

BUSINESS AND SUCCESSION PLANNING FOR THE AGRICULTURE ENTITY

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I. INTRODUCTION

A. Business Objective and Purposes. In any closely-held corporation, limited liability company or partnership, the ongoing health of the business largely depends on keeping ownership of the business in the hands of those employees and/or family members who actually conduct the business. This is especially true in farm businesses where steps should be taken with respect to the business and estate plan to assure the owners' interest and investment in the business is protected and the interest is passed to the next generation or to the surviving owners with as little difficulty as possible. The objectives to be attained in a farm succession plan are:

1. Minimize income taxes during operation and an estate tax as to both transferor and transferee upon transfer.
2. Establish terms under which plan will operate to avoid need for future negotiations and to give all parties comfort that plan will be implemented.
3. Minimize personal liability and protect assets from third party claimants.

II. SUCCESSION PLANNING STRATEGIES

In implementing a farm succession plan it may be appropriate to utilize entity selection, documentation and agreements to establish the basis on which the succession plan will be structured, to provide retirement income to senior owners, to provide benefits, including incentive benefits to key employees and to establish a tax favorable means for passing the farm to the next generation whether family or non-family.

A. Senior Generation's Objectives.

1. Retirement income and security.
2. Farm continuation after retirement and death of parents.
3. Equitable or non-equitable treatment of farm and non-farm heirs.
4. Minimizing estate and income taxes for the parents and the next generation.
5. Reduction or elimination of management responsibilities for the parents (or the surviving spouse).
6. Protect assets for children and grandchildren with little if any exposure to creditors or spouses of children.

B. Junior Generation's Objectives.

1. Assumption of management responsibilities.
2. Attain or increase ownership.
3. Assure income needs of parents in retirement does not impair children's earning capacity on farm.
4. Avoid involving nonfarm heirs in management of operating entity.
5. Avoid unnecessary imposition of estate taxes/plan for payment of estate taxes through insurance policies on parents.
6. Deductibility of retirement income payments to parents.
7. Establish credibility in community and with lenders/vendors/customers.

C. These documents and agreements may include the following:

1. Buy Sell Agreements. As discussed in the Section IV the buy sell agreement among the owners of the farm sets forth not only the terms under which owners will hold their interest while employed or associated with the farm, but also sets forth the terms and conditions under which an owner's interest will be transferred upon the occurrence of certain triggering events such as death, disability and termination of the owner's relationship with the farm.
2. Estate Planning Documents An owner's will sets forth the terms under which the owner's "estate" will be distributed upon death. Included within the "estate" is all assets owned by the owner at the time of death. Because the farm owner has both business and personal assets, it is important that a properly prepared will is in place to insure that the business assets pass in accordance with all the farm members' intentions.

Without a properly prepared will, assets will be transferred in accordance with the applicable statutes. For example, if a farmer dies without a will and leaves a wife and three children, the law provides that the wife will receive \$50,000.00 and one half of the assets. The remaining assets will be divided

equally among the children (regardless of who is involved in the farm and who is not).

The estate plan should specifically address how farm assets as well as nonfarm assets are to be handled at the time of death. In many farms, the active farm members do not want to have to involve their nonfarm siblings in the day to day decisions that have to be made on the farm and what could be even worse is when the nonfarm siblings have a financial stake in the operations. Properly prepared estate planning documents together with business planning agreements avoid these problems.

Trusts may also be used in connection with a farmer's estate plan. These trusts may be created during lifetime or at the time of the farmer's death. In both cases, the documents should be structured with the farm succession plan in mind.

_____ 3. Gift Program. With a properly structured gifting program in place, ownership of the farm may be transferred over a period of years from one generation to the next. Such a plan may reduce income taxes as well as estate taxes. In addition, a plan that develops over time also allows the new generation to have the ability to gain experience over time in operations, lender and vendor relationships, etc. while the senior generation is still available for consulting in those areas. A gifting program is many times structured in combination with one or more of the agreements described in the following section to assure the senior generation of having a comfortable retirement on a basis that is tax favorable to the junior generation.

_____ 4. Operating/Retirement Agreements.

_____ a. Deferred Compensation Agreements. It is not unusual to provide a reasonable amount of compensation to the withdrawing shareholder/employee or partner/employee in the form of a nonqualified deferred compensation agreement. Payments under a deferred compensation plan may be subject to unnecessary FICA if not properly structured.

b. Consulting Agreements. Similar in tax substance to an employment agreement. However, consulting agreement payments will be subject to self-employment tax.

c. Employment Agreement. In some cases, an employment agreement with the parent may be appropriate for security purposes; i.e., if the father wants to be assured he will receive guaranteed income, health insurance, etc., during his "active" and retirement years, an

employment agreement would be a contractual obligation on the part of the farm to provide these benefits.

- d. Lease Agreements. In many farm succession plans, the senior generation will retain some or all of the real estate used in the operations and lease this real estate to the operating entity. The rental income is an excellent source of retirement monies for the retired owners because it is not subject to self-employment tax. In addition, the payments are deductible to the operating entity. There are other tax and non-tax benefits to having the land retained by the senior generation. If land is retained until death, the heirs receive a step-up in basis at the time of death which will allow them to sell the real estate with minimal, if any, income or capital gains taxes following death. This can be a significant benefit for farms that have been passed from generation to generation.

