

WINERY AND VINEYARD
ESTATE, BUSINESS
AND
SUCCESSION PLANNING

WINERIES UNLIMITED 2006

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Contracts
Corporate Law
E-Commerce
Elder Law
Estate Planning
Limited Liability Company Law
Mergers and Acquisitions
Real Estate
Federal and State Taxation

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Jeffrey M. Fetter is a shareholder and Chairman of the Business Practice Group of Scolaro, Shulman, Cohen, Fetter & Burstein, P.C. in Syracuse, New York. His practice focuses on business, estate, tax and succession planning for closely held and family owned enterprises. Services Jeff also offers his clients include: state, federal and international tax and business planning; estate and long term care planning; business and succession planning; e-commerce planning; employee and shareholder/principal relations and employee benefits; protection of intellectual property; transactional planning; acquisitions, dispositions, mergers, tax-free reorganization of business entities; entity structuring; contract negotiation, dispute resolution and the dissolutions of business entities.

Jeff is licensed to practice in the State of New York and the Commonwealth of Pennsylvania. He is a 1983 graduate of the Ohio Northern University College of Law. Clients Jeff represents are involved in professional service, e-commerce, manufacturing, communications, retail and agricultural businesses.

Jeff is a frequent lecturer for the New York State Bar Association, Cornell FarmNet and FarmLink and other professional and civic groups in the area of business and estate planning. He has authored several articles on business and estate planning for various periodicals.

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Scolaro, Shulman, Cohen, Fetter & Burstein, P.C. Agriculture Related Services

Scolaro, Shulman, Cohen, Fetter & Burstein, P.C. has established itself as a leading provider of legal services to the Agriculture community throughout New York and Pennsylvania. The firm represents farms, farm families and farm related businesses such as equipment dealers, equipment and product manufacturers, consultants and other service organizations in such diverse area as:

- Estate and Trust Planning and Estate Administration
- Business Entity Selection, Organization and Representation
- Farm Succession and Transition Planning
- Business Sales, Acquisitions, Mergers, Reorganizations and Development of Strategic Alliances and Partnerships Among Farm Businesses
- Tax Planning for Farms, Farm Related Businesses and their Owners
- Contract Negotiation and Dispute Resolution
- Real Property Purchases, Leases, Sales, Subdividing and Dispute Resolution between Adjoining Landowners
- Empire Zone Benefits Application and Negotiation
- Representation of Farms in Stray Voltage Matters
- Personal Injury Matters for both Plaintiffs and Defendants
- Governmental Support Program Applications and Disputes
- Employment and Labor Matters
- Establishment of Retirement Plans for Owners and Employees
- Long Term Care Planning for Purposes of Protecting the Family Farm

The firm has participated in hundreds of successful farm transfers over the past twenty five years, each case presenting unique facts and circumstances that must be addressed. When representing farms, it is important to not only understand the general principles of business, estate and tax planning that are applicable to all businesses, but to also have a very clear understanding of the specific needs of the farm and its owners. Many farms and farm related businesses remain within the same family for many generations. As a result, it is necessary to understand and address the needs of multiple generations within and without the operation.

Special emphasis is needed on ensuring that both the senior generation and the junior generations objectives are met when developing and implementing a farm succession plan. In many cases, there are both farm and non-farm heirs within the family and care must be taken to properly provide for everyone while protecting the primary asset of the family - the family farm.

Although there are many similarities within various farm businesses, each has unique and diverse needs. In most cases, this depends on the structure of the family, the structure of the farm business and the present state of the agriculture industry and the economy in general. Today's farm economy presents many challenges to the farm business and to its advisors. It is important that the farm advisors work together as a team to address these challenges and to best serve the farm client. Over the past several years, the firm has established itself as an integral part of that team.

Winery and Vineyard Estate, Business and Succession Planning 2006

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A few initial planning thoughts

*Regardless of whether your plan is simple or complex, involves merely a will or agreements among family and nonfamily members, the most important part of any plan is to **get it in writing!!!***

Remember, the only time you need to use an agreement is if you cannot agree or if you're not there to speak for yourself. The parties to an agreement can always agree to something else but, if you cannot agree you need to go back to what you put down in writing.

Having your plan in writing helps to avoid disputes, confusion, tension, deterioration of the business and the time and expense of having to end up in court.

Finally, the best time to implement a plan is yesterday!!

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 agriculture and other family owned 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 winery 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 winery 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 business to the next generation whether family or non-family.

