

Section Three:
**ABOUT FARM
TRANSFER
TOOLS**



THE TRANSACTIONS OF FARM TRANSFER

In Section One of this workbook, we emphasized the importance of exploring core values and developing a long term vision for the family's relationship to the farm. Also in that section, we discussed inherent risks to that vision: death, disability, divorce, disaster, and disagreement (the "D's"). If you consider these two concepts together, they demonstrate how the tools of farm transfer work.

Consider your life as a timeline, and identify two points: the "here and now" and the "there and then." If you have taken steps advised earlier in this workbook, both can somewhat be identified in your mind. Now, imagine one or more of the Five D's between those two points, and what happens to your vision when one of those things happens. The development and execution of estate planning and farm transfer transactions are what lawyers and other advisers prescribe to address the D's, the challenges to the future you envision. Because such events are foreseeable, legal agreements are meant to keep your wealth and your farm fairly intact as it is visited by a D risk event.

When it comes to agreements in farm transfer, it is helpful to consider that you are transferring three rights in an asset: Income, Management, and Control of Equity (ownership). The agreement you form with the person or persons to whom you are transferring the asset - say a farm - will govern all parties rights to these three things.

For example, when you transfer land, you transfer the right to earn income from it. If you sell it outright or make a gift of it, you completely relinquish your right to earn income from it. If you form a lease agreement with a farmer to use the property, you can retain income from the property in the form of rent, while the farmer receives the return on the sale of his or her crops. With a lease, you also allocate management while retaining control of the equity.

As outlined in this section, there are a number of legal instruments - wills, trusts, partnerships, limited liability companies, leases - that can transfer rights to assets. For some tools such as wills and trusts,

one generation can decide what is going to be done with the assets without the consent (often without the input) of the heirs, and that generation simply lives with the result.

For example, when you transfer land in your will, you often transfer the rights to income, management and equity to several people in equal shares. However, the rights in the income and management, while legally defined as equal rights, are nonetheless ambiguous between the new owners. Three people may have the right to manage the property, but what if they disagree? All have the right to income, but can all agree (and contribute equally) to the production of that income?

Often to keep a farm available for agricultural use, there must be a set of instructions, an agreement between owners and users, that define management, income and equity rights in property.

Often to keep a farm available for agricultural use, there must be a set of instructions, say in a trust or an agreement between owners, that define management, income and equity rights in property.

Sometimes this can be a lease, sometimes a business entity such as a limited liability company, whose operating agreement clearly defines all the owners' rights to income, management and equity.

It is helpful to remember that regardless of the differing tax treatments, management and reporting requirements of business entities, all are essentially a contract between owners that describes, often in great detail, the rights of all owners in the income, the management, and the equity of the property that is owned by the entity. The agreement also prescribes the reaction or options in the event of a risk event occurring. Care must be taken to make sure your advisers fully understand your desires, values and risks.

In sum, to ensure your vision for the future of your farm as working assets, you will have to form an agreement with those to whom you entrust that future. As noted earlier in this workbook, it is a process to get agreements in place, and process to continually monitor them and change them when needed. It is a series of transactions that occur in a flexible framework that reflects your vision for the future.

BASIC ESTATE PLANNING DOCUMENTS: WILLS, TRUSTS, AND GIFTING

Most families will transfer their wealth through their estate plans. An estate plan is a set of documents that clearly identifies who - and often under what terms - a successor will inherit property. Often, certain transactions will occur that can be referred to as 'estate planning' in the form of gifts or planned sales or other transfers in rights to property. The following narrative is a discussion of the nature of these documents and transactions.

The Will

Often referred to as your "last will and testament" a will is a document executed according to specific legal requirements that directs the distribution of your assets. The goal of any such document is to clearly express the intent of the person who makes it or directs its preparation and have it executed according to the requirements of state law, so that after your death anyone who disagrees with your distribution decisions will have a harder time trying to undo them.

In order to create a will you must be competent enough to know the nature and extent of your estate and be able to formulate a plan of distribution. A will must also be signed by you as "the testator" and signed by two competent and disinterested witnesses. These witnesses must be older than 18 years and must not benefit directly or indirectly under the terms of your will, and they must both sign in your presence and the presence of each other, all in front of an officer authorized to take oaths under state law, usually a notary public. Pennsylvania law offers testators and witnesses what is known as a self-proving affidavit, which appears as specific language before their signature. This allows the probate court to more easily accept the validity of the document.

To change the terms of your will, any amendments or changes - known as a codicil - must be made with the same formality required of a will. Handwritten modifications to a will have no effect, absent certain legal formalities. You can revoke your will by executing a new will and stating in the document that you are revoking any previous wills.

Dying without a Will

You will often hear it said that there is no such thing as "no estate plan." If you do not have a properly executed - and therefore valid - will, the Pennsylvania Consolidated Statutes has a plan for the distribution of your property and farm business assets. Pennsylvania's Intestate Succession law (20 Pa.C.S.A. § 2101) covers exhaustive distribution scenarios based on who is living and not living at the time of your death. Suffice it to say, if you plan to keep land interests in the family or pass a farm business within the family or to someone else, the ownership diffusion of intestate succession on the farm assets makes it highly unlikely that your farm will pass intact.

