FARM TRANSITION PLANNING:
HELPING CLIENTS DEAL WITH THE EXPECTED AND THE UNEXPECTED

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I. INTRODUCTION

A. Abstract

Business succession planning for family-owned farms and ranches can pose significant challenges for attorneys due to the complex natures of both the business and the family dynamics. However, a number of traditional business succession tools may be successfully applied to the farm or ranch, if agricultural attorneys can successfully aid farm and ranch families in the succession planning discussion. At the same time, agricultural attorneys should also aid their clients in preparing contingency plans for the unexpected loss of one or more key stakeholders to guard against one of the three key causes of farm transition failure.

B. Preface

Completing a successful transition of the family business to the next generation is a cumbersome process. According to a survey by the Family Business Institute, only about 30 percent of small businesses survive their transition to the next generation (Family Business Institute, "Succession Planning" (http://www.familybusinessinstitute.com/index.php/Succession-Planning/, last accessed April 23, 2016). Farms and ranches face all of the challenges of their small-business brethren, and also face a host of additional issues that make the transition of the business as an intact, viable entity even more difficult.

Ask a farmer or rancher what they want to happen to their operation when they die, and the vast majority will say "I want it to keep going and to stay in the family." The authors would dare to speculate none would reply "I hope my operation will go through a protracted probate process and most of it will be sold off into pieces to generate some kind of cash that can be used to silence my quibbling heirs."

Even if one were to put aside the numerous economic challenges involved in crafting a successful farm transition plan, there remain numerous other obstacles for even the most conscientious and current attorney, involving shades of property, wills, corporation, and tax laws. The importance of these issues is magnified in the estate-planning context, where the asset-intensive nature of the industry and the multitude of exceptions, exclusions, and special rules create even more traps for the unwary and amplify the consequences of "getting it wrong."

A brief examination of two scenarios can illustrate what is at stake. On one hand, the family may have multiple members who are actively engaged in the agricultural operation and rely on it as the primary means for their livelihood. While many farmers and ranchers welcome the involvement of their children in the operation, a multitude of families involved in the same operation also gives rise to a multitude of ideas about how to manage the operation. Differing views on the strategic direction the farm or ranch can take, if not carefully and thoroughly discussed, can lead to a breakup of the operation, which is exactly what the owner wished to avoid.

On the other hand, there may be only one heir with an interest in continuing the farm or ranch as a viable business entity. While this would seem to solve the problem mentioned above, it gives rise to others. "Off farm" heirs will likely feel entitled to their share of the farm assets in some form or fashion. Without careful advance planning, breaking off pieces of the farm or ranch to satisfy these claims can reduce the operation below a viable size. Summaries from two of the nation's predominant farm-management databases suggest that, for operations supported primarily by on-farm income (as opposed to operations where the majority of income comes from off-farm employment), approximately $600,000 to $750,00 of gross sales are needed to support each full-time equivalent (FTE) worker on the farm (*see* Kansas Farm Management Association, "Whole Farm Summaries," available at http://www.agmanager.info/kfma/, Illinois Farm Business Association Whole Farm Summaries, available at http://fbfm.ace.uiuc.edu/). Based on an average asset turnover ratio of 30 percent, this level of sales, in turn, requires on the order of $2 million of assets under management. Many farms simply do not have this level of economic productivity. As a result, farmers and ranchers anticipating a significant "outflow" of assets to off farm heirs must either provide a means for those heirs to receive non-farm assets or to participate in the farm operation in a way that does not hinder its viability.

These two scenarios represent mere points on a continuum of possible combinations of family involvement in the agricultural operation. Other players may become involved, including long-term employees. There also exists a continuum of outcomes, ranging from a seamless transition of the agricultural enterprise to new management and ownership to its complete liquidation. These possibilities require a note on terminology. This article will refer to "farm transition" more than "estate planning." This difference is explained in D. Marrison, "Planning for the Successful Transition of your Agricultural Business." Ohio State University Extension Fact Sheet 3607.

- Farm *estate* planning is determining how farm assets *(i.e.*, land, buildings, livestock, crops, investments, land, machinery, feed, savings, life insurance, personal possessions, and debts owed to or by the farm) will be distributed upon the death of the principal operator(s).

- Farm *transition* planning is the process by which the ownership and the management of the family business are transferred to the next generation.

In some situations, estate planning may be the appropriate mode. However, under the assumption the owner of the farm or ranch wants the entity to remain viable in the long term, the article will focus more on "transition" planning.

By its most basic definition, a "farm transition" is simply the process of transferring a farm or ranch operation to the next generation. While simple to articulate, this process can be quite complicated as it involves three complex and inter-related factors. First, there must be a transfer of the ownership (or possession, in the case of leased assets) of assets such as land, equipment, and in the case of farms organized as separate business entities, ownership of the business itself. Second, there must be a transfer of control over those assets. If the ownership of farm assets is held by individuals, this may seem like a straightforward issue, but even in such scenarios, other farm stakeholders may wish to have a say in farm management decisions. If the ownership of farm assets is held by a business entity such as a corporation or limited liability company (LLC), control may be allocated among owners in a variety of ways. Third, there may be a desire to allow participation in the revenues of the farm business by those who may or may not have ownership or control stakes. This issue becomes particularly important when such participation is a major source of retirement income for a farmer or rancher, or when one generation wishes to provide farm income to off-farm heirs in lieu of granting ownership in the assets themselves.

To address these concerns, this paper will discuss two critical elements of farm transition planning. The first element is the use of transactional tools and business entities as mechanisms for the orderly transition of farm ownership and management control. The second element is planning for the contingency of an unexpected loss of one or more critical stakeholders.

II. FARM TRANSITION PLANNING: PREPARING FOR THE EXPECTED

In a best-case scenario, the farm family has engaged in thorough discussions with all its stakeholders to determine the interest of all stakeholders in the operation of the business and the skills they bring to bear in that operation, and is prepared to create the business framework that will enable them to move from the status *quo* toward the desired business configuration. A number of transactional and entity tools may aid in this transition.

A. Transactional Tools

There are a wide array of transactions that can be used to help beginning farmers and ranchers begin their ownership and/or management of farm assets. Three primary tools are discussed here: the buy/sell agreement, the leasing of assets, and installment sales.

1. Buy-Sell Agreements

The process of transitioning the current business to the next generation will often result in the creation of a new entity with multiple owners. For example, a limited liability company (LLC) may be formed with the founding generation holding a significant majority of the ownership units with an agreement that units will be sold and/or gifted to the successor generation over time. However, unexpected events can happen. In order to make sure the new entity structure survives an unexpected death such as a shareholder death, departure, disability, or divorce, a buy-sell (buyout) agreement should be drafted to take care of the business in such contingencies.

A buy–sell agreement is a legally binding agreement between the owners of the business clarifying who can buy the departing individual's share of the business and at what price this transfer will occur. The agreement should also explain the events that will trigger a buyout of an individual. These could be a partner's death, disability or incapacity, divorce (in which the ex-spouse would get a portion of the business as a settlement – this can point to the need of both a buy-sell agreement and a pre-nuptial agreement), bankruptcy or foreclosure on debt secured by business assets, or desire to exit the business.

It is important to keep in mind that the reason for transition planning is to keep the business viable for future generations. Proper planning is needed to make sure that an external event does not destroy these plans. It is much easier to determine the provisions of the buy-sell agreement before the transition takes place versus after everything is in full operation and then try to fix it.

2. Leasing of Assets

Frequently, the incoming generation is "cash poor" and the older generation needs cash to cover the revenue foregone by exiting the farm business, as well as retirement expenses. Leasing of assets by the older generation to those that are entering the business often aids in this cash flow problem for both groups. Leasing business assets does have some income tax consequences depending upon the lease contract and the assets being leased.

A lease may be categorized as a rental of property (an operating lease or tax lease) or an acquisition of property (a capital lease or conditional sales contract) financed through a lease agreement. If the lease agreement transfers essentially all ownership rights and risks to the lessee, there is an acquisition of property occurring as specified in the lease contract. If ownership rights and risks do not transfer to the lessee, the lessee is simply renting the property. The distinction must be made when accounting for the asset on the books of both parties.

A capital lease is an arrangement that is termed a lease but has the qualities of a purchase. This is why this type of lease is sometimes referred to as a conditional sales contract or a lease-purchase agreement. The lessor may then be considered a dealer who also sells assets or a lender financing the lease. The lessee takes possession of the property and is usually responsible for repair expenses. The lessee is also required to make periodic lease payments which are similar in amount to loan payments that would be required to purchase the asset during the term of the lease. The lessee acquires an ownership interest in the property and also incurs a liability for the principal amount which was financed.

