Section Three:
Farm Transfer Tools

The Tools of Farm Transfer

In Section One of this workbook, we emphasized the importance of exploring core values and developing a long term vision for the family's relationship to the farm. Also in that section, we discussed inherent risks to that vision: death, disability, divorce, disaster, and disagreement (the "5 D's"). If you consider these two concepts together, they demonstrate how the tools of farm transfer work.

Consider your life as a timeline, and identify two points: the "here and now" and the "there and then." If you have taken steps advised earlier in this workbook, both can somewhat be identified in your mind. Now, imagine one or more of the Five D's between those two points, and you can picture the essence of the decisions involved in farm transfer tools. The development and execution of estate planning and farm transfer tools are what lawyers and other advisers prescribe to address the 5 D's, the challenges to the future you envision. Because such events are foreseeable, legal agreements are meant to keep your wealth and your farm fairly intact as it is visited by a D risk event.

If your goal is to pass your farm intact and in use across to the next generation, you will likely have to have some sort of agreement with that generation.

The timeline image is useful to illustrate another point about transfer tools. Picture each half of the line (with the D risk event still in the middle!) to identify a generation. As you plan to pass an asset to the next generation, consider what affect the D has on the recipients' rights to that asset. Without a clear distribution plan, and in many cases an actual agreement between both generational sides of the equation on how those rights are protected, many of those D risks will be poorly addressed.

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

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

As outlined in this section, there are a number of legal instruments - wills, trusts, partnerships, limited liability companies, leases - that can transfer rights to assets. For some tools such as wills and trusts, one generation can decide what is going to be done with the assets without the consent (often without the input) of the successor generation, and that generation simply lives with the result.

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

Often to keep a farm intact, there must be a set of instructions, say in a trust or an agreement between owners. Sometimes this can be a lease, sometimes a business entity such as a limited liability company, whose operating agreement clearly defines all the owners' rights to income, management and equity. It is helpful to remember that regardless of the differing tax treatments, management and reporting of business entities, all are essentially a contract between owners that describes, often in great detail, the rights of all owners in the income, the management, and the equity of the property that is owned by the entity. The agreement also prescribes the reaction or options in the event of a risk event occurring. Care must be taken to make sure your advisers fully understand your desires, values and risks.

In sum, to give your vision for the future of your farm its best shot, you will likely have to form an agreement with those to whom you entrust that future.

Basic Estate Planning Documents: Wills, Trusts, and Gifting

Editor's note: The following narrative is edited from part of a series produced by John Baker, Esq. of the Iowa Beginning Farmer Center. It has been edited to account for the recent changes in the Federal Estate Tax that became law on January 1, 2011. Note the current law is set to expire December 31, 2012.

A **Will** is a legal document that directs the court how to distribute your assets after death. In order to create a will you must be competent enough to know the nature and extent of your estate, be able to formulate a plan of distribution, know the natural objects of your bounty and understand the relationship of the above.

A will must also be signed by the testator (person for whom the will is written) and signed by two competent and disinterested witnesses - who will not benefit under the will - in the presence of the testator and each other. Wills must be revoked and/or amended with the same formality with which they are made. Any handwritten modifications to a will have no effect, absent certain legal formalities.

What happens to my property if I don't have a will?

It is often said that there is no such thing as no estate plan. If you do not have a properly executed - and therefore valid - will, there is a plan for the distribution of your property and farm business assets in the general statutes. Dying without a will is known as intestacy. The intestate distribution scheme under state law covers exhaustive scenarios based on who is living and not living at the time of your death. Suffice it to say, if you plan to keep land interests in the family or pass a farm business within the family or to someone else, the ownership diffusion of intestate succession on the farm assets makes it highly unlikely that your farm will pass intact.

Can I disinherit my family in my will?

If a surviving spouse is not happy with property given by will, the spouse can elect to take against the will and take the statutory amount instead. In Virgnia, this is known as the Augmented Estate, and the surviving spouse can elect to receive a share of the decedent's total net assets. In Virginia there is no statutory provision protecting disinherited children. However, if fraud, undue influence, or improper execution of the will can be proven, children may be able to assert inheritance rights.

What will happen to my estate after I die?

The probate process is the legal process for proving the validity of a will and distributing your assets according to that will. The person who is named in the will as executor will be in charge of the probate process. The process can be lengthy and costly and usually lasts several months. With the supervision of the county clerk of court or probate clerk, the executor must identify and inventory property of the deceased, have the property appraised, pay all debts and taxes and finally distribute the remaining property as the will directs. If you die intestate (without a will), the same process will take place except the court will appoint an administrator of its choosing to carry out the probate process and the remaining property will be distributed according to state law instead of as directed by a will.

Probate is a public process and the proceedings will be available in public records. The property may also be tied up in the process for several months and will not be readily available to the heirs. For these reasons, many people try to avoid extensive probate proceedings. Property held in living trusts, joint bank accounts or pay on death accounts, real estate held in joint tenancy, and some life insurance proceeds are not subject to probate. However, it is strongly advised you not take probate-avoidance manoevers without the advice of a legal professional. Also, probate may be necessary to get real property titled in the name(s) of the proper successor(s).

Trusts

A trust is a legal entity that separates the management of property from the enjoyment of property. A settlor, the creator of a trust, transfers title of his or her assets into the name of the trust; this is called funding the trust. This property, which is held in trust, is called corpus, principal or the trust estate. A trust instrument is the set of documents creating and detailing the terms of the trust. The instrument names a trustee to manage the trust property and one or more backup trustees. It

also names the beneficiaries who will receive proceeds from the trust during the life of the trust and the beneficiaries who will receive the trust assets when the trust is dissolved.

Reasons for establishing trusts include: avoiding or minimizing probate costs, guard against will contests, protect privacy in property transfers, protecting assets from risks associated with beneficiaries, allow for someone else to manage your property when you no long wish to or in the case you are no longer able to, allow someone else to manage property for minors, and in some cases to save estate tax. Trust options today are only limited by the creativity of the settlors and may serve different purposes depending on the terms. Outlined below are several of the more common types of trusts.

Living Trusts

A revocable living trust is created by the settlor during their lifetime and the settlor retains the power to destroy (revoke) the trust at any time during their life. Only at the death of the settlor does the trust become permanent (irrevocable).

A revocable living trust is sometimes referred to as a substitute for a will because its main purpose is to avoid probate of trust assets. Probate is avoided because the assets are no longer property of the deceased, but are owned by the trust – even though the deceased may have been both the trustee and the beneficiary. These trusts are particularly useful when property is held in several states and therefore would have to be probated in each respective state. Although probate costs are avoided, trusts cost more to create than a will because trusts are much more complicated to draft and fees may be associated with changing the title of assets if placed in the trust. In addition to avoiding probate, trusts are less susceptible to attack than a will, because the trust has been in existence for some time before death. The court accepts the fact that the settlor could have changed the terms of the trust during their lifetime as proof that the trust will operate in accordance to their wishes.

Because the settlor retains control of the assets during life (settlor retains the power to revoke the trust and have the property returned), the property remains part of the taxable estate. Revocable living trusts are not useful for reducing the value of the estate for estate tax planning purposes, except for enabling spouses to split their estates to keep the value of their separate estates under their applicable exemptions.

Revocable living trusts should be used in conjunction with a "pour over will". Since a will directs the court how to dispose of your assets at death, this provision will act as a catch-all and direct property still titled under your name to "pour" into the trust, normally to take advantage of an estate tax exemption of the first spouse to die.

Irrevocable Trusts

An irrevocable intervivos trust is a trust created during life that cannot be terminated once created. If created and managed correctly, these trusts can reduce the value of the taxable estate. The property will not be included in the value of the settlor's estate only if the settlor has permanently forfeited the property. Therefore, the settlor must not retain any interest in the income or corpus of the trust; it must benefit others. Additionally, the settlor cannot retain the power to change or transfer the property or the property will be included in the settlor's taxable estate. These trusts are often used to own life insurance policies, as insurance proceeds are normally part of your taxable estate.

Transferring property into an irrevocable trust is essentially a gift to the beneficiaries and transfers may be subject to gift tax. Annual amounts over the current annual gift exemption transferred into the trust will be subject to gift tax. Under current law, an election can be made to transfer up to $5 million into the trust without paying gift tax; however, the transfer will reduce the unified credit and increase the amount of your estate that will be subject to estate tax. (as noted above, this amount is only in place until December 31, 2012) For very large estates, it may be valuable to make the election so that property appreciates in the trust instead of in the estate. Since the property must be forfeited by the settlor, the beneficiaries must have a present interest in the trust property.

Other types of trusts include testamentary or pour over trusts which are established by will. Spendthrift trusts protect assets which may be recklessly spent by beneficiaries, by limiting the rights of the beneficiary to sell or spend the trust corpus or principal. A Qualified Terminable Interest Trust (QTIP) provides a surviving spouse income during his or her lifetime.

Charitable remainder trusts allows the settlor to contribute their property to charity and receive the income from the property over their lifetime. Special Needs Trusts can protect a disabled or elderly

individual's qualification for supplemental security income or medicaid.

Consequences of creating a trust including managerial capabilities, tax advantages and disadvantages, and revocability will vary greatly depending your specific circumstances. Consult with your attorney for more details.

Gifting

Giving assets to the next generation before death may be useful to decrease the size of very large taxable estates or to pass farm assets to cash poor successors. Gifting may seem simple at first, but there are several potential problem areas.

In order to make a gift you must have intent to give the property and there must be actual or constructive receipt of the gift. If property to be given cannot actually be moved into the possession of the recipient, there must be constructive delivery. Constructive delivery is some action or transfer that is symbolic of the actual transfer; for example, giving the keys to a car if the car is not in the same vicinity as you. Other examples of constructive delivery include handing over (or recording) the deed to land or a photo of the object to be transferred. Additionally, delivery must take place at the same time as intent to give is expressed. For example, Dad says, "I want you to have my John Deere A when I die." This statement does not satisfy the requirements of a gift because the tractor was not actually handed over at the same time Dad expressed his intent to give. The tractor will become part of Dad's estate and be distributed according to his will. Some one else may end up with the tractor.