Can you disinherit your family in your will?

If a surviving spouse is not happy with property given by will, the spouse can elect to take legal action against the will and take the statutory amount instead. Pennsylvania provides that the surviving spouse can elect to generally receive at least 1/3 of the deceased spouse's estate. Note that this is not automatic, whereby a surviving spouse must notify the probate court of his or her election within a certain time period.

In Pennsylvania, there is no statutory provision protecting disinherited children. Therefore children will only receive property bequeathed by will if a valid will is accepted into probate. The testator does not have to state that he or she is disinheriting, they are simply not named or don't otherwise fall under a general children definition in the will. However, disinherited children can always challenge the will, raising issues of undue influence and fraud, and a will not properly executed or without a self-proving notary affidavit can more easily be challenged.

What will happen to my estate after I die?

The probate process is the legal process for proving the validity of a will and distributing your assets according to that will. The person who is named in the will as executor will be in charge of the probate process. The process can be lengthy and can potentially tie up assets unless other provisions are made for their distribution

(ie. joint bank accounts, pay on death accounts, property in trust, etc.). With the supervision of the county clerk of court or probate clerk, the executor must identify and inventory property of the deceased, have the property appraised, pay all debts and taxes and finally distribute the remaining property as the will directs. If you die intestate (without a will), the same process will take place except the court will appoint an administrator of its choosing to carry out the probate process and the remaining property will be distributed according to state law instead of as directed by a will.

Probate is a public process, meaning the proceedings will be available in public records. It is usually advisable to try to avoid extensive probate proceedings. However, it is strongly advised you not take probate-avoidance maneuvers without the advice of a legal professional.

Trusts

A trust is a legal entity that separates the management and ownership of property from the benefit of the property. The person who creates the trust, which takes the form of a written agreement, is known as the settlor. The settlor generally transfers title to assets from him or herself to the trust; this is called funding the trust. The property then held in the trust is called the corpus, principal, or the trust estate. The legal ownership of the property resides with the Trustee, an individual or sometimes corporate institution appointed by the settlor for the purposes of managing and distributing income and ownership under the terms prescribed in the trust by the settlor.

The trust agreement itself is an often lengthy document, or the set of documents, that first creates and then details the terms of the trust. The agreement names a trustee to manage the trust property and should also name a backup trustee. The trust agreement also names the beneficiaries who will receive income or property from the trust during the existence of the trust, as well as the beneficiaries who will receive the trust assets when the trust is dissolved. The trust agreement will outline how and when (and often under varying circumstances) the trust is to dissolve.

There are numerous reasons for establishing trusts. These can include avoiding or minimizing probate costs, making will contests more difficult, protecting your privacy not only to the extent of your estate and

holdings, but to whom they will be distributed. Trusts are also used for protecting assets from risks associated with beneficiaries (ie. their bad habits, uncertain marriages, mental incapacity, etc.) by assigning someone else (ie. the trustee) to manage the property in the event of your incapacity or after your death. Trusts can allow a trustee to manage property for minors. In very large estates, trusts can be employed to minimize or avoid estate taxes.

The trust or trusts you create are only limited by your creativity and can serve many different purposes. Above all, trusts are more flexible to amend than wills in that they require less formality. They can provide a flexible framework in which you work through various asset management and income/asset distribution decisions as they become more clear over the course of your lifetime. Below are several types of trusts.

Revocable Trusts

A revocable trust (often called a “living trust”) is created by the settlor during his or her lifetime and the settlor retains the power to revoke or amend the trust at any time during his or her life. Settlers of revocable trusts often name themselves as the first trustee to serve until incapacity or death. The terms of the trust become irrevocable upon the death of the settlor.

A revocable trust often serves as a substitute for a will, whereby assets are “poured” without specificity into the trust, which is identified in the will under the direction that the testator’s assets be “inherited” by trustee of the trust (because you might change trustees, you don’t name a specific person in your will, just the trust). Property transferred into trust under this scenario will still be part of your probate estate.

On the other hand, if probate avoidance is your goal, you can transfer assets to your trust before you die, and thus the assets are property of the trust, you may have been both the trustee and the beneficiary when you die. Under this scenario revocable trusts are particularly useful when property is held in several states and therefore would have to be probated in each respective state. Although probate costs are avoided, trusts cost more to create than a will because they are more complicated to draft and fees may be associated with changing the title of assets.

Because the settlor retains control of the assets during life (settlor retains the power to revoke the trust and have the property returned), the property remains part

of the taxable estate, both under federal tax laws and Pennsylvania's inheritance laws. Therefore, revocable trusts are not useful for reducing the value of the estate for estate tax planning purposes even when assets are titled to the trust before your death. Because of the relatively high estate tax exemption passed as of 2013 (over \$5,000,000 per individual, \$10,000,000 for a married couple), using revocable trusts to minimize estate taxes is less a motivation than other circumstances that may warrant their creation.