The Farm Financial Standards Council (FFSC) recommends the application of four rules to which are used to determine if a capital lease exists. If any of the four rules apply, a capital lease exists for the lessee and the asset must be capitalized and depreciated in the same manner as if it had been purchased, which can have important tax implications for both the lessor and the lessee.

1. The lease transfers ownership of the property to the lessee by the end of the lease term.
2. The lease agreement contains a bargain purchase option. In this case the lessee has the option to purchase the property at the end of the lease term for an amount which would be significantly less than the value of the property at that time.
3. The lease term is equal to 75 percent or more of the estimated economic life of the property.
4. The present value of the lease payments at the beginning of the lease term is equal to or greater than 90 percent of the fair market value at that time.

If none of the above four rules apply, the agreement is an operating lease. The asset is rental property and the lease payments are treated as operating income by the lessor and operating expenses by the lessee. In addition, ownership of the leased assets does not change.

An operating lease is much simpler to establish and the tax treatment of the payments by both parties is less complicated. In an operating lease the lessee treats the payment as an operating expense and the lessor reports the payment as income. Since the lessor retains ownership of the assets, depreciation deduction is also retained by the lessor.

There is also one tax issue that occurs when only machinery and equipment are leased. In this situation, the assets are personal property and the IRS considers the lessor of personal property to be in the business of leasing which results in the payment being subject to self-employment tax. To avoid this self-employment tax situation, real property (land and buildings) are the only asset leased or the land, buildings, machinery and equipment are all leased as one unit that is in one agreement.

3. <u>Installment Sale of the Farm</u>

The decision to retire from farming may lead to the desire to sell the assets and invest the proceeds which are to be used as a retirement fund. Usually the sale of a farm business involves the disposition of farm land, machinery, equipment, marketable inventory plus all the remaining tools of the trade. Special tax rules apply to the sale of depreciable assets and the land that is sold under an installment contract. The sale decision may result in a large income tax liability if all the farm assets are sold in one tax year.

The use of installment sale contract simply means that the income from the sale will be received over a period of two or more years. Therefore the use of an installment sale for a farm liquidation allows for the sale proceeds to be taxed in the year that the payment is actually received. An installment sale is a tax management strategy that can be helpful for the seller to manage taxable income.

In order to fulfill the requirements of an installment sale, the buyer may be obligated to make future payments under a deed of trust, note, land contract, mortgage or some other evidence of indebtedness. It is necessary to properly record the debt, transfer ownership, and charge a reasonable interest rate on the note. The minimum interest rate that must be charged to avoid the "sale" being regarded as a "gift" by the IRS can be found with the help of your tax professional.

The main benefit of an installment sale is that the seller is able to spread the tax resulting from the gain on the transaction over the life of the contract. In addition, the buyer is able to obtain immediate possession of the property. The buyer also does not have to go through the process of acquiring a bank loan or other traditional financing.

A drawback of using an installment sale for all the farm assets occurs with the sale of depreciable assets. Deprecation taken on machinery, equipment, buildings, purchased breeding livestock, and any other depreciable asset must be recaptured as ordinary income in the initial year of sale. This can create a problem in the situation where the sale proceeds received in that year are not sufficient to cover the tax liability.

The sale of non-depreciable assets using an installment sale contract works well. Since there is no deprecation to be recaptured, only the gain from each annual installment is taxable. Therefore an installment sale of land and raised breeding livestock can help manage the income tax liability resulting from the sale since both of these assets are not depreciable.

An installment sale will spread the seller's income tax liability over multiple years. However it does create risk to the seller in the event that the buyer fails to make good on the contract. Sellers need to evaluate the credit worthiness of the buyer before entering into a sale agreement. In the event that a buyer defaults, the seller may have additional costs of foreclosure and repossession of the property. Be sure to seek proper legal counsel when considering an installment sale.

B. Business Entities

The term "business entity" refers to an organized business that exists, at least to some extent, separately from its owners. Often, people think of a business entity as something only used for large corporations, but business entities can be used for any size of operation. Business entities can be important tools for business succession. In this subsection, a variety of business entities and their characteristics are presented. Then, using a family farm example, the use of the various entities as transition tools (and the tax consequences of those choices) explored.

As the discussion proceeds, it will examine four basic entity forms: the sole proprietorship (It could be argued a sole proprietorship is not technically a business entity since it has virtually no existence apart from that of its owner. However, it is useful to contrast the sole proprietorship with the other entity forms, and thus it has been included in this discussion.), the general partnership (including general and limited partnerships), the corporation (including "C corporations" and "S corporations), and the LLC.

1. <u>Forming the Entity</u>

Sole Proprietorship: There really is no formation process for a sole proprietorship. Whenever a person starts a business activity without forming any other type of business entity, a sole proprietorship is created. There are no filing requirements necessary to start a sole proprietorship, although if the person operating the business wants to use a trade name, they will need to file a "trade name registration" or "Doing Business As" (DBA) registration.

Partnership: Partnerships require some form of "partnership agreement" among the people forming them, though the requirements for the partnership agreement are very low. All that is needed is for there to be evidence that one or more people intended to engage in some sort of business activity together. That being said, it is a good idea to carefully think through the partnership agreement (including what each partner will contribute to the business, how items of income and loss will be allocated among the partners, how decisions will be made, etc.) and to put the agreement in writing.

In a general partnership, there is no need for a government filing to start the partnership, although, as with the sole proprietorship, a DBA filing will be needed if the business will be using a trade name. On the other hand, creation of a limited partnership does require the filing of a registration form with the Texas Secretary of State. This is because (as discussed below) a limited partnership has at least one "limited partner." In exchange for the limited partner's liability protection, the limited partner must register with the Secretary[i]

Corporation: Both C corporations and S corporations must register with the Texas Secretary of State. The filing made with the Secretary is called the Articles of Incorporation. In addition to the Articles of Incorporation, a corporation must also have a set of bylaws. These bylaws should cover the classes of shares the corporation can issue, the officers of the corporation, how decisions will be made, the rights and obligations of shareholders with respect to the corporation and each other, what happens if the corporation decides to end its business, etc. The owners may also consider restrictions on who can be a shareholder and/or whether the corporation or the other shareholders will have the right (or obligation) to buy the shares of another shareholder if they choose to sell their shares.

LLC: LLCs must also register with the Texas Secretary of State. The filing made with the Secretary is called the Articles of Organization. In addition to the Articles of Organization, the owners of the LLC should create an operating agreement for the LLC. The operating agreement addresses the same issues as the bylaws of a corporation although, as discussed in the following sections, LLCs have much more flexibility in many aspects of the business than corporations do.

2. <u>Liability</u>

Sole proprietorship: The owner of a business operated as a sole proprietorship is personally liable for all of the liabilities of the business. For example, say the sole proprietorship is a custom wheat harvesting business. While harvesting wheat, a fire starts on the combine. The fire spreads to the field and eventually damages several nearby buildings. If the owners of the buildings sue the sole proprietor and win, not only are all the business assets (such as the harvesting equipment) at risk; all of the owner's personal assets such as his or her home, vehicles, and savings are also at risk. This is referred to as "unlimited liability" and is often a reason that people operating businesses chose a limited liability entity such as a corporation or LLC.

Partnership: In a general partnership, all of the partners have unlimited liability. While someone suing the partnership is generally required to take the partnership assets first to satisfy their claim, if those assets are not enough, they can then take the personal assets of the general partners. Further, partners also have what is called "joint and several liability." This means that if someone sues the partnership but one of the partners manages to evade the suit, the remaining partner is liable for the entire amount of the judgment in the suit. That partner can, in turn, sue the other partner(s) to contribute their "fair share" but if the other partners cannot be found or successfully sued, there is no recourse for the partner that paid the full amount of the suit.

In contrast, the limited partner in a limited partnership has what is called "limited liability." This means the liability of the limited partner is limited to what they have invested in the business. For example, consider the custom harvesting business mentioned in the section on sole proprietorships above. Say that the business was organized as a limited partnership, and that the limited partner contributed $250,000 to the partnership for the purchase of equipment and payment of other expenses. In this case, when the limited partnership is sued for the damages caused by the fire, and the partnership assets are exhausted, the liability for the limited partner is limited to the $250,000 he or she invested in the business. If the assets of the business are not enough to satisfy the claims in the suit, the general partner's personal assets will still be at risk, but the limited partner's personal assets are not. This is an important consideration for the limited partner. It is also another reason why the limited partner must be careful not to violate the restrictions on involvement in the day-to-day operations of the partnership, for doing so risks losing the limited liability protection.

