Chapter I

Legal Structure of the Farm Business

By Annette Higby

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Legal Structure of the Farm Business

In Vermont, most farms are sole or family proprietorships. According to the 2002 Agriculture Census, 88 percent of Vermont’s farms are sole proprietorships, while 7 percent operate as partnerships, and 4 percent fall under a corporate structure. Only 1 percent of Vermont farms fall under the “other” category, which includes cooperatives, trusts, estates, and limited liability companies, or LLCs. However, LLCs appear to be the fastest growing category in Vermont. LLCs have been permitted by Vermont law only since 1996, but as of January 1, 2004, there were 7,258 LLCs in the state. Any farmer who is starting a new on-farm enterprise, looking for a way to transfer assets to the next generation, reevaluating exposure to liability, or at some other important juncture in the life of the farm business needs to consider the most appropriate legal structure for achieving these goals. When choosing a business structure for a new or evolving farm operation, it’s wise to consider a number of factors.

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<th>Taxation</th>
<th>Ease of Transfer</th>
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<tbody>
<tr>
<td>Sole Proprietorship</td>
<td>No</td>
<td>Taxed as an individual</td>
<td>Transfer of individual assets</td>
<td>Less appropriate</td>
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<tr>
<td>General Partnership</td>
<td>No, but may elect to become a limited liability partnership.</td>
<td>Partnership taxation</td>
<td>Transfer of capital interest</td>
<td>Appropriate where structured as a limited partnership</td>
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<tr>
<td>Limited Liability Company</td>
<td>Yes</td>
<td>May choose to be taxed as a partnership or as a corporation. Single member LLC is a &quot;disregarded entity.&quot;</td>
<td>Transfer of units</td>
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<tr>
<td>Corporation</td>
<td>Yes</td>
<td>May choose to be taxed as a Partnership (S Corp) or as a Corporation (C Corp.)</td>
<td>Transfer of shares</td>
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<tr>
<td>Non-Profit Corporation</td>
<td>Limited Liability for members and uncompensated board members.</td>
<td>Tax exempt</td>
<td>Transfer of assets to other than another non-profit is prohibited.</td>
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<td>Cooperatives</td>
<td>Limited Liability for Members</td>
<td>Taxed as a cooperative</td>
<td>Transfer restricted to other eligible cooperative members (farmers).</td>
<td>Yes</td>
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</tbody>
</table>
Legal Structure of the Farm Business

Important Factors for Choosing an Entity

**Taxation**

Business taxation falls into three categories, as described below.

1. **Pass-through entities.** In a pass-through entity, income and expenses for the business are reported to the IRS, but tax liability “passes through” to the individual owners of the business and is based on their share of the business. Partnerships, for example, provide an informational return to the IRS, but the individual partners report and pay tax on their share of the partnership income.

2. **The double-taxation entity.** Some entities pay tax on business income. However, owners who receive that income as dividends pay taxes on it again. Corporations, for example, pay tax on corporate income when they are taxed as corporations, but shareholders also pay a tax on the corporate dividends that the corporation paid to them.

3. **Disregarded entities.** Some entities, such as one-member LLCs, are “disregarded entities.” The IRS disregards the entity entirely and taxes the owner directly. Certain kinds of trusts are also disregarded entirely by the IRS and all income is taxed directly to the owner or “settlor,” the person who creates a trust.

With a few exceptions, this chapter will cover only basic information about farm entity taxation.

Farmers should always discuss the tax consequences of any choice of entity with a tax professional before the entity is formed. It’s also a good idea to have the tax professional review the operating or partnership agreement. Farmers should have a clear understanding of the tax treatment of the business at every stage of the business—from formation to liquidation. A tax professional can also help farmers track their tax basis in any assets transferred to a new entity as well as inform them if a transfer of assets into a new entity will generate an income or capital gain tax.

Taxation seems to be the dominant consideration for many people when they choose a particular entity. Tax law, however, often allows a choice of taxation options for the entity chosen. Corporations, for example, may choose to be taxed as a double-taxation entity—a C Corporation—or a pass-through entity—an S Corporation. LLCs also have this choice. While farmers need to understand the tax rules, taxation shouldn’t be the tail that wags the dog. Other considerations are equally, if not more, important in choosing the most appropriate entity for the farm business.

**Limited Liability**

Corporations, limited liability companies, limited liability partnerships, and agricultural cooperatives all provide limited liability to their shareholders, members and partners. The limited partners of limited partnerships and the members and uncompensated directors of non-profit corporations also enjoy limited liability. Limited liability means that a stakeholder’s financial risk in an enterprise is limited to his or her investment in the enterprise.

The public purpose behind limited liability is to encourage people to take risks with their

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**Factors to Consider in Choosing an Entity**

- **Taxation.** Will the entity be taxed like a partnership or like a corporation?
- **Limited Liability.** Will the owners of the business be personally liable for the debts and obligations of the farm business?
- **Ease of Transfer.** Does the entity structure make it easy to track and transfer ownership interests in the business to the next generation?
- **Life of the Entity.** When does the entity terminate? Will the entity continue beyond the life of one or all of its owners?
- **Raising Capital.** Does the entity allow for outsiders to invest in the business?
capital and to foster economic growth. For many small business owners, limited liability shields the family home, the retirement account, and other personal assets from the financial risk of the business. But in the farm context, the line between business and personal assets is not so neat. The farm is usually the family’s home, and the farmland its retirement plan. If the entire farm is put into a limited liability entity, everything is at risk. Unless there are significant non-farm assets, it may not make sense to put the entire farm into one limited liability entity. More often, it makes sense to put the farmland into one entity and the farm operation into another entity. Or, a new on-farm enterprise can be contained in a separate limited liability entity to shield the farm from the financial risk of a new enterprise.

The Limits to Limited Liability
Limited liability will not shield a business owner or an employee from personal liability for his or her own negligence. If an employee negligently causes an automobile accident while working for an LLC, there are three potential defendants. The employee may be held personally liable for the action. The LLC can also be held liable because the employee was working for it. The employer may also be held personally liable if he or she was negligent in hiring or supervising the employee. Similarly, if a member of an LLC negligently causes an automobile accident while working for the LLC, liability will fall on both the business and the member.

Secured Creditors and Other Contractual Exceptions to Limited Liability
Limited liability will not prevent a member or shareholder from agreeing to be held personally liable for the debts or other obligations of the entity. In fact, most creditors, lessors, and other parties will insist on personal liability for the debt or other obligations of the contract. Secured creditors, in particular, will most likely ask members or partners to remain personally liable on their note and may also ask them to pledge non-farm assets as security for the loan.

Losing the Liability Shield
Once a liability shield is obtained, certain steps must be taken to maintain it. Courts may disregard the liability shield — or pierce the corporate veil — and allow plaintiffs, unsecured creditors, or other claimants to reach the personal assets of the owners of the business under certain sets of facts. Most of the cases that address piercing the corporate veil involve the corporate form, but courts have been applying the same rules to limited liability companies and other limited liability entities. The two primary ways to lose the liability shield include disregarding the entity and inadequate capitalization.

Disregarding the Entity
Courts often remove the shield of limited liability in cases where owners fail to treat the business as a separate entity. Co-mingling business funds with personal funds or failing to prepare corporate resolutions or document business transactions between the entity and its owners, for example, are all factors a court might use to pierce the corporate veil. It is especially important in a family setting to document with leases, promissory notes, and other documentation transactions between family members and the family entity.