Irrevocable Trusts

An irrevocable *intervivos* trust is a trust created during your lifetime that cannot be terminated once created. If created and managed correctly, these trusts can reduce the value of the taxable estate in that the property placed into the irrevocable trust will no longer be owned by you, thus not under your control and therefore not part of your probate or taxable estates. The settlor must not retain any interest in the income or corpus of the trust or serve as trustee (as is common in revocable trusts). You as the settlor cannot retain the power to change or transfer the property or the property will be included in the settlor's taxable estate. These trusts are often used to own life insurance policies, as insurance proceeds from policies you own are normally part of your taxable estate.

Transferring property into an irrevocable trust is essentially a gift to the beneficiaries and transfers may be subject to gift tax. Annual amounts over the current annual gift exemption transferred into the trust will be subject to gift tax. Under current law, an election can be made to transfer up to the lifetime gift tax exclusion into the trust without paying gift tax; however, the transfer will reduce the unified credit and increase the amount of your estate that will be subject to estate tax. In order to qualify for the \$14,000 annual exclusion for gift-tax purposes, irrevocable trusts often contain a provision giving the trust's beneficiaries a temporary right to withdraw annual contributions. This withdrawal right is known as a "Crummey power" in reference to a federal court case. For very large estates, it may be valuable to make the election so that property appreciates in the trust instead of in the estate. Since the property must be forfeited by the settlor, the beneficiaries must have a present interest in the trust property.

Other types of trusts include *testamentary trusts* that are created as part of your will, and activate when

you die for the specific purposes you identify in your will. Testamentary trusts are often used by parents of minor children to ensure management of money for them (e.g. life insurance proceeds) until they reach a designated age for distribution of the money in the trust. *Spendthrift trusts* can protect assets that could be recklessly spent by beneficiaries. These trusts limit the rights of the beneficiary to sell or spend the trust corpus or principal, but otherwise allow them to receive income from the trust assets. A *Qualified Terminable Interest Trust* (QTIP) can provide a surviving spouse income during his or her lifetime.

Other trusts are *Charitable remainder trusts* allows the settlor to contribute their property to a qualified charity and then receive the income from the property during their lifetime, with the charity receiving the assets upon you death. *Special Needs Trusts* can protect a disabled or elderly individual's qualification for supplemental security income or medicaid.

Gifting

The gifting of assets to the next generation before your death may be useful to decrease the size of very large taxable estates or to pass farm assets to a farm successor. There are several tax and other issues to be aware of when considering transferring assets by gift.

A gift of property is made only when you (the donor) exhibit the intent to give the property and there is actual or constructive receipt of the gift by the recipient (the donee). If property is of a nature that cannot actually be moved into the possession of the recipient, there must be what's known as constructive delivery. Constructive delivery is some action or transfer that gives the recipient the power to control the item received. Thus, a promise to make a gift, as in "All this farm equipment will be yours someday," does not satisfy the requirements of a gift. The farm equipment is still owned by you, and will become part of your estate if you do not otherwise dispose of it before you die.

Gifts must be given free of any restrictions and cannot be taken back at your request. In other words, you must be ready to completely part with the property and all its benefits (ie. use, income, etc.). For example, Dad gives Son his farm equipment but continues to use the farm equipment. This may be alright, but Dad uses the equipment under Son's permission. To eliminate any future questions by other heirs, tax authorities,

etc., Dad should write up a list of the farm equipment and how much each item is worth, and attach it to a writing that clearly expresses his intent to give away the equipment with no strings attached. The son should sign the document to indicate he is aware of the gift, demonstrating his constructive receipt of the property.

Parents will often gift land to their children. There are tax consequences to such gifts (see below), but otherwise it is an effective way to transfer real estate. Once the land is gifted, however, the parents no longer have the right to receive rent from the property, so they should make sure that they have other sources of income for their later years. Parents sometimes find that gifting land gives them a piece of mind and the satisfaction of handing over a deed and witnessing the recipient's gratitude. However, although this may count as a gift, the recipient should record the deed immediately to ensure they take title to the property.

Tax Implications of Gifting

The gifting of property is not without tax implications. First, you can plan to gift property under your federal annual gift tax exclusion. In 2013, the annual exclusion amount is \$14,000. This means that any one donor can make a gift of \$14,000 to a single recipient without filing a gift tax return, and without deducting from their lifetime unified credit (amount of your estate excluded from estate tax) \$5,250,000. Husbands and wives can combine their annual exclusion and give any recipient an annual tax-free gift of \$28,000. Gifts can be made in these amounts to as many donors as you choose. Gifts for payment of educational and medical expenses are tax exempt.

Gifts in any amount are excluded from the recipient's gross income for tax purposes. However, if the recipient decides to sell gifted property there may be capital gains taxes. When a donor gifts an item to the donee, the donee receives the donor's basis in that property. Generally, "basis" is your cost of acquiring property plus the cost of improvements less cumulative depreciation. If the donee sells the gifted property, the donee will pay a capital gain on the difference between the sale price and the basis. (If an heir receives an asset at death by will or living revocable trust instead of during the life of the donor, they will receive a "stepped up basis" which is equal to the fair market value at the time of death.) The capital gain is an issue for the donee, and when offering a gift you might alert them to the choice of receiving the gift now with the carry-over basis, or waiting to receive the gift at your death (where they take the risk that you will have sold it or gifted to someone else in the meantime).