III. CHOICE OF ENTITY

A. Objectives.

1. Limited Liability.
2. Transferability of Interests.
3. Centralization of Management.
4. Minimizing Income Taxes.

B. Tax and Non-Tax Considerations in the Selection of a Farm Business Entity.

Sole Proprietorships	Corporations	General Partnerships
Limited Liability Companies	Limited Liability Partnerships	Limited Partnerships

1. Sole Proprietorship: A sole proprietorship is a farm owned and operated by a single person. A business certificate may be filed in the county clerk's office if the business is operating under an assumed name. Income of the owner is reported on the taxpayer's 1040, Schedule F. Eighty percent of farming operations are operated as sole proprietorships.

a. Advantages:

- (1) Very informal operation.
- (2) No formal requirements to organize.
- (3) Owner makes all decisions without having to be accountable to others.
- (4) No double taxation of an entity – all income reported on owner's returns.

- (5) Owner bound by acts of others in entity.
- (6) Ownership interest freely transferable.

b. Disadvantages:

- (1) No limitation of liability for owner from contractual or tort liability.
- (2) Reporting of all income on Schedule F may be disadvantage – i.e., no opportunity to shelter income.
- (3) Limitation on ability to deduct certain benefits provided to owner and owner's family.
- (4) Tax liability is at owner's rate. If separate entity utilized could be opportunity to have lower tax rate or to share tax liability with others who have lower tax rate.
- (5) Unless preliminary steps are taken, entity disappears upon death of owner.

2. General Partnership: A general partnership is an organization which is composed of two or more persons. A partnership can be created without a written agreement. However, it is advisable to have a partnership agreement. A certificate of doing business as partners must be filed in the county clerk's office. Partnerships are not taxed as a separate legal entity. They are "pass through" entities.

a. Advantages:

- (1) Very easy to organize – few formalities, nominal operating costs.
- (2) Decision making process may be very informal if desired.
- (3) Detailed statute provides guidance on decisions making and on other matters concerning operation and dissolution if no agreement in place.
- (4) Pass through tax treatment for owners avoiding double taxation.
- (5) Entity files Form 1065, not Schedule F.
- (6) Partnership interests are not freely transferable.
- (7) May generally be liquidated tax-free/no double taxation.
- (8) Flexibility in capitalization.
- (9) May be easily converted to another entity.
- (10) Farm partnerships can elect cash or accrual accounting.

b. Disadvantages:

- (1) Unlimited personal liability for owners for acts of entity and acts of partners and employees acting in name of entity.
- (2) Partnership interests are not freely transferable.
- (3) Entity dissolves upon occurrence of certain triggering events (death, bankruptcy or withdrawal of a partner).
- (4) Any partner may dissolve partnership by withdrawal.
- (5) Each partner may obligate the partnership.
- (6) Taxable year generally calendar year – partnership must conform taxable year to the taxable years of partners. I.R.C. §706(b)(1)(B)(i).
- (7) Partners are not employees for purpose of deducting fringe benefits.
- (8) Partnership return required even if no income. Exception for “small partnerships” under I.R.C. §6231(A)(1)(b) [ten or fewer partners, each of whom is natural person or an estate, and equal sharing of profits and losses].
- (9) Partners taxable on income whether distributed to them or not. I.R.C. §701.

3. Corporation: A corporation is a legal “person” that is created by filing of a certificate of incorporation in the Secretary of State’s office. A corporation generally has perpetual existence. The owners or shareholders of a corporation have limited liability for the corporation’s activities. A corporation is taxed as an entity separate and apart from its owners (unless S status is elected by the entity and its shareholders). S Corporation status is for income tax reporting only – no statutory differences between S Corporation and C Corporation under New York law.

a. Advantages:

- (1) Limited liability of owners for tort and contractual liability of entity: liability limited to capital contribution that is utilized for purchase of shares. Exception: wages (New York) and certain taxes (sales/payroll).
- (2) Owners are not liable for acts of co-owners.
- (3) Entity not terminated upon death, bankruptcy or withdrawal of owners (unless otherwise agreed in writing). Entity’s existence may be perpetual.
- (4) Interests (stock ownership) are freely transferable (unless restricted by agreement).

- (5) Ability to have centralized management (i.e., several owners but board of directors/officers selected to manage day to day operations.
- (6) Ownership interests may be different among owners (i.e., voting/nonvoting interests, preferred/common interests.
- (7) If low profits, C corporation may allow use of lower tax bracket than pass through entity.
- (8) C corporation offers the ability to deduct benefits payable to owners. S corporation's ability is limited, similar to a sole proprietorship.
- (9) Ability to retain profits and avoid taxation at personal level.
- (10) Corporation laws throughout country are very similar and have long history of interpretation.
- (11) Simple to create.
- (12) Flexible capitalization requirements.
- (13) Ability to select fiscal year.
- (14) S corporation distributions not subject to self-employment tax. However, the IRS has announced it will begin review of wages and dividends paid through S corporations.

b. Disadvantages:

- (1) Certain operating procedures must be followed to avoid piercing of corporate veil and resulting in personal liability for owners (i.e., annual meetings of shareholders, directors; maintenance of corporate minutes, etc.).
- (2) Depending on tax structure (C vs. S) double taxation in operations and upon disposition of assets.
- (3) S Corporation is restricted from having entities, certain trusts and nonresident aliens as shareholders.
- (4) Upon incorporation, if liabilities assumed by the corporation exceed shareholders' basis in assets contributed, taxable gain results; I.R.C. §357(c). Otherwise, tax-free; I.R.C. §351. The basis of stock or securities received by the transferors is the basis of property transferred, less boot, plus gain recognized if any. I.R.C. §358(a)(1). If the corporation assumes a liability of the transferor or takes property of the transferor subject to any liabilities, the liability reduces the basis in the transferor's hands. I.R.C. §358(d). If there is debt in excess of basis, a taxable transaction results and gain is realized. I.R.C. §357(c).
- (5) A corporate level tax is assessed against sales or exchanges of appreciated assets, that were acquired while the corporation was a C corporation, which are disposed of within 10 years

after election of S corporation status. I.R.C. §1347(a). The rule does not apply to assets acquired after S election is made. Except for land, most farm assets are replaced in three to six years (cattle, equipment, etc.). Therefore, built-in gains tax may not be a burden to a farm corporation.