A liability shield is also put at risk in cases where the members or shareholders lead others to believe they are dealing with them personally rather than with a separate entity with a limited liability shield. You must include “LLC,” “Inc.,” or some other indication of limited liability on the business checks or letterhead. By statute in Vermont, the business name must include words such as “corporation,” “incorporated,” “company,” “limited, corp. co.,” or “ltd.”

Undercapitalization
Courts are especially inclined to let creditors reach personal assets when the assets in the business are inadequate to meet the ordinary and expected obligations of the business. If a business is not much more than an empty check book, a court will likely look to the personal assets of the owner. Adequate capitalization also means having adequate insurance.

Limited liability entities can make themselves vulnerable by making distributions of income or assets that lead to inadequate capitalization. By statute in Vermont, for example, members of LLCs are prohibited from making distributions that leave the entity thinly capitalized. “Thiny capitalized” means that capital is inadequate to
meet obligations as they become due in the ordinary course of business, plus the costs of dissolution. If a prohibited distribution is made, members will be personally liable up to an amount by which the distribution exceeds necessary capitalization. This prohibition includes loans or other transfers of assets to shareholders or members that lead to insolvency.

**Ease of Transfer**

Another factor that drives the choice of entity or a conversion from one entity to another is ease of transfer. How easily will a particular legal structure facilitate a lifetime transfer to the next generation? Legal structures that reduce the farm to “units” or “shares” can simplify farm transfer. Certain legal structures make it easier to value, track, and transfer an interest in a farm business. In an LLC, for example, the senior generation can transfer a number of units each year to the junior generation, gradually transferring the business. Partnerships that track the partners’ “capital accounts” on an annual basis can also gradually transfer equity to the junior generation. In contrast, a sole proprietorship can’t easily make a lifetime transfer of farmland a few acres at a time. It is more difficult to make lifetime gifts of an interest in a sole or family proprietorship than it is to transfer shares in a corporation or membership units in a limited liability company. It is also easier to use the latter two structures to transfer an economic interest while retaining or gradually transferring control over the asset.

These issues are described in more depth in “Transferring an Interest in a Farm Business” on page 37 of Chapter II, Farm Transfer and Estate Planning.

**Special Duties and Authority to Make Business Decisions**

Members of multi-member entities often have an extra set of obligations that they owe to their business partners, for example: duties of good faith, fair dealing, and loyalty. The rules regarding who can speak for and bind the company also vary depending on the entity type.

**Nature of the Business and the Business Assets**

Some businesses present more financial risks than others. A new enterprise that lacks data about markets or other considerations that can help to predict success is financially risky. The purpose of the limited liability shield is to encourage entrepreneurs to take risks with their capital. If the business is operating in an untested market, a limited liability shield — to contain that risk — makes a lot of sense.

If assets are appreciating rapidly, it may be wise to put them into an entity that allows you to begin moving them out of the estate to reduce liability for future estate taxes. If, on the other hand, it is a low-basis asset, then the capital gain consequences of a lifetime gift must be weighed against the potential for estate taxes.

**Life of the Entity**

A sole proprietorship ceases upon the death of the sole proprietor. Corporations, on the other hand, can conceivably last into perpetuity. Other entities can exist for a “term of years” or “at will,” meaning that members can terminate the entity at any time. Most partnership or operating agreements provide for rights to purchase from a deceased estate in the event of death and life insurance to fund it. Where farm transfer is contemplated, an entity that will outlive the senior generation may make the most sense.

**Raising Capital**

Some entities are more appropriate than others if you want to attract capital investors — LLCs, corporations, cooperatives, and limited partnerships are a few entities that are especially structured to facilitate the use of outside capital. Entities that seek outside capital must also comply with the rules regarding the sale and registration of securities. For more on securities regulation, see “Raising Capital Using the LLC Structure” on page 28.
Farmers who decide to operate their business as a sole proprietorship are in good company; the majority of farms in Vermont operate as a sole or family proprietorship. The sole proprietorship is the essence of simplicity. The sole proprietor owns, manages, and is responsible for paying taxes on all income earned by his or her business. All income, losses, credits, and deductions are reported on the sole proprietor’s personal income tax return. The business identification number can be his or her social security number. However, if the business has employees, the sole proprietor must apply for an Employer Identification number from the IRS. (For an on-line application go to: http://www.irs.gov/businesses/small/article/0,,id=102767,00.html.) The sole proprietor bears the full risk of financial failure, with both business and personal assets on the line. But the sole proprietor also has sole control of business decisions and owes no duty to partners or others in the business.

When the sole proprietor dies, the business terminates, although business assets may be left to an heir by will or in a trust.

A sole proprietor in Vermont may choose to operate under a trade name. To operate under a trade name, “ABC Farms,” for example, the farmer must register that name with the Vermont Secretary of State’s office for a fee of $40.00. The trade name must be different from, and not deceptively similar to, another registered trade name or other registered corporation, partnership, or limited liability company. The trade name registration database is available online at: http://www.sec.state.vt.us/seek/tradseek.htm.

The majority of farms in Vermont operate as a sole or family proprietorship. The sole proprietorship is the essence of simplicity.
According to the USDA agricultural census, in 2002, 7 percent of Vermont farms were organized as farm partnerships. Vermont’s partnership statute was updated and overhauled in 1997, and became effective as of January 1, 1999. The general concepts under the new and old statutes are quite similar. The primary difference is that the new law offers a limited liability partnership option.

Simply put, a partnership is any association of two or more persons formed with the purpose of carrying on a business for profit as co-owners. The “persons” or partners can be other partnerships, LLCs, business trusts, corporations, or any other legal or commercial entity.

While it isn’t legally necessary, it’s best to have a written partnership agreement that governs the relations between the partners.

An Implied Partnership

It is possible to form a partnership without any written or formal declaration. Intent to form a partnership isn’t necessary. A partnership can be “implied” simply by the fact that you conduct business with another person or entity and share profits. However, joint ownership and/or sharing gross returns aren’t enough to establish that a partnership exists—sharing profits suggests that there is a partnership. One of the dangers of being in an unintended partnership is that partners are liable, both individually and together, for the debts of the partnership.

Understanding the partnership structure is all about understanding the law of “agency.” Each partner in the partnership is an agent of the partnership, and the partners are agents of one another. Each partner can contractually bind the partnership and the other partners in the ordinary, everyday matters of the partnership. Unless a partnership agreement provides otherwise,
matters outside the ordinary course of business must be authorized by all the partners. You can limit the scope of a partner’s authority to act for the partnership by the terms of the partnership agreement. The limitation upon an individual partner’s authority, however, must be on file in a “statement of partnership authority” with the Secretary of State's office. With the exception of real estate transfers, those doing business with the partnership will also need to be aware of this limitation or it will not be effective.

**Special Duties**

Partners owe certain duties to the partnership and to each other. These duties include a duty of loyalty and a duty of care. Partners must refrain from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law, and they must discharge their duties with an obligation of good faith and fair dealing. They must also account to the partnership for any property profit or benefit derived from the conduct of the business or from a use of partnership property. This includes the appropriation of a partnership opportunity.