Many families have traditionally gifted partial interests in land by deed to their children, whereby the deed transfers, by way of example, a 1/64th interest in the property. It may be best to avoid such gifts as they create co-tenancies in land which may be hard to sort out later. An alternative is for families to place land in an entity such as a limited liability company, then gift interests in the company that fall under the annual exclusion. The interests in the real property, while not free of the carry-over basis issue, are nonetheless governed by the limited liability company's operating agreement, which grants options for ensuring that land can be controlled by the owners of the entity and stay in the family and available for farming use.



ABOUT THE FEDERAL ESTATE AND GIFT TAX: A 2013 UPDATE

A concern in farm transfer planning for many years has been the federal estate tax. Since 2001, the federal estate tax has had an expiration date, where at some point in the future, the current relatively high estate and gift tax exemption would revert to a much lower exemption, potentially exposing your estate to taxation. At the very close of 2012, Congress passed the American Taxpayer Relief Act that established an estate tax regime that for the first time in over a decade did not have an expiration date. However, though many call the new law “permanent,” it is nonetheless subject to change should Congress later decide.

The basics of estate and gift taxation are this: the totality of your wealth is subject to taxation at your death, unless its disposition qualifies as a deduction from taxation (ie. you transfer it to your spouse), or your total estate falls below a certain threshold amount, known as the *estate tax exemption*. No tax is paid on each dollar below that threshold, but for every dollar above that threshold a tax is paid based on a percentage calculated according to the size of your estate (your “bracket”).

Likewise, gifts made during your lifetime are also subject to taxation, but no tax is paid by the donee so long as the gifts during your lifetime do not exceed a certain threshold. This threshold is your lifetime *gift tax exemption*, and it is the same figure as your estate tax exemption. In fact, this is a unified exemption: every dollar you use of your lifetime gift exemption is deducted from your deathtime estate tax exemption. Each individual also has an annual exclusion, whereby you can give gifts in a single year totalling a value that falls below a certain amount without deducting from your lifetime exemption (see below for amounts). For annual gifts of a total larger than that amount, the donor is required to file a gift tax return for that year, thus alerting the Internal Revenue Service that something must be deducted from their estate tax exemption.

2013 Federal Estate and Gift Tax Overview

What follows is a simple summary of the key components of the law for 2013 and beyond. The figures are scheduled to rise with inflation over the years, unless Congress again changes the law.

1) Estates worth \$5,250,000 or less are excluded from the estate tax. Thus, if your estate is worth less than \$5,250,000, your estate will not owe a federal estate tax.

2) Estates worth over \$5,250,000 will be taxed at top a rate of 40%. The 40% tax rate only applies to the amount of the estate that is greater than \$5,250,000. For example, if your estate is worth \$6,250,000, an estate tax would be calculated on \$1,000,000 of that amount.

3) Using the “portability of exclusion” rule, married couples are allowed to exclude up to \$10,500,000 from the estate tax. Under this rule, each spouse can exclude up to \$5,250,000. If the first spouse does not use all of his or her exclusion, the surviving spouse can add the remainder to his or her estate. It is not automatic: the surviving spouse must file Form 706 to capture this “portability.”

4) The lifetime gift exemption is \$5,250,000, which is tied to the estate tax exemption. Any gift that is made within an individual’s lifetime in excess of the annual gift exclusion (\$14,000) is deducted from his or her estate tax exemption. Thus, if you gift \$1,000,000 in 2013, your remaining estate and gift tax exemption will then be \$4,264,000 ($\$1,000,000 - 14,000 = 986,000$; $\$5,250,000 - 986,000 = \$4,264,000$)

5) Individuals who distribute assets to a generation beyond their children (ie. directly to their grandchildren) will be exempt from the generation skipping tax (GST) if the transfer is less than \$5,250,000. The top tax rate on amounts that exceed \$5,250,000 is 40%.

6) Appreciated property in an estate can receive a step up in basis.

2013 Pennsylvania Inheritance Tax

Though your estate may fall well below Federal estate and gift tax exemption, Pennsylvania has an inheritance tax that, unlike the federal estate tax, is charged against the shares of certain beneficiaries. Like the federal estate tax, the executor must pay the Pennsylvania inheritance taxes within nine months, but the estate can receive a discount if owed taxes are paid within three months. And as of 2012, land employed in agriculture that is transferred at death to family members is now exempt from state inheritance tax.

Inheritance tax rates are as follows:

- For inheritance between legally married spouses or bequeathments to charities: 0%
- For direct descendants such as children and grandchildren: 4.5%
- For property inherited by siblings: 12%
- For property inherited by all others, including unmarried domestic partners: 15%
- Life insurance is typically free from inheritance tax.

