Chapter I. Business Planning for Farm Transfer

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The materials that follow were prepared for the Farm Succession Advisor's Training held in May of 2017 by Land for Good. This material was presented at an early bird session aimed at attorneys in practice for fewer than five years. An important objective of the training was to encourage young lawyers to make farm transfer a part of their new practices and to assist them in providing competent representation. This chapter provides some basic considerations for attorneys providing business planning services for farm transfer clients. It covers ethical issues, general intake, drafting considerations to facilitate transfer, and taxation issues that arise in transfer cases.

A. Introduction: Business planning in the context of farm transfer

Farm Transfer is a Team Sport

The skills and insights of an attorney, along with an accountant/tax specialist and/or a farm business planner are essential to crafting a feasible farm transfer plan. Often, other advisors are part of the team; these can include conservation professionals, mediators, coaches or facilitators, lenders, insurance providers, appraisers and health care specialists.

Legal structure and farm viability are inextricably linked. A careful reading of the farm's balance sheet, business plan and cash flow is essential to drafting an effective operating agreement. Is the farm generating or projecting enough income to bring in a new member who will require an income share? What share of income can the senior generation afford to direct to a new member? Is the farm building or losing equity? It will be difficult for a new entrant to grow an equity interest if the farm is losing equity. Is the debt load sustainable? Feasibility of the farm transfer--from family goal-setting and successor readiness to assessment of the numbers--should be evaluated before a word of any operating agreement is drafted.

In addition, transitioning farmers, many of whom carry the financial details of the operation in their heads rather than on a balance sheet, need to be able to communicate these details to family members, successors and other key stakeholders. Developing a balance sheet, written business plan and cash flow is an important early step in farm transfer. In this respect, a farm business planning consultant is probably the most important member of the farm's transfer team.

Good tax advice is also essential. For example, farms transitioning from sole proprietorship to partnership taxation as part of the transfer plan will need to understand how partnership income is tracked and taxed. Basis in assets transferred to the new entity will require tracking. Maintaining and tracking capital accounts will need to be explained.

Who is your client?

This question is possibly the most important one to discuss and resolve with the client at the initial interview. Should each prospective member have independent counsel? Are you

representing the senior generation? Are you representing the family? The business? It's easy to envision situations in which those at the table do not share the same vision or goals regarding the farm transfer.

Rule 1.7 of the Rules of Professional Conduct in all six New England states generally prohibits joint representation that presents a concurrent conflict of interest. A concurrent conflict of interest exists where the representation of one client will be directly adverse to another client or where the lawyer's representation would be materially limited by the lawyer's responsibilities to the other client.

Notwithstanding the existence of a concurrent conflict, a lawyer may undertake joint representation when:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
(2) the representation is not prohibited by law;
(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
(4) each affected client gives informed consent, confirmed in writing.

Even if the members want to consent to joint representation, the lawyer must still decide whether the conflict is "consentable." Where business partners or members appear to have more common objectives than discordant ones, multiple representations can save them time and expense. However, if serious conflicts are apparent at the outset, it is best for each party to have separate counsel.

One of the comments following the New Hampshire Rule 1.7 cites the "harsh reality test" and is instructive:

"(i)f a disinterested lawyer were to look back at the inception of this representation once something goes wrong, would that lawyer seriously question the wisdom of the first attorney's requesting the client's consent to this representation or question whether there had been full disclosure to the client prior to obtaining the consent. If this "harsh reality test" may not be readily satisfied by the inquiring attorney, the inquiring attorney and other members of the inquiring attorney's firm should decline representation . . . ."

New Hampshire Bar Association Ethics Committee Opinion 1988-89/24 (http://nhbar.org/pdfs/f088-89-24.pdf).

These issues should be discussed openly with the clients and the outcome of that discussion should be included in the engagement letter or fee agreement.