**Liability or Limited Liability**

In a general partnership, all partners are jointly and severally liable for all obligations either in tort or in contract of the partnership. Individual partners may thus be held liable for the tortious conduct of another partner while acting for the partnership. Under Vermont’s new partnership statute, which became effective on January 1, 1999, a new option was offered to allow general partnerships to convert, or new partnerships to be formed, as limited liability partnerships. The advantage to this is that any obligation arising in contract, tort, or otherwise is solely the obligation of the limited liability partnership, not the individual partners. The liability shield for a limited liability partnership is virtually identical to the liability shield provided to Vermont corporations and LLCs.

To become a limited liability partnership, the partners must file a “statement of qualification” with the Vermont Secretary of State's office and pay a filing fee of $75.00. The statement of qualification is a simple form that requests some basic information about the business and its principals. Limited liability partnerships must also file an annual report with the state to maintain the liability shield. The partnership must put others on notice that it is operating as a limited liability entity by including “LLP” or some other indicator in the business name, letter head, checks, and other business documents. The partnership agreement should be restated to reflect the election to become a limited liability partnership.

**Taxation for Partnerships and Limited Liability Companies**

A farm partnership or an LLC that chooses to be taxed as a partnership is a “pass-through entity,” which means that each partner or LLC Member must report any share of partnership income, gain, loss, or deductions on his or her individual tax return. Each partner’s “distributive share” must be spelled out in the partnership or operating agreement. The partners or members may agree to split profits any way they choose. This distributive share will be taxed to the individual partner or member whether the distribution is

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**What is Basis?**

Under the simplest definition, the “tax basis” in property is its purchase price. If the price of the asset was $75,000.00, its tax basis is $75,000.00. The tax basis can be adjusted over time to reflect improvements made to the property – addition to basis – or depreciation taken on the property – reduction in basis. If the property is sold for more than its tax basis, a tax will be due on the gain. The tax rate will depend upon how long the property was held. For most types of property held for more than 2 years, the federal capital gain rate is 15 percent.

Gain or loss must be reported whenever property is sold or exchanged or upon any transaction deemed by the IRS to be a taxable transfer. Even a foreclosure of property is viewed by the IRS as a taxable transfer. And most importantly for our purposes, when property is transferred into a new entity, it will sometimes result in the recognition of gain.
made or not. There are some limitations, however, on the amount of loss that individual partners or members may claim in any one year.\(^{17}\)

Each partner or LLC member will have a basis in the business that must be tracked over the life of the partnership or LLC. A partner’s basis in the partnership will determine whether he or she owes any capital gain tax when the partnership is dissolved. It will also be used to determine whether there are any limitations on deductions a partner can claim from the partnership. Generally, the basis in the partnership equals any cash a partner contributes plus the basis of any contributed property. The basis will change over time depending on depreciation taken or new investment in the business.

The following is an example of calculating basis:

Dick and George decide to form a partnership to harvest wood and manufacture wood products. George contributes $50,000 in cash and debt-free forest land for which he paid $250,000. Dick contributes $250,000 in cash and wood-processing equipment for which he paid $50,000. Given these figures, both George and Dick have a basis of $300,000.

A transfer of property into a partnership in exchange for a partnership interest will generally not trigger recognition of gain. There are, however, some exceptions to this rule, most notably the “debt in excess of basis” rule.

Debt in Excess of Basis

You need to be careful when transferring property subject to debt into a partnership or an LLC that is taxed like a partnership. If the debt is assumed by the partnership or LLC and the partner or member is relieved of personal liability for the debt, the individual partner may have to report a gain on the transfer. The transfer of responsibility for the debt is considered by the IRS as the same thing as a cash distribution from the partnership. If the amount of the debt is in excess of the partner’s basis in the partnership, the partner will have to recognize the difference as gain. This situation frequently arises in situations where a partner is contributing farm-raised or other farm assets with a zero basis.

The following is an example of such a case:

Dick and George decide to form an LLC to produce yogurt. George contributes $50,000 in cash and a herd of Jersey cows worth $100,000. The cows have a zero basis and they are subject to a $100,000 operating note for which George is personally responsible. The partnership assumes full responsibility for the note and George is relieved of any personal liability. Dick contributes $100,000 in cash and yogurt processing equipment for which he paid $50,000. At this point, George’s basis is $50,000, and Dick’s basis is $150,000.

Because the partnership relieved George of a $100,000 liability, he is deemed to have received a $100,000 cash distribution from the partnership. The cash distribution exceeds George’s basis in the partnership. He will have to recognize gain on the transfer to the extent that the debt exceeds his basis. In this case, he will have to report a gain of $50,000 upon formation of the partnership.

However, if George remained personally liable for the note, there would be no distribution and no gain on transfer of the cows. He must remain personally liable – offering a secondary guarantee of the indebtedness to the creditor would not be adequate to avoid recognizing gain.

### George

**Contributions of:**
- $50,000 cash
- $100,000 cows subject to debt of $100,000 assumed by LLC

**George’s basis is** $50,000

George was relieved of a $100,000 debt. The debt exceeds his basis by $50,000 which is his gain on the transfer.

### Dick

**Contributions of:**
- $100,000 cash
- $50,000 equipment

**Dick’s basis is** $150,000

### Ease of Transfer

Partnerships fall between sole proprietorships and LLCs when it comes to the ease of transferring the operation to the next generation. In an LLC, you can transfer “units” representing a fractional share of the farm assets in the entity. In a partnership,
Participants in federal farm programs must be actively engaged in agriculture. Payments per “person” are also limited. The payment limitations vary by program. If the operation is conducted jointly with others (a parent or child or spouse, for example), the entity chosen will affect whether the operation is considered one “person” or several. As a general rule, each partner in a general farm partnership is considered a “person.” Three partners farming under a general partnership could effectively triple the payment limitation. On the other hand, entities that enjoy limited liability, such as a limited liability company, a corporation, and even a limited liability partnership, are considered just one “person” for purposes of the payment limitation.

Spouses who farm together in a general partnership are treated differently. Spouses who farmed separately prior to their marriage and who continue to farm separately after the marriage may be considered two “persons.” In addition, spouses who are actively engaged in farming and are not receiving a payment through another farming entity may each be considered a “person.” Being actively engaged requires each spouse to put “at risk” a significant contribution of capital commensurate with their share of profits and losses and active personal labor.

Any change in a farming operation that increases the number of “persons” entitled to a payment will be carefully evaluated by the Farm Services Agency (FSA) to ensure it is bona fide and substantive and not primarily for the purpose of increasing farm program payments. FSA should be notified whenever:

- A new partner or member joins the farming operation.
- There is a significant gift or sale of farm assets to a new participant in the farm business.
- There is any change that might affect the “person” determination.
According to the most recent agricultural census, there are very few farm LLCs in Vermont. LLCs, along with non-profits and cooperatives, accounted for little more than one percent of all farm business entities in Vermont in 2002. LLCs, however, may be the fastest growing choice of entity in the state. According to the Vermont Secretary of State’s office, there were 7,258 LLCs in Vermont as of January 1, 2004. LLCs have only been authorized by Vermont law since 1996. Unfortunately, it is not clear how many of these entities are farm businesses.

