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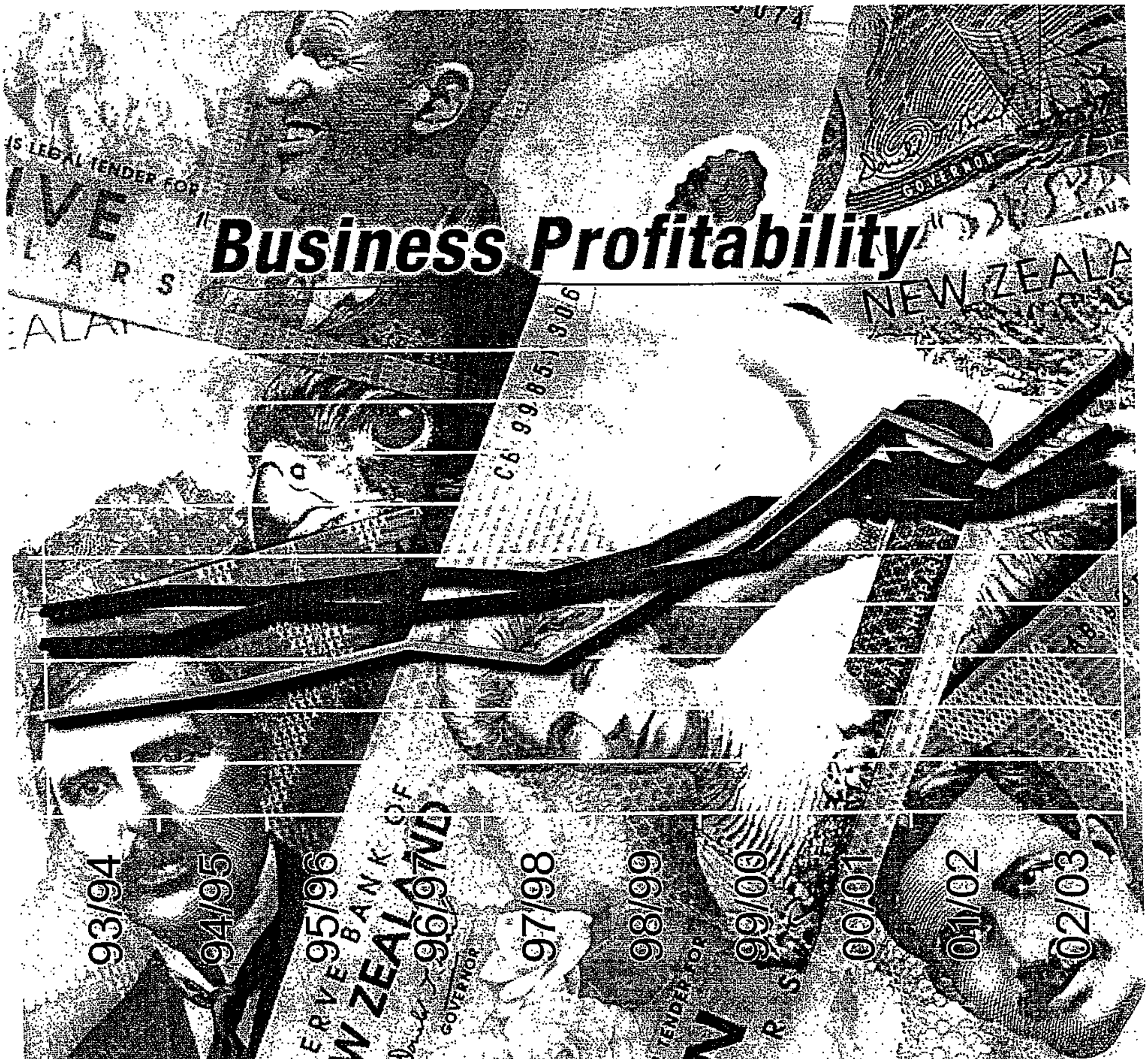

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NZ Institute of PRIMARY INDUSTRY MANAGEMENT

Lead Article

ASSET PROTECTION AND SUCCESSION PLANNING

George Collier

Introduction

The average family farm business has in excess of $2 million of equity, with the top 20% of farming businesses by size having in excess of $4 million of equity. Increasing land and asset values, coupled with average farm incomes relative to prices now being paid for land assets, means the incoming farming generation faces an uphill battle to accumulate the necessary cash and tax- paid savings for future farm purchase.

