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Foulston Siefkin Estate Planning: FARM & FAMILY BUSINESS SUCCESSION PLANNING

Closely held family businesses, whether they involve agricultural property or are other types of enterprises, are "living" economic entities subject to complex family dynamics that must be carefully nurtured if they are to sustain a generation to generation transfer. In providing for the succession of a family business to a succeeding generation, parents must carefully consider many issues, including: how the business is to be maintained and structured following their disability or death; the family members who will succeed to the family business interests; how, when and in what manner such family members should receive such business interests; and what non-business assets passive family members should receive either in addition to or in lieu of family business interests.

Practical problems are frequently faced in the family business succession context. Although interests in businesses can be given to more than one person, often the business itself cannot be easily, practically or equitably divided between or among children. It is also important for a parent to understand and fully appreciate the substantial risk of contentious disagreements that can arise not only between active family members regarding business decisions, but even more so among active and non-active family members who have succeeded to ownership in the business enterprise. These disagreements can be fueled by what passive family members who have succeeded to an ownership interest in the business perceive to be an unfair distribution of the parent's estate or trust assets or inequitable lack of control of the business enterprise. When such business succession occurs at death under the provisions of a parent's Will or Revocable Trust, there is a particularly fertile period for family dissension during the administration of the parent's estate or trust estate in preparation for the distribution of family business assets to the parent's descendants. Further, a failure to incorporate in the estate plan protection against subsequent voluntary or involuntary transfers to third parties of business interests by family members who have succeeded to the ownership of family business interests can result in serious damage to the continuity of the family business enterprise.

Thus, as discussed more fully below, it is normally critical that sophisticated estate planning strategies be employed to ensure that the business continue as a functioning harmonious unit following the death of a parent, family members are not inequitably treated (from the parent's vantage point) during the distribution phase of a parent's Will or Revocable Trust and passive family members or unwanted third parties are precluded as much as practically possible from succeeding to the ownership of family business interests. Basic estate planning strategies simply do not properly address these issues and thus are highly prone to failure in the context of a family business succession plan.

Unfortunately, many of the foregoing important business succession considerations often are either ignored or not properly addressed in the estate planning process. The failure of the family business succession plan which can result raises the ominous specter of significant administrative and legal costs, loss of business value, the potential forced sale of business assets, and last but certainly not least, irreparable family disharmony due to contentious family disagreements. Due in no small part to the vast majority of estate plans failing to appropriately address these factors, it has been estimated that 70% of family businesses fail to survive the second generation and 87% fail to survive the third generation.

Determining Whether the Business Can Be Continued

The first and most important family business succession consideration is whether it is even practical or legally permissible for the business to be continued by family members following the death or disability of a parent. Certain businesses, such as those involving a licensed professional (e.g., law or medicine), normally cannot be legally continued following the death of the owner by family members who are not similarly licensed. The same is true for certain

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franchise operations subject to restrictions on transfer to family members. Even if the farm or closely held business is one which can legally be passed to other family members, often there are no family members who either are interested in succeeding to the management of the business or possess the necessary skills to competently manage it.

In the situation where family members will not continue the business enterprise following the owner's death, the maximum economic value is obtained by liquidating or selling the business as soon as practically possible following the owner's death. For such businesses, it is especially important that key employees remain operative in the business following the owner's death to maintain the economic viability of the business until it can be sold to key employees or third parties. Entering employment contracts containing covenants not to compete with key employees can also be quite crucial in order to prevent such employees from taking the good will, customer lists, and any trade secrets of the business during and following their employment, a particularly significant financial risk following the death or disability of the principal owner. As discussed in more detail below under fiduciary considerations, it is equally necessary regarding an on-going business to name a capable fiduciary following a parent's disability or death to ensure capable management of the business until it is able to be sold for its maximum value to a third party.

Determining Family Members Who Are to Receive the Business Interests and When Such Succession Should Occur

If the family business is to be continued as a viable functioning economic enterprise by other family members inheriting the business following the death of the principal family owner, decisions need to be made with respect to the specific family members who are to receive the business interests and how the business is to be managerially structured following the owner's death. Additional issues involve whether some or all of the business is to be transferred to family members during the owner's lifetime. As discussed under the "What Basic Strategies Can Minimize Federal Estate Taxation?" subject under this "Special Areas of Interest" topic area, transfers during lifetime to children or other descendants can save estate taxes by lowering the value of the owner's taxable estate.

