

Beginning Farmer: Transfers, Agreements & Structures Some Examples

I. Transferring Assets

There are many ways to transfer assets and no one way works for every situation. Let's look at some of the possible legal tools to help with transfer of assets.

Outright Sale

Owner of property sells it outright to beginning farmer or rancher. Full purchase price is paid. Does beginner have the resources to buy it? Can he or she service (cash flow) the debt? Does the seller want the tax consequences of the sale, i.e. capital gains or recaptured depreciation tax liability?

Installment Sale

Owner sells asset to beginner over time. For example, sale of land, cow herd or machinery over a period of years. May help with beginner's cash flow, perhaps through lower interest rate and/or longer term of repayment than commercial loan, and through timing of payments to coincide with generation of money. Will asset depreciate faster than payment term, leaving seller undersecured, should something go wrong? Seller has to report all recaptured depreciation in the year of the sale, although payments are spread out. If buyer and seller related, capital gains (if any) may also be taxable in year of sale. For third parties, capital gains taxed in year payments are made. Interest payments taxed as received.

Gradual Sale

Sale of single assets over period of years. For example, sale of one piece of machinery each year, or sale of fixed number of cattle each year. Develop plan that shows which assets will be sold and in what year. Helps with cash flow of beginner. Number of items sold can be adjusted each year to fit with cash flow of beginner. Recaptured depreciation and capital gains spread out over several years.

Leasing

Lease often combined with one of the preceding asset transfer tools. Lease payments should cover owner's depreciation (approximately 8-10% of fair market value) and cover return on investment (6-8% of FMV) or, lease payments might typically equal 15-20% of FMV. Renter pays for fuel, repairs and maintenance; owner pays for capital improvements, i.e. major overhauls or engine replacements.

Lease with option to buy allows beginner to use equipment for a period of years and then to buy it. May help beginner cash flow, and does not lock beginner in to a purchase from the start; chance to see how things work out. Lease payments are taxed as received by

owner and are business expense to beginner. Owner depreciates. Option to purchase is a sale with tax consequences for capital gain and recaptured depreciation. Under lease with option to buy, there needs to be a final purchase price equal to the FMV at time of purchase.

Gift

A person can gift up to \$12,000 each year to another person without tax consequences. Gifting may be done on its own or in combination with sale or leasing. Beginner recipient of gift does not acquire a new depreciable basis in the asset, but acquires the owner's basis.

Trusts or Entities

A trust may be used to accomplish the transfer of assets over time to a beginner. It may also be used to give a beginner managerial control (while the owner retains the right to undo the trust) in order to see how things work out.

Business entities or structures are briefly described below. Some of those structures may be used quite handily to transfer shares or interests in a business over time. Shares may be transferred to a beginner for example, who thereby begins to acquire an ownership stake, while the established farmer or rancher can retain control for as long as necessary. Buy/sell agreements can be used to allow the beginner to buy out the heirs of the established farmer at the time of his death, or sooner.

II. Agreements

There are numerous types of agreements that might be used to help beginners get started and build up an ownership interest. Some are listed here.

Joint Venture Agreement

Livestock-Share Farm Lease

Contract for Sale of Farm – Installment Contract

Cow-Calf Share Agreement

Agistment Agreement

Enterprise Operating Agreement

<http://www.extension.iastate.edu/AgDM/wholefarm/html/c4-43.html>

Farm Business Operating Agreement

<http://www.extension.iastate.edu/agdm/wholefarm/html/c4-44.html>

Wage and Incentive Agreement

<http://www.extension.iastate.edu/agdm/wholefarm/html/c4-42.html>

Farm Machinery Joint ventures

<http://www.extension.iastate.edu/agdm/crops/html/a3-37.html>

Joint Machinery Ownership

<http://www.extension.iastate.edu/agdm/crops/html/a3-34.html>

Labor and Machinery Sharing Agreement

<http://www.extension.iastate.edu/agdm/wholefarm/html/c4-45.html>

III. Business Structure (See “Ownership Structures for Your Farm or Ranch: Basic Considerations” for more detail and tax discussion.)