Gifts must be given free of any restrictions and are not revocable. The donor (giver) must be ready to completely part with the property. For example, Dad gives Son five cows and the cows are moved to the Son's pasture. However, Dad still checks them every day, decides which bull to breed them to, and continues to make all managerial decisions regarding the five cows; anyone challenging the gift could argue it was not a gift but a loan or a lease, and the cows will still be part of Dad's estate. Additionally, if Dad reserves the right to take the cows back or receive proceeds from use or sale, no gift was made. It is a good practice to execute a gift declaration describing the property, and to have the gift recipient sign the declaration acknowledging receipt of the gift.

Tax Implications of Gifting

In 2012, the annual exclusion amount remains $13,000. This means that any one donor can make a gift of $13,000 to each recipient without filing a gift tax return, being subject to gift tax or affecting the unified credit (amount of your estate excluded from estate tax) of the donor. Husbands and wives can combine their annual exclusion and give any recipient an annual tax-free gift of $26,000. Any gifted amount in excess of $13,000 per donor/donee will result in a corresponding reduction in their federal estate exclusion and thus affect the size of the donor's taxable estate at death. Gifts for payment of educational and medical expenses are tax exempt. In 2013, the annual exclusion is scheduled to increase to $14,000. (See "About the Estate Tax" pg 57 for more information on the lifetime gift tax exemption).

Gifts in any amount are excluded from the recipient's gross income for tax purposes. However, if the recipient decides to sell gifted property there may be significant capital gains taxes. Generally, "basis" is your cost of acquiring property plus the cost of improvements less cumulative depreciation. Capital gain is the sale price of the property minus your basis. When property is transferred by gift, the recipient must take the donor's basis in the property which may be much less than the current fair market value and may result in large capital gains if sold. If an heir receives an asset at death by will or living revocable trust instead of during the life of the donor, they will receive a "stepped up basis" which is equal to the fair market value at the time of death. Time of death transfers will significantly reduce capital gains tax if the recipient decides to sell the property.

About the Federal Estate Tax: A 2012 (and 2013) Update

Editor's Note: A major issue in farm transfer, due to high land values, is the federal estate tax. The law, however, is changed often due to a series of political compromises. The following summary was prepared with the assistance of Paige Gentry, JD Candidate, Duke University, 2013.

A fact of life in farm transfer planning is that Congress continues to change estate and gift tax laws. Addressing possible future changes is near impossible, so what follows is a simple summary of the key components of the law for 2012 and how the current law applies to estates opened in 2013.

2012 Estate and Gift Tax, Key Components:

1. Estates worth $5,120,000 or less are excluded from the estate tax. Thus, if your estate is worth less than $5,120,000, it will not be taxed.

2. Estates worth over $5,120,000 will be taxed at a rate of 35%. The 35% tax rate only applies to the amount of the estate that is greater than $5,120,000. For example, if your estate is worth $6,120,000, the estate would only be taxed on $1,000,000 ($6,120,000- $5,120,000), for a tax of $350,000.

3. Using the "portability of exclusion" rule, married couples are allowed to exclude up to $10,240,000 from the estate tax. Under this rule, each spouse can exclude up to $5,120,000. If the first spouse does not use all of his or her exclusion, the surviving spouse can add the remainder to his or her estate (estate must file Form 706).

4. The lifetime gift exemption is $5,120,000, which is equal to the estate tax exemption. Any gift that is made within an individual's lifetime in excess of the annual gift exclusion ($13,000) is deducted from his or her estate tax exemption. Thus, if you gift $1,000,000 in 2012, your estate tax exemption will then be $4,133,000 ($5,120,000 - $987,000). (Note the $1,000,000 in this example is reduced by the allowable annual tax-free gift exclusion of $13,000 [$1,000,000 - $13,000 = $987,000])

5. Individuals who distribute assets to a generation beyond their children will be exempt from the generation skipping tax (GST) if the transfer is less than $5,120,000. The tax rate on amounts that exceed $5,120,000 is 35%.

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

2013 Estate and Gift Tax, Key Components:

1. Estates worth $1,000,000 or less are excluded and will not be taxed.

2. Estates worth over $1,000,000 will be taxed at a rate of 55%. The 55% tax rate only applies to the amount of the estate that is greater than $1,000,000.

3. The "portability of exclusion" rule is extinguished. Any unused exclusion amount cannot be passed to the surviving spouse.

4) The lifetime gift tax exclusion will be $1,000,000. The same unification rules apply as in 2012. However, the annual gift tax exclusion increases to $14,000.

5. The generation skipping tax exemption will be reduced to $1,360,000, with amounts in excess taxed at 55%.

6. The step-up in basis remains in place.

7. As a way to reduce estate tax exposure, under Section 2032A, executors in 2013 can elect to have land in an estate be valued at "use value." Subject to strictly enforced requirements, the value of farmland in an estate may be reduced up to $1,070,000.

Common Methods to Manage Estate Taxes

Regardless of future tax law uncertainty, there are several methods to reduce or eliminate estate tax exposure. Below are several possible strategies:

1. Reducing the valuation of assets at death: Several sections of the tax code allow estates to claim a lower valuation of certain assets. Claiming a reduction in land value with qualified conservation easements (see pg 84) and/or use of section 2032A (see above) are two possibilities. Placing land in a limited liability company may allow for valuation discounts due to transfer of interest restrictions governing those interests by agreement.

2. Splitting estates: In years past, spouses divided joint property by deed to capture individual exemptions. This can still be done, as can a proper disclaimer of 1/2 property interest by the surviving spouse. Without a trust, however, both distribute property interests directly to heirs as tenants in common, which may not be ideal for continuation of a farm. Jointly owned land placed in a limited liability company can also split land interests.

3. Use of Trusts: In addition to managing efficient distribution of assets, revocable trusts can also be used to maximize marital, individual and GST estate tax exemptions that are no longer portable. Irrevocable trusts can remove property from individual ownership and thus reduce the estate for taxable purposes (see pg 55).

Entity Choice for Agricultural, Forestry, or Horticultural Ventures

***Editor's note*:** One of the most common questions encountered when engaging farmers on transfer planning is about business entities, and their effectiveness in limiting operating liability (i.e. protecting assets from lawsuits and creditors). Placing land and operating assets into business entities is also an effective tool in transferring income, management and ownership/control of those assets to ensure they remain productive or under ownership of the family. The following narrative is an overview of the different business entity choices, written by Theodore Feitshans and Guido van der Hoeven of North Carolina State University for the *Rural Lands Update* professional credit series, held in North Carolina in 2008. It has been edited to reflect Virginia law and the changes to estate tax law that went into effect in 2011.

Land owners engaged in agriculture, forestry, and horticulture have a wide variety of entities available to them to manage working assets and capital. This wide variety of entities reflects the diversity of interests of those involved in agriculture, forestry, and horticulture. Choosing an entity is an important task that requires research reflection and, typically, expert assistance. Concerns about choice of entity are often prompted by concerns about tax or tort liability. While these issues are important they are generally not the most important issue driving the choice of entity. Issues such as management of the business, whether the activity is even a business (i.e., motivated by a profit motive), business continuity, transfer of land interests, and the need to attract outside capital often override tax and liability issues.

Decisions made solely upon the consideration of tax and tort liability fears often result in a business structure unsuitable to the activity or to succession planning. The failure to make a decision about business structure is indeed a choice. Some of the entities discussed below are created by the operation of law.

Entity types

Sole proprietorship

The sole proprietorship is the simplest type of entity. Nothing is needed to create one although there may be a need in some cities and counties to apply for a business license (generally not true for agricultural, forestry, and horticultural operations). The owner of a sole proprietorship has the widest latitude to operate the business possible. Indeed a sole proprietor may do anything that is not prohibited by law. Any business engaged in by an individual without the formalities of creating a separate entity is a sole proprietorship. The sole proprietor retains unlimited personal liability.

Partnership

General partnership

A partnership is an association of two or more persons to conduct a business for profit. The relationship is consensual and usually contractual. A partnership is treated as an entity for litigation, holding title to property, and bankruptcy proceedings. Many states have adopted the Uniform Partnership Act (UPA), which Virginia adopted in 1997. Under the UPA, the partners must have equal management authority and share equally in profits and losses. They have an equal obligation to contribute their time, energy and skill without compensation to the partnership business. Each partner has unlimited personal liability to the creditors of the partnership, and all partners are liable for wrongful acts and breaches of trust by any partner.

A partnership files a federal information tax return (Form 1065) annually. However, all income flows through and is taxed to the individual partners. A partnership interest is personal to the partner. The partnership is dissolved by the death of a partner or by the sale of a partnership share. Most provisions of the UPA can be modified in a written partnership agreement (e.g., capital contributions, management, sharing of profits and losses, rights and obligations, terms of property ownership, termination and dissolution, and buy/sell agreements).

A general partnership agreement may be oral. If there is never any attempt to make an agreement but two or more people begin conducting business together then a partnership agreement is created by

operation of law. Its terms are the default terms in the UPA. Courts (particularly bankruptcy courts) have imposed a partnership relationship upon parties who did not think that they were partners. Examples of relationships that may, in actuality, be partnerships include employer/employee relationships, particularly where the employee has received a share of the crop and has shared in the risk of production; and landlord/ tenant relationships, particularly those involving share-lease arrangements. Likewise some poorly constructed partnerships may be recharacterized by the Internal Revenue Service (IRS) employer/employee relationships. In such a situation the relationship could remain a partnership for state law purposes but not for purposes of federal tax law. Farmers are particularly prone to these types of costly mistakes because they often proceed without professional advice. Correcting such a problem is much more difficult than avoiding it in the first place.

Limited partnership
A limited partnership has the characteristics of both a partnership and a corporation. It is used when some partners want neither management responsibility nor unlimited liability for the business venture. Most states (including Virginia) have adopted the Revised Uniform Limited Partnership Act (RULPA). Under statutes modeled on RULPA, a limited partnership is formed by at least one general partner and one or more limited partners. A general partner manages the partnership and has full personal liability for the debts of the partnership. A limited partner contributes cash or other property. His liability for partnership debts is limited to the amount of his investment in the partnership. Limited partners do not participate in the management of the partnership. A limited partnership also files an information tax return, but income is taxed to the individual partners. Limited partnerships are required to file with the department of the secretary of state and pay the required filing fee. An annual report and fee are often required.