Corporation: All shareholders in a corporation enjoy limited liability – only their investment in the business (through their purchase of shares or contribution of assets to the business) is at risk for any liabilities of the business. Corporations are the original limited liability business entity form, as their limited liability was one of the original features of the corporate from when it was established centuries ago. Importantly, though, shareholders can lose their limited liability protection if they fail to respect the boundaries between shareholders and the corporation. One common way this happens is the commingling of personal and business assets, most frequently when shareholders treat the corporation's accounts as their own (making payments that are not salaries, dividends, or documented loans) or vice-versa. Another way limited liability can be lost is when the shareholders fail to follow proper business formalities such as holding regular shareholder meetings, documenting meetings through the recording of minutes, voting on actions of the business, or paying the annual fees for the corporation's filing with the Secretary of State. These actions can enable parties suing the corporation to "pierce the corporate veil," meaning they can destroy the limited liability protection of the shareholders and can thus claim both the corporation's assets and the assets of the shareholders to satisfy their claims.

LLC: As the name "limited liability company" implies, LLCs have the same limited liability features as corporations. Importantly, though, the LLC holds some advantages over the corporation in this regard. For example, an LLC could choose to operate and be taxed like a partnership (even to act as a limited partnership) but all of the members would have limited liability. Thus, it is possible for LLCs to combine all of the liability protections of the corporation but to operate like a partnership if it so chooses. Further, the LLC is somewhat less susceptible to "piercing the corporate veil" since there are fewer formalities required of the LLC than of the corporation. This being said, though, LLC members should still use caution to respect the separateness of the LLC and its members.

3. <u>Entity Ownership</u>

Sole proprietorship: Entity ownership for a sole proprietorship is very straightforward. The sole proprietor of the business is the one and only owner of the business and all of its assets.

Partnership: The partnership is, not surprisingly, owned by the partners. The partnership agreement may specify the contributions of property to business by the partners, and this property may be referred to as "partnership property." Defining partnership property may be important if the partnership is dissolved, and to some extent if the assets of the partnership are at risk for some liability (though, as discussed below, the risks are different for limited partners in a limited partnership).

Corporation: A corporation is owned by its shareholders. It is important to note the property of the corporation is owned by the corporation itself, not by its shareholders. For example, if a corporation owns a piece of land, the shareholders do not have the right to possession of the land itself. Similarly, the funds of the corporation belong to the corporation and not directly to the shareholders. It is important for the shareholders to respect this separation and not treat corporation property as their own, or vice versa. Failing to do so, or comingling personal and corporation assets can lead courts to rule that the corporation did not exist as a separate entity, thus allowing creditors and others claiming a liability against the corporation to reach the personal assets of the shareholders.

Ownership for S corporations is restricted by the Internal Revenue Code to only individuals, certain kinds of trusts, and estates (and shareholders may not be corporations or partnerships), must have 100 or fewer shareholders, and must have only one class of stock. 26 U.S.C. § 1361(b).

LLC: As with a corporation, an LLC is owned by its members. Property of the LLC is owned by the LLC itself, rather than the individual members. As with corporations, it is important for LLC members to avoid comingling assets.

4. Management and Control of the Entity

Sole proprietorship: Sole proprietors have exclusive control over all aspects of the business.

Partnership: In a general partnership, all of the partners can have the right to participate in all decisions of the business. Partners can, through the partnership agreement, choose one of the partners to serve as a "managing partner" who oversees the day-to-day operations of the business, while all partners share in the "big picture" or strategic decisions of the business. In a limited partnership, the general partner(s) have the right to participate in all decisions of the business. On the other hand, the limited partner(s) cannot participate in the day-to-day decisions of the business; doing so creates a risk that courts would determine them to be general partners and thus lose their liability protection.

Corporation: In a corporation, shareholders have control over the business, but do not directly participate in most decisions of the business. Instead, the shareholders elect a board of directors. The board makes major decisions, chooses when to declare dividend payments to the shareholders, and sets the long-term goals of the business. The board also selects officers for the corporation (who do not have to be shareholders) to manage the day-to-day operations of the corporation. Shareholders still hold ultimate control over the business through their power to vote out officers or directors, to overrule their decisions, or to vote to dissolve the corporation.

LLC: LLCs can choose to be either "member-managed" or "manager-managed." In a member-managed LLC, all of the members have functions like those of shareholders, directors, and officers in a corporation in that they directly participate in all decisions of the business. This model is typically used only when there is a small number of members who all wish to have an active role in the business. Alternatively, the members of the LLC can choose to be manager-managed; this approach means one or more managers are selected, and function like the officers of a corporation to manage the day-to-day operations of the business. This model is sometimes chosen by LLCs with many members or when some members do not wish to be part of the day-to-day operations of the business. As with a corporation, the members still retain ultimate control over the LLC with the power to vote out managers, overrule decisions, or to dissolve the LLC.

5. Continuity

Sole proprietorship: There is no business continuity with a sole proprietorship. Since there is no separation between the business owner and the business itself, the loss of the owner means the business ceases to exist in its current form. For this reason, sole proprietorships cannot survive the death of the proprietor, and the sole proprietorship in and of itself cannot be used as an estate planning tool. Sole proprietorships can sell assets and can even transfer clients or "books of business" but doing so dissolves the original sole proprietorship and creates a new one in the purchaser.

Partnership: Partnerships have slightly more of an ability to survive the loss of someone involved in the business than a sole proprietor. Technically, a partnership does not survive the loss of one of the partners, but rather becomes a new partnership. However, for most practical purposes, the partnership is regarded as "surviving" so long as 50 percent or more of the original partnership interest remains in the partnership. If a family-owned business is using the partnership form, it is very important that the partnership agreement include rules governing who can be a partner, including to whom a partner can transfer their interest (if they are even allowed to transfer their interest), if there are certain events that will require them to sell their interest (such as bankruptcy, divorce, inability to participate in the business due to illness, a requirement that a partner's estate sell the interest if the partner dies, etc.), and if the other partners must approve the addition of a new partner.

Corporation: Corporations can have unlimited continuity if properly constructed. The corporation's articles of incorporation can specify the corporation's existence as either limited to a set period of years, or to be perpetual (this is the case for most other states as well). The potentially unlimited existence of corporations (as well as LLCs) gives them a significant advantage as a business transition tool. Corporations can add or lose owners simply through the purchase or sale of stock. For large, publicly-traded corporations, this happens thousands of times per day, with no impact to the business. For smaller corporations, though, adding or losing owners can have more of an effect, since the shareholders are likely more directly involved in the business. Thus, for small corporations, it may be advisable to have rules such as those discussed for partnerships governing who can (and who cannot) be shareholders. Corporate law imposes more restrictions on these rules, and requires certain rights for shareholders, than is the case for LLCs, giving LLCs more flexibility in this area. Given this, and the fact that it can be difficult for shareholders in small corporations to sell their shares, the shareholders should consider whether "redemption" or "buy-sell" agreements (discussed above) should be enacted. These agreements govern how either the corporation itself (in a redemption agreement) or other shareholders (in a buy-sell agreement) will purchase shares in case a shareholder wants or needs to sell them. Such agreements can also be triggered by the death, divorce, disability, or bankruptcy of a shareholder.

LLCs: As with corporations, LLCs can have potentially unlimited existence if properly constructed. This gives them much flexibility as a business transition tool. Just like corporations, LLCs can change members by the purchase and sale of membership units. LLCs do have an advantage over corporations, though, in that they have much more flexibility in setting restrictions on only on who can and cannot be members of the LLC, but also in restricting the transfer of units. While this can be beneficial in crafting an LLC specifically to hold and transfer a family business, it also requires the business members to use extra caution in crafting the operating agreement, along with any redemption and/or buy-sell agreements associated with the business.

6. Salaries, Dividends, and Other Distributions of Income

Please note that a fuller discussion of some of the issues regarding the distribution of salaries, dividends, and other distributions of income can be found in the discussion of the tax implications of the various entity forms in the following subsections.

Sole proprietorship: Salaries, dividends, and other distributions of income are irrelevant to sole proprietorships, as there is no separation between the business and its owner. While the business owner may maintain separate bank accounts and accounting records for the business and his or her personal accounts, the law makes no distinction between the two. As a result, transfers of payments between the business and individual carry no legal consequences.

Partnership: Partnerships have some flexibility in allocating payments among the partners. Partnerships can pay salaries to the partners (though care must be used in a limited partnership; remember that a limited partner is not allowed to participate in the day-to-day operation of the partnership). Another payment that can be made to partners is a "guaranteed payment," which is similar to a salary but is made regardless of the amount of income of the partnership (as opposed to other payments which may depend on both the income of the partnership and the partner's percentage of ownership in the partnership). Partnerships technically do not have "dividends." However, partnerships also have the flexibility to distribute the income of the partnership either in proportion to the partners' percentage of ownership or out of proportion to that percentage. Making distributions out of proportion to the ownership requires language permitting such distributions in the partnership agreement.

