# PIFF Newsletter

## Spring Edition

Purdue University | Purdue Initiative for Family Firms, College of Agriculture

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**Included in this Issue:**


- ⇒ Welcome to PIFF........1
- ⇒ Valuation of Agricultural Land for Business Transfer Decisions *by Michael Langemeier*...............2
- ⇒ Estate Planning - What Tools Are Available? Part II *by Craig Dobbins*....................3
- ⇒ Budgeting for the Family in the Family Business *by Jennifer Pendergast*...............4
- ⇒ Do You Want Your Succession Plan to Stay Safe? *by Andrew B. Martin*........................6
- ⇒ Meet PIFF & the Authors....................8


## Welcome to PIFF!

The Purdue Initiative for Family Firms (PIFF) is an initiative in Purdue's College of Agriculture. PIFF is an integrated research, outreach, and teaching program. It offers educational programs that address the major competencies needed for effective family business ownership and management. The goal of the initiative is to prepare family business stakeholders—strategically, financially, and emotionally—for the significant and sometimes unpredictable transitions and decisions that must be made, which determine the success and continuity of the family business.

PIFF provides multi-generational family businesses with research-based business management resources aimed at improving personal leadership performance and driving operational growth. Our ambition is to prepare family business owners, managers, and stakeholders (including non-owner spouses and future owners) to be effective stewards of their family enterprises.

PIFF publishes a quarterly newsletter that will house an article from each part of the pie, found on our website – purdue.ag/piff. The four quarters of the pie include topics of: estate and personal financial planning, strategic business planning, maintaining family bonds, and leadership and succession planning. Each section houses articles, guides, and assessments of related topics which can be viewed online or downloaded. Also found on the website is a *Question of the Month*, PIFF Research, an option to subscribe to our quarterly newsletter, and upcoming events.

# Valuation of Agricultural Land for Business Transfer Decisions

Michael Langemeier

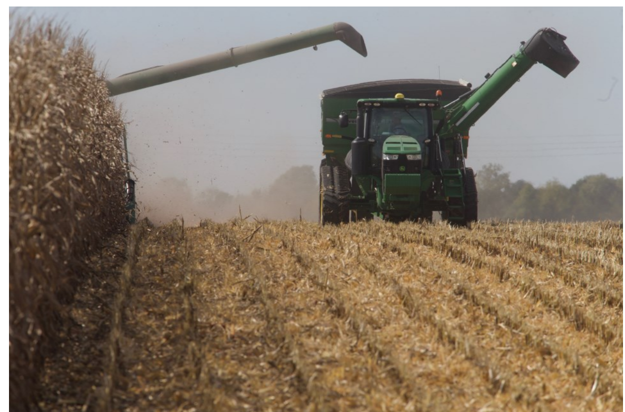
When transferring assets from one generation to the next, it is imperative that the farm values the assets that are going to be transferred. This is particularly important when developing a buy-sell agreement and when examining the financial feasibility of transferring assets to the younger generation. This article will focus on the valuation of agricultural land.

There are three approaches that appraisers use to value agricultural land.

1. The first approach is referred to as the market or sales approach. The market or sales approach uses comparable sales to value agricultural land. This approach recognizes the fact that a buyer was willing to pay a certain amount for a farm and that a seller was willing to accept the buyer's offer. In other words, this approach recognizes that supply equals demand. One of the problems with this approach is that there are often special circumstances involving the sale of a specific parcel. For example, the buyer may have land adjacent to the parcel that sold and thus bid accordingly. These special circumstances need to be taken into account when using the market or sales approach.
2. The second approach is referred to as the income approach. The income approach uses the net return to land and the capitalization rate to value agricultural land. The net return to land can be computed using long-run prices, yields, and costs, or market-based cash rent. The capitalization rate varies over time, and depends on interest rates, the rate of growth of net return to land, and the relative riskiness of farmland compared to a portfolio consisting of stocks and bonds. Currently, the capitalization rate is approximately 3 percent.
3. The third approach is referred to as the cost approach. The cost approach uses a cost-based balance sheet to value assets such as agricultural land. An obvious problem with this approach is that land that was purchased many years ago was purchased at a price well below its current value. In this instance, the cost approach would arrive at a value well below the values obtained with the market or income approaches.

