Succession Planning: What about the Financial Considerations?

Carrick Aland Rural and Small Business Financial Specialists

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Many farming families recognise that for the good of their business, they need to provide more responsibility and autonomy to the next generation, but for exiting farmers many find themselves wondering, "What challenge or interest will be left for me?"

"There's more to succession planning than just the financials"

Holistic Succession Planning must consider the full range of individual, emotional and wellbeing responses, in addition to the financial and legal aspects traditionally seen as the domain of Accountants, Financial Planners and Lawyers.

Not only should successors be challenged with opportunity, but the older generation should be encouraged and supported to think broadly about their future contribution, finding new roles for themselves, drawing upon their broad experience and thinking laterally as to how they can apply in a revised and yet meaningful way.

Now, let's examine the financial considerations of rural succession planning...

Exit or retirement funding

"Achieving future financial security for the exiting generation"

For exiting farmers to step back their farming involvement, they not only need something meaningful to turn their endeavours to, but they need financial security.

So what is financial security? In a nutshell, achieving financial security is ensuring that the retiring generation has the means to meet their financial needs for the rest of their lives.

A plan that is actioned without establishing their financial needs, is like jumping from a plane without goggles and a parachute!

With help from statistics around ageing and life expectancy, we need to look at current living costs, what those exiting wish to do with their newfound time, and what that means for discretionary spending, along with the natural progression of one's health and associated support costs.

It is not only about considering the weekly groceries and electricity, or even planning holidays but, rather, *possibly* the cost of providing living arrangements away from the farm and most *probably* the ever-increasing need for some form of supported living or age care.

A sobering fact is that for full fare paying individuals, we are finding that Refundable Accommodation Deposits or RADs required by local age care facilities can be in the order of half a million dollars. Although refundable, exiting farmers still need to be secure in knowing that they have this capital available when needed.

Starting one's planning in this way quantifies a target amount for a capital sum or an ongoing income stream that we can then look toward providing.

Different funding approaches

Financial security is one thing; financial independence (from the farm) is another – this distinction leads to different ways of structuring the financial arrangements that lie at the core of any succession plan.

In providing the framework for financial security, ideally, we should also seek to insulate exiting parties from the business risk and seasonality, typically associated with ongoing farming. Attaining financial independence provides retirees with the freedom to make future lifestyle choices, unconstrained by the seasons being experienced.

The "gold standard" approach here is to endeavour to set aside for those exiting the farm, a capital sum that is invested and drawn upon independently of farming fortunes.

Such independence not only adds a layer of comfort and confidence for retirees but when the need to be concerned with the ongoing management decisions of the next generation is removed, maintaining harmonious family relationships becomes a lot easier.

For succeeding farmers, attaining financial independence for those exiting goes a long way toward achieving true management independence, but in many cases will also mean taking on further commercial debt.

The instinctive response here can often be to seek ways of avoiding the burden of further security and servicing commitments to bankers as well as, simultaneously, the need to become overnight investors, in perhaps unfamiliar financial markets.

Accordingly, some farming families may be tempted to deliver, to those exiting, an ongoing income stream, rather than a capital sum, with such an income stream formalised as internal loan repayments.

In this sense, in prudently managing the financial risks associated with a continuing reliance upon the farm, exiting farmers would have to become more like Bankers, requiring a level of security and regular financial scrutiny, not dissimilar to a commercial provider. Also, even with adequate security, exercising your legal rights and priorities upon third-party lenders and family members may be difficult in practice.

Certainly, words like 'default', 'foreclosure' and 'eviction' do not go down well over the family dinner table!

Also, contrary to the instinctive understanding of many, is that the long-term cash flow impact of financial independence, does not necessarily have to be greater!

Establishing a well-structured investment portfolio, that seeks to deliver after tax returns in excess of commercial lending rates, will require an additional servicing commitment, no greater than the total income stream requirements of retirees.

Where real property security levels are adequate to allow for commercial lending, attaining financial security, independent of continuing farming activities, must be seriously considered as the preferred approach.

Providing certainty for the next generation

For succeeding farmers, the certainty of a farming future revolves around securing the availability of those assets essential to ongoing operations.

Typically, transfers of ownership in property, plant and livestock are how this is achieved and are also the mechanisms that can deliver the capital asset required, for the financial security of the retiring generation.

No matter the approach, borrowing a sum to pay out Mum and Dad, or committing to delivering a regular living allowance, farm successors need to know exactly how addressing the financial security of an exiting generation will impact their own future viability.