Corporation: Corporations can pay salaries to their officers, and can also pay stipends to their boards of directors. Salaries are also deductible in the case of C Corporations, since they are taxed as a separate entity, but salaries are not tax-deductible for S Corporations. Unlike partnerships, neither C corporations nor S corporations are allowed to make distributions of income, such as dividends, out of proportion with the shareholders' ownership. However, corporations can create different classes of stock (such as "preferred" stock and "common" stock). These classes of stock may be treated differently; for example, preferred stock might receive a dividend in some years that common stock does not. However, within each class of shares, each shareholder must be treated the same in proportion to their share ownership.

LLC: LLCs can pay salaries to their offices and stipends to boards of directors. The tax deductibility of these payments depends on whether the LLC chooses to be taxed like a C corporation or as a partnership. The ability of the LLC to pay dividends and other distributions of income (and to make such distributions out of proportion to the member's ownership percentages) also depends on the tax treatment chosen by the LLC. Generally, though, LLCs have more flexibility than corporations in choosing how to make payments to their members.

C. The Business Entity as Farm Transition Tool

How can a business entity serve as a farm transition tool? As discussed earlier in this handbook, the three reasons so many farms fail to successfully transition from one generation to the next are inadequate estate planning, inadequate capitalization, and a lack of communication and opportunities for those involved with the operation to grow into their new roles. When used carefully, a business entity can help address all three of these concerns.

Business entities can help deal with the estate planning issue by providing another estate planning tool. For example, as discussed below, business entities can be used to help property get an increased tax basis before its contribution to the farm business, thus reducing the future tax liability for the business. Entities can also be used to gradually gift portions of the business to potential heirs without incurring gift tax liability.

Business entities can also help deal with the capitalization of the farm business. Since having a business entity requires a separate set of accounts, it can clarify recordkeeping and make the profitability (or lack thereof) more easily determined. It can also allow for more transparency in how the members of the business invest in it, which can actually encourage additional investment.

Last, but certainly not least, a business entity can create more opportunities for family members to gradually increase their involvement in the farm business. If the founding generation is reluctant to "hand over the reins" to the next generation because they are concerned they don't have enough management experience to profitably lead the operation, a business entity can create the opportunity to slowly increase the amount of management responsibility the next generation has. Gifting or selling small amounts of stock will increase the investment and decision power the recipient has over time, rather than transferring all of the assets at death, as is typically the case.

To explore how the business entity can be used as a farm transition tool, consider the following example. Ward and June currently operate their farm business as a sole proprietorship with Ward as the sole proprietor. They have three children: Tom, Dick, and Harry. Two of them (Tom and Dick) want to come back to the farm while the third (Harry) has little interest in the farm business but has a sentimental attachment to it. Ward and June have decided that they wish to transition the business and now must consider the types of business entity to select based upon a variety of tax and non-tax items. They are considering a partnership, S corporation, C corporation, or Limited Liability Company.

The assets in the business include land, buildings and improvements, machinery and equipment, and livestock. Their home is on the land, but since it will continue to be their home even as the rest of the assets are transferred in the transition plan, it is to be kept separate. In addition to the issue of how to best transition the farm business to the next generation, the family must also consider the income tax implications for the transfer of the assets to the various types of entities.

1. <u>Basic Tax Considerations with Business Entities as Transition Tools</u>

Ward and June must decide what assets they are going to contribute to the entity of choice. The farm's asset information is as set forth in Exhibit 1.

The first item they consider is the land. The contribution of the land into an entity must be carefully evaluated, because it will have some long-term tax implications. The land has considerably appreciated in value since it was purchased for $750,000 (here, the purchase price is the "cost basis" of the land) and is currently worth $3,500,000. This means the land has increased in value ("appreciated") by $2,750,000 ($3,500,000 current market value - $750,000 cost basis = $2,750,000). If Ward and June were to sell the property right now, they would pay capital gains tax on the $2,750,000 appreciation (or capital gain) on the property. Capital gains are taxed at much lower rates than ordinary income but the capital gain still represents a tax cost. On the other hand, if Ward and June held on to the property until their death, the property's cost basis would be "stepped up" to its fair market value at the death of the last party to hold the property. For example, if Ward and June were to die today, the cost basis in the property would be stepped up from $750,000 to the current fair market value of $3,500,000. If the property were then sold, there would be no capital gains tax, since the capital gain on the property would then be zero ($3,500,000 fair market value - $3,500,000 cost basis).

Now, what if Ward and June contribute the land to a business entity? In such a case, the property would keep its cost basis of $750,000 (instead of receiving a stepped up basis at Ward or June's death). If the entity were eventually to sell the property, it would have to pay capital gains tax on the excess of the property's fair market value at the time of the sale over the $750,000 cost basis. In addition, if the entity of choice is a C corporation, capital gain is taxed at the same rates as ordinary income which is much less beneficial than the capital gain treatment received by an individual. None of this may be a problem if the entity is never terminated or if none of the land is ever sold. However, what if Ward and June keep the land in their name and rent it to the entity, they will have source of income as well as the opportunity to allow the cost basis of the land to be stepped up to market value at their date of death. This will allow the transfer of the land to obtain a significant tax advantage at that time. Ward and June could let their estate plan contribute the land into the existing entity with this higher basis.

If Ward or June contribute assets to a business, they likely will receive an interest in the business in return. As discussed above, once assets are contributed to a business, it is the business that owns them, not the people who own interests in the business. Thus, the tax treatment of the assets contributed and the business interest received are handled differently. For example, say June contributed a piece of land to the business entity that was worth $250,000 at the time of the contribution, and that the land was purchased for $200,000. She receives an interest in the business entity valued at $250,000, and the business entity gets a piece of land with a cost basis of $200,000. Further, assume that due to the success of the business and the appreciation of its assets, the value of June's interest at death has grown to $300,000. June's business interest will receive a stepped up cost basis of $300,000. However, the business' cost basis in the asset June contributed will remain at $200,000 (June's cost basis in the property at the time it was contributed).

Should Ward and June decide that they need some additional cash at the time the entity is established, they could sell some assets to the entity instead of contributing them for ownership interest. For example, if they sell all of their machinery and equipment to the entity at its fair market value of $400,000 they would get $400,000 of cash but would have a tax liability since the assets have been depreciated to the point that the adjusted basis is $300,000 ($700,000 cost - $400,000 depreciated value = $300,000 adjusted basis). If Ward and June are in the 20 percent ordinary income tax bracket, the sale of all the machinery and equipment will result in a tax liability of $20,000 due to a taxable gain from the sale of $100,000 [($400,000 sale value - $300,000 adjusted basis = $100,000 taxable gain) x 20%]. It is important to work with a tax advisor to evaluate all the potential income tax consequences of the sale transaction.

Partnerships, corporations, and LLCs each carry their own unique tax considerations when family members contribute assets to the business entity. These considerations are discussed with each business form below.

Another tax issue is the self-employment tax. Most taxpayers working for an employer have FICA and Medicare withheld from their wages. The amount withheld is matched by their employer. Consequently, they will receive retirement and medical benefits when they reach retirement age. They are also entitled to disability and survivor benefits. The self-employed individual must pay self-employment (SE) tax to be entitled to similar benefits. This is paid when they file their federal income tax return. The SE tax rates equate to both the employer's and employee's share of FICA and Medicare.

Any income other than salary or wages is "earned income." Therefore, a person operating a farm or ranch they own or rent must pay SE tax on the profits. A person must "actively participate" in the operation to have SE income. Individual taxpayers that are involved in a business entity that is a sole-proprietorship, partnership, an S corporation or an LLC electing to be taxed as a single member LLC, partnership or S corporation will be subject to the SE tax. Individuals that are employees of a C corporation or an LLC electing to be taxed like a C corporation are not subject to the SE tax since the corporation pays the employee's portion of the FICA and Medicare tax due. For more detailed information concerning the SE tax and rules visit the [RuralTax.org](http://ruraltax.org) website using the following link: http://ruraltax.org/htm/tax-topics.

2. Partnerships as Transition Tools

The creation of a partnership – specifically a limited partnership – between Ward, June, Tom, Dick, and Harry is one possible solution. A limited partnership would allow the non-farming son (Harry) to have an interest in the business without the issue of his personal assets being at risk. The general partners will include Ward, June, Tom, and Dick but not Harry. Harry would instead be the limited (non-managing) partner. Harry could receive a guaranteed payment from the business or he could receive a share of the profits; since he is a limited partner, his income will not be subject to self-employment tax since limited partners will generally not be participating in the business.