If "consentable" you should explain to clients that the duty of confidentiality will not apply to communications from an individual client. Anything one prospective member or partner tells you can be shared with the other members. They should also be made to understand that if a

serious adverse conflict arises and cannot be resolved, you may be forced to withdraw and they will then need to go forward with independent counsel. You should also counsel them to have the draft operating agreement or other foundational documents reviewed by an independent attorney.

The Operating Agreement should include a provision stating that: Each person signing this Agreement understands that this Agreement contains legally binding provisions and has had the opportunity to consult with a lawyer and has consulted with a lawyer or has consciously decided not to consult a lawyer. (See Sample Operating Agreement at 3.7)

B. The Basics

Dual legal structure and limited liability

Farm transfer is most often a two-step process. The first step is to gradually transfer an interest in the farming operation to the transferee--the next generation or to a non-family member. Farms in transition will often adopt a dual legal structure with the assets of the farming operation – livestock, crops, equipment, feed on hand, cash accounts, inventory, etc. – being transferred to a limited liability entity that does not include the farmland base. This separate entity provides the legal structure for transferring capital, income and losses, management responsibility and ultimately management control of the farming operation to the next generation. The transfer of farm operating assets either through gifting or growth in capital share through sweat equity or through additional investment provides an ownership stake in the business to the next generation. The gradual transfer of capital and management responsibility also makes the next generation more creditworthy and in a better position to borrow funds to either expand the business or purchase the farm or purchase additional farmland.

The second step of the process is the ultimate transfer of the farmland. Sometimes, this occurs during the lifetime of the older generation, but more often than not, for reasons more fully explained in the chapter on estate planning this transfer occurs at the second death of the transferring generation.

A limited liability entity is a sound legal structure for managing transfer of the farm operating assets. Limited liability means that members or partners of the entity are not personally liable for the debts and torts of the farming operation. The limit of their exposure is their investment in the business. Unsecured creditors or tort claimants cannot reach the personal assets of the members. Secured creditors, however, are likely to ask that personal assets or other farm assets including the farmland not included in the entity be provided as security or collateral. The primary benefit of limited liability, then is to shield personal assets from unsecured creditors, judgement claims and tort claims.

This dual legal structure with the farming operation assets held in a limited liability entity separate from the farmland has the effect of encapsulating risk in the farming operation and shielding the farmland base from liabilities associated with the farming operation.

Achieving limited liability requires the effective formation and transfer of assets to the new entity. Effective formation is a function of complying with the state's law regarding formation. The transfer of assets is accomplished through an operating agreement or partnership agreement that formally transfers specific assets to the new entity in exchange for shares (called units in an LLC) in the entity given to the members or partners. This can be accomplished by attaching a current balance sheet and/or equipment list to the operating agreement.

Limited liability must be maintained by keeping separate books and accounts and by putting the public on notice that you are a limited liability entity through state filings, labels, business checks, invoices, and other identifying documents. Mingling personal income and business income can cost a farm its limited liability shield and subject personal assets to the claims of unsecured creditors and tort claimants. Courts will require that the business maintain certain formalities including separate accounts, appropriate formation documents, and adequate capitalization to carry on a business.

C. Entity Choice

In the context of farm transfer, entity choice is primarily about choosing an entity that allows you to value, track and transfer farm assets. Transferring farm assets to an entity converts those assets to intangible personal property which are represented as shares or units in a business. The shares or units have a value tied to the value of the underlying assets as well as the rights and liabilities associated with those shares or units. Shares or units can be transferred to a new member by assignment as a gift or in exchange for a capital contribution to the business.

Most often the entity of choice in a farm transfer is the limited liability company or LLC and the narrative that follows focuses primarily on the LLC structure and the drafting of an LLC operating agreement. An LLC offers a great deal of flexibility in the allocation of income, capital, voting rights and liquidation rights. Unlike an S Corp, for example, it allows a greater income allocation to a new entrant providing the bulk of the day to day labor and management irrespective of his or her typically small capital share. And as it's name implies it provides limited liability for LLC members.