ENTITY CHOICE FOR FARM ENTERPRISE AND FARM TRANSFER PLANNING

One of the most common questions encountered when engaging farmers on transfer planning is about business entities, and their effectiveness in limiting operating liability (i.e. protecting assets from lawsuits and creditors). Placing land and operating assets into business entities is also an effective tool in transferring income, management and ownership/control of those assets to ensure they remain productive or under ownership of the family.

Choosing a form of business entity is an important task that requires consideration of numerous issues specific to your goals. Concerns about entity choice typically focus on tax or tort liability. Though important, there are other critical issues that should not be overlooked. Issues such as management of the business, whether the activity is even a business (i.e., motivated by a profit motive), business continuity, transfer of land interests, and the need to attract outside capital often override tax and liability issues.

Some business entities exist by default, or by operation of law based on the circumstances of the endeavor. Others must be created by a filing with the Commonwealth, and then managed according to either the law authorizing the entity, or a more specific contract between the owners. Below is a discussion on the various types of entities, ranging generally from the simplest to the more complex. In reality, with the advent of limited liability companies (see below), some of the entities below have become less favored except under very specific circumstances.

Sole proprietorship

The sole proprietorship is not really considered an “entity,” it is just you trying to earn a profit in your business activity. Nothing is needed to create one although there may be a need in some cities and counties to apply for a business license. The owner of a sole proprietorship has the widest latitude to operate the business possible, and may do anything that is not prohibited by law. However, the sole proprietor retains unlimited personal liability, meaning all assets owned by the sole proprietor, even those not considered part of the “business”, are subject to the claims of others.

Partnerships

General partnership

A partnership is an association of two or more persons to conduct a business for profit. The relationship is consensual and often contractual. Like many other states, Pennsylvania has adopted the Uniform Partnership Act (UPA). Under the UPA, the partners must have equal management authority and share equally in profits and losses. They have an equal obligation to contribute their time, energy and skill without compensation to the partnership business. Each partner has unlimited personal liability to the creditors of the partnership, and all partners are liable for wrongful acts and breaches of trust by any partner. In other words, your personal assets are liable to claims that arise from the actions of your partner, even if that partner has not contributed property to the partnership (see discussion on unintended partnerships below).

A partnership files a federal information tax return (Form 1065) annually. However, all income flows through the partnership and is taxed to the individual partners. Each individual partners share of income is shown on a Schedule K-1 issued by the partnership. Each partnership interest is personal to the partner. Under UPA, partnerships are dissolved by the death of a partner or by the sale of a partnership share. However, most provisions of the UPA can be modified in a written partnership agreement. Such items that are typically modified include acknowledgment of differing capital contributions, different management responsibilities, unequal sharing of profits and losses, rights and obligations, and the terms of property ownership, termination and dissolution. Many such agreements contain a buy/sell agreement to address the situation when a partner wants to exit the partnership.

General partnership agreements may be oral, and are then governed by UPA. Furthermore, two individual sole proprietors cooperating their assets and efforts in a business can be considered a partnership by default, and therefore subject to UPA. In other words, courts can impose a partnership relationship upon parties who did not think that they were partners. Examples of

relationships that may, in actuality, be partnerships can include employer/employee relationships, particularly where the employee has received a share of the crop and has shared in the risk of production; and landlord/tenant relationships, particularly those involving share-lease arrangements that are not in writing. .

Limited partnership

A limited partnership is a partnership whereby certain partners enjoy limited liability. This form of entity can be used when some partners want neither management responsibility nor the unlimited liability for actions of the other partners. Pennsylvania has adopted the Uniform Limited Partnership Act. Under this Act, a limited partnership is formed by at least one general partner and one or more limited partners. The general partner typically manages the partnership and has full personal liability for the debts of the partnership. The limited partner (or partners) contributes cash or other property only. The limited partner's liability for partnership debts is limited to the amount of his or her investment in the partnership. Limited partners do not participate in the management of the partnership. A limited partnership also files an information tax return, but income is taxed to the individual partners. Unlike general partnerships, limited partnerships do not exist by default, and must be created by a filing with the Secretary of State, accompanied by the required filing fee. A limited partnership is required to file an annual report for continued recognition under Commonwealth law.

A family limited partnership is a type of limited partnership used to promote efficient management of family businesses, business succession, estate tax management, as well as other purposes. Family limited partnerships are created the same as other limited partnerships and have the same filing requirements.

Limited liability partnerships

A limited liability partnership (LLP) is a general partnership that files an election with the Bureau of Corporations and Charitable Organizations. Such filing provides general partners with limited liability.

Limited Liability Company (LLC)

The LLC is a distinct entity that is a hybrid of a partnership and a corporation. An LLC is very similar to a limited partnership, only without the general partner who is required to accept unlimited liability. Owners of an LLC are referred to as

“members.” Those with management and decision-making authority are referred to as “managers.” Like a corporation, the members have limited liability for debts of the LLC. Ownership and management of an LLC is governed by an operating agreement between the owners. The operating agreement can address any number of issues, such as division of profits between members, the limits of management authority without a vote of the members, and restrictions on who can become members as well as restrictions on transfers of ownership. LLCs are often used in farm transfer planning for a number of reasons. They can be an efficient way to manage and transfer assets over time to the next generation as a valued percentage of the entity as opposed to re-titling of individual assets. they can also restrict ownership of the entity to lineal family members. LLCs can be used both for management of farm operations and as land-holding entities. Land interests transferred to the ownership of an LLC lose certain attributes of real property under state law, and are treated as personal property interests governed by the operating agreement.