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

Limited liability partnerships
A limited liability partnership (LLP) is a general partnership used by professionals such as attorneys and is not an appropriate entity for an agricultural, forestry, and horticultural operation.

Limited Liability Company (LLC)
The LLC is a distinct entity that is a hybrid of a partnership and a corporation. All states have authorized this type of business entity. It can be treated like a partnership, an S corporation or a C corporation for tax purposes. Like a corporation, the members have limited liability for debts of the LLC. This business entity offers more flexibility because of its hybrid nature. The LLC is technically not allowed to have an unlimited life, as a corporation is, but it may have orderly transfer provisions. Membership interests are not freely transferable without consent of all other members according to the operating agreement, but a member may assign his economic rights, but not his voting rights. Many state LLC statutes require only one member to create the entity. This business entity is often used in estate planning because it can be an efficient way to manage and transfer assets over time to the next generation as a valued percentage of the entity as opposed to re-titling of individual assets.

Corporations
A corporation is a legal entity, created under state law, that has rights and liabilities separate from its shareholders. A shareholder of a corporation is only liable for the debts of the corporation to the extent of his investment in the corporation. Shareholders elect a board of directors who set policy and appoint officers to manage the company on a daily basis. Shareholders do not participate directly in management decisions (unless they are also directors or officers). A corporation has a potentially unlimited life, and it is not dissolved by the death of a shareholder, director or officer.

Generally, shares of stock are freely transferable by the stockholder. However, state law permits the creation of restrictions on stock transfers under the articles of incorporation, bylaws, an agreement among shareholders, or an agreement between shareholders and the corporation. Such restrictions must be authorized by statute and not unconscionable under the circumstances, and there must be a conspicuous notice of the restriction on the certificate or in the information statement required by the statute. One type of restriction would be a buy-sell agreement between a stockholder and the corporation or other

stockholders requiring the selling stockholder to offer his stock first to the other party to the agreement. The agreement would set a price to be paid for the shares, which would be particularly useful if the shares were not publicly traded. (see *What is a Buy Sell Agreement?* following this article)

Shares in a corporation can be defined as common or preferred, based on the rights and privileges that belong to the owner. Common stock represents a fractional proprietary interest in the property and assets of a corporation. Therefore, the common shareholder participates on a pro rata basis in the distribution of corporate assets upon dissolution, participation in corporate profits (dividends) and management of corporate activities (right to vote). Traditionally, holders of preferred stock are not creditors of the corporation and therefore do not share in corporate assets upon dissolution. Instead, they have a right to a fixed dividend, due and payable before any dividends to common shareholders. However, the articles of incorporation can grant rights to preferred shareholders to receive preference over common shareholders with regard to distributions of dividends and corporate dissolution proceeds.

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

The articles of incorporation must be filed with the secretary of state, and depending on state law must contain the following information: (1) a corporate name, (2) the number of shares that may be issued, (3) the street address and mailing address, including county, of the initial registered office and the name of the initial registered agent, and (4) the name and address of each incorporator. This document may also provide: (1) the names and addresses of the initial board of directors, (2) provisions regarding the business purpose and par value of shares, etc., and (3) limitations on personal liability of directors. At the organizational meeting of the corporation, bylaws should be adopted. This document may contain any provisions for managing the company and regulating the affairs of the company that are legal and consistent with the articles of incorporation. The bylaws are the continuing set of governing rules under which the corporation, its officers, directors and shareholders exercise management powers, transfer shares, hold meetings and all other activities related to the corporate objective.

There are two ways to dissolve and terminate a corporation: voluntary dissolution and involuntary dissolution. The directors and shareholders may voluntarily dissolve a corporation by passage of a resolution of dissolution and filing of articles of dissolution with the Secretary of State. In addition, a corporation may be dissolved without its consent by court action or administrative action of the Secretary of State. If the directors are not acting in the best interest of the company, any shareholder may obtain judicial dissolution. If the corporation fails to file annual reports or pay the franchise tax, for example, the Secretary of State may administratively dissolve the corporation.

Subchapter C corporations
A corporation formed under Subchapter C of the Internal Revenue Code is an ordinary corporation subject to double taxation, which means that profits are taxed as they are earned by the corporation and then when those profits are distributed to the shareholders as dividends, they are taxed again to the individual.

Subchapter S corporations
A corporation formed under Subchapter S is a close corporation that has elected to be taxed like a partnership. Instead of being taxed at the corporation level, the income is deemed to flow through to the shareholders and is only taxed once, at the individual level (whether the profits are distributed or not).

Professional corporations
Professional corporations are another type of corporation used by professionals such as attorneys for their practice. Such an entity is not appropriate for agricultural, forestry, and horticultural operations.

Nonprofit corporations
These entities are corporations organized for charitable purposes including education. These entities are expected to fulfill a charitable purpose and are not designed to make a profit. These entities include family foundations that are often used by wealth families to carry forward the family's charitable activities.

Family foundations have only rarely been employed by landowners who are engage in agricultural, forestry, and horticultural operations. However, such an entity might be appropriate for a family's charitable activities. An example would include land that is used by local educational institutions in their educational programs. Property donated to such a family foundation would be excluded from the estates of family members but family members could be appointed to the board of directors to ensure that the family's charitable goals are realized.

Cooperatives
Cooperatives are another type of entity that may be used both by groups of farmers and for individual farm businesses. Most cooperatives are organized as corporations; however, ownership of shares is restricted to the customers of the business. Profits of a cooperative are all eventually distributed to the members, as a cooperative is not designed to make a profit. The U.S. Department of Agricultural provides both technical and financial assistance to farmers who wish to form cooperatives.

Trusts
Agricultural, forestry, and horticultural operations may also be operated through trusts. The most common type of trust employed for this purpose is a revocable living trust that also functions as a will substitute.

Estates
Estates may be created either as the result of the death of the owner or the bankruptcy of the owner. Although the former is under the jurisdiction of the state probate court and the latter is under the jurisdiction of a federal bankruptcy court there are similarities. Both involve a great deal of judicial control over the business, and both are generally in existence for a limited period of time.

TAXATION OF ENTITIES
Business entities become subject to various taxes over the course of entity existence. The sole proprietorship is subject to several taxing authorities during the life of the proprietor, but upon death, the proprietorship terminates, an estate is created and the estate of the decedent proprietor may be subject to estate taxes. In contrast, unless specified in the articles of incorporation a corporation does not "die" and can continue into perpetuity.

It is important for business operators to not let the "tax tail wag the business dog". Fundamentally, sound business decisions made using good business principles should be the focus of the business's management team. Once a business decision is made and the course of action implemented use of appropriate tax rules to optimally minimize the tax burden naturally follows.

Income Tax
Individuals and business entities generate income tax liabilities when business activities create a profit. Individuals acting as sole proprietors calculate and pay taxes on personal income tax returns using Schedule F (for farming activities) and Form 1040 to report all sources of income. Partnerships (general and limited), Sub-S corporations, LLCs, Estates and simple Trusts are "flow-through" business entities; meaning that business profits (or losses) are passed through on a pro rata basis to owners or beneficiaries of these entities. The individual recognizes the tax consequence on his or her own personal tax return (Form 1040).

C corporations are taxpaying entities and use Form 1120 to report gains and losses from business activities. Likewise, a complex trust operating a business will pay income taxes; the trust uses Form 1041. Furthermore, if a business is held, temporarily, in a bankruptcy estate positive income can be created and income taxes are due by the bankruptcy estate. Cooperatives and non-profit organizations are generally exempt from paying income taxes. However, circumstances may arise where income tax is paid by these entities. One such example is non-related business income in the case of a non-profit organization.

Gift Tax

Gift taxes federal and state, are imposed on natural person donors. However, some states (including Virginia) do not have a gift tax. Generally business entities do not make gifts. However, under certain circumstances a closely held corporation may transfer property without consideration to an individual donee (natural person) where the shareholders are deemed to make the gift [Treas. Reg. 25.2511-1(h)(1)]. The federal annual gift tax exclusion amount is currently $13,000 per donee and the lifetime gift exclusion amount is $5,000,000 until the end of 2012. Generally the donor is responsible for payment of gift taxes. However, if the donor does not make payment, the obligation falls to the recipient of the gift.

For donors of closely held business interests (corporate stock, LLC membership or partnership interests) a discount may be used to reduce the value of the gift. The IRS has allowed a 20 percent discount for lack of control (minority interest) and a second 20 percent discount for lack of marketability, though care should be given not to become too greedy with the use of discounts.

Estate Tax

A natural person's (decedent) estate may become subject to estate tax. This is dependent upon the size of the taxable estate. On December 17, 2010, Congress enacted a $5,000,000 estate tax exemption effective from January 1, 2011 to December 31, 2012. This means that a person's estate below this amount is free from estate tax.

The sole proprietor estate will have the business assets included in his/her estate. By definition the business ceases as the proprietor is deceased. Other business entities may be indirectly affected by the death of a shareholder, member or partner. Corporations, LLCs, partnerships and other formal business structures are not subject to estate taxes in a direct fashion since upon dissolution an estate is not created. It is the ownership interests of these entities that belong to the decedent that are included in the decedent's estate. Therefore, depending upon the size and liquidity (cash available) estate taxes may become indirectly important to the continuing success of the business. Without continuity plans for these entities a forced or fire sale of the business assets may occur to provide the funds needed to pay the estate taxes of the decedent.

Practical tips

It is quite common for a family to prepare documents, file papers and then never fund the entities created. Surveys show that very few attorneys follow up with their clients to ensure that plans are properly executed. More follow up would likely result in a greater degree of service and client satisfaction. Transferring property to the entities created must be done with care to ensure that the transfers are effective and that only the assets intended to be transferred are actually transferred. Married couples who own property as tenants by the entireties should understand that they give up the protections afforded by that form of ownership when property is transferred to an entity. In general the landowners' residences should not be transferred to the entity for this reason and for other business and tax reasons. Entities should be created in conjunction with the estate plans of the owners to avoid foreclosing estate planning opportunities. For example, it may be desirable, in restricting the transfer of ownership interests, to permit transfer to a living trust.