A buy-sell agreement is a legally binding agreement between co-owners of the business that governs how assets are dispersed if one or more of the co-owners leave the business. Buy-sell agreements can be very useful to the younger generation because with these agreements they are often given the opportunity to purchase land or other assets when the older generation wants to sell or dies. A buy-sell agreement should include a mechanism for how agricultural land or other assets will be valued.

An installment contract is a type of contract in which the payments are made in a series of installments rather than as lump sum. Installment contracts are often used to transfer agricultural land between generations or between farm and non-farm siblings. Again, a mechanism for how agricultural land or other assets will be valued is an important component to these contracts. It is also important to establish the terms of the installment contract pertaining to the number of years in which the installments will be made and the interest rate.



When developing a buy-sell agreement or when examining the financial feasibility of transferring land across generations, it is important to value farm assets. This article briefly discussed the market, income, and cost approaches to valuing agricultural land. Also, the article briefly discussed buy-sell agreements and installment contracts.

## Estate Planning – What Tools are Available? *Part II* *Craig Dobbins*

(continued from PIFF's Winter Newsletter)

A tool often used to help people avoid probate is a **trust.** Trusts have existed for centuries and today there are several kinds of trusts. A few of the types used in estate planning are listed below:

1. **Revocable Trusts** allow the grantor of a trust, the person that creates and initially funds the trust, the right to revoke the trust at any time prior to incapacity or death. At the time of death, the trust become irrevocable. These trusts are commonly used to avoid probate and to provide management of the assets should the grantor become incapacitated.
2. **Irrevocable Trusts** do not allow the grantor to take back the property transferred to a trust. To achieve estate and gift tax planning objectives, a trust must be irrevocable, but not all irrevocable trusts are effective estate planning tools. For example, if the grantor retains some rights over the property transferred to the trust, the value of trust assets may be included in the grantor's gross estate.
3. **Testamentary Trusts** are created after the death of the grantor. The grantor typically leaves instruction in their will for the executor of the estate to create and fund the trust. Two of the most common types of testamentary trusts are a credit shelter (bypass) trust and marital deduction trusts (Qualified Terminal Interest Property, QTIP Trusts, General Power of Appointment Trusts, or Estate Trusts).
4. **Standby Trusts** are created during the grantor's lifetime but is either unfunded or minimally funded. The trust simply stands by and waits for a triggering event to activate it. The trust may be used during life, during times of incapacity, or at death.
5. A **Pourover Trust** is a trust that receives assets from another source, generally the grantor's estate at the grant's death. The trust is generally unfunded or minimally funded until the assets pour into the trust.
6. **Grantor Trusts** can be revocable or irrevocable trusts. To qualify for grantor trust status, the trust must be created during the life of the grantor. When a trust is characterized as a grantor trust, the grantor of the trust, not the trust itself or the trust beneficiaries, is responsible for paying the income tax attributable to the trust's income.

Trusts provide a way to split the interests in property among different parties. As pointed out above, the grantor is the person establishing the trust. From the grantor perspective, trusts are helpful in reducing estate taxes and administration fees by avoiding probate and providing an increased level of privacy regarding financial matters. They also help discourage contesting the decedent's will. There is also a trustee. This is the person or entity responsible for managing the trust assets and carrying out the directions of the grantor expressed in the trust document. The beneficiary is the person (or persons) which hold the beneficial title or economic rights to the trust assets. The income beneficiary holds the right to current income or distributions from the trust or the right to use the trust assets. The remainder beneficiary is entitled to receive the assets that remain in the trust on the date of trust termination.

There is property that has a built in **transfer on death** provision. Life insurance and retirement accounts are examples. Property of this type asks the owner to specify a beneficiary that will receive the property upon the death of the owner. Property of this type generally avoids the probate process and passes directly to the named beneficiary. However, if the owner of the property did not properly complete the beneficiary assignment or the owner's estate is the assigned beneficiary, the value of the property will be included in the decedent's gross estate. Transfer on Death procedures can be used with other types of financial property such as checking accounts.