Corporations

A corporation is a legal entity, created under state law, that has rights and liabilities separate from its owners, which are called shareholders. A shareholder's liability for the debts of the corporation are limited to his or her investment in the corporation. The shareholders elect a board of directors who set the governing parameters of the corporation, known as bylaws, and appoint officers to manage the company on a daily basis. Normally shareholders do not participate directly in management decisions (unless they are also directors or officers). A corporation has a potentially unlimited life, and it is not automatically (by state law) dissolved by the death of a shareholder, director or officer.

Though shares of stock are freely transferable by the stockholder, smaller corporations such as farm operations can place limits on their transfer. Commonwealth law allows the creation of restrictions on stock transfers under the articles of incorporation, bylaws, or an agreement between shareholders and the corporation. One type of restriction would be a buy-sell agreement between a stockholder and the corporation or other stockholders requiring the selling stockholder to offer his stock first to the other party to the agreement. The agreement could set a price to be paid for the shares or a method by which they are

to be valued, considering the shares were not publicly traded.

Shares in a corporation can be defined as *common* or *preferred*, based on the rights and privileges that belong to the owner. Common stock represents a fractional proprietary interest in the assets and good will of a corporation. Therefore, the common shareholder participates on a pro rata distribution of corporate assets upon dissolution, participation in corporate profits (dividends) and management of corporate activities (right to elect members of the board of directors). Holders of *preferred* stock are not creditors of the corporation and therefore do not share in corporate assets upon dissolution. Instead, they are first in line to receive fixed dividends ahead of the holders of common stock, and can have preferred rights ahead of holders of common stock with regard to distributions of corporate dissolution proceeds.

The shareholders are the actual owners of the corporation, and they choose the people who will manage the company, known as the board of directors. The shareholders elect the board of directors to delegate the power of management. The board is responsible for all of the business affairs of the corporation, such as issuing shares of stock and the rights of the shares issued, the sale of corporate assets, mortgaging corporate assets, declaring dividends, and the election of corporate officers. The senior manager of the company, often known as the Chief Executive Officer (CEO) and others that may comprise a senior management team are responsible for the day-to-day operations of the corporation. Their authority and duties are prescribed by the bylaws and the votes of directors, which are also governed by the bylaws.

A corporation is created upon the filing of the articles of incorporation with the secretary of state. This can be done on a form found online with the Pennsylvania Department of State, or can be more expansive document. Pennsylvania state law requires that the articles of incorporation include the following information: (1) a corporate name which must be available for use (ie. not being used by another corporation), (2) the number of shares that may be issued or whether the corporation is organized under a non-stock basis, (3) the street address and mailing address, including county, of the initial registered office (a P.O. box is not accepted), and (4) the name and address of each incorporator. Though

not required, the articles of incorporation document may also provide: (1) the names and addresses of the initial board of directors, (2) provisions regarding the business purpose and par value of shares, etc., and (3) limitations on personal liability of directors. Pennsylvania law requires the incorporator to publicize in two newspapers of general circulation either the intent to file or the actual filing of the articles of incorporation (the proof of publication must be kept with the corporate minutes).

At the organizational meeting of the corporation, bylaws should be adopted. This document may contain provisions for managing the company and regulating the affairs of the company that are legal and consistent with the articles of incorporation. The bylaws are the continuing set of governing rules under which the corporation, its officers, directors and shareholders exercise management powers, transfer shares, hold meetings and all other activities related to the corporate objective. The bylaws can be amended from time to time.

A business corporation can be dissolved in one of two ways: voluntary dissolution and involuntary dissolution. The directors and shareholders may voluntarily dissolve a corporation by passing a resolution of dissolution and filing articles of dissolution with the Secretary of State. Alternatively, a corporation can be dissolved without its consent by court action or administrative action of the Secretary of State. Such "administrative dissolution" can occur if the corporate managers neglect to file the required annual report and pay any associated fee with the department of state. Also, if the directors are not acting in the best interest of the company, any shareholder may obtain judicial dissolution.

C Corporations and S Corporations

A corporation can elect to be taxed in one of two ways under federal law. The corporation can elect to pay a corporate tax as an entity on its profits, with the shareholders paying a tax on their dividends. This is the famous "double taxation" we often hear about. Such a corporation is known as a "C Corporation" has elected to be taxed under Subchapter C of the Internal Revenue Code (IRC).

A corporation formed under Subchapter S of the IRC is a close corporation that has elected to be taxed like a partnership. Thus, instead of being taxed at

the corporation level, the income is deemed to “pass through” to the shareholders and is only taxed once, at the individual level (whether the profits are distributed or not).