### Advantages and Disadvantages of Limited Liability Companies

#### Advantages
- Ease of transfer
- Flexibility in structuring management, income and control
- Limited liability
- Flexible taxation
- Limited liability for a one-member entity
- Ease of transfer

#### Disadvantages
- Cost of formation can be substantial
- Time spent observing the formalities such as record keeping and learning about the entity can be substantial

### Formation and Management

An LLC can be formed by filing Articles of Organization with the Vermont Secretary of State’s office. The filing fee is $75.00. The Articles of Organization must include the name and address of the company, names and addresses of the organizers, and basic information about the business. The Secretary of State will return a Certificate of Organization to the organizers. LLCs must also file an annual report for which the filing fee is $15.00. Failure to file the annual report can result in “termination,” jeopardizing among other things the limited liability shield. Reinstatement for a fee is available.

LLCs are governed by “operating agreements” that you are not required to file with the Vermont Secretary of State’s office. Consequently, many of the details of the capitalization and management of the business remain private. Owners of the LLC are called “members” and they own “units.” Unlike a partnership, it is possible to have a one-member LLC.

### Topics Included in Typical LLC Operating Agreements:

- Definition of terms found in the agreement;
- Formation of the company (name, principal place of business, duration, and purposes of the company);
- Books, records, and accounting aspects of the company;
- Capital contributions of members;
- Allocations of income and loss and distributions to members;
- Meetings of members;
- Management of the company;
- Tax matters;
- Transfers of ownership interests including buy-sell agreements;
- Dissociation of members;
- Purchase of dissociated members; and
- Dissolution of the company.
Some aspects of the operating agreement are dictated by statute and cannot be varied. As in a partnership, members owe a duty of good faith and fair dealing to one another, and this duty may not be waived or altered by the operating agreement. Otherwise, there is tremendous flexibility in structuring ownership, management, control, and rights of transfer of individual LLC members.

An operating agreement, for example, can restrict a member’s rights to transfer units outside the family. The operating agreement can limit the management rights of parties who receive units as a result of bankruptcy or divorce. Voting rights may also be restricted by issuing voting and non-voting units. In this way, control of the business can be initially concentrated in the senior generation and gradually transferred to the next generation. It is this flexibility that has led to the popularity of LLCs and the reason that they are particularly useful in estate planning.

In Vermont, an LLC may be either manager-managed or member-managed. Choosing to be a manager-managed entity allows members to avoid the agency pitfalls of the general partnership. If the LLC is manager-managed, only the manager can bind the company in matters related to carrying on in the ordinary course of business. If the LLC is member-managed, then each member can be an agent of the business and can bind the LLC in these matters. Members may also designate certain members to act in certain areas. One member, for example, may be designated to deal with all matters of taxation.

The operating agreement of the LLC should address the potential for sale or transfer of units to new members or to buy out existing members. Where there is a buy-sell agreement, there should also be a method of valuation. Members may decide to do annual appraisals or to agree among themselves on the value of all LLC property every year. (See “The Buy-Sell Agreement” on page 38.)

As in a partnership, profits and losses needn’t be strictly based on ownership share. Allocations, for example, can reflect a greater contribution of management and labor on the part of one or several members. The operating agreement may also allow members to increase their ownership shares by reinvesting their share of profits back into the business.

**Limited Liability**

As the name suggests, LLC members enjoy limited liability, meaning that they are not personally liable for the debts, obligations, or other liabilities of the company. As is the case in other limited liability entities, however, an individual member may become personally liable for his or her own acts or conduct while acting on behalf of the business. (See “The Limits to Limited Liability” on page 4.)

As is the case with other limited liability entities, a court may decide to “pierce the veil” and look to the personal assets of the members to cover the obligations of the business where members disregard the entity or the entity is undercapitalized.

(See “Losing the Liability Shield” on page 4.)

**Taxation of LLCs**

LLCs can choose to be taxed as a corporation — a double taxation entity — or as a partnership — a pass-through entity. Single-member LLCs are “disregarded” entities, meaning that the IRS disregards the entity entirely and the member reports income and losses on his or her personal tax return.

Most farm LLCs choose to be taxed as a partnership. In instances where an entity is considering a broader array of employee benefits, choosing corporate taxation may make more sense. Most farm operations will choose pass-through taxation. For LLCs taxed as partnerships, the operating agreement can provide some flexibility in terms of allocating income, losses, deductions, and credits among LLC members. This flexibility can be useful when a senior generation member is in a higher tax bracket and can make better use of deductions or losses. The allocations can vary somewhat from the member’s actual capital contributions, but the IRS wants to see a relationship between the allocation of losses and deductions and the member’s actual economic benefits and burdens. Deductions on partnership losses may also be limited by rules regarding passive loss and in cases where the losses exceed a member’s basis in the LLC.

With some exceptions, when a member contributes land or other farm assets to an LLC taxed
as a partnership, there will be no tax consequence. One exception to this rule is described in “Debt in Excess of Basis,” page 9, in the previous section on partnership taxation. This is the case where a member contributes property subject to a debt, the LLC assumes the debt, and the member is relieved of personal liability for it.

A partner or a member may also have to recognize ordinary income if he or she exchanges services for an interest in the business. As is the case in partnerships, LLC members will have a basis in the business that must be tracked. See “Partnership Taxation for Partnerships and Limited Liability Companies,” page 8.

Ease of Transfer
The LLC probably offers the easiest means of transferring farm assets from one generation to the next. Farmland, livestock, equipment, and other farm assets can be reduced to “units” that can be transferred annually from the senior generation to the junior generation. For example:

The Jones family wants to begin transferring the farmland to their farming heirs. They create the Jones Family Farmland LLC. The LLC issues...
20 Tier A units and 480 Tier B units. The Tier A units have both economic and voting rights, meaning that holders of Tier A units share in the Company's profits and losses and can vote on issues of management. The Tier B units, however, have only economic rights, meaning that holders of Tier B units share in profits and losses but they have no voting rights and therefore have limited management rights.

The operating agreement also restricts transfers of the units, requiring agreement by the other members for transfers outside the family. The LLC operating agreement also limits the rights of transferees who come to own the units as a result of divorce or bankruptcy. Initially, Mr. and Mrs. Jones each hold 10 of the Tier A voting units. As well, Mr. and Mrs. Jones each own 240 of the Tier B units. Each year, they will transfer some Tier B units to their heirs. The value of their gifts will stay within the annual exclusion under the gift tax.

While the Jones' initially transfer only the Tier B units, within five years they will have begun to transfer the voting shares to the farming heirs. As management and ownership shifts to the heirs, they may continue to receive distributions of income tied to the Tier B units they have retained.

<table>
<thead>
<tr>
<th>If you’re looking for:</th>
<th>Consider these entities:</th>
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</thead>
<tbody>
<tr>
<td><strong>Limited Liability</strong></td>
<td>Limited Liability Partnerships, Limited Liability Corporations, Corporations, Cooperatives, and Non-profits all enjoy limited liability. Limited partners in a limited partnership also enjoy limited liability.</td>
</tr>
<tr>
<td><strong>Partnership (pass-through) Taxation</strong></td>
<td>Partnerships, Limited Liability Partnerships, and S Corporations are all taxed like partnerships. Limited Liability Companies may choose to be taxed like a partnership.</td>
</tr>
<tr>
<td><strong>Corporate Taxation</strong></td>
<td>C Corps are taxed as corporations. Limited Liability Companies may also choose to be taxed like a corporation.</td>
</tr>
<tr>
<td><strong>Ease of Transfer</strong></td>
<td>Business entities that make it easier to track and transfer individual ownership interests make farm transfer from one generation to the next much easier. These include Corporations, Limited Liability Partnerships, Partnerships, and Limited Liability Companies.</td>
</tr>
<tr>
<td><strong>Ability to Raise Outside Capital</strong></td>
<td>Limited Partnerships, Limited Liability Companies, and Corporations can all facilitate outside investments. Farm Cooperatives can raise capital from co-op members.</td>
</tr>
</tbody>
</table>
Legal Structure of the Farm Business

The Farm Corporation

Advantages and Disadvantages of Farm Corporations

Advantages
• More attractive to outside investors
• Ease of transfer of shares
• Flexible taxation
• Limited liability shield

Disadvantages
• Legal and other costs of formation
• Ongoing formalities, including annual meetings and minutes, unless it is a “close” corporation
• Tax consequences of dissolution
• Potential for double taxation of profits

According to the Agricultural Census, there were 261 family-held farm corporations in Vermont in 2002. A corporation is a separate legal entity. The life of the corporation begins when the Secretary of State issues a “Certificate of Incorporation.”

