***Successful Family Business Transitions***

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## 1. Introduction

Planning for business transition or succession is a subset of the broader planning process commonly referred to as “business planning”. The business plan is intended to be a written summary of what the organization hopes to accomplish, and how it intends to accomplish those dreams. The business environment is constantly changing, and any ongoing business needs to think about where the business is going, and how it intends to get there. Succession planning (the topic of this particular paper) is just a special case of the broader topic of transition planning, which is in turn just a component of the broader topic of business planning. Generational transfer (succession planning) is arguably one of the top challenges facing family businesses. In a well managed succession, a stable business in which family members have so much invested can be handed down to the next generation.

While many family owned businesses have a long-term objective of “passing the business on to the next generation”. In reality, only about 30% of family owned businesses successfully transfer to the second generation. Furthermore, only about 15% make it to the third generation, and only about 5% make it to the fourth generation. Why are so many family businesses unsuccessful at making the transition to the next generation? Perhaps it is simply an inconsistency of goals among the various generations (older generation has a dream of the younger generation taking over, but the younger generation really has no desire). In many other instances, however, it appears to be a lack of understanding of the underlying issues, a failure to communicate, and a lack of planning that results in the inability to successfully make the transfer happen. Planning involves communication, which is often difficult and strained in family businesses, and it involves openly discussing topics that often are not talked about (such as finances). In addition, the older generation is often reluctant to release control, and may be somewhat afraid of retirement (they may view it as a loss of identity, or even a step closer to death). Finally, business succession often involves one child returning to the business, while siblings pursue other careers and activities. Issues of fairness vs equality, etc. frequently complicate the succession planning process. When the business and the family are inter twined, the web of relationships becomes quite complicated, and family decisions can have greater consequences that decisions in more typical families. Communication skills and planning are essential to ensure both the viability of the business, and family harmony.

Successful transition planning, like business planning in general, is a process, not an event. The probability of success will be enhanced if the participants follow time tested steps for making sound decisions. First, take stock of the business to determine current strengths, weaknesses, financial position, etc. Next, spend considerable time with all stakeholders developing a shared vision, objectives, and goals for the business, and family members involved. Develop a workable plan to move the business forward, and implement the plan. Finally, it is important to constantly monitor progress, and if necessary modify or improve on the plan to keep the business on track to achieving the vision.

## 2. Assessing The Current Business

### Financial Measures

When considering a generational transfer of the family business, it is pointless to think about passing down a systematically unprofitable operation. In the case of farms or ranches, farm financial standards suggest that profitability be evaluated by looking at net farm income, rate of return on farm assets(ROA), and rate of return on farm equity (ROE). If return on assets and return on equity are adequate, net farm income becomes simply an issue of size (addressed later). ROA is defined as net farm income - interest expense - the value of operator labor and management, divided by the farm asset base. It is important to know whether this measure is calculated including capital gains (especially on owned real estate) or not. An average acceptable ROA for farm businesses when calculated without accounting for capital gains would be about 5%. Obviously, higher returns are better. When calculated with capital gains included, an acceptable ROA for the farm business should at least approximate historical returns to other similar investments, a minimum of 9 or 10%. The closely related measure, ROE, is defined as net farm income - the value of operator labor and management, divided by the farm equity (the portion of the asset base that is debt free). Close examination reveals that ROE is simply the leverage adjusted counterpart to ROA. If ROA is greater than the average cost of capital (interest rate paid), then a leveraged farm will have a higher ROE than ROA (making money on borrowed funds). Of course the opposite is also true. Therefore, a perfectly acceptable benchmark would be to have an ROE that is higher than whatever the farm's ROA is. The point is there are many farm and ranch businesses (the competition) that are performing much better over time than these subjective benchmarks. Similar benchmarks can be found for other family businesses, based on generally accepted accounting calculations. Businesses that have not historically achieved at least an industry average profit level over time will have difficulty surviving into the future.

### Strengths and Weaknesses

In addition to evaluating the overall financial performance (and potential financial performance) of the business it is important to reflect on what specific things the business does well, and what specific things the business might not be as good at. This is essentially the process of identifying the "competitive advantage" of the business, an important consideration for the long term viability of the business.

The strategic planning literature often refers to the well know SWOT (Strengths, Weaknesses, Opportunities, Threats) thought process to help managers prepare for the future, evaluate changes, or consider investment opportunities. Internal factors (such as per-unit cost of production for certain product lines, or base resources available to work with) are viewed as either strengths or weaknesses. External factors (factors over which you have very little control, but still impact your business) are viewed as either opportunities or threats. Examples of external factors might include political decisions affecting your industry, or changing consumer preferences for products produced by your industry.