Corporations can also be not-for-profit, whereby all revenues are used by the business for charitable purposes. Non-profit corporations must apply for non-profit status with the Internal Revenue Service by filing a Form 1023 and paying the associated fee. Great care must be taken in completing this form, as IRS scrutiny of allowing non-profit status has increased in recent times.

Cooperatives

Cooperatives are another type of entity that has traditionally been used by groups of farmers to reduce the costs of inputs or to better pool and market products. Most cooperatives are organized as corporations; however, ownership of shares is restricted to the customers of the business. Profits of a cooperative are all eventually distributed to the members, after some is kept for administration of the cooperative. The cooperative itself is not designed to make a profit. The U.S. Department of Agricultural provides both technical and financial assistance to farmers who wish to form cooperatives.

Observing the Formalities

It is quite common for a family to prepare documents, file papers and then never fund the entities created. Oftentimes, attorneys that create the entities for the client fail follow up with their clients to ensure that the entities are being properly managed. Such management is required to demonstrate the continuing “business purpose” of the entity, to ensure that its limited liability holds up under the scrutiny of creditors and claimants.

Observation of formalities of entity maintenance such as holding necessary meetings and keeping minutes of those meetings must be strictly followed if the benefits of forming the entity that were hoped for are to be actually achieved. All required filings must be made and fees and taxes paid to avoid involuntary dissolution of the entity.



WHAT IS A BUY-SELL AGREEMENT?

A buy-sell agreement is a contract creating an option for one business owner to buy all or a portion of the business (which includes its assets) upon the retirement, death, divorce or disability of another business owner. Such agreements are often found as clauses in the governing documents of business entities such as partnerships and limited liability companies to restrict ownership of business interests. Sometimes they are stand-alone documents added later to an existing business by agreement of the owners.

The buy-sell agreement specifies who can buy the ownership interest, how the purchase price will be set and paid and at what interest rate. Terms of the sale and when the sale will occur are also included. Funding of the purchase can be an important consideration in drafting an agreement, and is usually accomplished with business cash flow, loans, life insurance proceeds or through the sale of other assets.

A buy-sell agreement allows the owners of business interests to agree ahead of time how to establish the value of the company and the value of ownership interests in a mutually beneficial agreement for all owners and their families. Such agreement helps to reduce uncertainty about what happens in the event tragedy befalls an owner. The agreement minimizes disruptions to the business operations after an owner's exit because the general circumstances of the exit have been contemplated ahead of time by all parties in interest.

Planning for the future of a farm in this way assures the business's stability and continuity and provides investment-decision stability for the purchasing owner and perhaps other key employees. If the buy-sell agreement covers land, it manages the risk that others - such as off-farm heirs - may gain an ownership interest and have different ideas about the use or disposition (ie. sale) of the land. In this form it is sometimes used to allow other heirs to participate in the equity of the land without ultimate control over disposition.

A common form of buy-sell agreement in limited liability company can work this way: One owner suffers a triggering event, such as death, a disability, files for divorce or files for bankruptcy, or a desire to leave the business. The agreement requires him or her (or his or her representative) to notify the

other members in a specified manner, which starts a clock. The business itself may have the first option to purchase the business interests of the departing member. In the case of death of a member, the company may have purchased a life insurance policy on that member and the agreement may require that the company purchase the interest. In the absence of such requirement, if the business fails to exercise its option within the time period, the next option may fall to the remaining owners to purchase the shares, and if more than one steps forward, they can purchase a share commensurate with their then current percentage of ownership.

Agreements can identify future purchasers by name, which may be useful when a current user of the property - such as a farm successor on the farmland - needs assurance that he or she will have the resources to operate in the future, thus giving them confidence to continue investment in enterprises. Often this option is opened to the identified person's lineal descendants where it is important to keep land in the family.

An option holder usually has no right to force the sellers to give up their property, only the right to be the first in line to buy the property if the sellers decide to put the property on the market. The option holder cannot guarantee that the business interest will be put up for sale at a time where the option holder is able to cash flow the sale.

Rights of first refusal may also be written into a trust. Such an option would normally be triggered when a Trustee decides to sell a certain piece of property, such as land. If such an option is drafted into a trust, care should be taken to spell out how the price will be set along with the terms of sale. Trustees are bound by law to maximize the return to beneficiaries of the trust in the absence of any limiting language in the trust agreement. A specific person may be given the first option to purchase property from the trust of the deceased with the trust, and thus the beneficiaries, receiving the proceeds from the sale.

Though a buy-sell provision can make the use of entities a good option for families wishing to retain control of land, it is important to consider whether family members should be in business with each other, or whether it will be good for the family to create debtor/creditor relationships between them.

Worksheet 3.1

WHAT'S IN AN LLC OPERATING AGREEMENT?

As you will note from the preceding article on business entities, a lot of decisions are required for constructing an agreement to meet your needs. A common form of business entity in farming and land ownership is the Limited Liability Company (LLC). An LLC is governed by a contract between the interest owners called an Operating Agreement, which covers many issues which are posed below as questions. Many if not most items in an operating agreement also have a default provision in Commonwealth law, but can be changed by agreement.