However, in their parental zeal to either save estate taxes or satisfy the desires of active family members who wish to have a substantial ownership of the business prior to the parent's death, parents who have insufficient non-business assets to provide for their needs for the remainder of their lifetimes will need to properly structure gifts to descendants in the manner discussed below if they are to avoid unnecessarily taking a risk to their own financial well being by gifting voting control of the entity to descendant family members. Moreover, as also discussed under the foregoing subject areas, unless the transfers are made of business interests that will save estate taxes, i.e., the owner has a taxable estate, there could be an overall tax detriment to such lifetime transfers in that such transferred interests would not potentially receive a "step-up" in their income tax basis to their fair market value at the time of the parent's death, as might otherwise have occurred had the parent retained the property until death and alternatively made such transfers under the provisions of the owner's Will or Revocable Trust.

The Manner In Which Family Members Are To Succeed to Farm and Business Interests

Business interests can be given to children or other descendant family members either outright or into an irrevocable trust. Gifting or leaving assets at death in trust for descendant family members is normally preferable to outright gifts or distributions for one or more of the following reasons: maximizing the federal gift tax exclusion (regarding lifetime transfers), removing the assets from the family member's taxable estate at death, protecting family members from their own financial mismanagement or undesirable spousal influences, protecting the assets from third party claims (creditors, spouses through a divorce or inheritance claim, death taxes), and maximizing the availability of governmental resource benefits such as Medicaid and SSI to family members. This strategy is discussed in more detail in the "What Basic Strategies Can Minimize Federal Estate Taxation?" and "Asset Protection Strategies" subjects under this "Areas of Special Interest" topic area. As noted there under, if the goal is not to protect the beneficiary from potential mismanagement of the property or undesirable spousal influences, with sophisticated drafting techniques the beneficiary can be named Trustee of such beneficiary's trust and be given control over trust assets not significantly different than outright ownership without compromising the foregoing tax, asset protection and governmental resource maximization goals.

Moreover, parents who gift family business interests into an irrevocable trust for descendants during their lifetime may retain the authority to determine the Trustee of the trust without causing the trust assets to be includible in their taxable estates. This can be quite important in circumstances where parents are dependent upon the business enterprise for their financial needs and do not desire to incur the inherent financial risk which would otherwise occur if voting control of the enterprise was transferred to children who either subsequently mismanaged the business or diminished their expected cash flow by subsequently choosing not to continue their employment at assumed salary

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levels or not authorizing business income distributions commensurate with the parents' retained ownership interests.

With respect to farm land, rather than making specific bequests of farm land either outright or in trust in the Will or Revocable Trust to certain family members (or their trusts), the normal method of passing such business interests to family members following death, it is usually preferable for the family members chosen to succeed to the farm interests instead to be given the specific right under the provisions of the parent's Will or Revocable Trust to select farm land to satisfy their specified estate or trust share (be it equal or otherwise). This strategy avoids the possible diminution of an individual child's share of the estate or trust due to an unanticipated sale of the farm land following the execution of the Will or Revocable Trust prior to the owner's death, e.g., following an incapacity to provide necessary funds, a substantial downturn in the economics of retaining the property, a governmental eminent domain proceeding, or the owner accepting a high purchase offer that simply could not be refused. It also avoids land of unintentionally disparate value being given, e.g., oil being discovered on one real estate parcel following the execution of the Revocable Trust or Will but prior to the parent's death. Often, the owner either fails to change the provisions of the owner's Will or Revocable Trust to take into account such changed circumstances or is incapable of doing so due to a disability which has left the owner with insufficient capacity to amend such instruments. Moreover, there is a lack of flexibility inherent in specific bequests, e.g., a child or children may not then want the specific real property that has been allocated to their share under the provisions of the instrument. Under this alternative proposed strategy, there can be priority given in the selection of farm land by family members, e.g., a child who is participating in farm activities being given first priority as to farm property up to the value of such share with a purchase option from the estate or trust estate on any excess value over such child's share.