The partnership agreement formed by the family will need to include the terms for the sharing of partnership profits, gains, losses, deductions, and tax credits among the general partners. It will also explain how Harry will benefit from the business. The income generated from the business will be taxed to the partners, not the partnership. Income received by the partnership will be taxed even if the partnership retains the income and does not distribute it to the partners. In addition, losses and tax credits will be passed to the partners as well. The partnership agreement can also provide special allocations of income items such as rent for the land versus ordinary income from the sale of crops or livestock.

When the partners contribute assets to the partnership, the contribution is not a taxable event. For example, consider again June's contribution of a piece of land with a cost basis of $200,000 (her original purchase price) and a current fair market value of $250,000. If June were to sell the land to the partnership, she would have a taxable capital gain of $50,000 (the $250,000 current fair market value minus her $200,000 cost basis in the property). However, if she only receives a partnership interest in return for her contribution (that is, she does not receive cash for the sale but only an interest in the partnership), there is no taxable event, and no capital gains tax is owed.

The contribution of machinery, equipment, and the breeding livestock plus the value of any assets contributed by Tom and Dick would then be used to determine the partnership interest for the various parties. It must be noted that no partner would want to own 50 percent or more of the interest in the partnership since the sale, exchange, or estate transfer of the 50 percent partner's complete interest will terminate the partnership.

A partner may acquire a partnership interest by providing services. If the contribution of services allows the partner to get an interest in the assets or capital that has been contributed the partner will be taxed on the value of the interest received but if the contribution of services is to be paid from future profits the taxes are assessed when profits are received as payment.

It is important to work with a qualified accountant when establishing a partnership since the tax law associated with partnerships is extremely complicated. It is also important to work with a qualified attorney to make sure the partnership agreement is drafted properly to ensure that the desires of all the parties involved are met.

Finally, it is important to note that only Harry, the limited partner, has any liability protection through the limited partnership arrangement. Ward, June, Tom, and Dick are all jointly and severally liable for the partnership. It should also be noted that Harry runs the risk of losing his limited partner status if he becomes too involved with the day-to-day operations of the business.

3. Corporations as Transition Tools

Much thought must go into the decision to establish a corporate entity. For the purpose of farm business transitions the discussion will be limited to C corporations and S corporations. Both entities will result in the owners receiving stock representing their ownership. A corporation will also limit the liability of all shareholders unlike a partnership. The creation of a corporation requires the filing of articles of incorporation, the creation of by-laws, and the holding of regular corporate meetings with minutes of those meetings being kept. In addition, an annual franchise tax must be paid.

Corporate shares, whether C corporation or S corporation shares, can facilitate the transfer of the business from parents to children as well as others such as grandchildren over time. It is quite simple to transfer shares of stock to others since the signing of a share certificate accomplishes the transfer. C corporation stock can be sold, gifted, or inherited as well. Creating a sizable number of shares will make gifting easier as well as making sure that the gifts are below the annual gift tax excludable amount. Further, a large number of shares provides more flexibility to gradually increase family members' ownership over time, giving them the ability to slowly grow into more and more important roles in the corporation.

C corporation: A C corporation is taxed separately from its shareholders. This provides some advantages and disadvantages for tax purposes. One issue is the impact of "double taxation." If the corporation makes a profit, that profit is reported on the corporation's tax return at the corporation's tax rate. Then, if the corporation pays dividends and/or salaries to shareholders, those shareholders report those payments on their personal tax returns and pay tax at their personal income tax rate. Thus, payments to the shareholders effectively have been "double taxed" – once at the corporate level, and again at the individual level. Upon learning this, many people wonder why anyone would choose the C corporation form, but there are potential tax advantages to it. One of the major benefits of a C corporation is that fringe benefits such as health plans and retirement plans paid for the benefit of the employees are deductible by the corporation. To deduct these costs, the corporation must pay reasonable salaries to all employees but the salaries paid are deductible by the corporation, avoiding self-employment taxes. Thus, depending on the circumstances, the shareholders might actually receive more after-tax value by using a C corporation than an entity that is not separately taxed.

If and when the family contributes assets to the C corporation, the contribution of assets will result in the contributor receiving shares in the business. Shareholders can be given voting or non-voting shares. The voting shares can be held by those family members active in the day to day business operations (Ward, June, Tom, and Dick) and non-voting shares to the inactive members (Harry). The shares of stock then represent the ownership by the shareholders.

The contribution of property in exchange for shares of stock does not necessarily result in a taxable exchange. A taxable exchange occurs when the transferor receives shares as well as other property in the exchange. If shares are the only items received, no taxable event occurs. If everyone, as a group, that transfers assets into the corporation controls at least 80 percent of the voting stock and at least 80 percent of all other classes of stock then the basis of all the assets contributed will be the same after the transfer as the basis before the transfer which also ensures that a taxable event is avoided. It is a rare situation where the individual shareholders will not control at least 80 percent both voting and other classes of stock. This rule is most often triggered when one corporation owns another corporation; this is not common in a closely-held corporation as presented in this material.

S corporation: An S corporation avoids the double taxation issue since it is not taxed separately. All the income, expenses, gains, and losses pass through to the shareholders, who report these items on their individual tax returns. Thus, an S corporation is taxed, in effect, like a partnership. For this reason, the use of an S corporation can have an advantage over a C corporation if the business will experience periods of losses (as can happen in agriculture), since those losses can be passed along to the shareholders and deducted from their taxes.

Like a C corporation, the contribution of assets to the S corporation most often results in the in the contributor receiving shares of stock. However, an S corporation can only have one class of stock, which is common stock. This generally implies that all shares of stock have exactly the same rights for each of the holders. In other words, each share will receive the same distribution of profits in the corporation. Therefore there cannot be any discrimination from one shareholder to another. In our example, this might be problematic since Harry is probably playing a much different role and making different contributions to the operation and growth of the farm than Ward, June, Tom, and Dick.

This common stock can be either voting or non-voting. The voting shares can be held by family members active in the day to day business operations (Ward, June, Tom, and Dick) and the income that is generated will be subject to self-employment tax for those individuals who "materially participate" in the farm business. "Material participation" requires that the individual be actively involved in the production of crops and livestock, take a management role, and be actively involved in the business. The non-voting shares are again received by Harry and his income is not subject to self-employment tax since he is not materially participating in the business.

One issue with an S corporation is the need for more detailed bookkeeping to document each individual's basis in their stock, document adjustments in their capital accounts, and to determine the tax liabilities associated with their distributions. This is due to the fact that S corporation income is not taxed at the corporate level. All the income, deductions, losses, and gains flow from the entity to the shareholders. The amount of losses and deductions that a shareholder can take is limited the adjusted basis of the shareholder's stock. A variety of items will increase and decrease a shareholders basis. Therefore it is necessary to do a good job of bookkeeping because income will increase the basis while losses will decrease the basis. Basis is increased when a shareholder contributes cash or other assets to the entity. All of these must be documented and the tax information provided to all shareholders must contain this information as per IRS regulations.

Again, the contribution of property in exchange for shares of stock does not necessarily result in a taxable exchange. A taxable exchange occurs when the transferor receives other property as well as stock in the exchange. If stock is the only item received, no taxable event occurs. If everyone, as a group, that transfers assets into the corporation, controls at least 80 percent of the voting stock and at least 80 percent of all other classes of stock then the basis of all the assets contributed will be the same after the transfer as the basis before the transfer which also ensures that a taxable event is avoided (this is the same 80 percent rule as discussed with C corporations above).

4. <u>LLCs as Transition Tools</u>

As discussed above, LLCs are very flexible entities. The creators of an LLC can choose to have the entity taxed as an individual (a single member LLC also referred to as a disregarded entity),[ii] a partnership, or separately taxed like a C corporation. Thus, an LLC allows for a greater level of flexibility in management, control, income distribution, and taxation than either partnerships or corporations.

An LLC may be most beneficial in the transition of the farm business when it chooses to be taxed as a partnership. This avoids the double taxation issue of a C corporation, the S corporation limitations,[iii] and compensation and income distributions can be disproportionate among the various members if they so choose. An LLC's operating agreement can establish that each individual member can receive specific types of income or payments, receive voting or non-voting rights, and management rights can be reserved for only certain members. The operating agreement can easily be amended as the business transition progresses.

LLCs do not have stock that is issued to owners contributing property; instead, they issue membership units. As with corporations, the contribution of property to the LLC is not a taxable event so long as the member receives an ownership interest instead of receiving other property. Managing members in the LLC will be subject to self-employment taxes.

As with corporate stock, the membership units in an LLC can facilitate the transfer of the business from parents to children and grandchildren over time. It is simple to transfer a percentage of a person's interest and also keep the value below the annual gift tax exclusion amount. The interest can also be sold, gifted, or inherited as well. Thus, as transition tools, LLCs have virtually all the advantages of corporations, with additional flexibility.