Internal strengths and weaknesses of the family business should be identified and discussed during the succession planning process. Plans for the future need to build on the strengths that have give the business it's competitive advantage, and should address weaknesses that could lead to performance that is not competitive. Discussions of external factors that will need to be either addressed or taken advantage of will lead the planning process into the next phase, strategically planning for the future.

**3. Strategically Considering The Future**

Under the traditional command and control management style, planning for the operation and the future of the business is typically done in a very informal manner. The flow of the thought process for the management team (often one individual) often begins with a consideration of the resource base. Activities and enterprises are then selected that "fit" with the resource base. Perhaps some attempt is made to formalize goals and objectives, but in many cases these remain in the minds of the individual managers or owners.

Traditional thought process flow

Resource Base → Activities and Enterprises → Objectives (Maybe) → Goals (Maybe)

A more encompassing management style blends long-term dreams with short-run realities in a well thought out plan. The flow of the thought process for a "planned" 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 management team (and other stakeholders) begin with an over-riding vision of where they want the business or entity to go. The vision is focused down to a more concrete mission, which is made workable through well thought out 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.

Planned thought process flow

Vision → Mission → Objectives → Goals → Strategy ( Enterprises Activities) → Tactics ( Tasks) → Resource Base

The planning thought process flows naturally, and is systematic. It is an on-going circle, a never ending cycle of planning thought. At times management and stakeholder efforts devoted to long-term planning may focus on the Vision, Mission, Objectives, and goals components. At other times short- term planning sessions (weekly work detail meetings, for example) might be devoted to short-term goals, and activities and tasks that will lead to accomplishment of those goals. This systematic approach to planning and managing will not allow the entity to stray off in a direction that violates the fundamental principles spelled out in the vision and mission statements. Like other components of the overall business plan, successful transition plans need to begin with a “vision” in mind.

## Vision and Mission Statements

Vision is a long-term concept, focusing on where the business hopes to be in the future. The vision provides guidance for the organization over the long-term. Characteristics such as business size and scope, composition and quality of products or services, target markets, and work force composition may be reflected in the vision statement. Vision statements often directly reflect deeply held core values such as honesty, integrity, passion for rural lifestyle, concern for the environment, etc. Vision statements focus on what is really important, emphasize the future, and can be a unity building instrument to start the planning process. Once in place, a well drafted vision statement can increase motivation (especially during tough times), increase the chance of business success, and lead to increased satisfaction among all the family business stakeholders.

The more specific mission statement then needs to embody the broader vision. 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. To use the analogy of a physical structure, the mission statement provides a foundation for the rest of the plan. Just as physical structures can collapse in the absence of an adequate foundation, many businesses have failed due to lack of a shared purpose or understanding regarding direction. Therefore, in formulating a mission statement it is important to focus attention on the guiding values, principles, and primary roles of the organization so that you provide direction for the business. These can include economic, environmental, family, and community components as well as others. The mission statement is then used as a reference when making decisions.

To illustrate the flow from an over-riding “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. Because of this difficulty, and the belief by some production oriented managers that it is not a critical component (remember the traditional thought process flow), many business plans are not well grounded on a solid foundation. Those who do expend the time and effort to base their planning activities (including succession planning) on an over-riding 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.

Developing Vision and Mission Statements

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. This ultimately results in a more effective plan. Therefore, all family members (whether directly involved in the busines or not) need to be included in the process. Each individual needs to think about, and share with the others, what they would like to see happen to business, and what they expect from the business emotionally, financially, and otherwise. Each should also express their thoughts regarding future ownership and management of the business. The visioning process cans assist families in "coordinating" these expectations and finding common ground. Throughout the process, keep "core values" in mind. Think about what you admire or respect in other people or businesses. Think about what needs can be filled (Not "what products are produced"). Keep in mind what the business is really good at, who the customers are, and what are their needs. Think about both the present (mission) and the future (vision). There are many ways to begin pulling all these thoughts and expectations into vision and mission statements. Thinking about (and filling in) the following matrix of business and personal attributes may help each stakeholder to concisely verbalize "why the business exists", and "what they want the business to look like in the future".

Realize that developing vision and mission statements that are appropriate for your farm or business will require a significant amount of time and effort. Spread that effort over numerous family and stakeholder discussions (family meetings will be discussed later).

## Visioning Matrix

| | Now<br>(Mission Statement) | Future<br>(Vision Statement) |
|---|---|---|
| What business are we in; what products / services do we provide | | |
| Primary production practices (standard or unique) | | |
| What do I see as the appropriate size and scope (enterprise mix) of the business | | |
| Marketing practices (traditional or unique) | | |
| How is the business to be managed, owned, and organized | | |
| Social - environmental concerns / responsibilities | | |
| Human resource structure and philosophy | | |
| Expected financial performance, and how it is distributed | | |
| Other "family value" expectations from the family business | | |

Begin with the following generic templates to illustrate and stimulate the thought process. If it helps you get started on the visioning process, look back at the points you included in the visioning matrix to help you individualize the following generic statements.