GENERAL CONSIDERATIONS	
State where entity will be formed	
Name of entity vs. trade name of business	
Cross check names with state Secretary of Corporations	
Narrative of business purpose (very important for farm LLCs)	
Term of entity (e.g. indefinite)	
Member-managed or Manager Managed (for LLCs)	
Identity of managers	
Agent and address for service of process	
CAPITAL CONTRIBUTIONS	
Initial capital contributions (and percentages) of each member	
Will members be required to make additional contributions if necessary?	
What happens if a member fails to make a required capital contribution?	
Who is allowed to become a member (e.g. lineal descendants of grandfather)	
What approvals are required to add new members?	
Are members allowed to withdraw their capital contributions? If so, under what circumstances?	
Is a member entitled to interest on his or her capital contributions?	
Does any member have any priority on distributions over any other members?	
INCOME AND TAX ALLOCATIONS	
How are profits and losses to be divided among the members?	
How are tax allocations made?	
When are distributions to be made?	

Should the agreement require special distributions to be made to at least pay for tax on each member's pro rata income from the business?	
COMPENSATION OF MANAGERS	
What fees is the manager entitled to?	
What reimbursements is the manager entitled to?	
Is the manager entitled to incentive compensation?	
BOOKS, RECORDS, MINUTES	
What books and records are to be maintained by the business?	
What access rights will the members have to books and records?	
What reports will the members be required to receive?	
Who will be the tax matters partner?	
VOTING RIGHTS	
What voting rights will the members have?	
What major actions can the manager take without other members' approval?	
Will a supermajority be required for some actions of the business?	
MEETINGS	
Where will meetings be held?	
How often will meetings be held?	
How can meetings (regular and special) be called?	
What notices for meetings must be given?	
What quorum is necessary for meetings?	
Can actions be taken by written consent of the members?	
ASSIGNMENT AND TRANSFER OF INTERESTS	
Do the members have the right to assign their interests in distributions?	
What rights does an assignee of a member's interest get?	
In what situations will assignment be prohibited?	
What are the procedures for substitution of members?	
What happens on the death, incompetency or bankruptcy of a member?	

Is there a right of first offer or first refusal on transfers of interests?	
Are there restrictions on transfer of ownership interests? (i.e., owners can only be direct lineal descendants of grandma or grandpa)?	
Should a buy/sell agreement be included, setting out a formula to value ownership interests upon divorce, withdrawal of an owner, etc.?	
If included, should the buy/sell agreement include terms of payment for such business interests, allowing installment payments at a modest interest rate?	
Should key person life insurance provisions be included to fund purchases of a deceased owner's interest in the business?	
Should there be a prohibition on sale of ownership without permission of the other owners?	
REMOVAL OF A MANAGER	
Under what circumstances can the manager voluntarily withdraw as the manager of the business?	
What are the events that will result in the manager ceasing to be the manager of the business?	
Under what circumstances can the members remove the manager?	
What happens to the manager's interest when it has ceased to be the manager?	
DISSOLUTION AND TERMINATION	
Under what circumstances will the business be dissolved?	
Under what circumstances can the business continue notwithstanding a technical dissolution?	
How are distributions to be made on liquidation of the business?	
How can the business agreement be amended?	

Table 3.1

QUICK COMPARISON OF BUSINESS ENTITIES

	Sole Proprietorship	General Partnership	Limited Partnership	Corporation	Limited Liability Company
Ownership	Single individual	2 or more general partners	1 or more general partners and 1 or more limited partners	1 or more shareholders	1 or more members
Direction and Control	Single individual	All partners	1 or more general partners and 1 or more limited partners	1 or more directors	1 or more members
Management	Single individual	Managing partner or all partners	1 or more general partners	1 or more officers	1 or more members
Liability	Owner has unlimited liability	Partners have unlimited personal liability	Limited for limited partners, unlimited personal liability for general partner	Limited	Limited or unlimited
Transferability	Not applicable	May be assigned, but assignee not a partner	May be assigned, but assignee not a partner	Corporate stock freely transferable, "S" corporation restrictions must be met	May be assigned, but assignee may or may not be a member
Continuity of Life	Terminates on owner's death	Dissolves upon death or withdrawal, unless continued by partners	Generally dissolves upon death or withdrawal, unless otherwise specified in agreement	Perpetual	Operating Agreement determines continuity
Federal Taxation	Individual Taxed	Pass-through entity (each partner taxed individually)	Pass-through entity (each partner taxed individually)	"C" corporation and shareholders taxed; "S" pass-through entity, shareholders taxed	Pass-through entity (members taxed individually)
Legal and Administrative Costs	No initial or annual filings or fees or legal costs	No initial or annual filings or fees but may need legal service to draft partnership agreement	Initial and annual filings and fees, legal fees for drafting limited partnership agreement	Initial and annual filings and fees, legal fees for drafting documents, annual meetings	Initial and annual filings and fees, legal fees for structuring entity