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**Power of Attorney & Power of Appointment** provide a way for a trusted person to make important decisions for the person granting these powers. These powers generally transfer when the person granting the power (principal) cannot make decisions or execute documents for themselves. The power of attorney authorizes another person to act on your behalf. This power can be general, allowing the person to act on your behalf in all areas, or it can be limited, allowing the person to act on your behalf in only one or a small number of areas. The power of appointment gives the person the power to determine the disposition of property (appoint). This power can again be broad or it can be limited. For both of these powers, it is common to find these powers tied to a triggering mechanism. With a triggering event, the grantor of the power retains the power until a specified event, such as becoming incapacitated, occurs.

**Durable Power of Attorney for Health Care** names a person to make health care decisions for the person granting the power. This is different than a Living Will or a Do Not Resuscitate (DNR) order. The Living Will and DNR are focused on taking special steps for sustaining f life (what should be done when the heart stops beating). Durable Power of Attorney for Health Care is focused on making decisions with the objective of the patient getting better when you are not able to make those decisions.

### Summary

This article provides a brief summary of general tools used in in estate plans. There are additional tools available and there are some important tools for owners of closely held businesses that were not included with this list. This review should indicate to you that with the tools available it is likely whatever your estate plan objective, there is a way it can be accomplished. This brings us to the most difficult issue in estate planning and the issue that prevents many estate plans from being developed – What do you want your estate plan to accomplish?

## Budgeting for Family in the Family Business

Jennifer Pendergast

One of the hallmarks of highly functioning ownership groups is their ability to maintain strong family relationships even as the family grow larger and more dispersed. To help strengthen family bonds, many successful business-owning families conduct shareholder meetings, family retreats, family council work and development of active communication channels. Often, initial family governance activities are undertaken without much thought to an overall budget. As the activities expand, questions are raised among the family: How much can the family afford? What activities are most important? Who will pay and for whom?

We find that implementing a formal budgeting process for family work is valuable, regardless of whether these questions have been raised. Creating a budget engages the family, shareholders and management in a conversation that aligns them around its goals and priorities for the family and the business. It also makes explicit the investment is being made in family unity and shareholder development.

### Where do we start?

Development of a budget is often prompted by management or the board of the family enterprise, as they are the ones funding the family activities. In this case, the family council will submit a budget to management or board for approval as part of the business budget cycle. Often, budgets don't vary significantly from year to year, so the council may put in a request to match funding from prior years.

When the budgeting process is the responsibility of the family council, many are faced with the challenge of determining the "right" amount to spend on family activities. While it would be useful to have a rule of thumb to determine a family budget, the factors that drive the expenses are too complex to define a simple metric such as a percentage of profits. When setting a budget, a family must take into consideration its culture, climate and objectives.

*(continued on page 5)*

For instance, how does your family feel about spending money on nice trips? Do you value investment in education? Should service to the family (such as family council members) be volunteer or paid positions? Answers to questions like these can help you determine your family's culture.

Similarly, climate affects financial allocations. If the economy is suffering or your business is facing a downturn, it may be a time to rein in expenses. Even if money is available to pay for a nice family trip in a slow economy, the signal sent to employees who are facing layoffs, hiring freezes or suspension of raises may be inappropriate.

Ultimately, the primary driver of budget should be the family's goals, which may include:

- Next-generation leadership development
- Investment in family relationships
- Development of family policies or governance structures
- Definition of ownership vision and financial objectives
- Improvement in communication infrastructure (e.g., website, newsletter)
- Family education family about the roles and responsibilities of ownership

Goals should to be filtered through the lenses of culture and climate to determine an appropriate budget. Goals can be achieved in different ways such as inexpensive webinars vs. contracting speakers for a family event or holding a family meeting at corporate headquarters vs. a high-end resort. Whatever the approach, maximum attendance is necessary to accomplish the goals listed here. Most families find that an attractive location and interesting activities increase attendance.

