FARM BUSINESS

FACT SHEET

GRDC
GRAINS RESEARCH & DEVELOPMENT CORPORATION

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Legal aspects of succession

PHOTO: SHUTTERSTOCK

KEY POINTS

- Know the rules: identify relevant legislation
- Adopt best practice: plan to get it right the first time
- Get some perspective: seek expert and independent advice
- Be open and resourceful: there is plenty of expert help available

INTRODUCTION

Knowing how the law applies to all aspects of a farm business and complying with legislation is one way to significantly reduce risk. The areas explored in this fact sheet are succession and the business structures and documentation for intergenerational transfer. A real-life example is used to demonstrate the potential impact of getting it wrong and a checklist is provided.

SUCCESSION

The transfer of control of a farm to the next generation is an inevitable process in many family enterprises.

The best-case scenario is to start planning from when a family member first expresses an interest in returning to the farm. The aim should be to create a legal structure that protects the rights and assets of all parties. This not only sets the scene for a smooth intergenerational transfer when the time comes, but also provides important legal safeguards to protect the business and individuals from financial loss in other risky scenarios such as land purchases.

In the excitement of returning to the farm, the younger generation can jump into situations they later regret. The option of placing the returning family members on an employment contract can work well while the structure of the new business is carefully considered.

Succession planning should incorporate structures that promote transfer of control and avoid triggering adverse tax consequences, with the two most common structures used in farming being partnerships and trusts.

In establishing either of these, the goal remains to protect the rights and assets of all parties. The starting point is to make sure everyone understands the legal and financial consequences of the structure they are to become part of.

That means reading the documents properly, getting independent advice and considering all scenarios, including death and how wills deal with debts owed to the family business.

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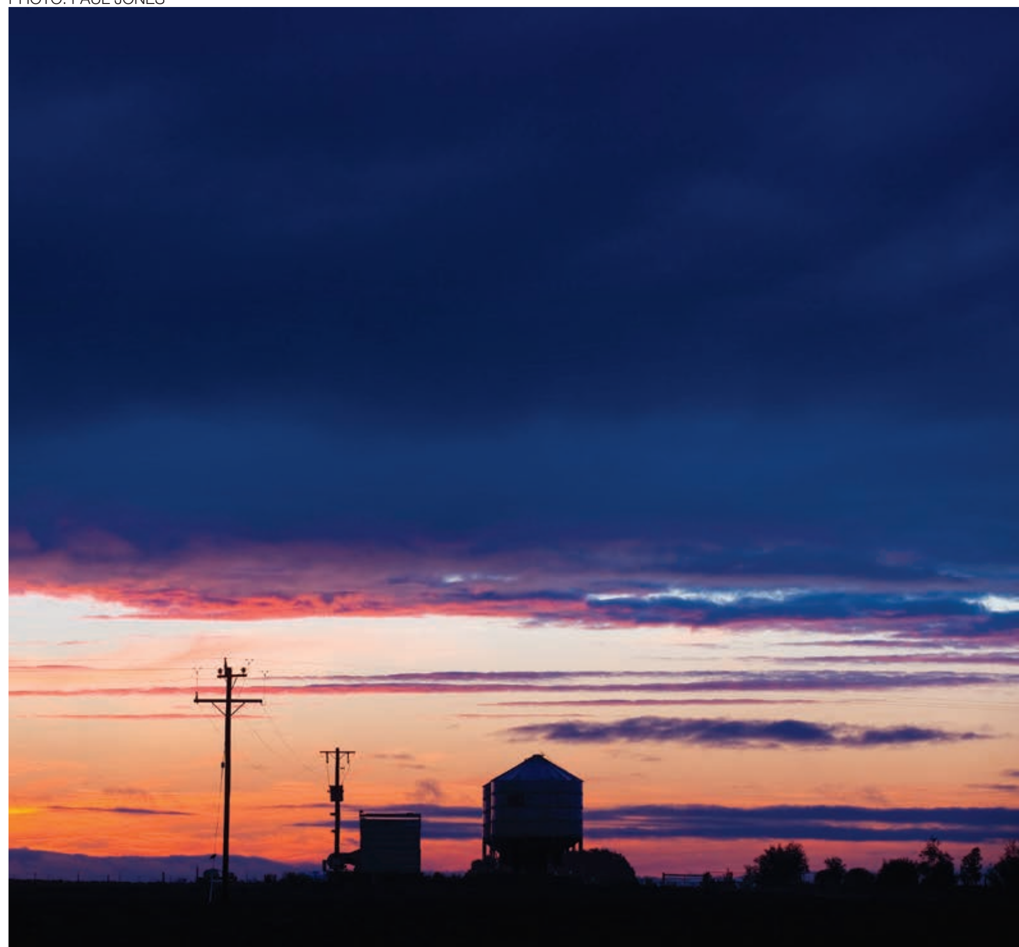
WHY BE PROACTIVE? WELL, THINGS CAN GO WRONG. TAKE THIS REAL-LIFE EXAMPLE

Two brothers decided to return to the family farm after working in the mining industry. Both had wisely invested the money they had earned, building up off-farm assets that, for one, included buying a house. To support the extra family members who would be working in the cropping enterprise, it was decided that more land would be needed to increase scale.