A corporation is owned by its “shareholders.” The operation of the corporation is governed by by-laws and a Board of Directors with officers elected by the shareholders. In Vermont, corporations must have, at a minimum, a president and a secretary. It may have other officers if the by-laws so require.

As a separate legal entity, the business principals owe certain duties to it. Directors, for example, must act in good faith, with reasonable care, and in the best interests of the corporation, rather than in their own self-interest.

Corporations are limited liability entities, meaning that shareholders will not be held personally liable for the acts or debts of the corporation. As noted earlier, however, a shareholder may become personally liable by reason of his or her own acts. For example, a shareholder who participates in a fraudulent business practice involving the corporation can be held personally liable for his or her own actions.

Distributions to Shareholders

Along with limited liability come certain requirements with respect to capitalization. To maintain the limited liability shield, a corporation must have enough capital to meet its ordinary business obligations. Distributions to shareholders that render the corporation unable to pay its debts as they become due in the usual course of business or that

Corporate Formation

The filing fee for the Articles of Incorporation is $75.00. Corporations must also file an annual report and include a filing fee of $25.00.

The Articles of Incorporation must include:
• Corporate name,
• Classes of shares and number of each class that the corporation is authorized to issue,
• The street address of the registered office and initial registered agent,
• The name and address of each initial incorporator, and
• Classes of shares with rights to vote and rights upon dissolution.

The Articles of Incorporation may include:
• A listing of the Board of Directors,
• The purpose of the business and other information that would be included in the corporate by-laws.
lead to insolvency are prohibited by law.34

Corporate Taxation Issues
Corporations may choose to be taxed as a pass-through entity, as an “S” Corporation, or as a double taxation entity as a “C” Corporation. The “C” and “S” come from the chapter headings of the legislation authorizing this tax treatment.
As a “C” Corporation, the corporation is taxed as a separate entity. Corporate income is taxed first at the corporate level and again at the shareholder level when income is distributed as dividends.
As an “S” Corporation, the corporate income is not taxed at the corporate level but “passes through” and is taxed at the shareholder level. An “S” corporation provides a limited liability shield but treats taxes more like a partnership.

A Close Corporation
In Vermont, corporations with fewer than 35 shareholders can elect to form or convert to a “close” corporation.35 Close corporations can be operated directly by the shareholders. This eliminates the need for a board of directors, who are the same people as the shareholders in many small corporations. A close corporation can dispense with by-laws and operate under “shareholder agreements” that are similar to partnership agreements.
A close corporation can also eliminate the requirement for annual meetings and may choose to be taxed as either a “C” or an “S” corporation.

Non-Profit Corporations
Farms provide many “public goods.”36 Open space, wildlife habitat, and recreational opportunities are just some of the benefits that farms provide to the community. Many farmers are also highly skilled in traditional and non-traditional farm or homesteading practices or crafts and can offer educational opportunities to the community. But simply because a farm offers goods and services that have educational or environmental benefits does not mean that the non-profit business structure is a good choice for the business. If these goods and services are incidental to the farming operation and are offered to the public for a fee – for example, an agri-tourism business that invites city dwellers to spend a week on the farm learning how to milk cows – a for-profit entity is probably the best choice.

The non-profit structure provides federal and state income and other tax exemptions and broader access to grants from foundations as well as contributions from private individuals. Along with this access to funds, however, comes a great deal of complexity. The complexity is a result of the IRS rules intended to minimize fraud or schemes to avoid taxation. The non-profit form

Advantages and Disadvantages of Non-Profit Corporations

Advantages
• Significant tax exemptions
• Availability of grants
• Opportunity to contribute to the public good

Disadvantages
• Substantial complexity
• Requires non-profit administration skills
• Assets belong to the public and must be transferred to another non-profit at termination
• May not seek private investment capital
• Special duties owed to the public
• Penalties for violating rules against private benefit from use of non-profit assets
requires a farm operator to have a high tolerance for complexity and a healthy respect for the need to comply with IRS rules. It requires someone who can consistently and carefully separate the non-profit finances from the for-profit aspects of the farm. The complexity also means that there are certain economies of scale to be considered. Unless the potential for grant income is significant, it may be best to consider alternatives to the non-profit structure. (See “Alternatives to Forming a Non-Profit” on page 18.)

Non-profits are governed by both state and federal law. Vermont law governs the formation and operation of non-profits. Both Vermont and federal law govern taxation issues relevant to non-profits. On the federal level, non-profits that the IRS designates as “501(c)(3)” organizations receive federal income and other tax exemptions and benefits. While there are other types of non-profits under federal law, we will only deal with 501(c)(3) corporations, which are the most common in Vermont.

You can form a non-profit under Vermont law without bothering to seek a 501(c)(3) designation from the IRS, but you will forgo significant federal tax benefits as a result of doing so.

Generally, to acquire and maintain 501(c)(3) status, the following criteria must be present:

1. The corporation must be organized for a religious, charitable, or scientific purpose and the organization’s activities must further that purpose.

2. No private benefit must accrue to members from organizational activities, assets or earnings. Use of the organization’s assets for private gain or excess compensation will cost an organization its status as a 501(c)(3). When a 501(c)(3) organization is dissolved, its assets must go to another 501(c)(3).

3. The organization must not violate IRS rules about lobbying and electioneering. While a broad range of public educational activities are allowed, the IRS frowns on direct lobbying about legislation in excess of certain limits or on supporting a particular electoral candidate.

4. The organization must also demonstrate to the IRS that it has sufficient public support to qualify as a public charity. Charities that can ascertain that at least one-third of their total support comes from governmental agencies and private individuals pass the test. Charities that fail the mechanical test may still qualify if certain facts and circumstances indicate an effort to attract new and additional public support.


The Board of Directors

Under Vermont law, a non-profit must have a least three board members. Directors must be individuals and cannot be other profit or non-profit corporations or an LLC, for example. A majority of board members must be “financially disinterested.” No more than 49% of the board can be employees, independent contractors, consultants, or otherwise receive compensation from the corporation or a spouse, sibling, parent, or child of same. Board members have special duties of good faith, ordinary care, and must act in the best interests of the corporation.

State and Federal Taxation

Non-profit corporations that have received a 501(c)(3) designation from the Internal Revenue Service are exempt from federal income tax. Vermont law also exempts 501(c)(3) organizations from state corporate income taxes.