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

Although most landowners will want to create their entity under laws of their respective states, there may be valid reasons to create the entity under the law of another state. If that is done the foreign entity must be domesticated by filing with the secretary of state. It is also possible to make certain determinations about how disputes among the owners will be resolved. Among the issues that may be resolved in advance are valuation of assets upon dissolution, choice of the state law applicable to the dispute, the forum for resolving the dispute, the admission and rights of successor owners, and whether to employ alternative dispute resolution tools such as arbitration or mediation.

What is a buy-sell agreement?

Editor's note: The operative clause of any business entity agreement is the buy-sell agreement, which can restrict ownership to family members, and protect the farm manager from the sudden pressure of a buy-out. The following is part of a series produced by John Baker, Esq. of the Iowa Beginning Farmer Center.

A **buy-sell agreement** is a contract obligating one business owner to buy all or a portion of the business upon the retirement, death or disability of another business owner. Such agreements are often found in the governing documents of business entities such as partnerships and limited liability companies to restrict ownership of business interests. The contract specifies who will buy the ownership interest, what price will be paid and the interest rate. A well-drafted agreemenet will also include whether any discounts apply as well as terms of sale. Funding is an important aspect of this planning technique and is usually accomplished with current cash flow, loans, life insurance proceeds or through the sale of other assets.

A buy-sell agreement allows the business owners to agree on a process to value the company at a future date and the ownership interests therein in a mutually beneficial agreement for all owners and their families. The agreement also avoids or reduces disruptions to the business operations after one owner leaves the business because the event has been planned for and management will continue. Planning for the future in this way helps assure the business's stability and continuity and provides job stability for the buying owner and other key employees. A buy-sell agreement also can prevent off-farm heirs or unqualified shareholders from obtaining an ownership interest, or selling an interest to an outsider. Below are several variations of buy-sell agreeemnts that may be alternated within one agreement.

Cross Purchase Agreement – Each business owner buys a life insurance policy on the lives of the other owners. Under the agreement, the owners are obligated to use the proceeds from the insurance at the death of an owner to purchase the business interests from the deceased's estate.

Entity Purchase Agreement – The business itself is obligated to purchase the business interests of the deceased using life insurance policies that the business has purchased on each of its owners. The company incurs the cost of the life insurance and also retains the cash value instead of the individual owners.

Wait and See Buy-Sell Plan – The business itself has a first right of refusal and therefore has the first right to buy the deceased owner's shares. The business can wait to decide whether to purchase the share or let the remaining owners purchase the shares personally. If the business elects to let the remaining owners purchase shares, it is required to buy any remaining shares that remaining owners do not purchase.

Option Agreements

One of the most common option agreements is a "right of first refusal." This is an option contract between a future seller and a potential buyer that allows the buyer the first chance to purchase property by matching other bids. This type of agreement may be useful when current property owners wish to retain the property but ensure that it will first be offered for sale to a specific individual or group of individuals.

The agreement will always be triggered by the sellers and not the potential buyer. The potential buyer has no right to force the sellers to give up their property, only the right to be the first in line to buy the property if the sellers decide to put the property on the market. There is no guarantee that the property will ever be put up for sale or even that it will be put up for sale at a time where the option holder is able to cash flow the sale.

A right of first refusal does not shelter sales from any kind of taxes or gift implications if the price is artificially low. It only ensures that the option holder will have the option to purchase the land above anyone else.

Options to buy may also be easily written into a trust. This is a slightly different situation than a right of first refusal because the option is triggered at death of the property owner instead of during life when the owner wishes to sell. A specific person may be given the first option to purchase property from the estate of the deceased with the specified heirs receiving the proceeds from the sale. Fair market value, a discounted price or a specific below market value price may be set as the sale price by the will. Gift tax will not be an issue if the price is set artificially

Table 3.1

Quick Comparison of Business Entities

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

Worksheet 3.1

Checklist for Business Agreements

As you will note from the preceding article on business entities, a lot of decisions are required for constructing an agreement to meet your needs. The worksheet below identifies some of these decisions and provides space for you to jot down answers for discussion with your business partners, family members and professional advisers. This list includes many of the items that should be covered in a well-drafted entity agreement.

General	
Under what state law will the business be formed?	
What is the name of the business?	
Has the name been checked with the Secretary of State?	
What is the purpose of the business? (very important for farm LLCs)	
What is the term of the business?	
Is the business member managed or manager managed?	
Who is the manager if manager managed?	
Who is the agent for service of process?	
Capital Contributions	
What is the initial capital contribution of the managing member?	
What is the initial capital contribution of the other members?	
Will members be required to make additional contributions if necessary?	
What happens if a member fails to make a required capital contribution?	
What approvals are required to add new members?	
Are members allowed to withdraw their capital contributions? If so, under what circumstances?	
Is a member entitled to interest on his or her capital contributions?	
Does any member have any priority on distributions over any other members?	
Allocations	
How are profits and losses to be divided among the members?	
How are tax allocations made?	
When are distributions to be made?	

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

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

Notes

Developing a Lease for the Farm

Editor's note: A review of published literature in the Southeast found little on developing lease agreements, so we have turned to other sources from regions with issues similar to those we face here in the Southeast. The piece below draws heavily from several sources: *A Lease Agreements Guide for Landowners and Farmers*, from the University of Vermont, written by Deb Heleba, David Major and Bill Snow, and *Managing Landlord-Tenant Relationships: A Strategic Perspective*, published by Ohio State University and authored by LeeAnn E. Moss and Bernie Erven. Other observations are those of the author based on experience working with traditional and non-traditional leasing arrangements.

If you want to keep your land in farming, you will need someone to farm it. For most landowners, that will mean developing an agreement with a farmer for how the land will be farmed.

Traditionally in the Southeast, landlord and tenant arrangements have been based on family or neighbor relationships, and rarely in writing. In areas where farmers utilize fairly large tracts of land, rotating a limited number of commodity crops through the years, land is changing hands between generations which will likely change the way farmers and landowners have been doing business together. As more and more parents pass on, adult children inheriting rights in farms may want to hold on to them but are seeking a more formalized agreement with the farmer who has been tending the land. Closer to urban areas, some landowners who wish to hold on to the land for the foreseeable future may find opportunity in working with a farmer whose farming practices require a stronger tenure relationship than the traditional handshake. Even within families, a successor must often become a tenant before he or she becomes an owner of the land.

Guidelines for Landowners

There are several issues to consider before you enter into an agreement to create a successful working relationship with a farmer. For those landowners without experience renting or leasing land to a farmer, this narrative is meant to provide you with some of the basics involved with putting together an effective farmland lease agreement that will serve your needs. For those with experience, changes in agriculture practices and markets will likely bring up new issues you must address.

First, as emphasized in the previous section, you need to take stock of your land and take a look at what you have to offer and your goals for the property. For landowners, determining the amount and quality of land you have available is an obvious place to start. Keep in mind that not all land is created equal, particularly in the Southeast. Land usually slopes in one or more directions, it can be rolling and hard to see from all points. The key is knowing exactly how much land you have to work with.

Poor land, very small parcels, or land with poor accessibility and/or obstructions may not even be worth considering, as these may be too difficult to farm. Parcels too small to accommodate ever larger planting and harvesting equipment, yet remote from direct market opportunities may not be marketable for farming use. However, if the land is fertile, accessible, and of a decent size, you may find farmers interested in farming it. Indeed, in some areas you may be blessed with a healthy competition for leasing your land.

Landowners can turn to several sources to "discover" their land if indeed they do not already have a recent relationship with it. Many will have recreational relationships with their parents' land (e.g. hunting, fishing or horseback riding), but may be less familiar with how it is managed for income production through farming or forestry. Landowners can inquire for their records through the county Farm Service Agency (FSA) office, which may include crop production history, aerial photos, NRCS program participation. Landowners can also request assistance from their county Cooperative Extension service who may have a working knowledge of how their particular parcel has been managed over the years, or the county Soil & Water Conservation District office, who might be available to walk the land and point out important soil and hydrological features, as well as certain restrictions pertaining to environmentally sensitive tracts of land.

Probably your best *first* person to help educate you

about your land is the farmer who has farmed it. In many cases, this will help lay the foundation for a continuing, if more formalized, legal relationship.

As emphasized in Section One of this workbook, a clear statement of your values, goals and needs - as well as your desired role in decision-making - for your farm will form the foundation of your work on agreement with someone who will farm it, whether that person is related to you by blood or not. Below are a few points to consider from your side of the agreement:

1. **The written lease**: Lease agreements for farmland or other real property assets should be in writing. The limited advantage of an oral, annual agreement is that the agreement ends at the close of the season. However, such arrangements create instability for both landowners and farmers. For landowners who will be providing more than just passive use of their land, such as providing lime, providing cash for custom tillage work from a neighboring farmer, or other inputs, you must protect your own liability by ensuring that the relationship with your tenant cannot be construed as a legal business partnership. Furthermore, you may wish to limit your own liability from practices of the farmer that may give rise to liability, such as misapplication of chemicals, environmental degradation, etc., and be sure that you are indemnified for any liabilities you may incur due to these actions.

2. **Ask questions**: Increase your understanding of how land is used. Understand that the language used by the farmer is that of his or her profession, terms that have everyday meaning to him or her will be unfamiliar to you. Do not be afraid that asking even a basic question will somehow expose ignorance and put you at a disadvantage in your discussions about a rental agreement.

3. **Be flexible (and clear) on your role**: In some cases, personal values that the land be farmed and well-taken care of will drive a landowner's desire to rent the land to a farmer. For those landowners particularly enthusiastic about emerging local food systems and environmental stewardship, you should be prepared that a farmer may have challenges with sharing daily operational decisions if you have no farming experience to offer. It may be best to consider your investment of land into this equation as your contribution, and defer to the skills of the producer in managing that contribution (again, subject to your goals, etc.). Even in share-lease situations, understand that a lease is not a partnership and should not give you the go ahead to weigh in on day to day decisions (unless you both have so agreed), this is a breeding ground for frustration and disagreement.