A. Parents' Objectives.

1. Retirement income and security.
2. Winery continuation after retirement and death of parents.
3. Equitable or non-equitable treatment of winery and non-winery 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 the winery.
4. Avoid involving non-business 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.** The buy sell agreement among the owners of the winery sets forth not only the terms under which owners will hold their interest while employed or associated with the winery, 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 winery.
2. **Estate Planning Documents**

The Absolutely, Positively Essential Estate and Health Care Planning Documentation

- a. **The Will.** 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 winery 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 owners' intentions.

Without a properly prepared will, assets will be transferred in accordance with the applicable statutes. For example, if an owner 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 winery and who is not).

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

- b. **Updated Health Care Power of Attorney.** Sometimes known as a health care proxy, this document ensures that people you have appointed are making health care decisions on your behalf in the event you are unable to do so on your own. An "updated" proxy is necessary that (1) specifically grants your agent authority to obtain records that are considered private under recently enacted "HIPAA" privacy regulations and (2) appoint an alternate agent as well as a primary agent. In New York State only one agent may be appointed at a time.
- c. **Living Will.** The burden of having to make a decision as to whether life continuing measures should continue is a tremendous one. The living will sets forth your own wishes if such a situation arises and relieves your family and friends from having to be faced with such a decision. The living will sets forth your wishes and the conditions under which such a decision will be made.

- d. **Updated Durable Power of Attorney.** A durable power of attorney appoints your agent or "attorney in fact" as the person who can take care of personal, business, financial and legal matters on your behalf. A power of attorney may be an "immediate power" or a "springing power". An immediate power of attorney grants this authority (which is great) in the hands of a person immediately. A "springing power" states the conditions under which such a power will come into place at some point in the future. E.g. in the event of your disability or illness which renders you unable to act on your own.

Because of the great power given under such documents, they should be carefully thought out before signing, but they are critically important to have in place to ensure that bills are paid, checks are cashed, assets are managed, children are provided for etc. in the event you are unable to act on your own.

Similar to the health care power of attorney, the durable power of attorney should also be updated if you already have one to include specific references to HIPAA and also to authorize your agent to make transfers of assets on your behalf in excess of \$11,000.00 if those are your wishes. Under the statutory form that is usually signed, there is a limitation on the amount of gifts that may be made. In some situations gifts in excess of that amount may be appropriate for medical, estate and financial planning. Again, care needs to be taken in designing the document that meets your wishes and expectations.

- e. **The Sometimes Essential Trust Documents.** Trusts may also be used in connection with an estate plan. These trusts may be created during lifetime or at the time of death. In both cases, the documents should be structured with the winery succession plan in mind.

3. **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; e.g., 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 winery to provide these benefits.

III. **ESTATE TAX PLANNING**

An estate plan primarily involves taking steps so that in the event of your death, your assets (whatever they may be) pass in the manner that you desire. However, estate planning also needs to take into consideration the possibility of estate taxes being due at the time of your death. These taxes are not paid by the decedent but by the estate of the decedent. If not planned properly, there may be the need to liquidate assets in order to pay estate taxes. In a typical winery entity this is not a desirable option because there is very little liquidity in the assets owned by the business owner.

With properly structured estate planning documentation in place and the proper steps taken to reduce an estate during lifetime, estate taxes can be minimized or even avoided (legally). However, without the proper documentation and plan in place, it is possible that there will need to be a liquidation of assets in order to pay estate taxes. Although the IRS has payment plans, they are not always available and are not necessarily beneficial to the taxpayer.

There is continuous discussion about the elimination of the estate tax (or "death tax"). However, there can be no guarantee that this will ever take place. Recent events at the state and federal levels certainly do not set the stage for allowing a very lucrative income stream to disappear. And, there is no certainty as to what will be the then current state of the law at the time of anyone's death. Presently, federal law provides that from 2006 through 2008 there will be an estate tax exemption of \$2,000,000. In 2009 the exemption increases to \$3,500,000 and for deaths that take place in 2010 there is no estate tax. **But**, on January 1, 2011 (which is not that far away), the estate tax exemption returns to being only \$1,000,000. With a properly structured estate plan, a married couple's estate of \$4,000,000 can avoid all federal estate taxes.

New York law does not follow the roller coaster of the federal legislation. The exemption is \$1,000,000 and is not scheduled for increasing (or decreasing) at the present time. New York tax rates are much lower than the federal rates (approximately 16% vs. 46% federal), but even on a \$2,000,000 estate that has not been structured properly a family can end up having to pay over to the state about \$64,000 in unnecessary estate taxes (which is on top of the other expenses that are incurred in the administration of an estate).