Exemptions are also available to Vermont non-profit 501(c)(3) corporations for the meals and room taxes, sales and use taxes, land gains taxes, and local property taxes. The local property tax exemption is available even if an organization has not been given a 501(c)(3) designation provided that the property is used for “public, pious or charitable uses.”

In addition to the direct tax exemptions available to non-profit corporations, donors to non-profits designated as 501(c)(3) status may take a charitable deduction for their contributions to the organization. Private foundations often require proof of 501(c)(3) status prior to making a grant.
Non-profits, however, are NOT exempt from employment taxes, and they also have to be concerned about something called “unrelated business income” which will be taxed by the IRS at the regular corporate rates.

**Unrelated Business Income Tax**

Tax exempt organizations must also be aware that income derived from the organization’s business activities may be subject to the “unrelated business income” tax. Business income from a trade or business that is regularly carried on and related to the organization’s exempt purposes may be subject to taxation at the regular corporate tax rates. This issue is arising more often as non-profits become more entrepreneurial in their activities and their fundraising and the IRS becomes more savvy at analyzing these transactions. Many of the cases, for example, involve non-profit organizations renting or selling their mailing lists and using the earnings to fund their charitable work. State and local tax issues also arise in these cases. Unrelated Business Income Tax (UBIT) is one more indication that if the farm activity is primarily fee-based, a for-profit entity makes the most sense.

**Raising Capital**

Non-profits are prohibited from issuing capital stock, so they can’t raise investment capital from their members. They may, however, impose dues and/or fees upon members to raise operating funds. They may also establish different classes of members or decide not to be a membership organization at all.

**Limited Liability and Non-Profit Corporations**

Vermont law provides that members of a non-profit are not personally liable for the acts, debts, liabilities, or obligations of the corporation. Vermont law also provides limited liability to directors, officers, and trustees of 501(c)(3) organizations who serve without compensation. As long as they act in good faith, they will not be personally liable for any acts or omissions committed while acting in the scope of their official duties. They are also shielded from liability for any acts or omissions of employees of the non-profit or other directors or officers.

**Farm Transfer**

Non-profit assets belong to the public. When a non-profit terminates, the assets must go to another non-profit. As such, the non-profit structure is not appropriate where generational transfer is a goal. As well, given the strictures on private benefit and unrelated business income, the non-profit structure is not appropriate where a primary objective is to build wealth and provide for one’s retirement.

**Alternatives to Forming a Non-Profit**

Incorporating charitable or educational purposes into a farming enterprise is an income diversification strategy. Forming and managing a non-profit and maintaining 501(c)(3) status, however, can be daunting. Farms seeking grant income have some alternatives to forming a non-profit entity. Farms can partner with existing non-profits with purposes and a mission that are complementary to what the farm has to offer. The non-profit can contract with the farmer to provide these services for a fee. The non-profit can cover that fee with grant income. The local historical society, for example, can pay the farmer to host a workshop on farming with horses. Farmers, however, shouldn’t expect to make a lot of money on these charitable endeavors. It is, after all, charity.
There is a rich tradition of cooperative organization in agriculture. The Grange in the late 19th century was one of the earliest proponents of the cooperative structure in agriculture as a way to increase the bargaining power of individual farmers and capture economies of scale. Examples of farm cooperatives are legion. The federal Farm Credit System established in 1916 is a cooperative that provides credit to farmers and other cooperatives. In its zenith, the cooperative model was instrumental in bringing electricity to rural America after the Capper-Volstead Act provided anti-trust immunity.

Co-ops have been used to provide marketing, farm supply, and farm services to members. What’s so different about a cooperative? The biggest difference between a cooperative and other business entities is that ownership and control of the business is in the hands of the users or producers of the goods and/or services provided by the co-op, i.e., the members of the cooperative. Cooperatives are democratically controlled. Unlike a corporation, for example, voting power is not a function of how much stock a member owns. In a cooperative, each member gets one vote.

The traditional principals of cooperatives include:

- Open membership – anyone can be a member.
- One member, one vote.

Advantages and Disadvantages of Agricultural Cooperatives

Advantages
- Anti-trust exemption
- Significant tax advantages
- Capture economies of scale
- Add bargaining power
- Democratically controlled
- Operated for mutual benefit
- Limited liability for members

Disadvantages
- Relative difficulty of raising capital
- Tax complexity
- Substantial commitment of time to manage the cooperative

- Cash trading – no credit to members.
- Membership education.
- Political and religious neutrality.
- No unusual assumption of risk.
- Dispersed ownership – limits on number of shares of co-op stock that any one member can own.
- Goods sold at regular retail prices.
- Profit (margins) distributed according to patronage rather than ownership – corporations pay dividends on number of shares; co-ops pay patronage dividends based on usage of goods or services.
- Operating capital comes from members — retained patronage dividends, which are a portion of individual members’ savings or earnings that the cooperative retains as investment capital.

Special Benefits to Cooperatives – Antitrust Exemption

Agricultural cooperatives that meet certain tests under federal and Vermont law are entitled to exemption from federal and state anti-trust laws. Formation and governance of the cooperative is governed by Vermont law, but both Vermont and federal law govern the availability of the anti-trust exemption. The federal law is called “Capper-Volstead” and it gives farm cooperatives a limited exemption from anti-trust for the marketing of farm products co-
operatively. Farmers may “collude,” meaning they can agree on a price to be charged for the goods and services produced by members. They may also share pricing information with one another. This provides a significant marketing advantage. For other kinds of entities, price collusion and sharing price information is illegal.

The agricultural anti-trust exemption is only available to cooperatives that meet certain organizational and operational tests as set out in Capper-Volstead:

1. Co-op members must be farmers or persons engaged in the production of agricultural products as farmers, planters, ranchmen, dairymen, nur, or fruit growers who collectively process or market their goods.

2. The cooperative must be operated for the mutual benefit of its members.

3. The cooperative must adhere to the principle of “one member, one vote.”

4. The dividends paid to members on stock or membership capital must be limited to 8 percent per annum.

5. The cooperative may not deal in the products of non-members to an amount greater in value than that it handles for members and no greater than 49 percent of product by value can come from non-members.

There is also a state exemption from anti-trust law in Vermont and another set of organizational and operational tests. A cooperative will not be deemed to be a “conspiracy or a combination in restraint of trade” under Vermont law or an illegal monopoly or an attempt to lessen competition or to fix prices arbitrarily, provided it complies with statutory requirements. These requirements mirror the federal requirements but there are a few differences.

In Vermont, if you call yourself a cooperative, you must meet the following minimum requirements:

- One member, one vote.
- Interest or dividends on paid-up capital stock that is paid to members shall not exceed 6 percent.
- The cooperative must maintain a reserve fund equal to 10 percent of net annually until it has a reserve of 50 percent of the paid-up capital stock.
- The remainder of earnings must be distributed based on patronage.
- No more than 10 percent of the capital stock can be owned by any one member.
- Members must be producers of the products the co-op handles.
- Certificates of stock in the co-op must include a statement that says the holder is entitled to only one vote.

Members of an agricultural marketing cooperative can be individuals, firms, partnerships, corporations, or associations, provided that the member is engaged in producing the agricultural products handled by the co-op. Co-ops can, in turn, organize, own, or be a shareholder in other corporations. For example, a cooperative may take an ownership interest or may itself form, operate, and control a corporation engaged in value-added activities – preserving, drying, processing, canning, packing, storing, handling, shipping, utilizing, manufacturing, marketing, or selling the agricultural products handled by the cooperative.