4. **Stay informed of market conditions**: This applies to both the market for land rents, as well as what is going on with either commodity prices or other product market conditions. Depending on the flexibility in your lease, or how you otherwise handle changed agricultural market conditions that affect the viability of your farmer tenant, you will need to be prepared to respond to the situation where the current rental rate agreement is jeopardizing the farmer's operational abilities.

5. **Schedule annual meetings**: Your ownership of your property should be considered a business, so you should have business-like meetings with your farm tenant to overview the season that has ended, issues that you want to bring up about the condition of the land, important changes in your life that will have an impact on the next year, particularly as they relate to your already stated goals for the farm. If there was something you saw that you were not happy with when you visited the farm, ask about it.

6. **Weigh new offers rationally**: Smooth working relationships between farmers and landowners often span generations. A stable farm tenant, when you consider your management options for the land, should be considered an asset. Be reasonable when offered a higher rental payment by a new and untested tenant, and allow your current tenant to address any issues where their work may appear deficient compared to what someone new is offering. In some areas, competition for land can be fierce, and though you may strive for a higher monetary return from the land, a revolving door of tenants may have its costs as well. Landowners should consider that, if not for this farmer and their stewardship of the land and relationship with their parents (which may have extended beyond mere payment of annual rent), they might have otherwise found the land in poor condition, eroded or grown up in "volunteers" (unintentional trees of no commercial value).

General Guidelines for Tenants

For farmers, take a look at what *you* have to offer. Be clear about what type of farming you want to

do on the land. You should be prepared to answer basic farming questions. Landowners - especially new purchasers or inheritors - may be extremely inquisitive about your farming practices simply because they may not be familiar with agriculture. Indeed, if you have been farming the land for a time, you may have had a fairly straightforward verbal rental arrangement with an elderly couple, perhaps a retired farmer, and then his widow, now only to find that those who have inherited the land are raising new questions about production practices and rent. Farmers may consider that the inquiry may bring changes to how they have operated the land, and should be prepared to offer a basic and open education in farming practices. Remember that a little education will go a long way in creating a satisfying longer-term relationship with a supportive landowner.

The end goal for most farmers is a delicate combination of stability, affordability and flexibility. Many of the suggestions below for farmers are soft approaches, but experience has shown that solid relationships can sometimes transcend economic and competitive issues normally associated with how much rent you can pay for use of the property.

The following points should be included in the farmer/tenant's landholding strategy:

1. **Ask for a written lease**: Oral leases - long a tradition in Southeastern agriculture - can provide opportunities for disagreement, even based on innocent misunderstandings, which once crops are planted become more difficult to resolve. Further, your investments in the land - such as a three-year lime application - are not protected under an annual oral lease, only your right to harvest planted crops is protected by state statute.

Clear language will resolve many issues, but a lease can also provide a dispute resolution scheme for when disagreements occur due to actions of either party during the lease. Further, should the land change hands during the term of the lease - due to death of the landlord or sale or gift of the property - a written lease offers protection to the farmer. Southeastern states require leases of certain length to be recorded with the county Register of Deeds in order to warn purchasers of the land that there is a tenant with farming rights on the land. For example, Virginia requires leases in excess of five years to be recorded. (Note: in order to protect the confidentiality of elements of the agreement, such as the rental rate, a Memorandum of Lease can be recorded to satisfy this requirement).

2. **Provide a resume**: When approaching landlords that you have not worked with before, you should provide an overview of your farming operation and experience, including philosophies on production practices, business objectives, education, tillage practices, equipment use, financial strength and other land tenure relationships. Some prospective landlords might not agree with your philosophies and practices, so it is good to know earlier as this will only cause problems in the arrangement as time moves forward, causing stress on the success of the operation.

3. **Agree on a cropping plan**: Open dialogue early on a cropping plan, which should include input and field operation specifics. For new and/or younger farmers interested in smaller-scale, high intensity production for direct market, be prepared to have your business plan ready for review. You must build this landowner's confidence in your ability to continue a business on their land.

4. **Keep communication open**: Providing regular updates on crop conditions, markets, and planned activities such as cropping and harvesting, conservation implementation (if authorized), general cattle rotations, etc. will help visiting landowners (who will sometimes visit the property in the farmer's absence) understand changes they are seeing on their property. A report can give you a baseline to refer to when asked later about something they have seen happening on their property. Consider including cost information in these communications, as this will help the landowner understand certain issues that may become relevant regarding rent amounts, landowner contributions (if applicable), etc. When on-farm problems occur, notify the landowner.

5. **Educate the landowner**: As noted above, just by virtue of time and rural demographic changes, more farmers will be working with more non-farmer and absentee landowners. Ohio State's Moss and Erven suggest regular mailings of farm journal articles and even developing a website which can both educate the landowners and their potential heirs while demonstrating the farmer's interest in their knowledge. In some cases, particularly

nearer to urban direct markets, it may be helpful to educate the landowner in how their land is part of a larger farming and food system, one in which they are a key player. Some inheritors of land, themselves urban dwellers with an interest in "local foods," express the interest that their land be farmed "organically" without understanding the technical nature of the term. Your ability to provide them with a bigger picture, while helping them understand the "technical" nature of organic production may serve you well.

6. **Improve the farm**: Experienced farmers often state a goal of leaving a farm in better shape than when they got it. The farm's appearance - maintenance of roadways, fences, clearing brush around old houses and structures - is usually the first impression other landowners get of the farmer's reputation in the neighborhood, which will correlate directly to the perception formed on that farmer's abilities and value as a tenant. Consider this a visual resume of your abilities.

7. **Pay attention to the current owner**: Acknowledging life events - holidays, birthdays, the passing of close relatives - of landlords improves a farm tenants' longer term access to the ground. When receiving honors for conservation or other practices, it sends a strong message - if the venue is right - to also invite and recognize the landowners you work with.

8. **Don't forget about the future owners**: Land is going to change hands, in many cases sooner rather than later. This workbook encourages owners of land to engage their families (i.e., children or other potential heirs) if planning needs to be done for the future of the land. Farmers should look for ways to include the "next generation" owners where possible in their passive communications with the landowner while being sensitive to established lines of communication within the family.

Types of Leases

Cash Rent

Most rental arrangements are for a set price per acre for a set time, normally per year. The farmer pays the landowner the total of the rate per acre multiplied by the number of acres farmed. Under this arrangement the tenant bears most of the costs - and thus most of the risks - of preparing the land for production and growing and harvesting the crop. Thus, the tenant still owes rent in the event of crop or market failure. Some cash leases provide for an amount paid tied to the price of the crop, actual yields, or a combination of both, and can offer a lower base rent to protect the farmer in bad years while rewarding the landowner in better years.

Crop Share

A crop share risk allocates risk between landowner and tenant, splitting the costs and the proceeds of production according to agreement. Crop (or livestock) share leases allow landowners in strong financial position to contribute to costs of production, which can be of great help to a newer farmer shorter on early season operating capital. Care must be taken to distinguish such an arrangement from a legal partnership. Share leases can also give the landowner a specified share of the crop (which the farmer can buy for a set price or the landowner can sell on the open market), so when the farmer does well the landowner does well. (See sidebar *Comparison of Cash Rent and Crop Share Leases* next page)

Basic Elements of an Agreement

Below are the basic elements of a lease agreement. As alluded to earlier in this narrative, there are many variations of the themes below.

1. **Identity of the parties**. The lease must be signed by the actual owner(s) of the property or those with proper authority to bind the property to the terms of the lease. Keep in mind that property that has been inherited may have more than one owner. If property is held in a trust, the trustee must sign. If land is held in a limited liability company, the person with management authority must sign. Failure to secure the signatures of the proper owners leaves the lease vulnerable to being voided by owners who did not consent to the agreement.

2. **Description of property**. The property description in the agreement identifies the land both parties intend to be farmed. The lease should identify the land area, buildings, equipment and animals (if applicable). Land can be described by inserting appendices to the agreement (properly referenced in the document) that contain either the deed description or a portion thereof, and/or aerial photos of the property from FSA or county Geographic Information System (GIS) websites, with fields and access marked on the photograph. Access should clearly be set out, especially where access crosses other land or to structures not in the leased premises.

3. **Term of lease**. The lease should specify when it begins and when it ends. Verbal rental agreements are normally protected by state statute for the term of one year, up through harvesting of crops on the land. In coming to an agreement, the farmer should consider the amount of time necessary to recoup his or her investments in the land. Multi-year leases can offer a set term that binds the property for that period, with a renewal clause that should be clear on how renewal takes place or notice of termination is given (i.e., time period and manner). It is reasonable to both parties to allow a minimum six-month period to announce an intent not to renew the lease.

4. Amount and terms of rent. For a cash rent lease, the amount of rent is normally paid in one payment by a particular date, traditionally near the end of harvest when the farmer has cash from the sale of crops. For more diversified operations with earlier market harvests, the parties can agree

Comparison of Cash Rent and Crop Share Leases

(from *Improving Your Farm Lease Contract*, Iowa State University)

Cash Lease

Advantages of a straight cash lease are:

- The lease is simple with relatively few chances for misunderstanding.
- The owner is relieved of making day-to-day operating decisions.
- The owner has very little financial risk.
- The tenant has maximum freedom in planning and developing the cropping and livestock programs.
- The tenant has fewer records to keep.

Disadvantages and potential problems of the straight cash lease are:

- A fair cash rental rate may have to be renegotiated each year.
- Cash rents are likely to be too low in times of rising prices and increasing yields, and too high in times of low prices or low yields.
- Tenants are required to supply more operating capital.
- Tenants bear all the risk of price and yield variability.

Crop-share Lease

The advantages of a crop-share lease are:

- Crop risks associated with price and yield variations are shared equally.
- The owner is more involved in operating decisions and marketing the crop during the year.
- Both parties share the benefits from adoption of yield-increasing technology, or unexpected high yields or prices.
- A second USDA payment limit is created.