5. <u>Single-member LLCs with Land and Minerals</u>

Land and mineral interests can present special challenges in transition planning. Since these assets can sometimes appreciate significantly in value, the tax treatment of that appreciation is an important factor to consider. At the same time, many land and mineral owners also want to protect such assets from liability risks. The following discussion examines the use of an additional entity – the single-member LLC – to hold assets that would benefit from a step–up in fair market value at the date of death of the owner, and that also require some measure of liability protection.

Before discussing the advantages of the single-member LLC, it is useful to examine the potential problems posed by other entity forms in this context. Using a partnership, corporation, or a multi-member LLC to transfer land or minerals can "trap" the low cost basis of the assets in the entity. If there is a need or desire to sell the assets, the capital gain tax can be significant.

To illustrate the capital gain issue, assume that a 160 acre parcel that was contributed to the entity when it was created is to be sold. The fair market value is now $2,500 per acre (for a total current fair market value of $400,000 for the entire 160 acre parcel) and the cost basis of the parcel was $500 per acre (for a total cost basis of $80,000). If the property were to be sold, the amount subject to capital gain tax treatment is $2,000 per acre ($2,500 current fair market value per acre minus $500 cost basis per acre) or $320,000. If the capital gain tax rate for the partners is 20 percent, the amount of tax owed on the sale would be $64,000.

Now, what if the contributor did not contribute the land when the entity was created, but held it until his or her death and transferred it to the entity as part of his or her estate plan? In this scenario, the property would receive a stepped-up basis to the fair market value at the date of death of the contributor. Assume that the fair market value of the land was $2,250 per acre at the date of death; this now represents the stepped-up basis of the property. If the partners now sell the land for $2,500 per acre (and assuming the same 20 percent capital gain tax rate), the capital gain per acre would be $250 per acre ($2,500 fair market value per acre minus the $2,250 cost basis per acre). Now the total amount of tax on the gain would be $8,000 compared to the $64,000 without the stepped-up basis.

While holding onto the land until death allows for stepped-up basis, there may be a desire to obtain the liability protection provided by an entity like an LLC. The creation of a single-member LLC (a disregarded entity for tax purposes) allows the land to be held by the parents and still have the LLC's liability protection. From the standpoint of both income and estate taxes, the assets put into a single member LLC are still controlled by an individual (the transferor) who pays the income tax generated from the assets and also controls them from an estate tax perspective. As a result, the property in the single-member LLC is eligible for a step-up in basis at the date of death.

D. The Authors Promised to Talk about Family Limited Partnerships

For years, family limited partnerships were often touted as an estate planning tool, particularly for farms. Indeed, some were even called "farm limited partnerships" or "farm family limited partnerships." The reasons these partnerships were promoted as a farm estate planning tool were that in an era of much smaller federal estate tax exemption amounts ($650,000 as recently as 1999), the asset-intensive nature of agricultural operations often required the lowering of the apparent estate value though the non-marketability and minority discounting features of a limited partnership. The problem was that at least one partner had to be a general partner with unlimited liability, and limited partners could not have input into management decisions for the operation (a frequently-violated restriction). Additionally, the later 1990s saw the rise of the LLC, which could accomplish everything a family limited partnership could (including the minority and non-marketability discounts and potential limitations on management input) while providing limited liability to all owners. For almost all cases, the LLC now provides superior functionality to the family limited partnership.

E. Conclusions Regarding Business Entities and Transition Planning

Business entities can provide a number of advantages for a farm business, both in and of itself, and in the context of preparing the business for a transition. As this discussion has demonstrated, there are many, many factors to consider in selecting a business entity for the farm business. It is critical to determine what the goals and objectives of those that will be involved in the business as well as the other heirs. The selection of an entity should be thoroughly analyzed with the help of a qualified legal and tax professionals. With careful work, the farm business entity can help preserve the farm business for generations to come.

III. PREPARING YOUR FARM AND RANCH CLIENT FOR THE UNEXPECTED ELEMENTS OF TRANSITION PLANNING

Simply getting most farm and ranch clients to embrace the transition planning process is an accomplishment in and of itself. Creating a robust farm transition plan for your client can create tremendous value and peace of mind for all stakeholders involved with the operation, and can protect the farm's integrity against a number of contingencies. However, even greater value can be created by discussing a number of "what if" scenarios to help the client contemplate a number of contingencies they may not want to contemplate. By doing so, though, both attorney and client can prepare for some of the most disruptive events that can befall the farm operation.

A. The What If Scenarios

Clients and attorneys play the averages, whether they do so consciously or not. For example, they both assume that the husband of the most elder generation will be the first stakeholder to pass. Statistically, this is the most common scenario, with approximately 80 percent of widowed spouses being the wife. AARP, 2001. However, all of us know scenarios where this was not the case, and spouses, children, or grandchildren pre-decease the "CEO" of the farm operation. No one likes to contemplate such situations, but they happen. To ensure the long-term viability of the operation, a truly robust transition plan must embrace these contingencies and provide means of handling them with a minimum of disruption to the operation and, inasmuch as possible, to the family as well.

In discussions with the client, the farm transition planning attorney should ask the client's desired outcomes with respect to their personal holdings and the farm business overall in the event of a number of situations, including:

- Their death first among the key stakeholders
- The death of their spouse before them
- The death of a child or grandchild before them
- Their own prolonged disability
- The prolonged disability of a key stakeholder

Many farmers and ranchers do not consider these scenarios since they do not perceive them to have a significant impact on the administration of their own estate. However, this estate-focused approach ignores the potential negative impacts these alternatives pose for the farm operation. For example, the death of a child means not only an emotionally devastating loss but potentially a significant loss of human resources need to maintain the profitable operation of the farm or ranch. A long-term disability may, perversely, result in an even more significant financial drain on the operation than a death. Thus, a farm transition attorney at the top of his or her game will help the client think through these issues and how they may be addressed.

B. Insurance Tools

Many farmers and ranchers overlook life insurance as a transition planning tool, but it can provide significant flexibility in satisfying a number of objectives. Life insurance frequently provides support to a surviving spouse and/or dependents. For this reason, life insurance may be even more important to *young* farm families than older families. Young farmers and ranchers are often much more heavily leveraged than their older counterparts, and their family may face very real financial challenges if the principal wage-earner in the family dies without sufficient liquid assets to satisfy remaining debts (to say nothing of providing enough liquidity for the support of surviving family members).

The death of any key stakeholder will, at a minimum, reduce the amount of human resources available to keep the farm operating profitably. That loss of human capital could dictate a reduction in size or the hiring of non-family employees to compensate. Further, if the stakeholder's personal credit was key to maintaining financing for the operation, lenders might demand additional security or a paydown of debts. Death may be an accelerating event in the case of many loans. As a result, clients should work with both their attorney and a financial professional to determine how life insurance may be used to manage these risks. Beyond managing the financial risks of the death of a farm stakeholder, life insurance may also be used to enhance the liquid non-farm assets available for distribution to an off-farm heir as well. For more information on these and similar strategies, see DONALD H. KELLEY, DAVID A. LUDTKE, AND BURNELL E. STEINMEYER, JR., ESTATE PLANNING FOR FARMERS AND RANCHERS, §11.7 (2002).

Life insurance is only one insurance tool available for dealing with contingencies in farm transition planning, though. "Key man" policies may be purchased by the farm business to protect against the financial risks attendant to the loss of a stakeholder, including the liquidity needs of purchasing the business interest from the stakeholder's estate (which, by the way, may be a mandatory triggering event under the operation's buy-sell agreement as discussed in Section II.A.1. above). Disability policies may provide much-needed cash to support a family in the event of an injury.

Long-term care insurance is another often-overlooked tool for farm families. The Department of Health and Human Services estimates 70 percent of people turning age 65 can expect to use some form of long-term care during their lives (DHS, "Who Needs Care," http://longtermcare.gov/the-basics/who-needs-care/, last accessed April 23, 2016). Many farmers and ranchers are concerned that long-term care will eat into the asset base of the farm, and try to engage in complex Medicaid planning strategies that can restrict access or control of farm assets. Volumes have been written both on the complexities of Medicaid planning and on what can go wrong in those efforts. While the point of this article is not that Medicaid planning should be avoided, the authors do argue that long-term care insurance can mitigate many of the financial risks associated with the need for long term care, and may be acquired for a relatively modest price if purchased early enough.

C. Entity Operating Agreements

The functionality of business entities in the transition planning process has already been discussed thoroughly above, but in the context of the current discussion, it is worth re-emphasizing that operating agreements for entities (and particularly, the buy/sell provisions of those agreements) must be carefully crafted so they can handle a number of contingencies such as the death or disability of a stakeholder. Connecting to the immediately previous topic, these agreements should also point to the source of liquidity to be used if such an event triggers the need to purchase ownership interests, or to point to assets first to be sold if a down-sizing is needed.