- c. Planning Strategies. Determining whether to use debt or capital: interest deductible dividends are not.
4. Limited Liability Company: Effective as of October, 1994, New York State allows the creation of a limited liability company which is a legal entity that offers its owners protection from personal liability but allows the entity's owners to be taxed as a partnership. An LLC is created by filing "Articles of Organization" with the Secretary of State and entering into an operating agreement (LLCL §1203) or by converting a general partnership to an LLC on a tax free basis.
- a. Advantages:
 - (1) Owners enjoy limited liability for obligations and liabilities of entity and other owners.
 - (2) Pass through entity – avoids double taxation.
 - (3) Flexibility in management and governance. Management may be by members or by managing members (similar to a board of directors).
 - (4) Ownership interests may be structured in a manner similar to corporation (i.e., voting/nonvoting interests, preferred/common interests).
 - (5) Common form of business operation internationally.
 - (6) Single Member LLC does not need to pay annual filing fee or to file separate tax return (report income on Schedule F).
 - (7) Simple to create. General partnership can convert to LLC tax-free. *PLR 9618021* (Feb. 2, 1996).
 - b. Disadvantages:
 - (1) Similar to a corporation technical operating requirements must be followed in order to enjoy limited liability and to avoid piercing of the veil.
 - (2) Certain steps must be taken in operating agreement and procedurally in order to avoid dissolution upon death, bankruptcy or withdrawal of an owner/member.
 - (3) May affect eligibility for ASCS/FSA payment programs.

- (4) Must be careful to avoid unnecessary self-employment tax for those not active in farm. An LLC member is subject to self-employment tax or income of LLC if a member is a manager or if the LLC has no designated manager. Prop. Treas. Reg. §1.1402(a)-18.
 - (5) Annual filing fee of \$100 per member (\$500 minimum for multiple members LLCs; \$100 for single member LLCs).
 - (6) Must publish formation in newspaper (case challenging statute currently on appeal). *Barklee Realty Company, LLC and Barklee 94 LLC v. George E. Pataki* (1st Dept. 2001). Appeal filed by the State of New York January 10, 2002. New York State prevailed in first round of appeals - currently on appeal to New York Court of Appeals.
 - (7) May be easily converted to another entity.
5. Limited Liability Partnership: A limited liability partnership is a general partnership, the owners of which are protected against tort and contract liability for acts of the other partners or acts of the partnership itself. In New York, LLPs may be composed only of certain professional firms (i.e., architects, accountants, physicians, lawyers, etc.).
6. Limited Partnership: A limited partnership is a partnership which has “general” and “limited” partners. General partners have unlimited liability for the acts of the partners and of the entity. Limited partners are not liable for the acts of the partners or of the entity itself. Taxed as a general partnership (i.e., a “pass through” entity). Limited Partnerships are created upon filing a certificate of limited partnership in the Secretary of State’s office.
- a. Advantages:
- (1) Offers all advantages of partnership.
 - (2) Allows creation of interests that have limited liability (more attractive to investors).
 - (3) Having general and limited partners allows for centralization of management in the hands of the general partners.
 - (4) Flexibility as to allocation of losses and profits among general and limited partners.
 - (5) Limited partner interests are not subject to attachment by creditors – limited to charging order.
 - (6) Ability to transfer equity interests to others while retaining control by general partners.

- (7) Form of entity may allow for greater valuation discounts to enhance ability to reduce estate values for owners' estate plans.
- (8) Only general partners may dissolve the partnership.
- (9) A partner may be both a limited partner and a general partner at the same time.
- (10) A limited partner's distributive share is not subject to self-employment income tax. 42 U.S.C. §411(a)(11), I.R.C. §77(c). Exception: If guaranteed payments are made as remuneration for services.

b. Disadvantages:

- (1) General partners are personally liable for farm activities as in a general partnership.
- (2) Limited partners may not participate in management or they risk loss of protection from liability for acts and obligations of entity and partners. A limited partner should have no participation in management. Personal guarantee of partnership's obligations could subject limited partner to liability for all partnership liabilities. Limited partner should not provide more than 500 hours of service per year. Prop. Treas. Reg. §1.1402(a)-2(h).
- (3) Interests are not freely transferable.
- (4) More costly and complex to organize than general partnership (filing requirements, publication requirements).

C. Issues to Consider in the Selection of an Entity.

1. Taxability of the entity and its owners.
2. Ability of owners to obligate the entity and other owners. Personal liability of the owners for actions and liability of themselves, each others and the entity.
3. Centralization of management within the entity.
4. Transferability of interests in the entity. Ability to restrict transferability by agreement.
5. Perpetual or limited existence of entity.
6. Expense of formation and technical requirements which must be followed in the operation of the entity.

7. Form of ownership interests; e.g., S corporations may not have entities and certain trusts as owners and number of owners is limited (75).
8. Flexibility with respect to allocations of profits and losses of entity.
9. Form of capital contributions being made, equity and nonequity, voting and nonvoting interests being created.
10. Does the entity fit within the owners' estate plans; e.g., only certain trusts may be shareholders of S corporations, may be desire to limit liability of estate for actions of entity etc.
11. What requirements are set forth in the statutes for resolution of shareholder, director disputes? (For example, the ability of a minority shareholder to petition a court for dissolution.) May a shareholders or partnership agreement govern instead of statute?
12. Events which may cause or result in dissolution and tax effects of dissolution.
13. Annual or other regular filing requirements are there for the entity? (For example, tax returns, biennial statements with New York State, etc.)
14. Need for keeping owners' participation on an anonymous basis.
15. Creation of multiple entities may meet family objectives (e.g., land held in one entity [e.g., LLC] with machinery, equipment, livestock in separate operating entity).