LLCs, however, are not the only game in town.

General Partnerships and Joint Ventures

A general partnership consists of two or more owners who are engaged in a business for profit and who share their net income. A general partnership does not provide a limited liability shield for the partners. Each partner is jointly and severally and personally liable for the claims in tort or contract against the partnership.

So why would anyone choose to do business as a general partnership? The rules regarding payment limitations for farm program payments treat general partnerships differently than entities that enjoy limited liability. In New England, particularly with respect to dairy, the

program that is most relevant to this consideration is the EQIP program. The payment limitation for the EQIP program is $450,000 for contracts entered into after February 7, 2014 through fiscal year 2018. There can be no waiver of the EQIP payment limit as was the case under previous farm bills.

Each person in a general partnership has a separate payment limit. Each partner can receive up to $450,000 in EQIP payments provided each partner in the general partnership is jointly and severally liable for the obligations of the business. For entities that enjoy limited liability – a corporation, a limited liability partnership or an LLC, the entity may only receive one EQIP payment of up to $450,000.

A joint venture is a general partnership undertaken for a limited period of time and for a limited purpose. Joint ventures can be useful structures for short term projects around a limited business purpose. A "you bring the tomatoes and I'll bring the chilies and we'll make salsa together" sort of arrangement. In the farm transfer context, a joint venture such as a discreet crop or livestock enterprise can be a useful way to help an heir or a potential non-family business partner to get a start in farming, to acquire farm assets and to gain management experience. A sample joint venture agreement and survey questionnaire is included as Appendix 3.

Cooperatives

The cooperative legal structure is unique – unlike more common legal structures that farmers and attorneys are more familiar with and perhaps more comfortable with. In the farm transfer context, an exiting farmer with a committed workforce might consider using a worker cooperative structure to transfer the farming operation. For a discussion of cooperative land ownership, see Chapter V.

The primary differences in the cooperative legal structure relate to:

- voting rights
- distribution of profits
- initial capital contributions, and
- the purpose of the business.

In a non-cooperative business, voting rights are usually, though not always, determined by a member's capital share in the business. In a co-op, every member has one vote regardless of their capital.

In a non-cooperative business, profits are usually though not always distributed on the basis of a member's capital share. In a cooperative, profits are returned to the members in proportion to their use of the co-op. In this way, members are encouraged to do business with the co-op rather than some other business. The return is called a "patronage dividend." In a land co-op, the patronage paid is rent, and profit is returned in proportion to the amount of rent paid by the member.

In a cooperative, the initial capital contribution is most often equal. Many state cooperative formation statutes, in fact, limit the amount of capital that can be owned by any one member. In a non-cooperative business, capital contributions can vary quite a lot.

The purpose of a non-cooperative business is to make money for its owners. The purpose of a co-op, however, is to provide goods and services to its members at cost. This is why, some state statutes refer to cooperatives as non-profits. While a co-op is a for profit venture, the profits are returned to members in proportion to their patronage.

Co-op taxation also is quite different. Co-ops can retain earnings or distribute them to members. Co-op income can be characterized as unallocated equity, or non-qualified deferred patronage which is taxed at the co-op level, or as cash distributions to members, or qualified allocated equity which is taxed at the member level. Identifying an account familiar with cooperative taxation is essential.

Using a worker cooperative structure to effectuate farm transfer will require a committed and cohesive set of employees and specialized legal, tax and financial management advice.