D. Business Records

Producers like to produce; frequently, they do not like keeping records. This is a broad generalization, and many top producers achieve that distinction by keeping meticulous records to improve their performance and benchmarking. Still, many farmers and ranchers keep a lot of records in their head or in places not known to any other stakeholders.

In the event of the sudden, unexpected death or disability of a stakeholder, good farm records can be critical to keeping farm operations going without undue disruption. Inventory records for commodities and supplies and the locations thereof are necessary to allow marketing and maintenance functions to continue. This is doubly true for livestock operations; where knowing herd locations and feed requirements in a timely matter is crucial. Records of financial accounts are vital for the same reason, though they must also be accompanied by measures such as durable powers of attorney to give trusted parties access to the funds if necessary.

Though it may seem trivial, simple things such as a stakeholder's contact list and electronic account access can be hugely important in continuing operations after a death or disability. For many producers, the entirety of their contact records and potentially much of their farm records may be kept on a mobile phone. Regular backups of that phone to a desktop, laptop, or cloud service may be needed to provide access to that information if needed (particularly since phones can be damaged or lost in farm accidents), and another stakeholder should have the ability to access backups if needed. Similarly, a record of all electronic accounts and their logins and passwords should be kept in a secure location accessible by another stakeholder.

Records of business relationships may be another critical item. It is an essential first step for stakeholders to record their key vendors and customers, but that alone is insufficient. Potential farm successors need to be introduced to these contacts; current stakeholders should take an active role in cultivating relationships between successors and these contacts.

E. The "Hit by a Truck" Plan

A key stakeholder in the farm or ranch operation passes away suddenly, with no warning. How does the farm operate the next day? The time to contemplate this is not after it has happened. In such an event, all other stakeholders are likely paralyzed with shock and grief at the loss of a loved one. Military personnel and emergency services staff know the key to functioning well in emergencies is planning before the need – knowing what you have to do before you have to do it, and then training so that critical responses become automatic.

A thorough set of farm records is crucial to this process, but more is needed. For each critical stakeholder, a plan is needed to specify exactly what must be done to continue farm operations in their absence. The attorney can engage with the client, business advisors, and other experts to craft this plan which should detail not only the farm operations to be undertaken, but also who can be asked for technical assistance or simply "boots on the ground" to help, a list of records that must be kept for farm operations, and a list what can be done without the need for approval by other stakeholders, what must be done only after consulting with relevant professional advisors, and what activities should only be undertaken with the advice of an attorney, accountant, or with approval of the court overseeing the estate of the deceased party. The plan's simplicity or complexity depends largely on the simplicity or complexity of the operation involved.

The plan must be continually updated as farm operations change, and the plan should be kept where it is accessible to anyone who needs it.

F. Helping Clients with the Loss of a Loved One

In the agricultural practice of a small town, our clients are frequently more than just clients. They are our friends, fellow members of our church, parents of our children's schoolmates, members of the same local cooperative, and so on. Even if the relationship with the client is simply that of client alone, the loss of a family member often compels us to do more than send a card.

What helps? In many small towns, the good intentions of many caring neighbors sometimes turns the home of the bereaved into something of a bed and breakfast. Guests at mealtimes must be fed (and try to time your visit to avoid mealtimes), and out-of-town family members need a place to stay. Consider providing food (that is not a casserole – the lead author assures you that within hours there will be more casseroles at the home than can possibly be consumed within a human lifetime) that is easily frozen or refrigerated and conveniently reheated. Sandwich ingredients and other convenience foods may also be appreciated. Since refrigerated storage may be used up quickly, providing ice and the loan of an ice chest or portable refrigerator may be valuable. Disposable plates, cups, utensils, and napkins ease the burden of dishes for the family. Gift cards for local restaurants, particularly those that deliver, can be a good idea, as the family may simply want to get out of the house for a while. Don't be afraid to offer some comfort foods and indulgent snacks. The family may choose to eat a few feelings in the form of potato chips or share a fond memory over some ice cream; they can walk off the calories at a later date.

If you are close to the family, offering a guest room for overnight visitors can help ease the crowding, burden, and expense of such visitors.

With support coming in, a multitude of thank you notes are needed. Gifts of thank you notes and postage can help with this.

Visitation can be welcomed, but timing can be crucial. If the client is a close personal friend, do not hesitate to offer your support. Do not mention any of the legal mechanics unless there are items that simply must be attended to immediately; simply let the bereaved know that you are ready to assist them when they are ready. Keep your visit brief to express your support; longer visits may be more appropriate a scheduled viewing or visitation at the funeral home or church; of course, if the family requests you stay longer, don't feel like you must cut the visit short.

The family may have a number of visitors prior to the funeral, but unsurprisingly there may be few after the funeral. The funeral marks the beginning of the long and potentially very lonely "long haul" of dealing with grief, and a visit a few days *after* the funeral can do a great deal to help the family remember there are those that are there for that long haul. If the only relationship with the family is that of client alone, simply let the family know of your support and that you are available whenever they feel ready.

Human empathy compels many of us to form some sort of connection with the bereaved, and sometimes the words "I know how you feel" slip out. In the early days following a loss, no one wants to hear that. Whether true or not, their loss feels very uniquely and intimately theirs. If indeed you have experienced a similar loss, the time to access that shared experience is later, and with the introduction "I know I can't know exactly how you felt, but when something similar happened to me, I felt…" Well-meaning assurances that "he's in a better place" or "this will work out for the good" can trivialize the loss; consider instead simply saying "our hearts are heavy for you" to express your compassion and offer your thoughts and prayers.

IV. CONCLUSION

A wise cowboy once said "there are two things that scare horses: things that move and things that don't." Similarly, there are two things that can derail a farm's successful transition: things that are easily foreseen and things that aren't. Fortunately, working closely with clients and engaging them in meaningful discussions with their stakeholders allows the farm transition attorney to craft transition plans that provide a path forward for deliberate, planned changes to the operation, as well as contingency plans that preserve the integrity of the operation such the unexpected occur.

EXHIBIT 1: Overview of Legal Form Choices (Jones and Langemeier)

Type	Individual Liability	Continuity	Management control	Taxation	Capital acquisition
Sole Proprietorship	Unlimited	None	Proprietor	Individual	Very Limited
General Partnership	Unlimited	None	Partners	Individuals	Limited to Partners
Limited Partnership	Limited (for limited partners)	None	General Partners	Individuals	Limited to Partners
C Corporation	None (unless a law is broken)	Perpetual	Board	Corporate Level (possibly double)	Stock issue
S Corporation	None (unless a law is broken)	Perpetual	Board	Individual	Stock issue
Limited Liability Company	None (unless a law is broken)	Dictated by founding documents	Members	Individuals	Flexible Alternatives Possible

EXHIBIT 2: Inventory Profile for Ward and June's Operation

Asset Description	Fair Market Value	Cost Basis	Accumulated Depreciation	Adjusted Basis
Land	$3,500,000	$750,000	-	$750,000
Buildings & Improvements	$500,000	$800,000	$650,000	$150,000
Machinery & Equipment	$400,000	$700,000	$400,000	$300,000
Raised Breeding Livestock	$350,000	$0	-	$0
Purchased Breeding Livestock	$20,000	$25,000	$15,000	$10,000
Market Livestock	$80,000	$0	$0	$0
Totals	$4,850,000	$2,275,000	$1,065,000	$1,210,000

EXHIBIT 3: Transition Planning Inventory

Adapted from
"Items to Consider for a Will or Trust" by Bruce Moates
"The Family Love Letter" by AXA Equitable Financial Advisors
"Estate Planning Inventory" by Mike Hardin

My Family Members

For each person, include the contact information for the person, any special needs the person may have, if you are a guardian for the person, and whether they are the beneficiary of any trusts or other instruments.

- ☐ Spouse
- ☐ Child (children) (include spouses)
- ☐ Grandchildren (include spouses)
- ☐ Parent
- ☐ Pets

My Emergency Contacts

For each person you would want contacted, include name, mobile phone number, home phone number, address, and relationship. Also consider entering each person in your mobile phone with a listing of ICE ("In Case of Emergency) 1, ICE 2, ICE 3, etc.

My Important Numbers

Include numbers for yourself and your spouse

- ☐ Social Security number
- ☐ Drivers license number
- ☐ Passport number
- ☐ Medicare number
- ☐ Employer identification numbers (EINs) for any business entities owned
- ☐ Any other identifying numbers

My goals and objectives

- ☐ What standard of living do I want to provide for my surviving spouse?
- ☐ What type of gifts do I want to make to my family members?
- ☐ What type of gift do I want to make to charities, churches, and other community organizations?
- ☐ Is it important that my farming operation stay in one piece?
- ☐ Is it important that the farming operation be continued by a family member?
- ☐ What are my goals for the future of the farm operation?
- ☐ If some of my goals come into conflict, what values should guide the decision as to how to proceed?