IV. FARM BUY-SELL AGREEMENT

It is important that each farm have an up to date business plan so there is included an up to date Buy-Sell Agreement in effect that will address the terms and conditions under which an owner's interest will be transferred upon a death, total and permanent disability or termination of the owner's relationship with the farm. Upon the occurrence of any of these triggering events, it is important to carefully determine how an interest will be acquired, whether it be an optional purchase or a mandatory purchase. It is also important to carefully define how the payment for the purchase will take place so that there is not an unnecessary and disastrous drain on the cash flow of the farm.

There are several issues which must be discussed in structuring a farm Buy-Sell Agreement and each one should be given careful consideration depending on each owner's personal family and estate circumstances. The following sets forth those issues which should be considered in structuring a Buy-Sell Agreement.

A. PURPOSES

1. To provide a buyer in the event of termination of employment of a partner/employee.
2. Protect the partner/employee or his estate from being locked into an interest in a farming operation in which there is no continuing participation.
3. Provide a source of funds with which to pay estate taxes or to generate income for the terminated partner/employee and/or his family.
4. To provide a value for the purposes of estate taxes.
5. Preserve control of the farming operation with the remaining partners.
6. Preclude individual partners from selling their interest in the farm without the consent of the other partners.

B. WHAT TYPE OF AGREEMENT SHOULD BE EMPLOYED?

Redemption vs. Cross Purchase. Should the purchaser be the farm entity (Redemption) or should the purchaser be the remaining partner or trust created for the family of the remaining partner (cross purchase)? In some cases where the farm family is structured so children of a deceased partner will continue with the farm, it is more appropriate to have a trust created in the will of the deceased partner to acquire the shares. This insures the interest is preserved until such a time that children have proven that they are ready to take on ownership of the farm and also insures that an entire family is not mistakenly cut out of the farm because a surviving sibling has acquired all the interest. All of this depends on how active the children are in the farm. And, this may change from time to time as the children mature. Therefore, the overall plan should be reviewed on a regular basis as family structures change.

- (a) If the farm entity redeems the partnership interest of a terminating partner, the remaining partners' cost basis is unchanged. Gain on all subsequent sales by the remaining partners will be measured by the difference between the original cost for their interest and the sale price. The terminating partner typically would have a capital transaction.
- (b) If a cross purchase is used, the remaining partners will have paid for the interest of the terminated partner. Their basis would, therefore, increase upon the purchase of the interest. Any gain on a subsequent sale would be reduced.

If the sale occurs by reason of death, typically there is no gain recognized by the selling partner's estate because the estate benefits from a "Step up" of the deceased's cost (or "basis") to the fair market value as of the date of death.

C. WHEN SHOULD THE AGREEMENT BECOME OPERATIVE?

1. Death. Almost all buy-sell agreements are triggered by death. If a redemption agreement is used, the purchase price may be covered by life insurance on the deceased partner owned by the farm entity. If a cross purchase is used, the insurance policy on the deceased partner may be owned by the other partners. The proceeds when received are used as full or as a down-payment.
2. Disability. The agreement should also cover total and permanent disability. If a principal is no longer capable of performing his duties, it is quite possible that profits would be reduced. Unfortunately, a disability buy-out is more difficult to fund with insurance than a death buy-out. Disability buy-out insurance, while available, tends to be quite expensive.

Disability insurance for farmers has traditionally been difficult to obtain because it is a high risk occupation. However, there are certain policies that are available which can provide a valuable benefit.

3. Termination of Employment. If a partner is active in the operation of the farm, consideration should be given to providing for a buy-out upon the termination of employment.

Consideration should be given to having a buy out only if employment is terminated for certain events. For instance:

- (a) Voluntary Termination. If a Partner- Employee voluntarily terminates his employment with the farm entity, this may, depending on the circumstances cause a hardship on the farm and could effect the operation of the business. Termination could be a result of having to relocate for health reasons, job dissatisfaction, a fear of the Partner's partnership interest value declining, etc. Therefore, the terms under which a Partner-Employee will be bought out when he resigns be carefully spelled out. Options available are to provide for vesting schedules, long-term payment provisions, or not having a buy-out mandatory in such an instance.

If someone voluntarily terminates their association with the farm a discount penalty of 20%-40% is common. This reflects that the farm

must now replace one of its key employees and also protects the farm from being adversely affected to the extent it cannot make the payments. Such a penalty provides an incentive for the partners to stay together. Also, a long payout may be utilized for a partner who has voluntarily left the farm. In many cases, the discount may be less or no discount at all if there is termination as a result of attaining a pre-arranged retirement date.

It is also common to include a provision that states if a partner voluntarily leaves the farm that the remaining partners may elect to sell the entire operation rather than have to buy out their partner.

- (b) Termination for Cause. If a partner is terminated for cause, certain limitations on the buy-out of the partner's interest may be imposed. Generally, employment agreements are entered into with partners which define when a termination is "for cause". It is, of course, difficult to imagine a termination for cause on a closely held farming operation, but it should be addressed.
- (c) Retirement. The agreement should also define when a partner will be considered as having terminated employment as a result of "retirement", i.e., notice requirements, etc.

The primary events of termination that should be covered are death, disability and if someone decides they no longer wish to farm. Each of these situations can cause unexpected problems. Therefore, the terms under which each of these situations will be handled should be agreed upon while the parties are in agreement.

D. MANDATORY SALE VS. OPTION

With respect to the methods set forth above, should the purchase and sale be compulsory?