S and C Corps

C Corporations which are taxed first at the entity level and again upon distributions are rarely an entity of choice for agriculture. An S Corporation taxed as a pass through entity. If S Corp status is elected, the operating agreement must reflect the S Corp qualification rules. The primary qualification that can complicate farm transfer is that an S Corp can only have one class of stock and all shares must have identical rights to distributions and liquidation. This would preclude, for example, providing a greater income share to a new entrant than his or her capital stake would dictate. An S Corp, however, can issue voting and non-voting shares provided each share has identical distribution and liquidation rights. (See 26 C.F.R. §1.1361-1-S (l)(1))

D. General intake – attorney's farm client questionnaire

A completed Business Planning Questionnaire will inform the initial attorney / client conference as well as assist in completing the initial filing for formation. An annotated Confidential Business Planning Questionnaire is included as Appendix 1. The answers provided will also form the basis for the written operating agreement. The questions in the sample questionnaire can be complex. Many clients won't know how to answer many of the questions. The cover letter to the questionnaire should let clients know that if they don't know the answer to the question, the question should be left blank and the issue can be discussed at the first conference. The questions left blank provide a checklist to the attorney for issues that need further explanation and discussion. A Business Planning Questionnaire should elicit information on the following subjects:

I. The Farm Business: Names and Contact Information

II. The Nature of the Business
III. Duration of the Business
IV. Contributions of Partners/Members
    a. Personal property
    b. Real Property
    c. Cash contributions
    d. Future capital contributions
    e. Withdrawals
V. Labor Contributions
VI. Distributions of Income
VII. Accounts and Records
VIII. Management of the Business
IX. Dissolution of the Business
X. Insurance & other service providers

The annotations to the Business Planning Questionnaire in the Appendix provide the rationale for the question and other information. A completed Business Planning Questionnaire will inform the drafting of the operating agreement and provide a useful agenda for the initial client conference.

E. Operating Agreements: Contents, Drafting and Maintenance

In the absence of an operating agreement your state statute will provide the default provisions regarding the management of the LLC, relations among members, and the conduct of business. These provisions may not be in your client's best interest or in keeping with their goals of farm transfer. These statutes may dictate control based on capital share or dictate allocations and distributions based on capital share, for example. The operating agreement allows the attorney to craft provisions for management of the business that will effectuate transfer, providing a larger share of income than capital share would dictate, for example.

There are a few aspects of management that cannot be overridden by the operating agreement. - these non-waivable provisions may include the elimination or restriction of the obligation of good faith and fair dealing, or restrict the duty of loyalty owed to other members. Check your statute.

Initial Contributions and Capital Accounts

Initial contributions to a the new entity can include farm equipment, livestock, the farm checking account, cash contributions and other items. These assets are contributed to the new entity in exchange for units or a capital share in the new entity equal to the value of the assets. For example, if Member A contributes livestock and other assets with a value of $50,000 and Member B contributes equipment and other assets with a value of $50,000 to the entity each will receive 50% of all units issued or capital held by the entity. If the entity issues 100 units, Member A would receive 50 units with a value of $1,000 per unit and an initial capital account of $50,000. Member B would receive the same. The contributions, their value, the number of

units issued, whether the units were voting or non-voting, and the amount of the initial capital account would all be reflected in the written operating agreement.

Most often, in the case of farm chattels, balance sheet values as provided to or generated by a lender can be used to place a value on contributions. In the case of a unique type of property or where there is disagreement as to value, an appraisal may be called for.

In the farm transfer context, if Member A is the founding generation and Member B is the new entrant, the contributions are likely to be much more lopsided than the example above. In some cases, a new Member B would start out with minimal to zero capital interest but with a right to a percentage of the income of the new entity. The agreement must be drafted to provide a means for the new entrant to grow their capital share in the new entity over time.

All New England states except for Rhode Island will also allow the contribution of services and intangible property (including, for example, sweat equity) to an LLC as a capital contribution. Rhode Island's LLC statute provides that the contribution must be capital. R.I. Gen. Laws § 7-16-24

Service contracts as a capital stake are most often used for a service members with special skills or who bring specialized intellectual property to the business. A cheese maker, or a grazing specialist, for example. While the members or partners in these five New England states can treat a services contract with the new member as a capital contribution, the IRS will require the recognition of income to the service member equal to the capital interest. Valuation of the services contract may also be problematical if the members cannot agree as to its value.