Adding even more pressure to the family farm structure and the first farm purchaser, is the prospect that in the current environment, a farm business needs to grow by at least two and half times within the next 20 years for the successive generation to purchase and operate a business that will continue to be viable. For farm succession to be achievable requires strong underlying profitability, a focus on business growth and a well thought-out action plan. Without sustainable farming profits, it is difficult to make the whole exercise work going forward.

The dilemmas that make the process challenging include adequate retirement income, being fair to all children, managing succession so that the successors and the farm business are not burdened with debt, and ensuring that everyone retains a sense of family cohesion at the end of the process. Regardless of equity arrangements or ownership stakes, many non-successor siblings will retain emotional ownership of the farm throughout their lives. Treating all children equally and ensuring viable farm succession is a financial impossibility for the majority of farming families. The key is to strive to be fair rather than equal in the provision of non-successor children. This is why it is important to involve non-successor siblings in family meetings when discussing the future of the farm business.

Low debt loading within some farm businesses will provide the opportunity to pursue off-farm investment options which can provide cash returns and capital growth for non-farming children. It can be very tax effective and can provide the opportunity for further farm expansion if that is desired.

The importance of correct business structures and wills

There are several issues to consider in trying to determine the most suitable business structure.

One of the key issues that comes across my desk on a regular basis is that many wills and business structures do not reflect the succession plan or adequately protect the family equity. There are a number of specific areas which need to be looked at in detail to cover all the interrelated issues in relation to wills and structures.

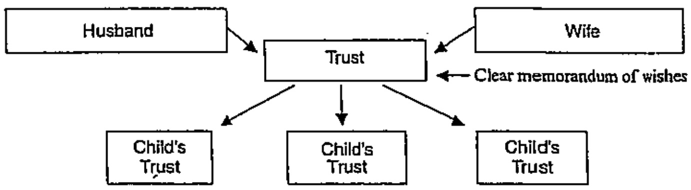
Estate planning – protecting the legacy

The conventional approach has been to have spouse-to-spouse wills or parent-to-children wills.

There are a number of reasons why this conventional wisdom has some inherent risks.

- Remarriage of a spouse who has inherited an estate – do the children from the first marriage get any inheritance?
- Divorce of children – bequests can be recognised as joint property if intermingled
- Wayward children – retaining control over their inheritance

The main issue at stake for the individual making a bequest through their will is having a much higher degree of certainty as to the outcome. This can be achieved by having trust wills and a very clear memorandum of wishes for each trust.



Asset protection

In today's commercial business environment the risks of holding all assets in our personal names are high. There are greater legislative requirements being placed on businesses more than ever before. In addition to these legal requirements and threats we are facing a greater challenge from potential litigation. While it is illegal to deliberately defraud creditors, it is important to ensure that some personal equity is protected to cope with any eventuality.

The solutions include the following –

- Future inheritance directed towards trusts rather than individuals
- Growth and wealth accumulating assets held by a trust or company with majority trust shareholding
- Bank or creditor guarantees always limited to a certain amount of money and limited to a maximum number of assets
- Personal guarantees used with great discretion

Tax planning

We have sorted out the estate planning but a farmer's assets may still be vulnerable to wealth tax on death or the sale of a farm. The risks are death duty, capital gains tax, taxation clawbacks upon sale of assets or nothing.