## What are the cost categories?

As families get larger, family meetings are the primary driver of the budget. We find that families who meet twice a year are more cohesive than those who meet less often. Ideally, one shareholder meeting is held at headquarters with presentations by management and the other meeting focuses on building family relationships. Some families hold their annual family-focused meeting at a resort location while others save up for a destination trip every few years. Beyond location, cost is driven by the geographic dispersion of family members, extracurricular activities, on-site child care and whether the family pays for family travel to meetings.

In addition to family meetings, budget categories can include:

- Communication (newsletter, website)
- Seminars/education (family business conferences, paid webinar series)
- Consulting resources (meeting facilitation, assistance in developing family policy/governance)
- Compensation for service (family council participation, administrative support)

After defining your goals and cost categories, draft a budget then evaluate based on affordability and adjust accordingly.

## Who pays: the business or the family?

The final step requires consideration of the various sources of funding. Most families pay for family meetings out of business profits, but you should consult with your accountant about allocating family expenses to the business. Typically these expenses can come under the heading of shareholder relations. Some allocate a percentage of dividends to pay for family expenses -- the downside being that these expenses are paid after taxes. Some families establish trusts earmarked for family activities while others contribute to a family pool to fund family engagement.

The benefits to the company when using corporate money to pay for family activities:

- It is an investment in shareholders (similar to a shareholder relations expense in a public company) and can be deducted prior to taxes with careful planning.
- The company demonstrates its support and commitment to the shareholder base and creates an ongoing commitment to the business.

*(continued on page 6)*

- The company receives the benefits of ensuring it has a strong, cohesive, educated shareholder group, which is a strong determinant of family business success.
- Shareholders who spend time together tend to have a greater connection to each other and to the business.

There are also benefits to having shareholders fund at least part of the family activity cost. It ensures the money is spent on the priorities that really matter to shareholders. It also sends a clear message to the company that owners are truly invested and care about the future of the business. And, no matter which budget category is assigned to these expenses, it ultimately comes out of the shareholders' pockets.

### How do we stick to the budget?

Regardless of who funds the activities, the budgeting process helps families be good stewards of their resources. Beyond setting the budget, ensuring accountability for sticking to the plan is important as well. We recommend capturing the budgeting process in a formal policy which could include:

- a timeline for submitting the budget;
- who is responsible for approving the budget categories that will be covered;
- who is responsible for paying expenses;
- how expenses will be tracked;
- how individuals will be reimbursed for expenses they pay individually;
- and, who will review the budget to ensure it is being followed.

This policy should be agreed upon by the family and business board if they are funding some or all activities.

Regardless of your culture, climate and goals, developing a budget forces the family to reflect on its goals and appreciate the investment made in the family. Similarly, it encourages management to reflect on the importance of maintaining a strong shareholder base and the expenditures required to achieve cohesion. Investing in the family not only validates that the business is committed to its owners, but that the owners are just as committed to their business.

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## Do You Want Your Succession Plan to Stay Safe? — Andrew B. Martin

To ensure the succession plan stays safe, it will need what I call **Integrating Farm Safety into Your Succession Plan**. Integrating farm safety into your succession plan is more than just orientation and training successors about safety issues on the farm. I describe this process as:

"Potential successors get adjusted to the social and performance aspects of their roles, and learn the attitudes, knowledge, skills, and behaviors required to function effectively within an organization, all while implementing farm safety rules."

This will help ensure that succession can happen safely and securely. Integrating farm safety into your succession plan continues until the successor is acclimated to your farm vision, core values, and farm culture. The goal is fully performing his or her job responsibilities in a safe matter. It includes much more than learning the safety skills and responsibilities of the position.

Integrating farm safety to expand beyond your past understanding of succession transfer and the occasional farm safety training may sound like unnecessary time and work. *(continued on page 7)*

However, think about the example of first impressions. These are very important and often very long-lasting. We can apply this same scenario to farm safety and its importance in your succession plan. Without this implementation, you could forfeit the farm because of death, dismemberment or impairment due to a farm accident. Bad habits not dealt with can threaten the business for its whole duration. Unnecessary risks can be the demise of everyone involved in the succession transfer.