A new corporate trust was set up with the father and two sons as directors. The father also acted as the trust's appointor. As directors, all three were required to sign personal guarantees for bank finance. Unfortunately, there was a default on repayments two years later and the land had to be sold at a loss. The lender issued proceedings against the directors for recovery of the shortfall. A negotiated settlement meant bankruptcy was avoided but all three lost most of their assets, including the home the son had bought with his savings from working in the mines.

Independent legal advice could have had the sons become joint appointors of the trust rather than directors, which would have given them some control without having to sign personal guarantees for the loan. As it was, having their father as sole appointor – a position that brings with it the power to remove directors at any time – meant they were taking on all the risk without ownership or appropriate remuneration.

PHOTO: PAUL JONES



"Know what you want to do, hold the thought firmly, and do every day what should be done, and every sunset will see you that much closer to the goal."

– ELBERT HUBBARD

In partnerships, one of the most important concepts to understand is 'joint and several liability' and its impact. Put simply, it means that every partner is liable for 100 per cent of the debt, regardless of the size of their equity. With this in mind, asset protection should be a priority and there are several ways partners can structure their affairs to reduce risk.

1. Have a non-business partner spouse – a couple will often both become partners in the business when they come back to a farm, leaving their off-farm assets exposed. Consider only one spouse becoming a partner and moving the off-farm assets into the non-partner spouse's name.
2. Use a discretionary family trust to hold off-farm assets, which will quarantine them from the partnership.
3. Use a discretionary trust with no assets rather than an individual as the partner.

A partnership deed that sets out the obligations, boundaries and rights of the partners is essential. Partnership business structures are governed by state or territory legislation that, in most jurisdictions, allows certain provisions to be overruled by prior arrangement (i.e. in a deed) and there are good reasons for this.

For example, the law generally states that a partnership must be dissolved immediately upon the death of a partner. When this happens, banks will freeze accounts until they know what is going on so, unless instructions to the contrary have been included in a deed, the business will be unable to trade. When time is critical – such as just before harvest or sowing starts – this can put a family farm under financial pressure, as well as having to deal with the loss of a loved one.

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Suggested features of a tailored deed that can prove valuable are:

- setting dollar limits on individual partners entering contracts. This prevents one partner buying a new harvester or vehicle or signing a grain trading agreement with significant liabilities without the consent of the others;
- including provisions for expelling partners. Under some state legislation this is not possible unless provision is made by prior agreement (sometimes necessary when a partner has drug or alcohol problems);
- setting out dispute resolution policies. If partners cannot agree, the deed sets a resolution process that must be followed;
- outlining exit strategies if someone wants to leave the partnership; and
- making provisions for the handling of debts owed to the partnership by individual partners upon death. (i.e. overdrawn equity).

Deeds for corporate trusts should also be tailored to individual circumstances with similar risk management provisions for a partnership included. The same principles of understanding the legal consequences of the trust structure apply.

CHECKLIST

☑ **Get it right from the start:** succession is a planning exercise. Start thinking about how it will be managed as soon as a family member expresses an interest in returning to the farm.

☑ **Don't rush:** an employment contract is a good first step to provide job security for the next generation while the structure of the new business that will support succession is considered.

☑ **Individuals get independent advice:** no one lawyer or financial adviser can provide fair representation to all parties.

☑ **Understand the structure:** what are the legal and financial consequences of the business structures you are considering? Work with your advisers to make sure you fully grasp what is being proposed.

☑ **Do the deed:** a partnership deed that sets out the obligations, boundaries and rights of the partners is essential.

☑ **One size does not fit all:** tailor the deed to your own specific circumstances. This could include provisions for dispute resolution, spending limits, what will happen in the event of a death and exiting the structure.

☑ **Look at the details:** what are the advantages/disadvantages of any legal role you are taking on in the business structure? Be wary of carrying risk without having any real control.

☑ **Asset protection:** there are ways of structuring your affairs to reduce the risk of asset loss. Consider other options to becoming a director, such as setting up a discretionary trust or putting assets in a spouse's name.

☑ **Safeguard the succession plan:** do not include matters related to the business structure in wills, as they can be challenged. Draw up a separate deed.

PHOTO: EVAN COLLIS

CONCLUSION

Legal compliance for farm businesses should not be daunting as long as basic principles are applied: be proactive, know the rules and follow them.

Aim to get it right from the start by seeking expert and independent advice before major decisions and use the many resources that are available to manage risk.

PHOTO: PAUL MATHEWS

USEFUL RESOURCES

GRDC Fact Sheet: *Succession planning – plan to manage family changes and your farm business*

Link: www.grdc.com.au/GRDC-FS-SuccessionPlanning

GRDC Fact Sheet: *Transitioning a viable farm business to the next generation*

Link: www.grdc.com.au/FS-TransitioningFarmBusiness

GRDC booklet: *A guide to succession: sustaining families and farms*

Link: www.grdc.com.au/GRDC-Guide-succession-SustainingFamiliesAndFarms

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MORE INFORMATION

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