There is also the issue whether a business interest currently owned outright (e.g., as a sole proprietorship) should instead be operated under an entity to achieve centralized management, asset protection and continuity of the business estate planning goals. Business interests can be owned by a wide variety of entities, including limited liability companies, limited liability partnerships, family limited partnerships, simple partnerships, and corporations (both S and C corporations). Various tax and administrative considerations are involved in selecting the appropriate entity.

Entity ownership facilitates management by multiple owners (normally subject to majority control), and prevents a minority member from being able to force a liquidation of the business. Entity ownership is particularly important with respect to multiple owners in farm land or other real estate, as any tenant in common could otherwise unilaterally judicially force a partition, which normally results in a public sale of the entire parcel unless the land is divisible into separate parcels without loss of value. Entity ownership can be structured so as to provide non-voting and voting interests, thus permitting active family members to have the voting interests and senior family members to give non-voting interests (normally at substantial discounts in their value for gift and estate tax purposes) either outright or in trust to junior family members without losing voting control of the business enterprise even if more than 50% of the ownership interests in the entity is transferred to descendants.

Finally, entity ownership can achieve asset protection objectives also discussed in the "Asset Protection Strategies" subject under this "Areas of Special Interest" topic area.

Proper Consideration of Family Members Who Are Not Involved In the Business

One of the biggest problem areas in transferring business interests to family members is the treatment to be accorded family members who are not involved in the business enterprise. Often, children who have been active in the business are given a greater share of the total value of the estate in consideration of their efforts. In other circumstances, the owner wishes that all children receive an equal share of the estate. A serious problem is presented if there are insufficient non-business assets to equalize desired shares of the estate between or among children.

When both active and passive family members must inherit a farm or closely held business in order to satisfy their individual shares of the estate or trust intended by a parent, there frequently will be significant intra-family disagreements. Most of this comes from passive family members who may disagree with the management of the business by active family members who have majority voting control of the business enterprise, feel that such active family members prefer themselves in terms of salaries, conclude that distributions of business income to them is no commensurate with their ownership interests, or simply strongly resent not having received liquid assets from a parent that they could have freely disposed of as they wished. On the other hand, providing for a skewed distribution of shares of an estate or trust favoring active family business members solely for the purpose of ensuring that only such active family business members will receive family business interests can cause severe stress on family harmony, trigger disagreements and feelings of bitter resentment from passive family members who receive what they perceive to be a less than fair share of the parent's estate or trust, and normally not be in keeping with the parent's perception of fair treatment of all children from an inheritance standpoint.

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Strategies addressing this situation involve giving business interests to all family members but reposing management decisions strictly in active family members, while at the same time structuring the business enterprise so as to equitably address the financial interests of inactive family members. Under this scenario, non-active family members are usually given only non-voting interests in the business. However, such interests can be given preferential distribution rights (e.g., preferred stock) to balance against the active family members controlling both the business and distributions of salaries and business income. To provide liquidity to non-active family members, these non-active interests also can be given what are termed "put" rights, pursuant to which such non-active family members can compel active family members or the business entity to purchase their interests (perhaps at a slightly reduced value and on an installment basis so as to not cause undue financial hardship to the business) either immediately upon receipt of the interest, following a certain period of time or only upon the occurrence of certain adverse financial events.

However, even such compensating types of arrangement will often prove unsatisfactory to passive family members in the long term and normally will only serve to diminish the frequency and severity of significant intra-family disputes, not totally eliminate them. The selection of a few active family members to manage a business to the exclusion of other passive family members having an ownership in the same business creates the same very high risk of family disharmony as does the selection of a child or children to be a financial fiduciary over other family members discussed below. As noted above, passive family members are highly prone to "second guess" the management and business decisions of active family members and will tend to blame them for any loss in value in their business interests.

Even the foregoing "put" strategy has its limitations. By the time such "put" right is exercised, often there have been significant family disagreements between active and passive family members or an economic downturn in the financial status of the business enterprise blamed on active family members which precipitated such exercise. Moreover, even with a "bright line" standard for determining the value of the subject interest under such "put" right, there can be disagreements as to the fairness of the value so determined. Thus, if at all possible, it is normally best to avoid this high risk of conflicts and family discord by not giving business interests to inactive or passive family members at the outset.