## Vision Statement

In ten years our business will be providing ______..... We will be recognized for our ability to _____ .... We are pursuing these activities because_____ ....

Mission Statement

. The mission of _______________ is to operate a ______________ ..... This endeavor will provide: (desired financial results)
(desired product results)
(desired living-family environment)
(desired family - business transition results)
(recognition within industry, community, etc.)

Your business may, or may not, currently have vision and mission statements. If it does, you should check for currentness, and support. If not, your business will be better off, and dreams of business succession will have a better chance of success, if management provides the leadership and commitment necessary to develop them.

Objectives and Goals

All family business managers have in mind certain things that they want to accomplish in their business, and in other roles in life. The planning thought process simply helps define and formalize those "dreams" into short-term goals and longer-term objectives that support the over-riding vision and mission of the organization. For lack of a better terminology, we will refer to the process as "goal setting". In general, objectives and goals describe conditions that you hope to achieve and reflect hopes and dreams for your business or personal life. Continuing the flow from formulating vision and mission statements, the goal setting process is often challenging for agricultural business managers because many people have not tried to formalize their abstract ambitions. Clearly defined written goals are essential for a serious transition plan, as they provide a solid framework for achieving the mission and vision of the organization.

Goal setting requires creative thinking, discussion and compromise among family and business partners (communication is critical throughout the planning process). Think about your business, and ask the following questions: What are we trying to achieve? What can we do that is most productive and worthwhile? As you document some of the thoughts that come to mind it may be time to ask the reality check question: When can we realistically achieve these things? As you think about the things you would like to accomplish, also consider the people, and the potential conflicts involved by considering the following questions: How can we capitalize on the interests and abilities of the people involved? How do we resolve conflicts? You may, or may not have satisfactory answers to these questions at this time, however you should begin to realize the importance, and the power, of considering these issues. An additional broad issue is on the minds of many late career business owners and managers: Who will take over when I retire? Remember, it is the process of contemplating these and other tough questions that ultimately helps business managers and family members to begin to formulate objectives (longer-term general direction), and goals (short-term measurable actions).[1] Under the

[1] I have adopted the convention of referring to longer-term (usually more than one year) aspirations and associated written statements as objectives, and referring to shorter-term specific action statements as goals. Other authors use different terminology (long-term goals and short-

terminology convention that I have adopted (certainly not universal), objectives are more general, and have a longer time horizon. They reflect what the organization hopes to accomplish over the long-run. They should flow directly from the mission statement, translating it into motion. Examples include:

Increase gross income per acre:
Reduce work load:
Transfer the family business to the next generation:

Goals, on the other hand, should be specific time-bound statements that provide the benchmarks for measuring success. Goals translate objectives into statements that are specific. They work on the principles of focusing attention, mobilizing energy, increasing persistence, and developing work habits. Examples 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:
(*These example goals are actions directly related to the example objectives*)

The following widely used acronyms may help planners to distinguish between long-term objectives and short-term goals. Long-term objectives DRIVE (Directional, Reasonable, Inspiring, Visible, and Eventual). Short-term goals are SMART (Specific, Measurable, Attainable, Rewarding, Timed). 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 facilitate 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 on the following page. The broad array of objectives and goals that various stakeholders bring to the "table" from this exercise needs to be "thinned out" and prioritized. In other words, there is a need to make choices to reduce the demands on limited resources, and to reduce conflicts between business and family activities, as well as conflicts between the objectives and goals themselves. Examine whether any short-term goals aid or impede long-term objectives. Continually check for consistency with the overall mission and vision of the business. Finally, stakeholders need to agree on a prioritization, or ranking, of the various goals and objectives, as limited resources will not allow pursuing all at once.[2] Remember, at the end of the goal setting process the stakeholders will agree on a finite set of long-term objectives, each of which will have a list of

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term goals) for example. Please do not allow yourself to get bogged down in the terminology if you are gathering information on "goal setting" from a number of sources

[2]More detailed information on the visioning and goal setting process, including goal prioritization, can be found in a companion paper entitled "Building a Business Plan for Your Farm: Important First Steps", available on agmanager.info.

specific, attainable short-term goals associated with it. Keep in mind that the entire planning thought process is continual and iterative. Numerous meetings and conversations involving all stakeholders will be needed to develop a series of commonly agreed upon objectives and goals.

