerting them to other taxes that may be much more costly.

Based on business owners' answers to these six essential questions, our office provides guidance and formulates a plan to assist owners in the transition of their businesses to the next generation in the most efficient and economical way possible. We consider the tax ramifications and liability issues and address any potential road bumps that could derail the transition.