Some facts worth considering are –

- Society has increasing expectations of government for health, education and welfare which equates to increased taxation pressure.
- By 2040 Treasury estimates the ratio of workers to retired will drop from 5:1 to 2:1 equating extra taxation pressure.
- A political party 1996 manifesto included a reintroduction of death duties on estates of more than $450,000.
- There are international trend to standardise tax and commercial law, which means there is an increased likelihood that New Zealand will follow the tax law regime, especially from Australia, and introduce some form of capital gains tax.
- Stamp duty was, in some situations, a major barrier to farm succession and adopting the most suitable trading structure when land was held by individuals.
- Increase in land value and size of farming businesses gives greater exposure to wealth tax for land held by individuals.
- Wealth tax would have a large impact on many farm businesses.
- Farm land doubles in value every 10 years.

Death duty and capital gains tax

A death duty or capital gains tax of 40 cents in each dollar over $450,000 would have a massive impact on the average family farm business, especially if the wills are not trust wills, as there would be potential for a double tax.

Additionally, given that land on average doubles in value every 10 years, this would cause future taxation issues. This highlights the importance of having the correct structure to limit wealth accumulation in an individual's name. A potential capital gains tax would tend to revolve around the sale of a capital asset. This could be a major issue in transferring assets from one generation to the next to achieve farm or business succession.

Farming businesses, and land in particular, owned by individuals through a partnership are most vulnerable to potential capital gains tax.

Key issues to consider for solutions to death duty and capital gains tax are that –

- Wealth accumulating assets are owned by a trust, or preferably a company with major trust shareholding
- Wills are set up so bequests are made to trusts rather than to individuals
- Once the appropriate structures are in place, a gifting programme is commenced
- Transfer of ownership and control can be achieved without selling the underlying asset to avoid potential capital gains tax – company structure with majority trust shareholding.

Claw-back taxes upon sale or changing structure

Unfortunately, taxation often arises as a stumbling block to succession, estate and asset protection planning. This can result in these important issues being deferred. In the worst case scenario, the same tax issues would arise as would be seen on the sale of the business to a third party. These may include –

- Income from sale of livestock
- Depreciation recovered on sale of building
- Taxable gains on the sale of consumables such as hay, silage and grain
- Income from timber
- Income brought forward such as income equalisation deposits
- Farm development expenditure

Potential solutions

The most important consideration is the legal entity which owns the various parts of the farm business. If the correct structure is used then there should be little, if any, tax liability upon transfer of assets on death or in the succession process.

The timing of sale can be altered for taxation purposes by deciding in what financial year the transaction should take place, for example the first day of the next income year. In some situations a lease, bailment or profit share agreement of livestock may be applicable if large amounts of livestock taxation will occur upon sale. Taking out a forestry right over standing timber can defer the income tax payable, and harvest and forestry income can be spread over the year of the sale as well as the three preceding income years.

Succession planning

Background facts

When figures were compiled six years ago by MAF, the average age of retirement was 59. However the average age when succession was complete was 42, giving a transition period of succession of 17 years. All children thought their parents had done much more planning than they had. Some important outcomes of the farm succession process include –

- Secure retirement income of parents
- Expectation that all children would be treated fairly, not necessarily equally
- Ensure the ongoing viability of the continuing business.

Some of the key requirements to enable enduring succession include –

- Clear vision and purpose for the business
- Motivation beyond money, such as living the family dream
- A willingness to trust and support the successors
- Seeing the succession process as more than just passing on wealth
- A strong growth philosophy
- Long term inter-generational working partnerships
- Good communication between generations
- The structure used reflects the circumstances.

Suitable business structures

The correct business structure is determined by the needs, including emotional needs, of all the family members, aspirations and direction of the business and its owners.

The options are –

- Partnerships and sole traders
- Passive trusts
- Trading trusts
- Company with individual shareholders
- Partnership including trusts
- Company including a trust shareholders

A Trust as a major shareholder

There are benefits for a company farming structure with a trust as major shareholder. For estate planning a limited liability gives significant protection, wealth accumulation is largely in