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

**4. Communication Is Key**

There is a strong relationship between how well a family communicates on a daily basis, and the probability of a successful family business transfer. There are three overlapping, and often conflicting systems at work in a family based business. The management system is concerned with day to day activities of the business, and is responsible for production, marketing, financing, and other decisions. The ownership system is concerned with returns to various investors, and fairness and equity in the treatment of ownership stakeholders, or potential future ownership stakeholders. The family system is concerned with maintaining family unity and relationships. The family system is more concerned with emotional aspects, generational authority, and other inward looking issues. The management and ownership systems are business oriented, and outward looking with concerns about merit, profits, and getting the various tasks accomplished.

Sources of conflict often revolve around a failure to distinguish between the various business and family relationships. For example, disagreements regarding how the business should be operated may result from conflicts between the management and ownership roles. Business conversations framed in a parent-child context often confuse the family system with the management system. There can develop a perception of a lack of respect for business contributions, and promises and expectations often are assumed, but not clearly expressed, resulting in disagreement later. These, and other communication challenges, are exacerbated during times of significant business change (such as succession).[3]

Research has shown that healthy family business entities share decision making, and are committed to excellence in communication. Unfortunately, many family members who are involved in family businesses are reluctant to begin the process of “open communciation”. There are a variety of possible explanations for this reluctance. Past experiences may lead some family members to associate “communication” with “conflict”, so avoiding the issue is the easy road. Others may view opening the lines of communication as a “threat” in terms of relinquishing control, etc. Still others may simply be reluctant to any significant change. In any case, these “barriers to open communication” must be overcome. All stakeholders need to gain an understanding of the needs and concerns of the other stakeholders in the succession process. Remember even though the dream of passing the business on to the next generation may have been considered for many years, when the time comes to actually act upon the dream emotions can run high and conflicts can arise. Chances of success are much greater if the communication process has been open, and a well thought out plan is followed.

## Opening the Lines of Communication

Family meetings are a method of bringing stakeholders together to discuss issues that are important to the family, and to the business. In fact, regularly scheduled family meetings are a common trait of successful family businesses. These communication sessions help to unite the family, build a stronger business, develop trust and understanding, and resolve conflict. As such, family meetings provide an excellent venue for initiating discussions regarding succession. In order to help facilitate communication and achievement of common goals and objectives, family meetings should be well structured. For example, each meeting should have a facilitator. At first, this should be someone who has the respect of the whole family. Later the facilitating role can be rotated among family members. The facilitator keeps the meeting flowing, helps separate business from family issues, and helps resolve conflicts in a constructive way. Each family business meeting should have an agenda, distributed in advance so that stakeholders have a chance to prepare for the meeting. Initial family meetings might focus on the development of a shared vision for the business, while subsequent meetings could focus on specific day to day issues such as financing or marketing. The stakeholders who participate in each meeting will largely depend on the agenda for that meeting. Sometimes it is appropriate to invite an outside facilitator, business advisor, or key employees to specific meetings. In order to maintain a

[3]It is beyond the scope of this paper to provide a detailed discussion regarding family communication and interaction skills. However, there is a wealth of good literature available on the topic, and I would encourage business families to evaluate their communication skills as they proceed with the transition planning process.

healthy communication environment, certain ground rules should be followed at family business meetings. Participants should come prepared and on time. All stakeholders should practice good listening skills, and be willing to share information openly with each other. Group decision should be accepted and supported, and sensitive issues should not be shared beyond the group. Someone should be appointed to record important discussions and decisions and the documentation should be filed with other business records. Finally, the last order of business at any family business meeting should be to plan for the next meeting. The date, time, place, facilitator, and primary agenda items for the next meeting should be firmed up before adjourning[4].

## 5. Developing A Transition Plan

Fair vs Equal

A primary concern in most family business succession planning is the issue of "fair vs equal". Equal would imply passing an equal dollar value to each member of the junior generation, a solution that may not be possible if the business is to be handed down as a viable unit (and a solution that may not seem "fair" to particular successors who may have already contributed a great deal of "sweat equity" to the business). A fair arrangement may not necessarily be equal. Factors to consider may include: 1) the value of non-business assets; 2) the importance of passing down the business fulling intact; 3) what has been given already; 4) what various stakeholders have already contributed to the business; and perhaps 5) what opportunities various stakeholders have already foregone. Tolls that can be considered include (but are certainly not limited to) insurance, and long-term lease or purchase agreements between business and non-business heirs. What is critical is that the plan be spelled out early, and well communicated to all stakeholders very early in the succession process.

Retirement

It is important that the family, particularly the exiting generation, "plan for retirement". Will retirement be phased in, or all at once? How much investment, ownership, and control will be retained into retirement? Remember, the exiting generation may have years of valuable experience to offer the business, so a gradual exit may be desirable. Obviously, there are financial considerations for the retiring generation that have to be addressed (how will retirement be funded). An additional consideration that needs to be addressed (particularly in farm family business transition planning) is "who will live at the business headquarters"? If the retiring generation moves out, there may be lingering issues of control (we can't do any remodeling of the old farm house, because mom liked it this way and doesn't want to see it changed). Additionally, non business siblings may still have emotional ties to the home.