Although estate taxes should not be the sole factor in structuring a winery succession plan, when structuring such a plan, it is important to at least know what the possible implications

are and how they can be minimized. Advance planning is certainly necessary to avoid surprises.

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 Winery Business Entity.

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

1. **Sole Proprietorship:** A sole proprietorship is a winery 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 winery 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.

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- (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) Winery 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.

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- (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 winery assets are replaced in three to six years (cattle, equipment, etc.). Therefore, built-in gains tax may not be a burden to a winery 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 the winery. 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 \$50 per member (\$325 minimum).
- (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.
- (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 winery 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).

IV. PLANNING STRATEGIES FOR LONG TERM CARE

Caution!! Caution!! Caution!!
and in case that isn't enough warning

Caution!!

Changes are coming in the very near future in the state and federal laws that are going to have a significant impact on long term care planning for individuals, wineries and other family owned businesses. These changes are going to change the requirements for Medicaid eligibility such that traditional planning is going to go by the wayside.

On February 8, 2006, President Bush signed new legislation. Essentially what these changes are going to result in is that planning for long term care for winery owners and individuals is going to need to take place much sooner and the need for long term care insurance to protect family and winery assets is going to be a much more critical part of a winery succession plan.

Each state must individually adopt the new federal law. It is very unlikely that any states will not adopt conforming legislation because it affects their Medicaid Reimbursements. However, it is not certain as to when each state will adopt new legislation and what the effective date will be.

The following sections of the outline that address Medicaid rules, regulations and planning reflect the current law as of February 8, 2006. Although many references are to New York State law, there are many similarities among the laws of the states. A local attorney experienced in your state's law should be consulted.

If your winery succession plan involves the transferring of any assets, it is important that you obtain up to date advice and you act quickly to determine whether your plan will be affected by the new legislation. It is also important to determine whether you are eligible for long term care insurance. Even if you are not, there are other planning strategies that can be considered.

- A. The Need for a Long Term Care Plan. Despite best efforts in structuring a successful succession plan for a winery operation, an unexpected need for long term care for one of the owners can have a significant effect on the winery'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 winery 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 was \$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 winery client an opportunity to protect the assets in the winery. 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 winery's assets may be protected not only for the current owners but for the next generation. Without proper planning or insurance in place, a winery 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 wineries 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 20% of the premium is available. With these tax incentives the cost of long term care can become very affordable.

In addition, it is possible to have "group" policies in place that protect only certain employees. These plans allow the cost to be shared among a small or even large group of employees. Many insurance advisors are well versed in the most cost efficient policies that are available and should be part of your planning team.

- d. Don't get rid of those life insurance policies. Sometimes it is tempting to cancel life insurance policies you may have on an owner of a winery because maybe there is no longer an estate tax problem or the original reasons for having the insurance no longer exist. But, if there is a chance that you do not qualify for long term care insurance, these policies can become a "back door" benefit. Under current law, liens will be placed on a person's property upon his death which greatly restricts the ability of the new generation of operators to continue. However, if there is a life insurance policy on the owner, the Medicaid and nursing home bills can be paid with those resulting in no liens being placed on the winery.

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 \$4,000 in resources, and \$667 a month in income (plus an unearned income credit of \$20 per month).

For an individual seeking nursing home aid - a person can not have more than \$4,000 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 \$95,100 but a minimum of \$74,820 in assets/resources and \$2,378 per month (\$28,536 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 \$2,378 per month?

The income which is in excess of \$2,378 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 present 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 state. As noted below, all penalty periods in the future will be five (5) years. The resulting figure is the number of months during which the applicant is disqualified from receiving Medicaid coverage.

Example 1: Using the year 2005 average cost of nursing home care of \$5,988 for the Central New York region, if an applicant gave away an asset worth \$59,880, the applicant would be disqualified from receiving Medicaid coverage for ten months

(59,880 / 5,988). 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). New York has different rates for different geographic areas. Other states generally apply a uniform amount applied throughout the state.

Example 2: Same figures as in Example 1, except that the applicant gave away \$350,000 to her daughter. Calculating the number of months of ineligibility, (359,000/5,988), 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%.

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 winery owners that the winery 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 in 2005 and 2006, 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.