An outright gift of a capital interest with a value less than the annual exclusion amount or providing an income share without an initial capital interest may be a more tax friendly alternative to using the value of services as an initial stake in the business.

The outright gift can be embedded in the initial operating agreement and serve as documentation of both the gift and its acceptance. The current annual exclusion amount (2018) is $15,000. If the founding generation operate as a husband and wife sole proprietorship, the couple can make a so-called split gift of $30,000 in the form of a capital stake in the new entity to the new entrant. A gift tax return should be filed whenever a significant gift is made even if it is within the exclusion amount limit.

What is a capital account?

In the first instance, the capital account is simply the value of the initial contribution to the entity. The "aggregate capital account" is equal to the total value of the entity. Each member holds a portion of the aggregate capital account expressed both as a percentage and as a number. The capital account, and the owners' share of the whole, however, will change over time. The IRS requires that a member's capital account be "maintained" in accordance with IRS rules. (Treas. Reg. § 1.704) Adjustments will be made based on subsequent withdrawals or additions of capital as well as distributions and allocations of income.

The capital account is increased by the amount of any money contributed by the member, the fair market value of any property contributed to the member and allocations to the member of entity income and gain. The capital account can be decreased by the amount of money or the fair market value of property distributed to the member, the members allocation of losses and deductions and other adjustments.

The notion of a capital account is both a business and a tax construct and it can be very confusing for lawyers and their clients. It's essential that the client have an accountant who can both explain capital accounts and help the client track them over time. The lawyer needs to understand the concept well enough to incorporate into the operating agreement the magic language from the IRS rules regarding maintenance of a capital account and to explain that language to the client. 26 C.F.R. Section 1.704-1(b)2(iv)(b). And in the farm transfer context, the lawyer needs to understand how these rules can impact the growth of the capital share of the new member over time.

> **4.6 CAPITAL ACCOUNTS.** A Capital Account shall be established and maintained by the Company for each Member.
>
> (a) In general, each Member's Capital Account shall be increased by:
>
> (i) the amount of money contributed by the Member;
>
> (ii) the fair market value of property contributed by the Member (net of liabilities secured by the property that the Company is considered to assumed to take subject to); and
>
> (iii) allocations of net profits to such Member.
>
> (b) In general, each Member's Capital Account shall be decreased by:
>
> (i) the amount of money (exclusive of salaries) distributed to such Member;
>
> (ii) the fair market value of property distributed to such Member (net of liabilities secured by the distributed property that the Member is considered to assume or take subject to); and
>
> (iii) allocations of net losses to such Member.

Some payments to a member are not considered distributions and will not have an impact on a member's capital account. Guaranteed payments for example are not distributions but are more in the nature of a salary to a member owner and they are made irrespective of whether the business is generating a profit. Guaranteed payments are considered ordinary income to the member subject to self-employment tax. The operating agreement should also provide that the entity may make guaranteed payments.

In the farm transfer context, where you are trying to increase the new entrant's capital share in the business it makes sense that compensation to the new entrant be in the form of a payment that will not impact his or her capital account. Guaranteed payments can provide income while allowing the new entrant to build their capital share over time by not taking income distributions [4.6.(b)(i)above]. Income to which they are entitled under the operating agreement is left in the business. Conversely it will make sense for the founding generation to take income in the form of payments that will reduce their capital share. Taking their full income distribution or more will at least ensure that their capital share does not grow.

A common farm transfer scenario will start a new member with a zero capital account but with a right to some percentage of the entity income. The new member may receive guaranteed payments but will not take his or her full income share. If the entity is making money, his or her capital account and capital share in the business will grow over time. An important caveat, however, is that it is essential that the entity be profitable. If the new entrant starts with a zero capital share and in the first year, the entity allocates only losses, the new entrant can end up with a negative capital account. Language in the operating agreement should address the potential for a negative account. A negative capital account upon liquidation will obligate the owner to restore the deficit for distribution to creditors and other members.