It is all about projections and financial modelling, looking at likely farm production, the desired standard of family living and education costs, along with assessing the potential for comfortably servicing current debts levels, together with any additional financial commitment.

The second generation must also consider their own retirement funding and, with many families today experiencing a third-generation knocking on the door, the potential for funding their own succession. Any plan under consideration though, cannot leave the next generation with little or no capacity to improve their financial position. Future farmers cannot viably continue taking on additional debt to fund the next succession!

Overlay these considerations with the financial legacy that comes with each family's unique ideas on what fairness between successors and off-farm siblings might look like and one must recognise that, in some cases, succession may not be seen as financially palatable or even financially viable!

Family equity and Off Farm Siblings

Many farming families today, recognise the need to explore avenues for achieving, some measure of equity in dealing with continuing farmers and their off-farm siblings.

The financial reality, though, dictates that successors require, what some may view as a “leg up”, with farming assets transferred at less than market value to ensure future viability. On the surface such transfers can present as gifts, that may require some “balancing up” to achieve fairness among siblings.

Financial considerations for seeking equity

How appropriate is the concept of market value?

The mainstream method used by valuers of farming property is recent comparable sales in the local area. The resulting valuation is an assessment of the likely sale price and, unlike commercial property and non-farming business valuations, makes no reference to the income-producing potential of the asset.

Income yields

When looking at family equity, families need to acknowledge that where successors see themselves as custodians of the land for future generations, and there is no intention to sell, then the value that really matters should reflect how much income that property can produce, not what it could sell for. Typically, that means farming families considering the value of gifts and equity between siblings should realistically be discounting those mainstream valuations to account for the lower-income yields, relative to other non-farming business assets.

For example, if commercial property is assessed to have a sale value based on a 7% rental yield. With long term farming yields at something like 3-4%, there is a strong argument for property sale valuations to be discounted by at least half, when successors are truly successors and sale of the property is off the agenda.

Binding family agreements can ensure that if such a concept is adopted in arriving at a sense of fairness and successors end up changing their minds, a clawback of sale proceeds can be enforced to restore the balance of equity.

Sweat equity

The concept of Sweat Equity tends to raise its head regularly in the world of rural succession. Its recognition by families acknowledges that successors have in the past contributed at a level greater than the benefits received. Consequently, further discounting and what might otherwise be seen as gifts are justified as financial compensation for this shortfall.

Often, without a formal framework for assessing the value of past contributions and comparing this to the lifestyle benefits provided, applying this concept to arrive at a fair outcome is both highly subjective and highly reliant upon family goodwill.

In terms of financial advice, for future successions, the more structured and formalised financial arrangements families have with each other – treating family members more like employed managers and shareholders, where an expectation of reward and return is agreed from the outset – the less the concern for the need to secure the goodwill of family members having difficulty reconciling such a nebulous concept.

Something for Off Farm Siblings Now

In past successions and often by default, Off Farm Siblings have been resigned to relying on Mum and Dad's wills to deliver family equity, by gifting lifestyle assets such as the retirement house and any remaining investment pool. In this situation, Off Farm Siblings carry the financial risk of Mum and Dad's longevity, as well as the possible negative impacts of future financial events.

In recognising this, there is merit in finding something now for Off Farm Siblings that not only addresses these risks, but provides them with financial opportunity at a time in their lives that may be more beneficial. Of course, gifts now need to be assessed as having a greater value than those intended for the future.

Off Farm Assets

For the next generation, in preparing for future succession and the prospect of taking on additional borrowings to achieve it, the key is aiming for a strong balance sheet with a high ratio of assets to liabilities.

Enhancing this debt/equity strength can develop what is commonly known as "Off Farm Assets". Not only does the accumulation of investment assets outside the farm offer diversity of investment performance, but they can often be the oil that greases the wheels of succession when it comes to providing something for off farm siblings. Where off farm assets are not present, the prospect of further borrowings to provide a gift to non-farm siblings is rarely palatable to successors, so the ability to transfer or sell assets that are not essential to ongoing operations can be very useful.

Conversely, investing in more farming property than other investments such as the share market is often considered preferable for many. Of course, the use of the term 'off farm assets' does not mean that rural property cannot be a smart investment, but to be a smart succession investment that can provide options and liquidity to achieve a sense of family equity, the next farm addition may need to be viewed and managed as a saleable item.