1. Most agreements provide that upon the occurrence of an event that triggers a redemption or sale, the partner, or his estate, is required to sell and the farm (if a redemption) or the remaining partners (if a cross purchase) are required to purchase the shares of the terminated or deceased partner.
2. Some agreements are in the form of a "Put". This means that upon an event that would trigger a redemption or sale the terminating partner may require the farm entity or the other partners to buy the partnership interest of the terminating partner. The terminating partner is not required to sell.

3. The farm entity or the remaining partners could have an option or a "Call". This is the reverse of a Put. In other words, the remaining partners or the farm entity have the right to acquire the partnership interest of the terminated partner, but they are not required to acquire the partnership interest.

Many times the determination of whether a sale is mandatory or not depends on whether the purpose of the plan is for passing the interest in the farm to the next generation. In those cases, it may be advisable to allow a transfer to "Permitted Transferees". That is, family members who are active in the operation of the farm, trusts for family members or certain selected individuals who have shown a commitment to the farming operation for a period of years. In these cases, the remaining owners may not be given the first opportunity to acquire the terminated owner's interest.

E. RESTRICTION ON TRANSFER

Every buy-sell agreement should prohibit transfer by any partner other than in accordance with the terms of the buy-sell agreement or with the consent of the other partners. As discussed above, transfers to selected "Permitted Transferees" may be allowed either during life or at death.

F. VALUATION

This is the most difficult issue in any buy-sell agreement, especially in a farming operation. Dairy and produce prices fluctuate regularly and land and machinery values are difficult to exactly determine without an appraisal. If the event triggered is by death, the value could be the value established in the Federal Estate Tax Return. This is done by appraisal.

What is common is to have the value determined by the agreement of the parties on an annual basis. If there is a triggering event within the twelve (12) succeeding months, the agreed upon value governs. However, if the parties fail to meet to agree on a new valuation within twelve (12) months of a triggering event, the price will be determined by appraisal. This presents a price and value from becoming stale.

G. FACTORS TO BE CONSIDERED IN DETERMINING THE VALUES OF CLOSELY HELD COMPANY INTERESTS

1. The nature of the business and the history of the enterprise.
2. The economic outlook in general, the condition and outlook of the specific industry in particular, and the overall optimism or pessimism of the investing public.

3. The book value of the partnership interest and the financial condition of the business.
4. Prospective earning capacity.
5. The Farm's net worth.
6. Whether or not the farm has goodwill or going concern or other tangible value.
7. The Farm's position in the industry and its management, including loss of management from a death of the key manager.
8. The market price of farms in the same geographic area.
9. The value of the land, buildings, cattle and machinery.

H. TERMS OF PAYMENT

1. Death buy-out. If a death buy-out is contemplated, the purchase price may be totally or partially funded by life insurance. If a redemption is used, the farm entity would be the owner and beneficiary of the policy. If the purchase price, all or partially, is funded by life insurance, the balance could be paid in cash or by installment note.
2. Installment Payment. In all situations, the purchase price could be paid by a combination of a cash down payment and an installment note. The note could be for a stated number of years at a reasonable rate of interest. The note could be for a stated monthly or annual amount. If this form of note is used, the term of the note becomes the variable; however, the Companies are in an excellent position to budget without surprise. The length of the pay-out can be different for each triggering event. The pay-out should balance the needs of the partner (and his family) and the operating capital requirements of the farm entity.

I. RIGHT OF FIRST REFUSAL

It is appropriate to have a provision in the agreement that prohibits a partner from selling his partnership interest without first granting the remaining partner an opportunity to acquire the partnership interest. Therefore, if one of the partners wishes to sell his shares, he would notify the other partners of his intention to do so and the other partners are given a reasonable period of time to acquire the terminating partner's interest in the farm entity. The purchase price in such an event is generally

the lesser of the offer from a third party or the value as determined pursuant to the buy-sell agreement.

J. SECURITY

In the event of a sale, the selling partner may receive installment notes. These notes could be secured by a pledge of the partnership interest which was sold, by personal guarantees or by the farm issuing a security interest in its assets.

Care should be taken to balance the interest of the terminated partner or his estate and the needs of the farm. A standard security interest in farm assets may result in the farm's inability to secure bank financing if it is subsequently needed. Therefore, the terminated owner's interest is generally subordinated to third party creditors.

At the same time, care should be taken to insure that the selling partner is adequately protected in the event the farm is subsequently sold by the remaining partners. The agreement may provide that upon the occurrence of a subsequent sale, the balance of the purchase price is immediately due and payable.

VIII. PLANNING STRATEGIES FOR LONG TERM CARE

- A. The Need for a Long Term Care Plan. Despite best efforts in structuring a successful succession plan for a farm operation, an unexpected need for long term care for one of the owners can have a significant effect on the farm's and every owner's ability to continue.
- B. Effect of Failure to Plan Properly. Long term care expenses can range from \$3500 per month to \$9000 per month depending on the facility and the geographic location of the facility. Without insurance or the proper plan in place, a farm can find itself in the situation of having to sell in order to support the expenses incurred in nursing home care.
- C. Care Options.
1. Home Care
 2. Residential Care (i.e., independent/assisted living facilities)
 3. Long Term Care Facility (i.e. nursing home providing round the clock care for its residents.

D. Payment Options for Long Term Care Expenses.

1. Self Pay. Average cost of nursing home care in New York State in 2003 is \$70,000.00
2. Government assisted payments (i.e. Medicaid. Medicare may be available, but very limited benefits provided under Medicare)
3. Long Term Care Insurance.

- a. Partnership and Traditional Long Term Care Insurance Policies. New York is one of the few states that offers its residents both "Partnership" and traditional "Non-Partnership" policies for long term care insurance. Partnership policies are provided in connection with the state's participation in the Robert Wood Johnson Foundation project and are unique in that they allow a participant to protect their assets from attachment or seizure provided that the participant is covered by the insurance policy for a period of at least three years and provided further that the income from the participant's assets is available to and in fact is paid over to the Department of Social Services.