Value-Added Cooperatives in Vermont

Vermont law gives marketing cooperatives broad authority to add value to whatever their members produce. Cooperatives may “engage in any activity in connection with the purchasing, marketing, selling, preserving, harvesting, drying, processing, manufacturing, canning, packing, grading, storing, handling, or utilization of any agriculture products, or manufacture or marketing of the by-products thereof.” However, the majority of the product, by value, that the cooperative handles must come from its members.

Limited Liability

Co-op members can not be held personally liable for the debts of the cooperative. However, in a post-Enron nod to executive accountability, Ver-
mont law provides that any officer or director of a cooperative who knowingly subscribes to a false statement relative to the issuance of capital stock or false financial statement faces fines and imprisonment and shall be individually —personally— liable to shareholders.\(^6\)

**Tax Benefits to the Cooperative Model**

Corporate shareholders receive a return on their investment in the form of appreciation in the value of their stock as well as dividends paid from corporate profits. Corporate dividends are paid based on the number of corporate shares owned. In a cooperative, member benefits are based on patronage of the co-op. A cooperative distributes net earning as a “patronage dividend” or a “patronage refund” to members based on how much business the member did with the co-op. In some cases, the cooperative retains a portion of the patronage refund to use as operating capital for the cooperative – the retained patronage dividend. In this way, members finance the growth of the co-op. Members also provide capital by purchasing their membership shares.

**Cooperative Tax Advantages**

Cooperatives enjoy significant tax advantages over other entities. If all the IRS rules are followed, a cooperative can deduct both the patronage dividend paid to the farmer AND the retained patronage dividend used for operating capital. This allows the cooperative to significantly reduce its taxable income and its tax liability. Tax rules for cooperatives are complex and require specialized tax advice from a professional familiar with the cooperative structure.

**Special Duties of Cooperative Members**

Cooperative members are expected to actively contribute to the management and financing of the co-op.

**Among the duties of cooperative members are the following:**

- Knowingly exercise their vote to elect or remove directors; adopt and/or amend Articles of Incorporation and Bylaws; and vote on dissolution, merger, or consolidation.
- Provide capital in the form of retained earnings or up-front investment.
- Patronize the co-op.

**New Generation Cooperatives**

Most of the current growth in new cooperative formation is in the so-called “new generation cooperatives” (NGC). These entities are characterized by the following:

1. New generation cooperatives add value to raw farm commodities. These cooperatives add value by processing commodities to capture a larger share of the consumer food dollar for their members. They seek to utilize the economies of scale necessary to be competitive in the processing/retail market.

2. Membership is not open. The number of members in the co-op is limited. The number of members is dictated by the capital needs of the entity. Members are expected to provide the capital “up front” for the construction of processing facilities, feasibility studies, and other needs of the cooperative.

3. Transferable delivery rights. Members provide capital by purchasing “delivery rights” and only so many “delivery rights” are sold. The price of the delivery rights is a function of the cooperative’s capital needs for facilities and so on. Delivery rights are transferable to other eligible producers although the cooperative board of directors will ordinarily approve such transfers and may even set the price. The value of the delivery rights will appreciate or depreciate depending on the success of the cooperative or the income potential from the enterprise.

4. Membership versus Delivery Rights. Typically, these cooperatives issue two classes of stock. Each member gets one Class A share, which is a membership share. Class B shares are sold to members and include delivery rights. Delivery rights vary depending on the number of Class B shares the member
purchases. The delivery rights specify the amount of product, the delivery date, and how much and when the farmer will be paid. If the farmer defaults, the delivery agreement usually allows the co-op to purchase commodities on the open market and seek reimbursement from the farmer.

5. Capital and Patronage Dividends. These cooperatives typically pay out most or all of their net income to their members based on how much product they delivered. Because the farmers provide capital up front by purchasing delivery rights, there is less need to retain earnings to generate capital.

NGCs in Vermont
As long as the NGC complies with the minimum requirements for a cooperative under Vermont law and under Capper-Volstead, it is acting within the law. But the primary difficulty facing NGCs in Vermont isn’t legal, it’s financial. Few Vermont farmers are in a position to come up with the considerable amount of up-front capital necessary to start an NGC.

Some states, Minnesota and Wyoming, for example, have amended their cooperative statutes to allow “outside” member investors who do not patronize the cooperative to own it and receive profits. In Minnesota, for example, these outside investors may own up to 99.99 percent of the equity of the cooperative and receive up to 85 percent of its profits. This type of equity structure may put the federal and state level anti-trust exemption at risk because members may not be producers or the cooperative may no longer be operated for the mutual benefit of its members but for that of the outside investors.

Along with the anti-trust exemption, this type of equity structure might also subject a Vermont NGC to the securities regulations governing other kinds of businesses that seek investors. In Vermont, securities that are offered or sold only to cooperative members as a requirement of membership or are issued as a patronage dividend are exempt from the requirement of securities and broker registration requirements.77

If outside investors are necessary to the farm business, incorporation or an LLC may be a better option. An LLC can be structured to “behave” like a cooperative. States could also offer low-interest community development loans, tax incentives, and grants to support NGCs and ease the need for outside investors.

Legal and Other Professional Services for Business Formation

In 2005, the average hourly attorney fee in Vermont was $125.00 an hour. A typical simple entity formation can cost anywhere from $500.00 to several thousand dollars. If the formation requires special drafting or raises novel tax or other issues, the fee can be quite high. Farmers who come to the law office well informed and well prepared can save a lot of money. Carefully completing the attorney’s informational forms can save the attorney time and save the farmer a lot of money.

Land Link Vermont has an informational list of professional attorneys and accountants who handle farm transfer, business formation, and other legal, tax, and accounting matters. This list can be a good place to start. Go to:

http://www.uvm.edu/landlinkvt/referralnetwork.html.
Case Study: Group Ownership at Arethusa Collective Farm

By Don Jamison

Arethusa Collective Farm is a 14-acre organic farm in Burlington’s Intervale that sells vegetables wholesale, through the Burlington Farmers Markets, and through its Community Supported Agriculture (CSA) program. It is an unusual operation – not because of the crops raised or the agricultural methods used, nor because of its CSA – but because of how its ownership and operations are organized.

Arethusa has a worker-cooperative structure, designed for those interested in practicing democracy in the workplace. Cooperative members must be able to express their ideas clearly, listen respectfully and patiently to others, and be willing to bend. Vermont farmers have a history of making democracy work well in small groups — at town meeting. The farmers of Arethusa are attempting to transplant that tradition to the farm operation itself. For anyone interested in sharing responsibility, ownership, and decision-making, Arethusa represents a model worth considering.

Here’s how Arethusa’s four farmer-owners describe themselves and their farm on their website:

We are Jeremy Ward-Migner, Carol Hinrichsen, Ben Dana, and Thomas Case, a four-member, worker-owned farm collective. We have 14 acres in Burlington’s Intervale along the Winooski River. We share all the risk, responsibility, and profit of the farm, as well as the fun and joy of an agricultural lifestyle.

In addition to our CSA, we have a farmstand at the Burlington Farmers Market in City Hall Park on Saturdays from June through October. You will also find our produce at local stores such as City Market, Healthy Living, Shelburne Supermarket and at restaurants including Stone Soup, Sugarsnap, Sirloin Saloon, New England Culinary Institute, American Flatbread, and Café Piccolo. Scrumptious Café, Sweetwaters, and other local businesses.