A capital account will also be relevant at the end of the business's life or in the event of death, disability or withdrawal of a member. An owner's share of the aggregate capital of the business expressed as a percentage will serve as a proxy for the owners share of the business in the event of a buyout or his or her share of the liquidated value of the entity. Thus it is essential that capital accounts as well as the owners' agreement on the fair market value of the business be tracked over time – annually, at least.

Allocations and Distributions

The operating agreement will provide for the allocation of income, losses, deductions and credits among the members. Income can be allocated on the basis of capital share, work contribution or other factors provided those factors fall within the "substantial economic effect" test of Treasury Reg. § 1.704-1(b)(2). An income allocation not based on capital share must be "consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden." A member or partner with a small capital stake but who provides a majority of the day to day labor and management (economic burden) could receive a larger income share disproportionate to his capital share (economic benefit.)

Income allocation, expressed as a percentage, should be specified in the operating agreement. The operating agreement should also specify when and under what circumstances allocations will then be distributed to members. A majority vote? A unanimous vote? An income allocation will be taxed even if it is not distributed. In some cases, an operating agreement will

specify that the entity must at least distribute enough income to cover the tax consequences of the allocation.

Providing a larger income share to the new entrant who is contributing substantial labor or other services provides a mechanism to grow his or her capital share more quickly over time. This labor contribution can be specified in the operating agreement.

Management of the Business

The operating agreement needs to specify how business decisions – both large and small - are to be made.

An LLC can be either manager-managed or member-managed. Manager members will have the authority to make all the day to day management decisions without having to consult other non-manager members. Non-managers will not participate in the day to day decision making. Managers may be elected each year or for a specific term by all members and can be removed by a vote of a majority of the members. This is a structure that works best when there are members who have a capital stake but who are not engaged in the day to day operation of the farm. It's a structure that may be appropriate when a beginning farmer partners with a non-farm investor as a structure that grants significant authority and control to a low capital, farming member.

In a member-managed LLC, each member will have the authority to bind the entity. Members may individually or collectively make day to day management decisions. These types of decisions should be specified in the operating agreement. For example, hiring and firing of personnel, approval of employment or independent contractor agreements, to write or deposit checks and otherwise manage cash accounts and to enter into contracts in the ordinary course of business that bind the entity. See Article 6.1 of the sample operating agreement in Appendix 2.

Larger decisions, however, such as taking on debt, sale or purchase of new equipment, and other decisions outside the ordinary course of business will most often require the approval of a majority or even a super majority of all members. See Article 6.2 of the sample operating agreement. It's important to ask the client how they currently make decisions. If that process is working, the operating agreement should reflect that practice.

Voting power is most often tied to the number of units held by each member. The number of units, is a function of that member's initial and /or ongoing capital share. Units issued can also be voting or non-voting. A non-voting share will carry economic rights entitling the owner to an income allocation, for example but no vote on the major decisions regarding the entity.

In the context of farm transfer, the LLC structure allows the founding generation to gradually transfer management and voting control. Initially the majority of the voting units can be held by the founding generation. As the new member's capital share grows, so will the percentage of voting rights. Or, if voting and non-voting units are issued, the founding generation can retain full voting control until ready to assign them to the new member. Each family will be different and a timeline for transfer may not be apparent at the outset.

Drafting to Avoid Deadlock

Deadlock is an instance where members share equal voting or management rights and cannot agree. It can freeze the business in place and can even lead to a court ordered dissolution. If you can't structure the agreement to provide that one member or group of members will have majority control, the operating agreement should include some sort of tie-breaker or process for resolution. This can include a provision that the members agree to negotiate in good faith but if the issue cannot be resolved the parties will mediate the matter or refer the matter to a trusted third party for resolution. Some clients will want to make decisions by consensus. In that case it is important to define consensus as not requiring unanimous consent but a transparent process that seeks a resolution that most members can accept.