Partnership policies offer the farm client an opportunity to protect the assets in the farm. In many cases, the premiums for the partnership policies are less than the traditional policies.

- b. Application of Liens. As Medicaid continues to tighten the rules under which assets may be protected insurance policies provide assurance that a farm's assets may be protected not only for the current owners but for the next generation. Without proper planning or insurance in place, a farm can find itself in the situation in which liens have been placed against the assets in order to support the long term care expenses of the farms owners.
- c. State and Federal Tax Benefits. The state and federal government both endorse the utilization of long term care insurance policies because of the burden of these expenses on the Medicaid system. Under federal law, a deduction is available for long term care insurance premiums. If paid by an individual or sole proprietorship, the premiums are deductible if they exceed 7.5% of adjusted gross income. If provided by an entity for an employee, the costs of the premiums are deductible to the entity. There are some limitations based on the age of the insured. In New York State, an additional tax "credit" of 10% of the premium is available.

E. What is Medicaid?

Medicaid is a needs based system, whereby only persons who are in financial need will qualify for Medicaid. Medicaid is not to be confused with Medicare, which is not a needs based system.

F. What does Medicare pay for?

Medicare is government subsidized health insurance which is generally only available for persons 65 and older. There are now three parts to Medicare (Part A, Part B and Part C insurance). In order for Medicare to cover the costs of a skilled nursing facility, the patient must have been in the hospital for three consecutive days (including the day of admission) and must enter the skilled nursing facility within 20 days of leaving the hospital. Medicare generally limits patients to 100 days of coverage per illness. In addition, Medicare will typically only cover patients for therapy and physical rehabilitation, and will not cover extended custodial care.

As of January 1, 1999, the Medicare+Choice program permits an array of private Medicare options, including HMO's (available since 1982), Provider-Sponsored Organizations (PSO's), Medical Savings Accounts (MSA's), Preferred Provider Organizations (PPO's) and Private Fee-For-Service Plans (PFFS). These health plans must cover items and services offered by traditional Medicare under Parts A and B. 42 U.S.C. Section 1395w-21, et. seq.; 42 C.F.R. Section 422. Beginning January, 2003, PPO demonstration plans became available in 23 states, including New York.

G. If Medicaid is needs based, who qualifies for Medicaid?

There are several different standards for which Medicaid will judge a person's availability:

1. Individuals:

For an individual seeking home care aid - a person can not have more than \$3,850 in resources, and \$642 a month in income.

For an individual seeking nursing home aid - a person can not have more than \$3,850 in resources, and \$50 of income.

_____ 2. Married persons:

With married persons, it is important to distinguish between the Institutionalized Spouse (the spouse in the nursing home) and the Community Spouse (non-institutionalized spouse). Medicaid will deem that it is the responsibility of the Community Spouse to support the institutionalized

spouse. Therefore, Medicaid will consider all of the Community Spouse's assets available for care except the Community Spouse may retain up to \$90,660 (however, the New York Medicaid number is \$74,820) in assets and \$2,319 per month (\$27,828 per year) of income.

H. What if the Community Spouse's resources are more than \$74,820?

Those assets will need to be liquidated to pay for the cost of a nursing home before the Institutionalized spouse will be eligible for Medicaid.

I. What if the Community Spouse's income is in excess of \$2,319 per month?

The income which is in excess of \$2,319 per month will need to be contributed to defer the cost of the nursing home; however, only 25% of such excess income will be available, not 100%.

J. Are there any exceptions to the available resource rule?

Yes, in addition to the \$74,820 of resources a Community Spouse may have, the Community Spouse may also retain:

1. The Primary Residence, so long as the Community Spouse still resides in the home;
2. One automobile and essential personal property; and
3. Other various items (i.e., burial funds, etc.).

_____ K. Transfer of Assets:

In order to prevent individuals from inappropriately establishing financial eligibility for Medicaid by giving assets to family members, the transfer rule was established.

L. Penalty Periods:

If a Medicaid applicant transfers assets for less than fair-market value then he or she will be ineligible for Medicaid for a period of time known as the "penalty period".

If the applicant makes a transfer to an individual, regardless of the amount of transfer, the applicant will only be ineligible for Medicaid for a period of 3 years following the date of the transfer. If the applicant makes the same transfer to a trust, the period will be 5 years.

These are outside periods. The penalty period is in actuality the lesser of (i) 3 or 5 years (depending on whether the transfer was to an individual or into a trust) or (ii) the penalty period calculated by dividing the value of the uncompensated transfer by the average monthly cost of nursing home care for the applicant's region, as published by the Department of Social Services. The resulting figure is the number of months during which the applicant is disqualified from receiving Medicaid coverage.

Example 1: Using the year 2003 average cost of nursing home care of \$5,390 for the CNY region, if an applicant gave away an asset worth \$55,000, the applicant would be disqualified from receiving Medicaid coverage for ten months ($55,000 / 5,390$). An approximate penalty period of ten months will apply regardless of whether the recipient of the gift was a natural person or a trust, since in all events 10 months is shorter than 36 or 60 months (3 and 5 years, respectively).

Example 2: Same figures as in Example 1, except that the applicant gave away \$300,000 to her daughter. Calculating the number of months of ineligibility, ($320,000/5,390$), the applicant would be disqualified from Medicaid for just over 59 months. However, since it is a transfer to an individual, then the maximum period for disqualification is 36 months. The applicant will be eligible to apply for and receive Medicaid on the 37th month after the transfer.