Sole Proprietorship

- Business owned by one person. (Many farms and ranches, though owned by husband and wife, are treated as a sole proprietorship for tax purposes.)
- Owner calls all the shots.
- No registration required. (May need to be licensed, depending on what business activity you are doing.)
- Business is transferred by selling assets.
- No requirement to keep business and personal assets separate, or to maintain separate books, but probably a good idea anyway.
- Not taxed separately – owner is taxed on all profits (income minus expenses).
- Business typically ends with owner’s death or sale of business.

Partnership

- Two or more people in business together. They each contribute assets or services to the business and share in the management, profits and losses. Typically, equal rights to profits and equal say in management. Partnership agreement can change this.
- No need to file registration papers.
- Partners owe duty of trust to one another.
- Each partner personally liable for debts of partnership.
- Each partner is agent of partnership and can usually bind the partnership to a contract.
- Partnership does not pay tax itself, but everything flows through to partners
- Partnership agreement not necessary but a good idea. Things typically covered:
 - Business purpose
 - Contributions
 - Allocate profits, losses and draws – dividing up the money
 - Will salary be paid or only distribution of profits?
 - How much authority do partners have acting alone
 - Who will keep books, deal with bank

- How to let in new partners, if at all
- Can interest in partnership be transferred?
- What happens to business when a partner wants out, or dies?
- How will partners resolve disputes?
- How long will partnership last

Limited Partnership

- Must have at least one limited partner and one general partner.
- Limited partner is not active in managing the business and, in return, is only liable for the debts of the business to the extent of his contribution to the business.
(May be a good way to attract investors – someone who would like to provide money or assets to the partnership but is willing to risk only those assets.)
- General partner runs the business and is personally liable for debts of partnership.
- Must register with the state.

Limited Liability Partnership

- Similar to general partnership but partners not liable for misconduct of other partners, only for their own misconduct.

Corporation

- Separate legal “person”
- Limited liability for owners (shareholders). Limited liability can be lost if rules not followed.
- May pay its own taxes (“C Corporation”) or taxes may flow through to owners (“S Corporation”)
- Must be registered.
- Have to comply with housekeeping and management rules.
- Centralized management. Owners elect and remove board of directors who make decisions for the corporation. Directors typically elect officers, who run the day-to-day affairs of the business. In small corporations, shareholders and directors are often the same people.
- Shares in corporation are typically freely transferable, but in small corporations buy/sell agreement restrict transfers.
- Salaries and bonuses are deductible to corporation. As may be fringe benefits for employees, such as health insurance, medical expenses, retirement plans.
- Double taxation in “C”: corp pays tax on its income and then shareholders pay tax on dividends.
- “C” corp pays tax on first \$50,000 of income only at 15% rate.
- “S” corporation is a flow-through entity – does not pay its own taxes. Shareholders in “S” not subject to self-employment taxes on income they receive from corporation. S may not deduct fringe benefits to employee-shareholders.
- By-Laws govern day-to-day operations of business, including

- When and where to hold director meetings
- Duties of officers and directors
- Procedures for inspection of corporate books
- Removal of officers and directors
- Voting requirements
- Entering into contracts
- Incurring debt
- Signing checks
- Sale of shares
- Declaration of dividends

Limited Liability Company (“LLC”)

- Like a partnership and like a corporation – it’s a hybrid.
- Taxed like a partnership – flows through. LLC doesn’t pay its own taxes. Members pay self-employment taxes on income received from LLC, unlike S Corp.
- Liability of members is limited to the amount they put into the LLC.
- Members can run business and still have limited liability. Can also appoint managers.
- Must register with state.
- Operating Agreement, like corporate By-Laws, governs day-to-day operation of business

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