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[4]Again, it is beyond the scope of this introductory paper to provide details regarding how to plan and conduct effective family business meetings. There is a wide variety of excellent material on the subject available from your local library, or from the web.

## Structure

When family farm business owners see the term "business structure", typically the first thing that comes to mind is what type of legal entity the business is operating under. Actually, the term "business structure" can refer to much more than just legal structure. There are really three broad categories of "structure": Organizational; legal, and financial.

### Organizational (Management) Structure

Stakeholders (including employees) need to know what their role is, what is expected, who makes decisions (now and in the future), who is responsible, and who is accountable. A well-defined organizational structure yields a framework for stakeholder interaction, and assures that everyone involved in the organization understands the vision and mission of the organization, what is expected, and how decisions will be made. This is accomplished by providing an organizational climate that is conducive to open communication and problem solving.

The most traditional, and still common, form of organizational structure is the hierarchical management structure, where decisions are made in a top-down command and control fashion. Power and authority are retained at the top, and most decisions are made or approved by the manager. A second general form of organizational structure is the bureaucratic system, where responsibility is diffused among various levels of the workforce. Each individual in the management chain is constrained by rules and procedures that strictly dictate the decision making process. A human, or "people oriented" organizational structure spreads out the decision making responsibility among the individual employees and managers, or teams of employees and managers. A "hybrid" organizational structure might capture some elements of the people oriented organizational structure while providing some top-down direction from management.

Surveys have shown that the most successful family businesses exhibit shared decision making. Members of the incoming generation who perceive themselves as having significant influence in family decision making are nearly twice as likely to ultimately take over the farm. From a business plan development perspective, the critical thing to keep in mind is the importance of identifying a capable management team and a management structure that is consistent with the vision and mission of your organization. As stakeholders put together a vision statement and a mission statement, it is important to think about an organizational or management structure that will facilitate implementation of that vision. Many family businesses find it helpful to develop a graphical organizational chart to clearly illustrate the decision making framework for the business.

### Business Organization (Legal Form)

The legal form of the business structure can have significant implications for family tax management, estate planning, business transition planning, and other important business objectives. Therefore, a significant amount of attention should be given to this section of the plan, especially when preparing for business succession. This paper provides only a brief overview, and attempts to bring attention to the primary issues to consider. If you are considering a new venture, or substantial changes to the existing business legal structure, remember that legal requirements and documentation for various business entity possibilities vary from state to state. Work closely with legal counsel, an accountant, and other management professionals that are well versed in this area to decide which structure(s) may be most appropriate for your situation and to assist in developing those legal structures. When the stakeholder team of a business, or potential business, is considering the choice of an organizational structure the primary issues are: 1) source of capital, 2) liability, 3) management flexibility and control, 4) continuity, 5) taxation, and 6) legal filing requirements. The issue that is talked about as much as any other (and perhaps rightfully so) is the issue of liability. A primary objective of most equity investors is to limit their personal liability. This is particularly true of investors who do not wish to participate in management. The choice of organizational structure should not be taken lightly, as it can be very difficult and costly to change once a business is operating under a particular structure. The following is an overview of the principle types.

*Sole proprietorship*

The sole proprietorship is still the most common form of business organization for farms and ranches. The business is limited to the life of the owner, and the individual is responsible for all debts and obligations. Income is reported, and taxed at individual rate. Primary advantages of the sole proprietorship operating structure include ease of startup, as there are few formalities to go through to get the business going, and management control. Decision making is centralized with the owner - manager. An individual can conduct business in any state, with few reporting requirements. The corporate "double taxation" problem is avoided, with profits simply taxed at the owner's personal rate. Similarly, business losses can typically be used to offset other income for taxation purposes. On the other hand, there are certain IRS code benefits available to other organizational structures that cannot be captured under a sole proprietorship. Additional disadvantages in many situations include the fact that the sole proprietorship terminates with the death of the owner, and investment capital is limited to that available to the sole owner, making it difficult to obtain long term financing and limiting growth potential, particularly as the operator ages. This "life cycle" disadvantage results in the sole proprietorship being the least effective structure for maintaining the overall farming operation at peak efficiency. An additional important consideration is that the owners personal assets are subject to any business liabilities. Finally, the sole proprietorship organizational form can be a hindrance to estate planning, however, if the farm operation will cease at the owner's death, this may be the simplest structure to liquidate.