The cost of care for a private patient is derived at by utilizing the following formula. The average Medicaid rate for the private care facilities within a particular region where the patient is institutionalized is multiplied by 120%. The current regional rates are as follows:

2003 Regional Rates

<hr/> Central	\$5,390
<hr/> Long Island (Nassau and Suffolk)	\$8,583
<hr/> New York City (5 Boroughs)	\$8,157
<hr/> Northeastern (includes Westchester)	\$5,998
Northeastern Metropolitan	\$7,464
Rochester	\$6,058
Western	\$5,614

M. The Rule of Halves:

Asset transfers can be an effective planning technique even if the applicant will need to apply for Medicaid during the three year look-back period. Under a guiding "rule of halves", asset transfers can be used to preserve approximately half of an individual's assets by taking advantage of the computation of the penalty period.

Let's suppose an individual gives away half of his/her property prior to applying for Medicaid. He/she then uses the property which he/she retains to privately pay for his/her nursing home care during the months which, as a result of the initial uncompensated transfer, he/she is ineligible for Medicaid. Upon the expiration of the penalty period (and the exhaustion of his/her retained funds), he/she will now be eligible for Medicaid because (1) the penalty period on the transferred assets has expired; and (2) the remaining assets have been fully expended.

Planning must take place prior to actually implementing the rule of halves. Consideration should be given to setting aside a reserve amount that can be used for unexpected expenses that may arise during the private pay period that could result in a depletion of all available funds prior to the originally expected Medicaid application date. If that occurs, there may be a need to go back to recipients to collect funds for the support for the applicant. In reality, the "rule of halves" should really be looked upon as the "rule of one third/two thirds" or "three fifths/two fifths."

Some of the unexpected expenses that may not be covered by insurance during the private pay period include:

1. Daily rate of maintaining a bed while the applicant has gone to a hospital;
2. Hearing aids and other medical aides that may not be provided or protected by insurance;
3. Extraordinary medical expenses not covered by basic or medigap insurance plans.

N. Exceptions to the Asset Transfer Rule:

First, the asset transfer rule does not apply to transfers of assets between spouses. Second, the rule does not apply to applicants who are not in a nursing home or, under certain conditions, receiving comparable care in their community or home. Third, transfers by a non-applicant spouse, which are made after eligibility for Medicaid is granted, are not taken into account by the Department and will not subject the applicant to a penalty period.

O. Irrevocable Income Only Trusts:

With an Irrevocable Income only Trust, the applicant can, if planning far enough ahead, keep the income from the assets which they own, and at the same time give away the principal of the asset.

The trust, which is irrevocable, will provide that during the lifetime of the Settlor, he or she will receive all of the income from the trust. However, the principal of the

trust will be for someone else (usually Settlor's children). The trustees will be persons other than the Settlor.

It is important to note that such a trust is still subject to the 5-year rule for transfer of assets. Therefore, it is very important to make sure such a trust is created and funded far enough in advance of the Medicaid needs. Also, it is important to note that the Settlor gives up all rights to the principal of the trust. Therefore, the Settlor must be comfortable that they can live only on the income, without utilizing principal.

_____ P. Supplemental Needs Trusts:

Supplemental Needs Trusts are very different from Irrevocable Income Only Trusts but are an important part of the Medicaid planning process.

The Supplemental Needs Trust is a special type of trust authorized by statute in New York State to allow a person to create a trust which will not impair their ability to receive Medicaid or any other type of governmental assistance.

It was originally conceived in order to provide persons who are severely injured to protect the monies they receive in personal injury claims from the claims of Medicaid until after the death of the injured party. Medicaid has been able to successfully erode away this statutory protection through the years. However, Supplemental Needs Trusts are still utilized by third parties for the benefit of other persons. Specifically, this type of trust is utilized in the will or irrevocable trust of a parent whose child is receiving governmental assistance. Also, it can be used for spouses who leave their estate to the surviving spouse at death, when that spouse is currently in a nursing home and receiving Medicaid.

_____ Q. Applying for Medicaid

Applying for Medicaid is a complicated process and the appropriate legal and accounting advice should be consulted. As such, this outline should not be *relied* upon as legal advice without first discussing your personal needs with respect to Medicaid issues.

R. Planning for Long Term Care.

Although no one looks forward to the time when nursing home care may be required, it is necessary to consider how the expenses will be paid if such care does in fact become a reality. Long term care insurance should be considered for many of the reasons set forth above, but most importantly, it gives certainty to the family farm

owners that the farm assets will be protected. Underwriting for long term care insurance should be considered early to determine whether or not it is an option. If it is not available for health reasons, other steps may be advisable and/or necessary.

This memorandum was updated on May 28, 2003, but most of the above figures change each year. In addition, with the current state of the economy in New York and other states, Medicaid and the ability to avoid the expenses of nursing home care are being carefully reviewed.

IX. STRATEGIC PARTNERING AND ALLIANCES

- A. Objective and Purposes. In today's era of specialization, concentration and struggling to maintain a profitable operation, farm owners as well as others involved in agriculture are seeking to find new ways to increase yields while containing expenses to the extent possible. Milk and crop prices over the last few decades continue to maintain any stability and place the agriculture producer in a situation where long term planning is difficult if not impossible.

As a result, new alliances are being created among producers, suppliers and investors for sharing resources and capital as well as demonstrated expertises in various areas of the agricultural industry. These alliances may range from simple partnerships between neighboring farmers for the sharing of equipment and facilities to fully diversified organizations structured for the purpose of not only producing a product, but providing an opportunity for investment by both farm and non-farm individuals and entities.