Imposts and opportunities

Together with forward-planning, through financial management in building a robust balance sheet, families can enhance intergenerational succession by ensuring that every advantage is taken of available relief from government taxes.

Small Business CGT Concessions, Transfer Duty Exemptions, and special eligibility rules for access to the concessionally taxed investment environment of superannuation all present significant opportunities that are often overlooked or allowed to pass by.

Capital Gains Tax (CGT)

Property located in Australia and acquired after 1985 is subject to CGT upon a change in ownership regardless of a related purchaser or a discounted amount paid with the only exceptions being the family home and changes in ownership, resulting from an individual's death.

Effective farm succession necessitates the transfer of real property to the next generation during one's lifetime and the impost of CGT can often be viewed as a deterrent for such transfers. In the case of death, though, potential CGT liabilities never really go away, but are simply inherited by your beneficiaries, to rise to the surface when that property is later transferred or sold.

The availability of what are collectively known as Small Business CGT Concessions can change the inevitability that this impost will be borne by succeeding generations. Negotiating a complex web of eligibility tests, including a maximum net assets test of $6 million or a business turnover test of less than $2 million, can often deliver favourable outcomes for farming families, particularly those that allow themselves time to consider the succession pathway.

With forward planning, eligibility for these concessions can be enhanced and during your lifetime you can deal with those underlying tax liabilities as an exemption, so they do not carry forward to the next generation.

If you miss these opportunities, then it's a greater financial burden for your successors that you leave unaddressed.

Transfer or "Stamp Duty"

Like CGT, Stamp Duty attaches to the transfer of assets, but duty is imposed regardless of the acquisition date. Stamp Duty is also not imposed on ownership transfers upon death, making it another reason highlighted by those tempted to avoid the issue of farm succession. But facing potential stamp duty should not be a roadblock to the many other advantages of developing a succession plan during one's lifetime.

This is recognised by state governments that provide exemptions for the intergenerational transfer of assets to a wide definition of family recipients. The structure of business operations, together with current and intended asset ownership, can impact exemption eligibility though, so working closely with legal and financial professionals is essential in navigating these concessions when developing your succession strategy.

Superannuation – Not an investment, but merely an investment structure!

When planning for the independent, financial security of Mum and Dad, taking advantage of the significant tax concessions associated with superannuation cannot be overlooked. The amount of capital required to be funded by farming successors will be significantly less where the full advantage of the opportunities to invest within a tax-free superannuation structure is taken.

Combined with Small Business CGT eligibility, lifetime limits on contributions to super, can be dramatically increased. The ultimate opportunity here is for property that has been held for more than 15 years. If all the other eligibility requirements are met, then not only is the total capital gain exempt from tax but up to approximately $1.5 million of sales proceeds can be contributed to super by each individual seller. The catch, though, is that the sale must be connected to an actual reduction in business activity and the contribution must be made before turning 75. So, if you have actually reduced your activity and effectively retired some years before transferring or selling, or you have already turned 75, then you have missed the boat. It goes without saying then, that through a lack of consideration or timely action, this limited window of opportunity can be found to have closed behind those who are ill-advised or unprepared.

Another lesson surrounding gaining maximum advantage from these concessions and exemptions is to not put off committing to the process of succession because you think you will not be eligible. Eligibility rules are complex and until you have an expert in the field review your family's situation and what you are trying to achieve, you cannot know that every advantage has been gained.

Key takeaways

- **Exiting Farmers wanting financial freedom and unstrained relationships, must aim for Independent Financial Security.**
- **Successors need the certainty of securing farm assets, together with positive prospects for future improvement in their financial position.**
- **Market Sale Valuations are not relevant to true Custodians of the Land.**
- **Where possible, there is merit in finding something now for Off Farm Siblings.**
- **Off Farm Assets grease the financial wheels of succession.**
- **Take advantage of SBCGT concessions to avoid future tax.**
- **Do not leave succession too late to access superannuation and what might otherwise be, a full CGT exemption.**
- **Forward Plan, seeking professional financial and legal advice.**

Carrick Aland have several succession planning resources available online, including factsheets and checklists to get you started.

Alternatively, if you would like to speak personally with our team of professional financial succession planning specialists, don't hesitate to book an appointment:

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About the Author

With over 35 years' experience consulting to and advising rural families in the areas of accounting, taxation and financial services, Wayne Turner proactively assists in achieving the successful intergenerational transition of rural family businesses and their related assets.

Read more at:

https://www.carrickaland.com.au/succession/