In sum, in circumstances where there would otherwise be insufficient non-business assets with which to fund the desired share level of passive family members, alternative strategies are required if a parent is to be able to fully fund the desired value of shares of the estate or trust passing to descendants while avoiding passive family members from owning family business interests. One such alternative strategy is to require active family members, as a condition of receiving an interest in a business satisfying in whole or in part their portion of the trust estate, to purchase (perhaps on a specified optional installment basis) any business interests which would otherwise be allocated to inactive family members to fund their share of the estate or trust. Another strategy is to purchase a life insurance policy (possibly in an irrevocable life insurance trust) to provide estate liquidity and sufficient additional assets with which to fund the desired level of shares of the estate or trust estate of family members not participating in the business.

The Role of Buy/Sell Agreements and Options

A Buy/Sell Agreement is normally the cornerstone of any successful business continuation plan. Such agreements can prevent farm or other business interests from being gifted or sold outside the family unit without other active family members being first given the option of purchasing such interests (normally proportional to their interests in the business entity if the family business assets are owned in a partnership, limited liability company or corporation). Under the provisions of the Agreement, the purchase price of such option held by other active family members can be at the same price offered by the third party (a "right of first refusal"), a price determined annually by family member owners, under a predetermined financial formula, or by appraisal. Regarding farm land which is not held in an entity, such provisions are normally included in the provisions of the owner's Will or Revocable Trust to be placed in the deeds conveying the real estate.

A well-drafted Buy/Sell agreement can also prevent involuntary transfers by family members to third parties (e.g., pursuant to a divorce decree or bankruptcy sale). Additionally, a Buy/Sell Agreement may provide liquidity at the death of an owner of the business by requiring a mandatory buyout by other family members or the entity (often funded with life insurance). Otherwise, the family of the deceased owner of a minority interest could be left with an illiquid, unmarketable business interest or the remaining owners may now have an unwanted-and often disgruntled-family member of a deceased owner, such as the decedent's spouse, having an ownership interest in the business. The Agreement may also provide for purchase options in the entity or other family members of an owner's interest who has become disabled at a level which does not permit the owner to be able to properly participate in the business enterprise.

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Provisions of the Buy/Sell Agreement can also prevent what is known as a "freeze out." Let's assume a parent leaves stock in the family business to his three children in equal shares. All of the children are actively involved in the business. Following a disagreement over management decisions, two of the three children decide to exercise their combined majority control of the stock and "fire" their sibling. That sibling could be left with no significant employment opportunities and unmarketable stock in a family business which pays no dividends. In such circumstance, under provisions of the Buy/Sell Agreement the "fired" family member could be given a "put" similar to that discussed above with regard to passive family members, i.e., the right to force the corporation or the remaining stockholders to purchase the stock, perhaps at a price reflecting a modest reduction from its fair market value in order to reflect its minority interest. Without a "put," the disenfranchised family member could be forced to sell the stock to the remaining owners for a small fraction of its actual value related to its percentage of the total value of the business enterprise. Moreover, such "put" can have the beneficial aspect of discouraging "back room" maneuverings of family members against another family member in fear that such family member might then decide to exercise such "put" right.

In agricultural enterprises, additional options can be given to active family members in the Buy/Sell Agreement or under the provisions of a parent's Will or Revocable Trust disposing of such interests to lease or purchase farm land owned by inactive family members. Finally, a Buy/Sell Agreement can require mediation and binding arbitration of business disputes and controversies, thereby avoiding costly and protracted litigation between family members and a public "airing of dirty laundry" in court which is not only costly, but highly divisive as to family harmony.

Emotional and Psychological Considerations

If a business is to be transferred to the succeeding generation, the development of a good business succession plan also needs to address the emotional and psychological components of intra-family dynamics and the tension between family values and the fundamental rudiments of what it takes to operate a successful business enterprise. For example, sibling rivalries need to be addressed as well as the older generation's natural reluctance to "turn over the reins" of the business. For business succession to be successful, it is desirable for the succeeding generation to gain practical experience in business operations prior to the death of the older generation and sibling rivalries observed by the older generation in the operational phases of business operations if the business succession plan is going to be able to both react to-and modified as necessary-to address these developments. Thus, unlike many other estate planning situations, it is usually advisable to discuss the business succession aspects of the estate plan with children during the parent's lifetime in order to gain a greater assurance of the efficacy of the business succession plan following the parent's death.