Disadvantages or potential problem areas of a crop-share lease include:

- The landlord and tenant must determine how production expenses are shared.
- Adjustments for sharing costs for storage and drying facilities, herbicides that reduce field work, or fertilizer and pesticide application may have to be made.
- The cropping plan to be followed and whether or not the farm participates in government programs must be agreed on.
- Added cash rent for buildings and facilities may have to be negotiated.
- If the owner's and tenant's crops are stored in a common bin, marketing decisions have to be made jointly.
- The landowner may be considered a material participant, and farm income will be subject to self employment taxation.

DETERMINING A FAIR RENT

In a lease agreement, determining a fair price is often the most important factor for both parties, yet it can be difficult to establish in many farming situations. Location, soil quality, the forces of supply and demand, commodity and direct-market prices, as well as your personal goals for the land all play a part. For higher-grossing, larger acreage operations, establishing a rental rate can be more straightforward where there is a history (and reasonable forecast) of cost and price information.

Many landowners have traditionally charged just enough to cover the taxes on the land. Others don't charge, especially when the trade-off is keeping a pasture mowed (in exchange for the hay the farmer takes). Most agreements are set up on a per acre basis, where a rate per acre times total acreage used becomes the annual payment. Below are some considerations for setting the rental rate:

1. **Market rental rates**. The only practical way to determine real market rates is to ask around. As best as possible, talk with local farmers to get a feel for what they are paying for land. Call the cooperative extension office for the county: if your farm is in pasture, ask to speak with the livestock agent; if your farm is in row or field crops, ask to speak with the agent who advises farmers on those crops. If you are an "absentee landowner" (i.e., you do not currently live in that community), be sensitive to the fact that you are inquiring about issues that may economically impact the businesses of farmers that local cooperative extension agents and soil & water conservationists have worked with for years. Remember that land and the infrastructure on it can vary greatly, so what others are charging may not be appropriate for a particular farm. Make sure you compare your rate to rates for land of comparable quality, based on actual yields or productivity indices.[1]

2. **USDA Farm Service Agency (FSA) county average rental rate**. The USDA Agriculture Statistics Service surveys farmers and landowners to compile annual reports of average rents for high, medium and low productivity crop and pasture land. Note: The results of these surveys, while considered reliable, may not accurately describe conditions in certain parts of a county.

3. **Cost of land to the landowner**. Many landowners are content to simply cover their costs of "carrying" the land. These costs typically are the sum of depreciation (on certain structures), insurance, repairs, taxes, and interest. Most agricultural and horticultural land (and a fair amount of forested land) is enrolled in the state's "land use assessment" tax program whereby qualifying land is assessed at a property tax rate lower than its highest use. The program normally requires that farm and horticulture land produce a set annual gross income, which can be quite low, but nonetheless requires someone to farm the land and show income receipts.

4. **Costs of production (tenant's residual)**. Another approach is to calculate how much income the tenant has available for rent payments after subtracting all the tenant's costs associated with producing the crop on the land. This approach will require yield estimates, projected market prices, and perhaps government payments, to determine an income picture. Next, calculate the operating expenses for the year. Next, subtract the tenant's cost of machinery and equipment ownership, which includes costs such as depreciation, a return on investment, insurance, and machinery housing. Finally, a figure should be calculated and subtracted for the tenant's labor and management. The remaining amount is available for the payment of cash rent. Without the willing participation of a prospective and experienced farm tenant, this approach will be a challenge for most landowners.

1 http://www.extension.iastate.edu/agdm/wholefarm/html/c2-20.html

to an installment schedule for preparation of the land, spring crop harvest and fall crop harvest. Determining a fair rate is often a challenge, but there are several methods to consider (see sidebar *Determining a Fair Rent, next page*).

5. Allowable and prohibited uses. The lease normally limits use to agricultural production. Some landowners may want to specify prohibited uses, such as chemical application. Landowners should consider the practicalities of limiting certain activities that would otherwise reduce the productivity of the operation. Remember that all prohibited uses can be qualified by written consent if the lease so declares. Below is a partial list of issues to address:

- The lease should address protection of conservation program features, including buffers and grass waterways.

- State and federal regulations and laws should be incorporated by reference. If the landowner will allow application of chemicals (pesticides, herbicides, etc.) to be applied to the land (indeed essential to many production areas), the lease should state that only USDA approved chemicals be used and applied according to federal and state regulations. Further, the lease can restrict application of chemicals that have a residual life beyond the term of the lease.

- If the landowner intends to reserve mineral rights to the property, extraction activities such as removal of sand or gravel should also be expressly prohibited.

- It is prudent for the landowner to require the property to be left in the same condition as when the lease began, and include a redress for documented damages to the property (a photographic baseline can be made at the beginning of the lease). Though a prudent would-be tenant will have inspected the land, the soils and water availability before choosing to farm that property, the landowner should make clear that he or she offers no warranty as to the production capabilities of the land.

- Any land clearing should be discussed beforehand, and burning should be reserved to consent of the landowner upon showing of proper permits if applicable to the area.

6. **Repairs and maintenance and improvement costs.** Maintenance of property should be allocated between the parties, including responsibility for routine repairs and those caused by extreme weather events or fire. Be sure to list items such as fencing, gates, wells and pumps, etc. *See Worksheet 3.4: Repairs and Maintenance Checklist*.

7. **Rights and obligations of both parties.** Issues that can be addressed can include prohibitions on the right to sublease, payment of utilities, right of entry and inspection by landowner. A statement that the lease is not a partnership between landowner and tenant should be included, as well as a statement binding the heirs and assigns (i.e., subsequent purchasers) to the terms of the lease agreement. The lease should also contain a clear indemnity clause, requiring parties to pay for liability attributed to one party for the actions of another. It is common sense to require that both parties keep insurance policies at a designated level for just such a purpose.

8. **Termination of the lease and default**. Default means that one of the parties has not lived up to the obligations attributed to them in the lease. Numerous events can trigger default: failure to pay rent, failure to abide by any use prohibitions, maintain liability insurance, comply with laws and regulations, bankruptcy, etc. Default does not necessarily trigger termination, but should trigger a process for recognizing and curing the default if possible. If the default cannot be cured, a process should be spelled out for repossession of the property by the landowner, including reserved rights to crops by the farmer. Disagreements should be subject to a clear dispute resolution process.

As a practical matter, a lease is only as good as the parties' willingness to enforce it in court. The more thorough and open the agreement process, the less likely a disagreement will occur in the first place. Although it is likely impossible to build a lease agreement that will provide for all contingencies that might occur, both parties should try to anticipate foreseeable occurrences and identify the procedure for what the parties do should something unforeseen occur. Because both landowner and farmer benefit from a written lease agreement, both should take care in developing an agreement that supports each other's goals.

Worksheet 3.2

Short-Term Lease Checklist

Use this worksheet to ensure key areas are addressed in your discussion of a lease agreement. Each item will require discussion between both parties and legal counsel.

1. _____ Who are the parties? Make sure you have evidence of ownership and authority to act if the landowner is an entity (ie. LLC, estate, trust) other than an individual. Make sure the lease binds "heirs and assigns."

2. _____ What will be the lease term (length in years)? State law may require recording of the lease or memorandum in the register of deeds for the county where the land is located.

3. _____ Will the lease be renewable? Will both parties have the option to renew or not renew? How much notice is required for renewal, and what is the procedure?

4. _____ Do you have an adequate description of the property (real and personal) to be leased (land, boundaries, farm structures, residence, equipment, etc.) If a good written description is elusive, include an FSA aerial photo or GIS map with boundaries marked as an exhibit.

5. _____ How much and what type of rent will be paid? When must the rent be paid? (see worksheet *Determining Rent*)

6. _____ If the agreement includes a residence, will there be a separate residential lease?

7. _____ What will be the allowable and prohibited uses of the property under the lease? If chemicals are allowed, who bears liability for their misuse?

8. _____ How will the landowner and the tenant allocate responsibility for repairs and maintenance of the property? (see worksheet *Repairs and Maintenance*)

9. _____ How will the landowner and tenant allocate responsibility for capital improvements? If the tenant invests in capital improvements, how will they be compensated?

10. _____ Who will be responsible for obtaining and maintaining insurance - liability, casualty or crop insurance?

11. _____ What actions by either party will constitute default under the lease? Will the non-defaulting party have the right to terminate the lease or withhold rent until the default is cured? Will the lease include a procedure for dispute resolution?

Worksheet adapted from *Holding Ground: A Guide to Northeast Farmland Tenure and Stewardship*.

Worksheet 3.3

Estimating Costs and Estimating Rent

Use this worksheet to establish a fair rental arrangement between landowner and farmer. It will help establish a baseline of land ownership and operating costs to orient both parties toward an agreement on allocations of costs, income and establishment of a rental rate.