Planning for a Business Divorce

Bringing in a new partner whether a family member or a non-family member to the farming operation can be exciting for both the clients and the lawyer. An operating agreement, however, has to plan for both success and failure. New ventures and new relationships can be particularly risky. You need to take particular care in drafting the operating agreement to protect minority interests, to provide a mechanism for resolving disputes and to provide an escape hatch that will allow the business to continue in the event the business or the relationship sours.

Annual meetings for LLCs are not required. However, when there is a minority member or the relationship is newly minted it is a good idea to include many of the formalities found in the corporate structure. Meeting times, places and notice; quorum requirements, etc. should all be set out with specificity.

There may also be certain decisions that should require unanimous consent. Dissolution, capital withdrawal, the addition of new members, additional capital, and withdrawal of a member are all potential actions that might require unanimous consent.

Requiring the minimum distribution necessary to cover any tax liability for income allocations can also protect a minority member. These should be tailored to the appropriate tax bracket of each member.

Clearly delineating a member's rights to view all books and records of the Company is another important provision to protect a minority member's rights. The trend in state LLC statutes, particularly with manager managed LLCs is to hold requests for financial information from a member to a "just and reasonable" standard. See 11 V.S.A. §4058 for example. The operating agreement should provide clarity with respect to the extent to which books and records will be available to members.

Restrictions on transfer

If the members wish to prohibit voluntary transfers of their interests in the business outside the family or in any case the operating agreement should provide for that restriction. The agreement may prohibit transfers outright or allow transfers to new members if all existing members consent. Alternatively, a right of first refusal can be provided allowing an existing member to match any purchase offer by a non-member.

The operating agreement should also address involuntary transfers which occur as the result of bankruptcy or divorce of a member. Units transferred as a result of an involuntary process can be treated as "dissociated" members. Dissociated members will have economic rights including rights to income allocations but will have no management rights including the right to direct distributions. (See Annotated Operating Agreement, Appendix 2.) The buy-sell agreement should also provide a mechanism for voluntary purchase of the disassociated members share.

Member Withdrawal and Buy Sell Agreements

A buy-sell agreement is a means of planning for the death, disability or withdrawal of a member. The buy-sell can be a separate agreement or be embedded in the operating agreement. It is simply an agreement to buy and an agreement to sell an exiting member's interest in the business upon the occurrence of a certain triggering event. A buy-sell can be mandatory or voluntary. In the case of a gifted capital interest, the buy sell may impose a length of service requirement. It should be structured to protect the viability of the business by setting out payment terms that the remaining members in the business can withstand. A means of valuation should also be included. (See Annotated Operating Agreement, Appendix 2.)

Most buy-sell agreements identify death or disability as triggering events for the buy sell. The buy sell can also be triggered when a member wishes to withdraw from the business. In the context of farm transfer, the buy sell agreement can provide a structure for buying out the senior generation or when second generation decides they want to leave. The sample operating agreement provides a method for valuing the exiting member's share as well as the terms of payment.

Deadlock can be another potential triggering event under the operating agreement. If deadlock is the triggering event, it is less likely that the members will be able to agree upon a value for the departing member's interest and an appraisal method of valuation is an important addition in the event of deadlock.The continuing operation of any covenants not to compete entered into by the withdrawing member post break up must also be considered.What is and is not competitive with the Company will be a function of the scope of the purposes for which the LLC was formed and as described in the operating agreement and foundational documents filed with the Secretary of State.

F. Special Taxation issues

It is essential to have an accountant on the transfer team to both analyze the potential for any income or gain recognition issues associated with entity creation as well as to track each members basis (inside and outside) in the LLC over time. Basis is tracked to allow for calculation of gain or loss on subsequent transfer of shares or for gifting purposes. A gifted share of an entity will take a carryover basis meaning the donee takes the basis of the donor.