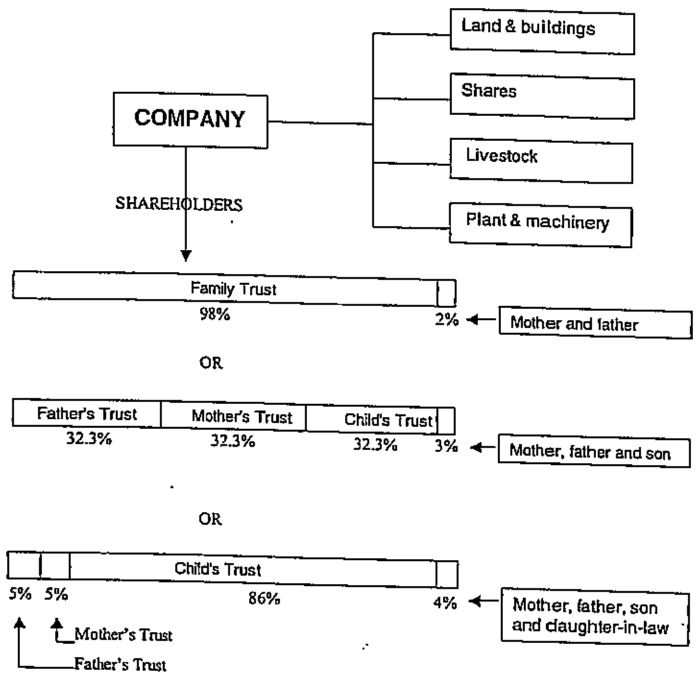
Types of business structures commonly used

	Estate planning	Asset protection	Usefulness in succession	Tax rate	Potential for tax planning
Sole trader	Poor	Nil	Nil	Up to 39%	Limited
Partnership	Poor	Nil	Limited	Up to 39%	Limited
Company with individual shareholders	Poor	Okay	Excellent	33% + use of money interest	Excellent
Trading Trust	Excellent	Excellent	Messy	33% + use of money interest	Excellent
Partnership including a Trust	Okay	Okay to excellent	Poor & messy	33% Trust up to 39% for individual	Okay
Company including a majority Trust shareholder	Excellent	Excellent	Excellent	33% +use of money interest	Excellent

the trust shareholding, there is asset growth and the company dividend goes to the trust. For taxable income there is the ability to spread income across all shareholders and directors, the maximum income tax rate is 33%, the Inland Revenue will treat all companies as a commercial trading entity and tax losses are not trapped in a trust.

Succession –
- Provides a structural vehicle for a living succession plan
- Excellent flexibility given transferability of assets by selling shares
- Equity growth is protected and can be transferred to successive generations through trusts
- Memorandum of wishes for each trust gives real effect to the living succession plan
- Transparency is reasonably clear
- Ability to include other non family shareholders
- Control retained by parents

Some of the issues involving taxation –
- Tax losses trapped in company, not attributed to individuals
- Losses and imputation credits can be lost with significant change of shareholding
- Fringe benefit tax regime
- If a qualifying company and it has a Trust shareholder, then dividends must be passed through to beneficiaries



Trading company with majority trust shareholding

Summary

New Zealand agriculture today is experiencing an evolution of a decreasing number of commercial farms. The importance of having the correct personal and business structures cannot be underestimated within a modern day agriculture business. The type and combination of structure will all have an influence on estate planning, asset planning, tax planning and succession planning

The increased use of trusts, trust wills and memorandum of wishes, combined with company ownership of assets, has significant potential going forward. The importance of a proactive professional cannot be over emphasised. Today's professional advisor has a role in being proactive in promoting positive business decisions.

Getting started is simply a matter of understanding what the important personal and business outcomes are for the farm business. However in some instances farm succession can easily get so bogged down in some of the issues that the capital and income needs of the retiring parents are forgotten. All too often it is easy to lose sight of the fact that the parents' wishes and financial requirement are paramount.

Like any business plan, a succession plan needs to be flexible so that changes in strategy can be quickly made. There also needs to be the flexibility in terms of the type of trading structure that will allow for the succession to take place.

There are no recipes sitting on the shelf, but there is certainly a number of important principles including open and honest communication, so everyone knows what is happening, beginning succession management early enough in the generational business cycle, and making provision for the non-farming children.

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