- B. Forms of Organization. Generally, an alliance should be documented in the same manner as any other relationship among owners and investors in a business. The form of entity may be a traditional entity such as a partnership, a corporation, a limited liability company or limited partnership. It is the terms under which the entity and its owners or participants come together and the terms of their relationship that distinguishes a strategic alliance from a traditional farming operation. Tax considerations must be addressed when the venture is created as well as when it terminates. Without proper planning, adverse (and unexpected) tax consequences can result. Regardless of the form of entity or enterprise, the terms under which the enterprise will be undertaken must be in writing:

1. The Joint Venture. Sometimes confused with a partnership, a joint venture is generally defined as an association of separate persons or businesses in a single enterprise for profit, for which purpose they combine their property, money, skill and knowledge without forming a partnership, corporation or other form of legal entity.

2. Management Agreement. The alliance may be structured around a management agreement pursuant to which one party will provide defined services to another entity.
3. Lease Agreements. One party may lease its facilities, equipment, land, cattle, employees etc. to another entity in exchange for a fee or for services that the leasing party requires in its operations. In cases where one entity has excess resources that it cannot fully utilize a leasing arrangement provides a source of income that would otherwise be unrealized.
4. Purchase / Retention of Key Employees. Where one operation is seeking or is in need of immediate capital it may be advisable to consider the sale of one operation to another under an arrangement where the surviving operation retains the services of the prior owners of the other operation or even offers ownership in the surviving operation to the former owners. This latter approach is generally considered a merger of the operations.

The objective in many cases is to provide the selling parties with the capital to pay off debt which is precluding the profitable operation of the farm. The farm's lenders may be calling for such a change in order to keep from foreclosing on the selling party.

5. Private Investment. Although not common many years ago, it is possible that an outside party may be interested in investing in the operation by providing capital. Similar to the private placement or public offering described below, the investor may be seeking a long or short term investment. The investor may be looking for active participation in management.
6. Private Placement. Generally more common in new enterprises or in the event there is a significant expansion being undertaken. A private placement is a solicitation of funds from a small group of investors. The size of the placement and the relationships of the investing parties to the operators of the enterprise will direct the level of disclosures and reporting that will need to be provided to the investor under the state and federal securities laws.

In many cases, funds can be solicited up to \$1,000,000.00 from "friends and family" without having to register the placement as a securities offering under the applicable laws and regulations. Placements of additional amounts may be accomplished without registration, but the sophistication, experience and financial wherewithal of the investors may need to be different.

Private placements are sometimes sought for new companies such as ethanol plants, digesters, manufacturing or high tech enterprises. Although not technically a strategic alliance, a successful private placement may provide

the capital that the enterprise needs in order to get off the ground. In many cases, the investor is bought out within a few years.

7. Public Offering. A public offering in an operating agriculture related business is rare. Generally, the costs of a public offering are generally so great as to make it impractical to utilize as a form of raising capital in an agricultural enterprise.

C. Creation of the Alliance. In creating the alliance, the objectives of each of the participants must be clearly established. This will generally dictate the form of entity that is the most appropriate for the alliance.

1. Will the existing entities remain intact? What are the tax consequences involved in structuring a new entity.
2. Will the existing entities remain operational? If so, to what extent?
3. What assets will each of the participants contribute to the venture?
4. What services will each of the entities contribute to the venture?
5. What outside services and asset will be needed in order to operate the venture? Is current land base sufficient for the proposed enterprise? Are facilities sufficient? If not, how will new lands/facilities be owned?

How will the assets be contributed? Sale, leasing, contributions as capital, loans, etc.?

6. Due diligence of each entity should take place to determine if either party has any liabilities which may affect the venture or any of the other partners. e.g. litigation, administrative proceedings or audits, environmental issues, etc.
7. If value of assets/services are not equal among the participants will this be recognized in ownership, management positions, allocation of profits/cash flow, compensation to individuals or entities, etc.
8. What lending relationships will be needed?
9. Are current operations compatible for the venture? For example, if a dairy operation, are participants utilizing the same co-op?

If employees are to be utilized is workers compensation experience (and, therefore, costs), compatible?

Will the form of venture have an adverse effect on the ability of the venture or its participants to continue tax benefits or FSA program benefits?

Are each participant's advisors compatible with one another? e.g. Accountants, attorneys, advisors.

10. How will expenses of the venture be shared? Based on contributions, productivity of the various divisions?
11. Long term planning - will additional participants be sought out, will there be a need for additional capital, etc.?
12. How will the venture be managed? Do the participants have the expertise and the time to manage the new venture or will outside management need to be retained?
 - a. Who will be the managing partner?
 - b. How selected, how removed?
 - c. What authority will be granted to the managing partner? When will the consent or the knowledge of the other partners be required?
 - d. How will the managing partner be compensated?
 - e. Will all partners participate in voting? Will voting and nonvoting ownership interests be more practical.
 - f. How will borrowings be approved?
13. How's the pie to be divided up?

D. Unwinding the Venture. Like any partnership or other venture, it is important not only to define how the operation will be put together but how it will be taken apart in the event the parties' objectives are not met. The time to structure the unwinding of an enterprise is when it is first being put together - when everyone is in agreement on all issues. In addition to those issues addressed earlier in Article IV above, the following matters should be resolved:

1. What rights will a particular party have to any particular asset? How will that be financially resolved? e.g. New barn on land of one partner.
2. How will value of venture be determined when unwinding?
3. What events will trigger the unwinding process? Death of principal? Sale of participant? Lawsuits? Passage of time?

4. What are the tax consequences of unwinding the venture? If a corporation, liquidation could have adverse tax consequences on the venture and on the participants.
 5. Under what terms will the unwinding take place? Will one party purchase the interest of the other? Will the venture be sold?
- E. Conclusion. A strategic alliance can bring together individual parties resources and expertise which can facilitate an increase in production and profitability in an agricultural operation as well as to provide the resources to provide new services and products to a community which would not be possible without the combination of these forces and talents.

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