Most often, the transfer of assets into a new entity will not be considered a taxable transfer requiring the recognition of capital gain. (See 26 U.S.C §721) The one exception to a tax-free transfer is when a member transfers property to an LLC subject to debt, the LLC assumes the debt and the liability exceeds transferor's basis in the new entity. This can easily happen when a member is transferring farm raised or other assets with a zero basis and the assets carry significant debt. Debt in excess of basis is considered a taxable cash distribution to the transferor. This is true even if the transferor retains personal liability on the debt. (See 26 U.S.C §357).

Partnership vs. S Corp Taxation

A single member LLC will be taxed as a sole proprietorship. A multi- member LLC will be taxed as a partnership. An multi-member LLC, however, may elect to be taxed as an S Corp. Most farm clients will choose partnership taxation. Some, however, choose to be taxed as an S Corp. Both are pass through entities in which income or loss of the business flows through to individual members and the individual members report and pay the income tax on their pro-rata share of income or loss. In an S Corp, however, a portion of the entity's profits can be taken as distributions and a portion as salary. Only the salary portion will be subject to self-employment taxes. If taxed as a partnership, distributions of income of the entity as well as guaranteed payments will be subject to self-employment taxes.

The tax savings associated with choosing S Corp taxation, however, will result in considerable loss of flexibility in how the entity is to be structured. If S Corp status is elected, the operating agreement must reflect the S Corp qualification rules. The primary qualification that can complicate farm transfer is that an S Corp can only have one class of stock and all shares must have identical rights to distributions and liquidation. This would preclude, for example, providing a greater income share to a new entrant than his or her capital stake would dictate. An S Corp, however, can issue voting and non-voting shares provided each share has identical distribution and liquidation rights. (See 26 C.F.R. §1.1361-1-S (l)(1))

Entity conversion, from an S Corp to an LLC, for example, can also have significant tax consequences. Sometimes, if you are working with an existing S Corp you will need to work within the constraints of the S Corp form. While all shares must be treated identically in terms of distributions and liquidation, you can issue voting shares to the founding generation and non-voting shares to the new entrants allowing a gradual transfer of management control. Distributions can be controlled by the rate of gifting by the founding generation. And a salary can be paid to new entrants to compensate for labor contributions.

All of these considerations should underscore the importance of having an accountant on the transfer team and the need for attorneys to explain the non-tax, business reasons for choosing a particular type of entity.

G. Leases

The dual legal structure of the farm business will typically necessitate a lease between the entity and the land owner or owners. A lease can be a simple document establishing tenancy for the LLC and allocation of costs for tax reporting purposes. A sample lease is included as Appendix 5. A basic lease will establish:

- A description of the property to be leased.
- Permitted uses of the property.
- Consideration.
- Which party is responsible for major and minor repairs and replacement of structures and fixtures.
- Which party is responsible for real estate taxes and other land costs.
- Term of the leasehold.
- Whether the lease is binding on heirs and assigns or third party purchasers.

A lease may also provide a mechanism for the ultimate transfer of the farm by including, for example, a right of first refusal or an option to buy the farm to the new entrant, LLC member. The option price can be set at agricultural value and or include a formula for taking into account improvements paid for by the LLC, and/or a generous rate of interest and other terms for payments made to the landowners estate. A long-term or rolling lease binding on heirs and assigns can also provide a measure of tenure security in the event of the death of the exiting farmer or landowner. For more on leases, see the Land for Good Lease Toolbox and the fact sheet on lease-to-own strategies in Appendix 6.

Chapter I Appendices

Appendix 1. Annotated Confidential Business Planning Questionnaire

Appendix 2. Annotated Operating Agreement

Appendix 3. Joint Venture Questionnaire

Appendix 4. Sample Joint Venture Agreement

Appendix 5. Lease Template

Appendix 6. Lease-to-Own Fact Sheet