*Partnership*

In a general partnership all partners share equally in rights and responsibilities of business management. Partners are jointly responsible for debts and obligations of the business. Income distributions, responsibilities, etc are typically spelled out in a partnership agreement. General partnerships can be registered with secretary of state, but this is not required (in Kansas). Income is passed through for tax purposes, so profits are taxed at the rates of the individual partners. Partnerships must file for a Federal Employer's ID number whether they have employees or not. Again, consult legal and accounting expertise when considering forming a partnership. At a minimum, it is strongly recommended that you prepare a buy-sell agreement and a partnership agreement, to avoid major conflicts down the road if circumstances change.

The primary of advantage of a general partnership relative to some of the more complex organizational structures is the ease of organization, and the low initial cost of organization. The general partnership is a quasi-entity that can own assets, enter into contracts, etc. Resources are drawn from all partners, expanding the resource potential relative to a sole proprietorship. Partners can take business losses as personal tax deductions. The liability issue is a primary concern when considering a general partnership. Liability is shared between partners, however each partner is liable for all obligations against the partnership, and may be held liable for obligations against another partner. Control and decision making are shared, and legally each partner can act on behalf of the business. This aspect has some advantages, however it does underscore the importance of choosing partners with care as it is difficult to get rid of a "bad" partner. As with a sole proprietorship, there is not continuity of life beyond the partners, and depending on the details spelled out in the partnership agreement and associated buy-sell agreements the business may be forced into liquidation with the death of a partner. Due to these uncertainties, it may be difficult for the partnership to obtain large sums of capital. Finally, unlike some of the more complex organizational structures, there is no way to accumulate earnings within the partnership tax deferred. The pass-through taxation characteristic dictates that partners must pay tax on their share of the profits, even if retained.

A more formal class of partnerships (requiring formal partnership agreements and other documents meeting the requirements of the state where formed) include limited partnerships, and family limited partnerships. The most general form, the limited partnership, is a formal agreement between one or more general partners and one or more limited partners. Limited partners have no voice in management. Therefore, the general partner views the limited partners as a source of capital, while the limited partner is essentially trading a voice in management for limited liability. A primary advantage is the limited liability feature. Each limited partner is liable for debts only up to the amount of his or her investment in the company. Another advantage is the flexibility of this organizational structure. A person may be both a general partner and a limited partner. Limited partner interests can be sold at any time to raise capital, though once sold there are limits on the ability to trade those interests. The life of the company is not tied to any one partner's mortality. Profits are "passed through" to investors, so income is taxed at individual rates. Disadvantages include the complexity and cost of formation, and the advanced accounting and reporting requirements imposed by state regulations. The general partner may expose themselves to unlimited liability, while the limited partners have little voice in management. The limited partnership is often considered to be a good choice for property ownership, or for raising capital.

The family limited partnership is a special form of limited partnership provided for by statutes in most states. The principle objective of a family limited partnership is to carry on a closely held business where management and control are important. The advantages and disadvantages are similar to those of a limited partnership, however, there are restrictions regarding who can participate as partners.

*Corporation*

The corporation is the most complex business structure that would typically be considered by an agricultural business. The corporation is a separate legal entity comprised of shareholders, directors, and officers. It is considered to be a separate taxable entity, however, it may be taxed under sub-chapter C or sub-chapter S. The C corporation reports income and expenses on a corporate tax return, and is taxed at corporate rates. Profits are taxed before dividends are paid. Dividends are also taxed to shareholders, who report them as income resulting in the "double taxation" of profits. The S corporation is taxed in much the same way as a partnership. Profits are taxed at the shareholder's individual rate. Either type of corporation can enter into contracts, own property, etc.

A primary advantage of the corporate organizational form is that no shareholder, officer, or director can be held liable for debts of the corporation (unless a law was breached). Additionally, interests in the business can be readily sold by transfer or sale of shares of stock. This simplifies the problem obtaining capital and compensating resource owners, and facilitates estate planning. Depending upon whether the corporation is formed as a sub-chapter S, or a sub-chapter C, various levels of flexibility in tax planning are available. The entity can exist into perpetuity as long as regulations are met, and there are some advantages in the availability of pension plans, medical plans, other insurance plans, etc. relative to other forms of business organization.

A primary disadvantage of the corporate structure is the initial startup cost, and ongoing administrative requirements. Fairly extensive articles of incorporation are required, and documentation is required in each state of business. Extensive record-keeping and filing of reports is required on an on-going basis. Furthermore, management control is vested in the board of directors and officers, so minority shareholders may feel left out. Under the sub-chapter C structure there is the possibility of double taxation of profits, and it is more difficult to use business losses to offset profits from other endeavors. Finally, the corporate entity can be the most difficult and costly to dissolve, making business exit difficult if circumstances change.