As another example, the focus on family values tends to be inward, whereas the focus of a business needs to be on the external factors which exist in the marketplace. As one consequence, compensation in a successful business tends to be based upon performance and skill level, whereas the family tends to desire equality in remuneration irrespective of these factors. The stress on family harmony which thus results in the transition of a family farm or business to a succeeding generation is as much a consequence of the conflicting values and needs of a family versus a business than it is intra-family dynamics and normal business decision-making. Such natural family predilections which tend to ignore marketplace factors can be quite antithetical not only to family harmony, but also the economic viability of the succession plan. Thus, they are in need of being carefully addressed if the prospect of success of the business succession plan is to be enhanced.

Fiduciary Considerations

As discussed more fully in the "Preserving Family Harmony" subject under this "Areas of Special Interest" topic area, if there is more than one child involved in the passing of family business interests, strong consideration should be given to naming a capable third party, such as a certified public accountant or corporate fiduciary (a bank or trust company) to serve as financial fiduciary (Executor, Trustee or Agent under a financial Power of Attorney) following a death or disability of a parent (normally succeeding a spouse who usually is named to serve in such capacity). A child serving as Trustee in this situation compounds the already high family harmony risk of serving as Trustee of a parent's estate or trust estate with the additional quite significant family harmony risk attendant to also being a fiduciary regarding the management and distribution of a farm or family business during the administration of the estate or trust estate. Consequently, having a child serve as financial fiduciary in this situation is unquestionably one of the most perilous not only to family harmony, but also to the ultimate viability of the family business succession plan.

If a non-family member is named as financial fiduciary of the probate estate or trust estate, consideration should be given to selecting a third party financial fiduciary with experience in managing the particular business interest involved.

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Alternatively, as such experience often may be lacking absent the selection of a large corporate fiduciary with expertise in managing the type of business interest involved, a family member or key employee could be named as Special Trustee or Co-Trustee to serve with the third party fiduciary and having the singular role of managing the business interest during the estate or trust estate administration period. The third party financial fiduciary would make all other administrative decisions, create shares of the estate for trust beneficiaries following death, and manage all trust property other than the family business.

Summary

For owners of farms and closely held businesses, the foregoing business succession considerations are often the most important, but least adequately addressed, aspects of their estate plans. As noted in the introduction, without proper business succession estate planning there can be a substantial loss of business value or possible liquidation of the business following a parent's incapacity or death, serious unintended financial disparities between or among family members in the distribution of the estate or trust, irreversible family disharmony resulting from intra-family disputes and actual or perceived inequities in the distribution of the estate or trust, and potential family litigation with its substantial attendant costs. Consequently, it is incumbent that farm and other closely held family business owners who desire for their descendants to be able to effectively and harmoniously continue the business enterprise following their disability or death consult with highly sophisticated estate planning counsel having significant experience in family business succession planning matters.

Foulston Siefkin's Estate Planning and Probate Group

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The estate planning law summary above was authored by the firm's Estate Planning and Probate Practice Group. Provided as a service to viewers, it is intended to be a general discussion of one of the Group's major areas of emphasis, estate planning strategies to preserve family harmony. However, the strategies discussed therein are not designed to be an exhaustive discussion of all asset protection strategies or even any one strategy. Moreover, they are subject to exceptions for which space did not permit a discussion, often are Kansas law specific, and are subject to varying and changing federal and state laws which may alter or diminish their efficacy. This document has been prepared by Foulston Siefkin for informational purposes only and is not a legal opinion, does not provide legal advice for any purpose, and neither creates nor constitutes evidence of an attorney-client relationship.

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Foulston Siefkin regularly counsels clients on issues relating to Estate Planning and Probate. If you are interested in additional information regarding these matters, please visit our website at **www.foulston.com** or if you would like to discuss specific ways in which Foulston can help you, contact Tim O'Sullivan at 316.291.9564 or **tosullivan@foulston.com**, or Stewart Weaver at 316.291.9736 or **sweaver@foulston.com**, or Matt Bish at 316.291.9729 or **mbish@foulston.com**.

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