My financial status

- ☐ Current balance sheet
- ☐ Current income statement
- ☐ Current cash flow statement
- ☐ Whole farm plan
- ☐ Operating budget for farm
- ☐ Personal monthly budget

My advisors

Include contact information for each

- ☐ Financial planner / investment advisor
- ☐ Stock broker
- ☐ Retirement plan administrator
- ☐ IRA administrator
- ☐ Estate planning attorney
- ☐ Business attorney
- ☐ CPA / accountant
- ☐ Former employers
- ☐ Mortgage holder
- ☐ Lenders
- ☐ Banker
- ☐ Primary care physician
- ☐ Specialist physician
- ☐ Farm consultants
- ☐ Others

My Assets

- Real property
  - ☐ Surface and mineral deeds for all real property
  - ☐ Abstracts for any property interests
  - ☐ Surface and mineral leases for all real property
  - ☐ Any additional agreements for land use
    - o Wind energy leases/easements
    - o Mineral leases
    - o Hunting leases
    - o Easements/right of way agreements
  - ☐ Property that is leased by you
    - o Copy of lease agreement
    - o Contact information for lessor
- Financial assets

  Include account number, contact information for holding institution, beneficiary designations (such as payable on death provisions), whether account is jointly held (and if so, with whom) and amounts
  - ☐ Savings accounts
  - ☐ Checking accounts
  - ☐ Money market accounts
  - ☐ Certificates of deposit
  - ☐ Custodial accounts
  - ☐ Savings bonds
  - ☐ Social Security updated statement (call 800-722-1213)
  - ☐ IRA documentation:
    - o Traditional IRAs
    - o Rollover IRAs
    - o Spousal IRAs
    - o Roth IRAs
    - o SEP IRAs
    - o SIMPLE IRAs
    - o Beneficiary IRAs
  - ☐ Qualified retirement plans
    - o 401(K) or 403(B) plans
    - o Profit sharing plans
    - o ESOP plans
    - o Pension plans

- Other qualified plans
- ☐ Section 529 Education Plans

[Financial assets, continued]

- ☐ Stock options / stock purchase plans
- ☐ Mutual funds
- ☐ Annuities
- ☐ Brokerage accounts
- ☐ Individual stocks
- ☐ Bonds
- ☐ Deferred compensation from employer
- ☐ Military retirement benefits
- ☐ Military survivor benefits
- ☐ Installment sale contracts owed to me
- ☐ Debts owed to me
- ☐ Legal judgments / settlements owed to me
- ☐ Other items
  - Frequent flyer miles
  - Retailer reward accounts

- Business interests
  - ☐ Partnership agreement / by laws / operating agreement for entity
  - ☐ Stock or ownership certificates
  - ☐ Copy of any buy/sell or ownership agreements for interest
- Personal property and non-financial assets
  - ☐ Automobiles (along with copy of title)
  - ☐ Farm equipment (serial numbers and other descriptive information)
  - ☐ Farm inventories
    Include descriptions, values, and location where kept
    - Livestock
    - Crops
    - Supply inventories (feed, seed, chemicals, other inputs)
    - Pre-purchased inputs, if not yet delivered (include vendor conact)
  - ☐ Recreational vehicles (titles or serial numbers and descriptive information
    - Boats
    - Motorcycles
    - ATVs
    - Utility vehicles
  - ☐ Aircraft (along with copy of title)
  - ☐ Household goods
    - Jewelry
    - China / silverware
    - Picture albums
    - Antiques
    - Collections (coins, stamps, other items)
    - Books
    - Art
    - Electronics
    - Furnishings
    - Kitchen goods
    - Firearms
    - Sporting / hobby equipment
    - Clothing / furs

My Liabilities

- Debts
  For each debt, list amount owed, contact information for creditor, any insurance tied to the debt, copy of the loan agreement, and any other information or documentation available.
  - ☐ Mortgage
  - ☐ Automobile
  - ☐ Equipment
  - ☐ Revolving credit for business (i.e. operating line of credit)
  - ☐ Mortgage-backed line of credit (i.e. home equity loan)
  - ☐ Credit card
  - ☐ Store credit
  - ☐ Personal guaranties for loans
  - ☐ Co-signed loans
- Recurring payments
  Include contact information for service providers
  - ☐ Vehicle / equipment leases
    - o Include copy of lease agreement
  - ☐ Utilities
    - o Electric
    - o Gas
    - o Water
    - o Garbage/recycling
    - o Telephone (landline and mobile)
    - o Television (satellite / cable)
    - o Internet
  - ☐ Subscription services (magazines, news & information services)

My Insurance Policies

For each insurance type, include a copy of the policy, the policy number, contact information for the carrier, the owner and beneficiary of the policy, the face value of the policy, any cash value, any loans against the policy, and the premium schedule for the policy.

- ☐ Life insurance
- ☐ Disability insurance
- ☐ Long term care insurance
- ☐ Health insurance
- ☐ Specific ailment insurance (such as cancer policies)
- ☐ Vision care plans
- ☐ Dental care plans
- ☐ Medicare insurance
- ☐ Prescription drug plans
- ☐ Medigap insurance
- ☐ Other insurance policies

My Important Documents
For each, include information about where the original document is located, and the date the document was executed. You may also want to indicate if such a document has *not* been executed.

- ☐ Will
- ☐ Living trust
- ☐ Advance directive for healthcare
- ☐ Living will (may be part of advance directive for healthcare)
- ☐ Organ donation documents (may be part of advance directive for healthcare)
- ☐ Medical power of attorney (may be part of advance directive for healthcare)
- ☐ General power of attorney
- ☐ Limited power of attorney
- ☐ Life insurance trust
- ☐ Charitable trust
- ☐ Minor trust
- ☐ Section 529 education plan
- ☐ Custodial account
- ☐ Guardianship papers
- ☐ Family partnership documents
- ☐ Partnership, corporation, or LLC documents
- ☐ Real property deeds
- ☐ Marriage license
- ☐ Domestic partner agreement
- ☐ Cohabitation agreement
- ☐ Pre-nuptial agreement
- ☐ Post-nuptial agreement
- ☐ Divorce or separation agreement
- ☐ Child support agreement
- ☐ Birth certificates
- ☐ Adoption papers
- ☐ Automobile title
- ☐ Boat/airplane title
- ☐ Citizenship papers
- ☐ Burial or pre-need agreement
- ☐ Life insurance beneficiary form
- ☐ Military discharge papers
- ☐ Employment or contractor contract

My Digital Estate

For each item, include the applicable user ID, password, and any other information needed for access

- ☐ Email accounts
- ☐ Facebook
- ☐ Twitter
- ☐ YouTube
- ☐ Instagram
- ☐ Other social media site or service
- ☐ Financial software or service (Quicken Online, Mint, etc.)
- ☐ Cloud storage (Evernote, Dropbox, iCloud, etc.)

My funeral arrangements

- ☐ Desired speakers
- ☐ Desired officiant
- ☐ Desired program / order of worship
- ☐ Specific people to be notified of your death and/or funeral
- ☐ Specific people you wish not to attend your service
- ☐ Particular songs, readings, or other elements of your service
- ☐ Specifications for burial or cremation
- ☐ Location of burial plot
- ☐ Who is to receive possession of cremated remains
- ☐ Desired wording of obituary

Implementing My Plans

In the event of my death or disability…

- ☐ Do I have financial resources available for my spouse and children so they can meet their living expenses while the estate is being settled?
- ☐ Does my operation have the financial strength (both in terms of solvency and liquidity) to meet my objectives?
- ☐ Have I trained two or more people to manage the day-to-day operations of my farm, if they needed to do so *today*?
  - o Have I walked them through the day-to-day operations?
  - o Do the people who will be handling my affairs have access to the suppliers, vendors, and professionals they will need to keep the operation going for as long as needed?
  - o Do they know where the land, livestock, supplies, equipment are located?
  - o Have I spelled out what actions can be taken without any permissions? What actions require consulting with a professional (such as an attorney or accountant)? What actions require approval of the court?
  - o Do they understand not only *how* the operation runs, but *why* certain decisions are made?

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[i] For limited partnership registration forms and procedures, visit the Oklahoma Secretary of State's website at https://www.sos.ok.gov/business/forms.aspx.

[ii] For purposes of a farm transition the following discussion will not cover the single member LLC.

[iii] That is, being limited to one class of stock and having no more than 100 shareholders.