*Limited Liability Company (LLC)*

A limited liability company is a business entity that combines the limited liability of a corporation, with the flexible management options of a general partnership. Kansas was the fourth state to authorize this form of business entity in 1990. Advantages include the limited liability of the various parties involved, relatively flexible management options that the structure allows, and partnership tax status. Depending on the way the company is set up, it can be perpetual, or there may be a limit on the life of the company. This form of business structure is not provided for in every state. Limited liability companies are complicated (and expensive) to form, and are subject to complex accounting and reporting requirements. In addition, ownership interests are not as liquid as shares of stock in a corporation, and are much more difficult to transfer making it a less attractive choice if estate planning is an imminent concern. The following table summarizes the pro's and con's of the various legal organization choices.

| Type | Individual Liability | Continuity | Management control | Taxation | Capital acquisition |
|---|---|---|---|---|---|
| S P | Unlimited | None | Proprietor | Individual | Difficult |
| Gen Partnership | Unlimited | None | Partners | Individual | Limited |
| Limited Partnership | Limited | None | General Partners | Individuals | Limited |
| C corp | None | Perpetual | Board | Double | Stock |
| S Corp | None | Perpetual | Board | Individual | Stock |
| LLC | None | Limited | Members | Individuals | Possible |

With all the complex choices available, it is important to seriously consider the legal organization structure of the agricultural business. There are no "blanket recommendations" as no single structure can meet the needs of all agricultural businesses in all situations. Many businesses consider changing the organizational structure when making major changes to the business, when attempting to bring another generation into the farming business, or when going through the estate planning exercise. General questions that need to be considered include: how much money do we need to raise now, and what are the sources of funding available? What is the possibility that we will need to attract capital for growth? What skills are needed in the business, and are there others currently available that have those skills? How much am I willing to expose myself, and others, to the responsibility for debts and other obligations of the business? What structure will provide the appropriate level of flexibility regarding ownership and management control, taxation flexibility, and transition and estate planning?

<u>Financial Structure</u>

Inadequate financing, or inappropriate mix of financing and be a major contributor to the failure of a family business to meet it's objectives, including generational transfer. In the context of the business planning thought process, there is a strong relationship between the legal structure, and the range of available financing options. For example, venture capitalists and the general public are more likely to provide financing in a corporate type structure. Providers of long term financing may in general feel more comfortable with a corporate structure, simply because of the life cycle nature of other business organizational structures where the business tends to follow the life cycle of the management/ownership team. Long term investors like to see an organizational structure that facilitates continued growth, and provides a motivation for the business to remain on the "cutting edge".

There are two major categories of financing available to businesses, debt and/or equity. Equity is a contribution of resources in exchange for an ownership stake. This can be cash or non-cash, tangible or intangible. The ownership stake allows the investor to share in the company's profits. A simple example of equity capital contribution is the contribution of owned land to a sole proprietorship farming operation. The “business” simply uses the land that is owned by the manager, and profits accrue to the manager in return for his or her contribution of land to the business. Debt involves borrowing resources from creditors with the stipulation of repayment of principle and interest in the future. Again, the resource can be cash or non-cash, tangible or intangible. The reward to the provider of debt financing is the interest payment. Debt can be secured, or unsecured. Secured debt is backed by some underlying asset of the business, meaning that if the debt is not re-payed according to the agreed upon terms, the creditor may exercise the right to take title to the underlying business asset. Leasing can be viewed as a special case of debt financing, where the creditor (leasing company, landlord, etc.) agrees to provide the use of a resource or asset in return for an interest (lease) payment.

**6. Feasibility, and Size**

An important financial consideration when planning for business succession is the issue of “feasibility,” or can the business generate enough cash flow over time to make all the required payments. This is separate issue from the topic of “profitability” (discussed earlier, and assumed to be adequate when proceeding with the succession planning process). A classic example of the conflict between long term “profitability” and “feasibility” that often reveals itself when planning for generational transfer occurs when a family farm business is considering expansion through a real estate purchase. The family may have concluded that succession is only possible if the farm expands (see next section), and may consider a land purchase to facilitate expansion. Farm real estate historically has “thrown off” a net cash return of 4 to 6% annually (either rental returns, or returns above all costs to operating the land). The remainder of the historical returns to owning land have been in the form of capital gains (averaging 4 to 5% annually). Adding these two returns together, the farm family may rightly come to the conclusion that a real estate purchase would be a “profitable” decision (total returns of perhaps 10%). However, in order to capture those returns, the farm would need to sell the land, essentially putting the farm out of business. Borrowing money to purchase the land, at say 6% interest, in order to generate an estimated 4% cash return might not be feasible for this farm if there is not income available from other sources to “make the payments.” When evaluating the financial implications of a generational transfer, it is important to consider both “profitability” and “feasibility.”