Item of expense	Estimated total value of asset	Interest rate %	Estimated Annual Expense		
			Whole Farm ($)	Landowner Share ($)	Farmer Share ($)
SECTION ONE. Fixed Expenses					
PART A. Fixed Investment Expenses					
1. Land					
2. Farm Buildings					
3. Farm Vehicles					
4. Machinery and Equipment					
5. Breeding Stock					
6. Dwelling					
7.					
8.					
9. TOTAL PART A					
PART B. Fixed operating expenses					
10. Labor					
a. Tenant's					
b. Unpaid family					
c. Landowner					
d. Hired					
11. Depreciation					
a. Buildings, fences and other farm structures					
b. Farm machinery and equipment					
c. Farm vehicles					
12. Repairs					
a. Buildings, fences and other farm structures					
b. Farm machinery and equipment					
13. Real estate and other taxes					
14. Insurance					
a. Liabilty					
b. Casualty					
c. Crop					
15. Soil amendments					
16. Conservation measures					
17. Timber					
18. Other:					
19. TOTAL Part B					
20. TOTAL SECTION ONE					

Variable Expenses		Estimated Annual Expense		
		Whole Farm ($)	Landowner Share ($)	Farmer Share ($)
SECTION TWO: Items of Variable Expenses				
21. Cash farm operating expenses				
a.	Livestock breeding			
b.	Hired labor			
c.	Conservation expense			
d.	Fertilizer/lime			
e.	Fuel			
f.	Seeds/plants			
g.	Utilities			
h.	Veterinary expense			
i.	Farmer training and development			
j.	Cash rent			
k.	Machinery expense			
l.	Marketing expense			
m.	Timber net expenses			
n.	Other:			
o.	Other:			
22. TOTAL VARIABLE EXPENSES				

SECTION THREE. Annual Farm Receipts					Whole Farm ($)	Landowner Share ($)	Farmer Share ($)
	Crops						
Expected yield (1) (unit per acre)							
Expected price (2) (per unit)	$	$	$	$			
Crop income (1 x 2)							
Other income (gov't, hay, other)							
	Spring		Fall				
Livestock sales	$	$	$	$			
Other							
23. TOTAL PROJECTED RECEIPTS							
SECTION FOUR. Summary Expenses							
TOTAL FIXED EXPENSES (#20)							
TOTAL VARIABLE EXPENSES (#22)							
24. TOTAL EXPENSES (#20 plus #22)							
RECEIPTS LESS TOTAL EXPENSES (#23 minus #24)							

This worksheet developed from USDA Pub. No. 836 and *Holding Ground: A Guide to Northeast Farmland Tenure and Stewardship*

Worksheet 3.4

Repairs and Maintenance Checklist

This worksheet can be used to support a clause in a lease agreement requiring that landowner and farmer will visit the issues of repair and maintenance on an annual basis. Each party should keep a copy.

Year: _____				% of Cost Contributed by Landowner and Tenant				Total Dollars Contributed Toward Repair		Value of Labor	
				Materials		Labor					
	Repair or Replacement to be Undertaken	Date to be Completed	Estimated Cost of Materials and Labor	L	T	L	T	L	T	L	T
Structures: Exterior siding/ Windows/ Roofing											
Fences											
Barn Equipment											
Water, Heating, Ventilating Systems											
Waste Management Systems											
Conservation Structures											
Total											

Landowner (signed)	Farmer (signed)

This worksheet adapted from USDA form AD 562 (Mar 1960)

Notes

About Conservation Easements

Editor's note: One question that our education collaborative has fielded consistently throughout the years is about conservation easements. Many landowners have asked, "Is it a good way to go?" The utility of the conservation easement as an effective tool in your farm transfer planning depends on your goals and financial needs, which are discussed earlier in this workbook and explored further in the narrative below.

Conservation easements are a land "protection" tool authorized by state law and recognized by the Code of Virginia and the Internal Revenue Code to protect and conserve land. Conservation easements are used to protect a variety of landscapes including farmland, forestland, ridgetops, historic structures, wetlands and beaches. They are a specific exception to the common law rule that one cannot create a permanent interest in real property.

Because conservation easements are a relatively recent legal concept, many landowners are unfamiliar with their use and particulars. At its most basic, a conservation easement allows a landowner to continue to own the land while placing certain voluntary restrictions on its current and future use. These restrictions can include limitations on subdivisions and development. In exchange for these restrictions, landowners can receive payment or tax benefits (sometimes a combination of the two).

This narrative should answer basic questions that a landowner -- particularly of farm and forest land -- might have about conservation agreements, and whether they are something to explore further. Remember that a conservation easement is a real estate transfer of certain rights and interests, and should be seriously considered with the help of a legal and tax adviser experienced with such transactions.

What is a conservation easement?
A conservation easement is a voluntary written agreement between a landowner and a qualified private non-profit organization, such as a land trust or conservancy, or a public body authorized to hold easements.

The conservation easement has two essential elements:

1. The landowner (grantor or donor) agrees to protect certain conservation values on the land, such as open space, scenic and historic resources, water quality, and wildlife habitat.

2. The conservation organization or public body (grantee) is granted the right to monitor the property and enforce the covenants of the agreement in perpetuity (forever). While the landowner may sell the land, the covenants of the easements continue to apply to all future landowners.

Many folks often ask whether a simple deed restriction can protect the conservation values of land. The key challenge is that there is no permanent mechanism of enforcing the terms of a simple deed restriction. The nature of a conservation easement is to grant another party the right to ensure that the conservation (or working) values are not threatened by actions to the land, such as uses that negatively impact the conservation values of the property.

These types of restrictive easements can be called by a number of names, including deed of conservation easement, open-space easement, a sale or grant of development rights, a working forest easement, or an agricultural conservation easement.

Conservation easements are intended to protect property from residential or non-farm commercial development, thus providing a benefit to the public by conserving open space vistas, making farmland available, protecting against water pollution from runoff, or protection of scarce natural resources such as wildlife habitat or rare species.

In exchange for this public benefit, there are sometimes funds available to pay for the diminution in property value caused by such restrictions, though in recent years of fiscal tightening these funds are less available. There are however significant federal, state, and local tax incentives for a landowner if he or she donates the right to enforce restrictions to a qualified organization. To qualify for these tax incentives, the terms of the conservation easement, though flexible, must conform to the regulatory requirements of these tax deductions, as well as the standards and expectations of the recipient of the easement, and any use exceptions -- particularly for farms and forests -- must not significantly diminish the land's conservation values.

In general, a conservation easement can be a useful tool to landowners who a) have a strong desire that the land not be further developed or used more intensively than at present (i.e. in farming), and b) are able to utilize attendant tax deductions and credits.

Conservation Purposes

A key feature of a donated conservation easement to understand is that it is perpetual and does not expire or revert back to the landowner at some appointed time. You may hear people refer to this as "forever protected," which, though difficult to imagine, means that as long as an entity exists to enforce the terms of the conservation easement, it will protect the land. Some states allow non-perpetual (or "term") conservation agreements. Though landowners will often be compensated for such agreements, these generally do not qualify for tax deductions or credits.

To qualify as a charitable contribution for federal tax and state tax purposes, a transfer of a conservation easement deed must be made to a qualified grantee (generally a nonprofit organization or a public body). The deed must restrict the property to the point of meeting one or more of the following conservation purposes:

1. Protection of relatively natural habitats of fish, wildlife, or plants;

2. Preservation of open space including farm and forest land;

3. Preservation of land for public outdoor recreation or education;

4. Preservation of historically important land or buildings.

These conservation values must be documented through a resource inventory that may include aerial and topographic maps, photographs of improvements and attributes, descriptions or surveys of specific resources and land features such as prime soils, historic buildings, wildlife habitats, or wetlands.. The inventory is known as the "baseline," and will be the reference point of the condition of the property at the time the easement is granted and the values that will be protected by the conservation easement. The owner can decide with the agency or organization receiving the easement which conservation purpose is met by which part of the property, and can distinguish ecologically sensitive areas from other areas that might be appropriate for other uses.

Rights, Restrictions and Allowable Uses

A conservation easement's restrictions should be tailored to the particular conservation values of the land and interests of the landowner and grantee. Examples of activities that may be prohibited or restricted in a conservation easement include industrial use, mineral exploration or soil excavation, subdivision into smaller tracts, residential development, road and infrastructure expansion, and extensive timbering.

Depending on the size and character of the land, conservation easements may allow limited subdivision of the land into parcels, and typically allow timbering, forest management and agricultural use. The conservation easement also usually allows wildlife management, hunting and fishing, or the construction and maintenance of a limited number of new homes or other infrastructure necessary to produce income from the property. Such improvements will often be limited

to construction within certain delineated areas called "envelopes," or conversely may be prohibited from being constructed in identified "no-build" areas.

The grantor retains ownership along with the right to manage, care for, and derive income from the property. Conservation easements are not generally effective in imposing affirmative duties or obligations on the landowner. In special cases, as in the case of sensitive wildlife habitat, a conservation easement holder with a particular expertise may have the right to undertake certain management activities on the land. A conservation easement qualifies the property for Use Value (or Land Use) Taxation if the locality has such a program. Production standards may still be required for certain categories of land use assessment.

As noted, a core function of a conservation easement is to limit subdivision or otherwise prescribe how land can be subdivided into smaller tracts. Even so, the owner can still sell, encumber (mortgage) or otherwise convey the rights in the land through lease, will, trust, or to a management entity such as a limited liability company. However, despite the type of transaction, the land remains subject to the conservation easement. The rights the landowner retains pass to any heirs or assigns (by gift or sale).

With regard to using the land for security on a loan, the value of the land as collateral will be its restricted value subject to the easement. Normally the fair-market value of the land is lowered due to the easement and its restrictions. The lower value primarily reflects its subdivision restriction, since smaller parcels are more marketable and can sell at higher prices. If there is an existing deed of trust securing a loan on the land, the lender will be required to consent to, and join in the grant of the easement. The loan will be subordinated to the conservation easement.

In order for the grantor to realize tax benefits for the easement, the holder of the conservation easement is required by the Internal Revenue Service to monitor and enforce the obligations contained in the conservation easement. Therefore, the conservation easement must provide, or allow, for monitoring visits by the conservation easement holder; these visits typically occur every one to three years. The grantor and the grantee can agree on more visits, particularly if the conservation easement has provisions for activities such as habitat research.

Where the grantor reserves rights, such as the right to timber or to subdivide, the conservation easement may require review and approval prior to the exercise of such rights by the grantee of the easement.

In most cases, a conservation easement does not require or allow entry by the public. The landowner retains the right to control or prevent public access. However, sometimes scenic and open-space easements require visual access from public roads, trails, or waterways to qualify for deductions under the Internal Revenue Code. These conservation easements are designed to protect the scenic character of the land, and thus the requirement that the land can be viewed by the public is critical to its conservation value.

Conservation Easement Tax Advantages

As noted above, there are tax advantages for the donor of a conservation easement. The tax implication is generally related to the value of what the donor is giving up: usually the right to subdivide and further develop the property.

Federal Income Tax

If the conservation agreement gift is made during the donor's lifetime and the land is considered long-term capital gain property, the donor may claim a federal income tax deduction for the full fair market value of the gift of the conservation easement. The value of the easement is the difference between the "before" value of the land (unrestricted) and the "after" value of the land (restricted). The diminution or difference in the land value due to the easement is the gift value eligible for use as a deduction.