Legislative Update

On February 8, 2006, the Federal government passed legislation titled "Deficit Reduction Act of 2005" which dramatically changes the eligibility requirements for Medicaid. This law still needs to be enacted by the New York State Legislature before it becomes effective in New York State. New York, however, will most likely make its law retroactive to the effective date of the DRA 2005 which was February 8, 2006. Essentially, DRA 2005 applies to transfers made on or after February 8, 2005.

The following is a summary of the key changes to Medicaid eligibility with the passing of the DRA 2005.

1. Changes to the "Look-Back Period":
Changes the "look-back period" for all transfers to 60 months (rather than 36 months for outright transfers).

This is effective for all transfers made on or after February 8, 2006;

2. Calculation of the "Penalty Period":

Shifts the start of the "Penalty Period" (the period of ineligibility for a transfer of assets) from the first day of the month following the month of the transfer to the **later** of (1) the Medicaid application date or (2) the date on which the individual is eligible for medical assistance under the State plan and would otherwise be receiving institutional level care (i.e. nursing home care) based on an approved application for such care but for the application of the penalty period.

This is effective for all transfers made on or after February 8, 2006.

In essence, this means that the Penalty Period does not begin until the individual moves to the nursing home and the person would otherwise be eligible for Medicaid (meaning until they have spent down to \$4,150 in New York or \$99,540 for the Community Spouse). In other words, the Penalty Period does not begin until the nursing home resident is out of funds and cannot afford to pay the nursing home.

3. Treatment of Annuities:

- a. Full disclosure required;
- b. Any transaction exceeding \$100,000 in past 60 months must be disclosed regardless of whether it was for Fair Market Value and will be treated as a transfer for less than Fair Market Value unless proved to the State it was for Fair Market Value (i.e. now a purchase of an annuity will be deemed a transfer for Medicaid purposes incurring a Penalty Period);
- c. Beneficiary designation must include a "pay-back" provision to Medicaid unless there is a spouse or minor child or disabled child;
- d. The treatment of annuities is effective for annuity purchases on or after February 8, 2006.

4. Income First Rule required:

This is currently required under New York State law.

Income from Institutionalized Spouse must be used first to increase Community Spouse's Minimum Monthly Maintenance Needs Allowance, rather than using excess resources.

This is effective for transfers made on or after February 8, 2006.

5. Home Equity Disqualification:
 - a. Individuals with equity in their home in excess of \$500,000 will not be eligible for Medicaid. States, however, can increase this amount to \$750,000 in their own discretion.
 - b. The new law states that Reverse Mortgages are not prevented to decrease the equity in the home.
 - c. This is effective Date as of January 1, 2006 for all Medicaid applications.
6. Entrance Fees to Continuing Care Retirement Communities (CCRC) and Life Care Community Admission Contracts:
These amounts are now considered a resource available to pay for long term care.

This is effective for applications made on or after February 8, 2006.

In essence, this means that there will always be a Penalty Period when an individual transfers anything of value unless the transfers were made over 60 months ago.

Example: Assume A has \$187,000 and transfers \$87,000 of it outright to A's son on January 23, 2006 when A's nursing home costs \$7,200 per month.

Under current New York State law (without the enactment of DRA 2005 provisions): there would be a 14 month Penalty Period starting February 1, 2006 and running through March, 2007, the time by which the remaining \$100,000 will have been spent down for A's care.

Under the new DRA 2005 law: the 14 month Penalty Period will start when the Medicaid coverage is sought, i.e., in April, 2007 & run 14 months from then through May, 2008. Thus there is no more "Rule of Halves" planning under the new DRA 2005 law.

On the other hand, if A has more than \$375,000 in total assets, A can gift the excess assets and use the remaining \$375,000 to privately pay for the 60 months in order to get through the new 60 month "Look-Back Period."

The difficult aspect of all this, however, is that this is not currently New York State law because New York has not passed its enabling legislation to correspond to it. New York will, however, most likely pass very similar legislation and make it retroactive to February 8, 2006 when, or if, New York ever passes its budget. In the interim, however, it is unclear as to how each county's Medicaid office will apply the law at this time.

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 with an attorney who practices in the area of Elder Law. Please feel free to contact either Jeffrey M. Fetter or Robert D. Scolaro of Scolaro, Shulman, Cohen, Fetter & Burstein, P.C. or visit our firm's website at www.scolaro.com if you have any questions.

V. STRATEGIC PARTNERING AND ALLIANCES

- A. Objective and Purposes. In today's era of specialization, concentration and struggling to maintain a profitable operation, winery 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 wineries 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 winery and non-winery 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 winery 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 winery. The winery'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.

4. 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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