Along with profitability and feasibility, the issue of size needs to be considered. If the family business in transition will need to support more family living expenses than it has in the past, it will need to generate more income. That may require expansion, or employment flexibility when bringing in the next generation. In order to quickly estimate the size of operation that may be required, first determine the net income that the business needs to sustain the current generation, to sustain the family living requirements of the generation coming in, and for growth (for example, target 2.5 to 3% nominal growth in equity for a farm business, or it will quickly become un-viable in the future). To illustrate, say the retiring generation needs to pull $30,000 out of the family business, and an additional $12,000 is needed on average for equity growth. If the incoming generation expects an additional $30,000 from the business, we are quickly up to needing $72,000 in net income. Next, determine what level of gross income will on average be required to generate that $72,000. Divide the net income requirement by the historical net income from operations ratio (basically the net income divided by the gross income). In my farm business example, I assume a reasonable average of 15%, however keep in mind that the best place to obtain the appropriate ratio for your own situation is your own business history. In this example, $72,000 divided by .15 means the farm needs to gross $480,000 to have a chance at providing the net income required. Finally, you need to ask if you have the asset base to gross $480,000? A quick estimate is obtained by dividing the gross income requirement by the asset turnover ratio (gross income divided by asset base value), in this example 35% (again, the best place to obtain the appropriate ratio for your own situation is your own business history). In this example you determine that you need nearly a $1.4 million asset base to support the families and continue to grow.

After conducting a quick evaluation to determine if a generational succession plan is even remotely possible, a more detailed plan can be assembled and implemented. Perhaps that involves tapping family equity or outside equity for expansion. Perhaps it involves a phased transition involving non family business employment. In any case, a multi-year financial plan will help smooth the transition.

## 7. Stages of Succession

Transferring a family business to the next generation is a dynamic process that begins when the younger generation comes into the business, and ends when the older party completely leaves the business. The succession process will be most successful if a "team approach" atmosphere is established, supported by good communication and continuous skill development. The length of the process will depend on the maturity and technical skills of the younger party, and the length of time until the retirement of the older party. The process can be relatively short, or can take several years, sometimes leading to frustrations.

Family businesses typically go through some very definable stages of the transfer process. During a "preparation" stage, the younger generation gains general education, and in many cases training in specific skills that might complement the existing management team. Often this stage involves a period of working outside the family business to develop a broader set of skills. The objective of the entry or testing stage is to determine whether the young person really wants to take over the business, and how well the various parties can work together. This stage typically involves a wage, or wage-incentive plan for the younger party. Pay can be established based on market wages, family needs, equality among stakeholders, or separately agreed upon returns to ownership and management contributions. The important thing is that the agreement is spelled out well in advance during the succession planning process. As the younger party begins to contribute more property and management to the business, the transition enters the commitment phase. Enterprise or whole business operating agreements that clearly spell out the division of income are common during this phase. Shifts in the organizational structure, and changes in the legal structure of the business are often needed during this phase. The established phase occurs when the younger generation has acquired the skills to manage the business, but the older party is still fully involved as well. Fairly rapid ownership transfer (especially of the machinery and equipment) occurs during this stage, and it is essential that the legal operating entity that is in place (corporation, partnership, etc.) be flexible enough to accommodate the rapidly changing capital, management, and labor contributions of each stakeholder involved. The last stage, the withdrawal stage, occurs when the older party withdraws from the management of the business at retirement. During this stage lease arrangements are used by the younger generation to obtain the use of real estate, and perhaps machinery and equipment, that is still owned by the older generation.

## 6. Summary

A comprehensive plan for family business transition or succession is especially important when there is a large fixed asset base involved. Important considerations that the planning process will help to resolve include whether or not the older generation is ready for change; whether the younger generation is committed to a successful transition; is there a common vision; is the business profitable enough and large enough to pass on; and can the family and other stakeholders get along and maintain family relationships throughout the transition? Consider the following abbreviated checklist if your family business is facing the generational transition issue.

1. Have we started planning early, and begun the process of facilitating communication and development of a shared vision.
2. Are we preparing a written succession plan as a part of a broader overall written business plan.
3. Is “passing down the farm” a deeply felt dream of a majority of the stakeholders.
4. Have we involved “all” of the stakeholders in preliminary communications regarding the succession plan, and have we addressed the “fair vs equal” concerns.
5. Have we, (or will we), taken advantage of outside advisors (legal, accounting, financial planning, family mediation, etc.).
6. Have we considered the financial profitability, feasibility, size, and risk issues associated with the succession plan.
7. Have we thought about a retirement plan for the older generation, including a target retirement deadline, sources of retirement funding, other interests to pursue, etc.
8. Do we have a written plan, and timetable, for implementing the various phases of the succession process on our farm or ranch.

Family business succession is not easy. However, a well crafted plan can smooth the transition and increase the chances of success, while at the same time helping to maintain family harmony.