However, to prevent a donor from using the deduction to avoid paying taxes completely, the Internal Revenue Service (IRS) places a cap on the amount of the deduction that can be claimed in any given year. For tax year 2011, the cap is set at 50% of the adjusted gross income for individuals. Individuals may carry over any unused portion of the donation for the next fifteen years subject to the 50% AGI cap each year.

For individuals who qualify as farmers by earning more than 50 percent of his or her income from "the trade or business of farming," the tax deduction is raised to 100% of adjusted gross income, and any unused deduction can be carried forward the next fifteen years.

For donations made after 2011 (unless there is a change in the legislation) the deduction reverts to 30% of AGI with a carryover period of five years.

Activities that count as farming for purposes of the deduction of up to 100% of AGI include:

- Cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including raising, training, and management of animals) on a farm;
- Handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner or operator regularly produces more than one-half of the commodity so treated; and
- Planting, cultivating, caring for, or cutting of trees, or the preparation (other than milling) of trees for market.

The easement in these circumstances must require the land remain "available for agriculture."

State Income Tax
In Virginia, taxpayers can claim a land preservation tax credit (offsetting state income taxes) of 40% of the value of the easement for donation of qualifying open-space easements. The amount of credit claimed by any one taxpayer may not exceed $50,000 for tax year 2011 or $100,000 for tax year 2012 and tax years thereafter, but any unused amount may be carried over for a maximum of 13 consecutive years if the credit originates in tax year 2011 or for a maximum of 10 consecutive years if the credit originates in tax year 2012 or thereafter. In the event that a landowner has more credits than he or she can use against state tax liability, the credits may be sold or otherwise transferred to other persons or entities. The Department of Taxation charges a fee of 2% of the value of the donated interest (5% of value of credits) for transfer of credits. For donors claiming a Virginia tax credit of $1 million or more (gift of an easement in which the easement value is $2.5 million or more), the deed of easement must meet Virginia Department of Conservation and Recreation criteria, which may require conservation restrictions additional to those required by the easement holder.

Federal Estate Tax
Conservation easements offer estate tax benefits, in that a conservation easement will generally decrease the land's fair market value due to development and subdivision restrictions. The restrictions will stall the rapid appreciation of the property tied to residential or commercial development potential for that property. The lower land value may serve to decrease the overall estate value that might otherwise be exposed to an estate tax.

Under the Internal Revenue Code, if certain requirements are satisfied, an executor can elect to exclude up to an additional 40% of the after-easement value of the land from a landowner's estate for estate tax purposes (subject to a $500,000 maximum).

However, be aware that, even with a conservation easement, land can still appreciate, and given the location and desirability, can appreciate higher than originally anticipated when the conservation easement is donated during one's lifetime as part of a comprehensive estate planning strategy.

If the conservation easement is granted by will, the donor's estate may claim an unlimited charitable deduction for the value of the easement, which has the same effect of reducing the estate tax. In this case, the testator can have directed that an easement be donated upon his or her death, or can give the executor the power (option) to do so if it appears such donation will serve to retain wealth (ie. lower or eliminate estate tax burden). Up to $500,000 of the land's residual value may also be deducted from the value donor's estate in some special situations.

Local Property Taxes
In Virginia, counties that have adopted Land Use Taxation or agricultural tax value programs must qualify and assess conservation easement properties at use value. If the county does not have a use value property tax program, the assessed value is limited to the lands restricted value under conservation easement and therefore should result in a reduction in the fair market assessment and attendant real estate taxes.

Valuation of Conservation Easements for Tax Purposes
An appraiser uses a before-and-after test to determine the value of a conservation easement. Simply, the value of the property whose uses are restricted by the conservation easement is subtracted from the value of the property as if there were no conservation easement restrictions. The difference between the two appraisals is the value of the conservation easement.

Sometimes, the presence of a park or other conservation property can soften the reduction in value as it

is an amenity to adjacent land, and actually results in added value to the adjoining land. This also may happen when the donor or donor's family owns property adjacent to the easement property. The adjacent property may increase in value due to the now-protected easement property. The appraiser must reduce the value of the donated conservation easement by the amount which the other property increases in value. This is known as an "enhancement" value and must be accounted for when appraising the easement property.

An appraiser who understands the local real estate market and conservation easements should do the appraisal. When the motivation for donation is an income tax deduction, one would think there is an opportunity to substantially increase the deduction by dramatically lowering the value of the land under the conservation easement restrictions. However, there are substantial penalties imposed on both donors and appraisers for such overvaluations. Furthermore, the donor, appraiser, and the grantee organization must all sign a special tax form (Form 8283) in order for the donor to claim a federal income tax deduction.

The Conservation Easement Transaction

Conservation easements may be granted to public agencies, such as federal and state agencies, counties and towns, or to a nonprofit tax-exempt conservation organization. A non-profit entity will normally be called a "land trust" or "conservancy". The largest holder of conservation easements in Virginia is the Virginia Outdoors Foundation (VOF), a public entity holding approximately 80 percent of all conservation easements in Virginia.

Conservation easement transactions are complex. To ensure the conveyance of a conservation easement will qualify for a federal tax deduction or a state tax credit, certain documents must be prepared, including:

1. Deed of conservation easement. This is the document that outlines the agreement and whose language supports the public purposes that qualify for tax benefits. The agreement should be drafted by an attorney.

The easement holder/land trust will normally have a deed that they commonly use that will reflect the land trust's "protection" concept and expectations. The deed then is tailored to address the particular conservation values of the property and the present owner's needs. Landowners are advised to seek the advice of an attorney of their choosing who will ensure that the conservation easement allows for the continued use of that land (i.e. for farming) by the grantor, with enough flexibility that will not otherwise endanger tax benefits. This deed will be recorded in the county court house with the county register of deeds.

2. Inventory of the property. This document is known as the baseline report, and can be prepared by the agency or organization that will hold the easement. This document supports any declaration of conservation purposes, and will also serve to illustrate the conditions of the property at the time of the donation and the particular attributes of the property that the easement holder will not want significantly changed.

3. Appraisal. The appraisal is prepared by an independent appraiser, who is hired by the landowner/grantor. The appraiser should be competent in conservation easement transactions. The appraiser will conduct essentially two appraisals: one for the land's highest and best use, and the second for its value under the conservation easement restrictions. The difference represents the value of your donation or sale if you are to receive payment, partial payment, or tax benefits for the granting of the conservation easement.

4. Title work. There must be title work completed on the property to determine true ownership and whether any encumbrances (such as deeds of trust or easements) exist. Title work helps insure that all owners or parties with an interest in the property are party to the deed, and sign in the appropriate capacity. This work should be performed by an attorney.

5. Survey and legal description. As with any real estate transaction, there needs to be adequate and accurate legal description of the property encumbered by the easement. In some cases a survey may be necessary to properly delineate the property to be subjected to the easement.

6. Form 8283. This is an attachment to the federal tax return of all individuals claiming charitable contributions of more than $5,000, prepared by the Grantor or his accountant, and signed by the Grantor, Grantee and appraiser. If the deduction claimed is greater than $500,000, then the full appraisal must also be attached.

Note federal tax law requires the grantee organization to maintain sufficient assets to carry out its monitoring and enforcement obligations in the future. Therefore, organizations that agree to hold conservation

agreements will have a stewardship fund or endowment set aside to pay for staff costs associated with monitoring. Therefore, they generally need to raise money to add to this fund whenever they add a conservation easement to their monitoring requirements. While it is not a requirement, the grantee organization (particularly private non-profit organizations) will usually ask the grantor to contribute to the fund.

Modification and Extinguishment of Conservation Easements

Grantors of conservation easements should never make their decision based on the possibility that the conservation easement will be revoked or able to be modified. Conservation easements are designed to be permanent, so amendment can be difficult and extinguishment is almost impossible. In rare circumstances, extinguishment may be accomplished through a court proceeding. Successful extinguishment requires a convincing demonstration that, due to a change in circumstances (normally regarding the surrounding land use) use of the property for the original conservation purposes of the conservation easement are no longer practical or possible. If the conservation easement is extinguished, the interest in the land (or the proceeds from any sale) is allocated to Grantee and Grantor, respectively, in proportion to the value of the agreement and the value of the land. In addition, Virginia law provides a special process for "converting or diverting" land from its open-space use. This process is different from the extinguishment process; one of the most notable differences is that when an easement is extinguished the holder of the easement is only compensated with the cash value of the easement, whereas the process for conversion or diversion requires replacement land to be substituted for the land that is converted or diverted. This process is only available for easements and other protected lands held by public bodies, such as the Virginia Outdoors Foundation.

It is possible that a conservation easement can be amended by agreement of the owner and the holder of the easement. Such agreements can clarify an ambiguity in the easement, but cannot in any way diminish the conservation value upon which any tax deductions were calculated. Amendments also can add acreage to an easement or add further to the protection of the property. For instance, an increase in the conservation value of the easement, such as adding acres or relinquishing a parcel right that was retained in the original easement could generate an additional gift value for tax purposes.

Remember that while a conservation easement can be a valuable tool, it is not a matter of right. Landowners must understand that holding and monitoring a conservation easement is a responsibility that a land trust or county must choose to undertake. Accepting an easement will depend on a number of factors, including a) the potential holder's organizational capacity, b) their conservation priorities, and c) the conservation qualities of your land or whether its use (in farming or forestry) aligns with the priorities of the organization.

For more information:

Virginia

Virginia Outdoors Foundation
http://www.virginiaoutdoorsfoundation.org/

Office of Land Conservation
Virginia Department of Conservation and Recreation
http://www.dcr.virginia.gov/land_conservation

Office of Farmland Preservation
Virginia Department of Agriculture and Consumer Services
http://www.vdacs.virginia.gov/preservation/

National or Regional

Land Trust Alliance
http://www.landtrustalliance.org

North Carolina

Conservation Trust for North Carolina
www.ctnc.org

South Carolina

South Carolina Land Trust Network
http://www.lolt.org/lolt

Georgia

Georgia Agricultural Land Trust
www.georgiafarmland.org/

You can also inquire with your county's Soil and Water Conservation District to see if they hold conservation easements.