Too often, it is assumed that exceptional successors are smart enough to figure things out on their own in regards to farm safety. However, this is a very dangerous assumption! Before the possible successor arrives, you must have a detailed onboarding plan -- orientating, training, and integrating farm safety with the new employee. Schedule time for yourself and others to connect with the new employee. It is easy to get engaged in activities and leave the new employee or successor "hanging" when it comes to safety.

## Orientation

It is likely that the incumbent generation has always been a part of the farm. The information that the new employee or successor requires in orientation is second nature to the incumbent. Undoubtedly, it is easy to miss many key items during orientation unless a checklist is used. This checklist should contain all the items the new employee needs to know to feel comfortable in his or her new surroundings. You can ask your newest employees and successors to help develop the checklist and add to it over time.

## Training

Be certain to explain why tasks are performed the way they are for safety reasons. This explanation will enhance the new successor's or employee's comfort level, confidence, and engagement in the tasks and the farm. Use farm safety publications from Purdue Extension and other land grant universities. Most equipment has safety information in their manuals; be sure to review it.

## Engagement

The more we learn from modern research about how to lead and coach employees, the more we understand. The most productive, easiest to supervise, and longest tenured employees are those that are passionate about the farm's success. They work because they want to, not because they have to.

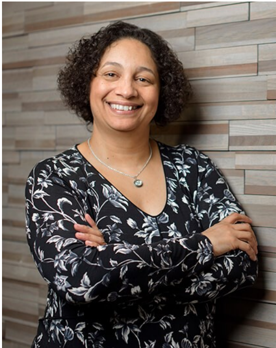
**Integrating Farm Safety into Your Succession Plan to create passionate employees requires your leadership and coaching from day one.**

Components for engagement that includes safety:

- Continually discuss and use the farm vision and core values.
- Explain your hopes and dreams of transfer and some of the strategic moves you have planned to fulfill those hopes and dreams. Don't say things for engagement but have no plans to make it happen!
- Talk about the history of your farm, including the founders.
- Share the traditions and important events to your farm culture.
- Provide clarity in instructions, tasks, plans, and expectations.

***Passion for safety takes time to develop, but might be the difference in <u>keeping your succession plan safe</u>.***

# Meet PIFF & the Authors



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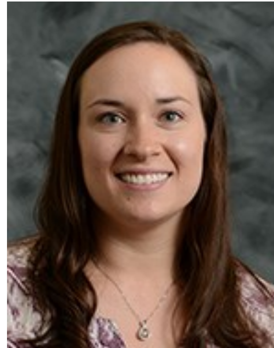

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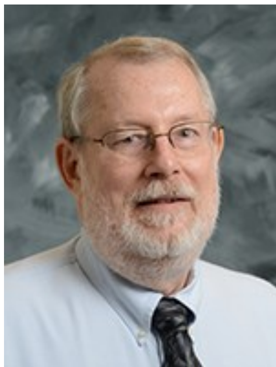

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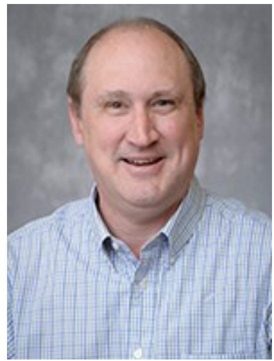

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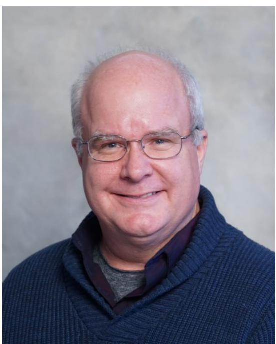

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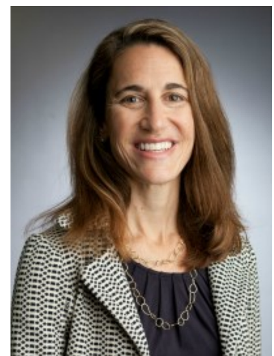

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