History

Arethusa Seed Farm was started in 1999 in Bakersfield, Vermont, by Thomas Case and Alice Stokes. In 2002, Thomas and Alice, now in partnership with Ben Dana, moved the operation to leased land in Burlington’s Intervale, with a new focus on marketing vegetables, rather than seeds. When Jeremy Ward-Migner and Carol Hinrichsen decided to join Thomas and Ben and Alice decided to step back, the group decided it was time to reorganize.

With a bit of funding from the Intervale Foundation’s Success on Farms program, the group found their way to the Vermont Employee Ownership Center (VEOC). To VEOC staffer Don Jamison, the group was already functioning as a worker-cooperative in many respects. Creating a formal co-op would solve some of the problems the group had already encountered or anticipated. He recommended an attorney, Mark Saunders of Shems, Dunkiel, Kassel & Saunders, who helped them create co-op bylaws and, in the summer of 2004, Arethusa Collective Farm was incorporated.

How the Worker-Cooperative is Designed to Work

Arethusa’s bylaws provide a roadmap for how someone becomes a “member” (i.e. an owner, in co-op lingo), members’ rights and responsibilities, the role of the Board of Directors, how profits and losses are distributed, and what happens when a member leaves. At Arethusa, full- or part-time employees are eligible to apply for membership after one year of work on the farm. Upon acceptance of their application by the board, they become a member after purchase of a membership share (currently valued at $1,000). Members elect the Board of Directors on a one-person/one-vote basis. The board is responsible for policy-level decisions. It distributes profits and losses to a retained earnings account and to

continued on page 24
individual members in the form of cash and/or credits to their internal accounts. Profits are distributed to members in proportion to the amount of labor they have contributed over the course of the previous year. After a member leaves, the cooperative buys back their member share and pays out the balance accrued in their account.

Operations at Arethusa
Carol Hinrichsen reports that the Arethusians have had their struggles with decision-making, but have gradually gotten good at figuring out which decisions require everyone’s involvement and which can be delegated. They also have experimented with matching members’ skills and interests with the jobs that need to be done. Carol, for example, had primary responsibility for PR during the past season, worked in the greenhouse, shared responsibility for bookkeeping with Thomas, did some of the calling for the wholesale side of the business, and did a share of the job she likes least – making deliveries. The members are contemplating some changes for next year – a different distribution of duties, a greater focus on some parts of their business, and possibly eliminating others. Challenging as it’s all been, it has also been very rewarding. Carol recently had a part-time job in a more conventionally-structured business and says, “I’ve gotten used to people caring about what I think about my work. It was weird just getting directives and carrying them out, without discussion before or after. Talking things over with those you’re working with, feeling that your opinion matters and can actually change things – it all just feels like the way it’s supposed to be.”

Contact Information:
Arethusa Collective Farm
P.O. Box 8082, Burlington, Vermont 05402
802-578-6429
www.arethusacollectivefarm.com
arethusacollective@yahoo.com

Questions on worker cooperatives and other forms of employee ownership can be directed to:
Vermont Employee Ownership Center
P.O Box 546, Burlington, VT 05402
802-861-6611
www.veoc.org
info@veoc.org
Creating a Limited Liability Company (LLC) - The Nitty-Gritty Details
By Beth Kennett, Liberty Hill Farm, Rochester, Vermont, with Bob Parsons, University of Vermont Extension, and Jesse Richardson, Virginia Tech

If you are contemplating expanding or transferring your farm or starting a new farm business, you are likely to be also considering an appropriate business entity for this change. Business entities include the sole proprietorship, partnerships, limited liability partnerships, corporations, and limited liability companies (LLCs).

The first huge task involves working with an attorney and accountant to choose the right business structure for your family’s farm. You then go through a detailed and agonizing process to develop a business plan and legal agreement according to state law that addresses the specific circumstances of your farm. Now you think you are almost done.

At this point, you could think that you were almost finished. But the job is only half over. You have the agreement, but now you have to implement the birth of a new business entity. These steps involve myriad details that need to be completed to actually transform your sole proprietorship farm (Mom and Dad’s farm) into the new entity as determined by your business agreement. Once you have completed the necessary details of working with an accountant and an attorney, you still have to accomplish an extensive “to-do” list. This list is a compilation of the “other” stuff that comes with forming a new business entity. An example of such a list follows. This example is based on forming an LLC, although most of the listed steps are similar, no matter what the entity. Note that the list is not exhaustive; different farms and situations require other items.

<table>
<thead>
<tr>
<th>With Whom</th>
<th>To Do</th>
<th>How Long</th>
</tr>
</thead>
<tbody>
<tr>
<td>Secretary of State (Contact official/agency. This varies from state to state)</td>
<td>File Articles of Organization with the Vermont Secretary of State’s office. The Secretary of State’s office will send your Certificate of Organization so recognized. Keep these documents in a safe place. You may also register a trade name. Your attorney can file for the trade name. You must include a filing fee to the state. In Vermont, the fee is $75 for the LLC and $0 for a trade name registration. Your attorney may advise you to purchase a corporate book that costs approximately $100. Retain records of the corporation in this book.</td>
<td>From ten days to two weeks to receive notification that your business name is accepted.</td>
</tr>
<tr>
<td>IRS/Federal Business ID number</td>
<td>Apply for a tax identification number on Federal Form SS-4 Employer ID Form (follow directions exactly). You will receive confirmation of your number via email and documents will subsequently arrive via mail</td>
<td>Online: 20 minutes to 2 hours. Mail can take 3-4 weeks.</td>
</tr>
<tr>
<td>Bank (Set up new accounts for the LLC)</td>
<td>Photo identification needed at bank. Bank needs information: - Routing number of bank to order checks, - Account number for new LLC account, - Decide on balance transfers, - Electronic transfers for direct deposit and automatic payment deductions, - Set up on-line banking, and - Assignment of overdraft protection to accounts.</td>
<td>Up to a couple of days, depending on bank.</td>
</tr>
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</table>
## Legal Structure of the Farm Business

<table>
<thead>
<tr>
<th>With Whom</th>
<th>To Do</th>
<th>How Long</th>
</tr>
</thead>
</table>
| Purchase new checks — must have LLC name printed on them | Computer checks for payroll  
Business checks for vendors  
Need bank routing number & account number. Need bank routing number & account number | Can take from 3 days to 3 weeks. |
| Milk checks or other income checks | Establish new member ID number. Documents needed:  
- Business ID number,  
- Copy of names of LLC owners,  
- Bank information: routing number & account number, and  
- Voided bank check.  
Decide on equity issue with coop. (Will benefits of equity established by parents go to parents or to the new business entity?) | Process takes approximately 2 weeks before check comes to LLC. |
| Lending institutions | Establish which liens will remain with individuals and which are reassigned to new entity.  
Contact mortgage holders to determine what paperwork they will need before approving any real estate transfer.  
Check with mortgage insurance holders.  
Contact lien holders of equipment, livestock, and other property to determine what paperwork they will need before approving an ownership transfer.  
Contact lenders, lien holders, suppliers, and others who have an assignment from product sales such as milk checks.  
Note: If you are transferring property with liens or mortgages, including real estate, equipment, or livestock, to the new entity, you will need consent from the lien holder prior to the transfer. | 1 to 2 weeks |
| Insurance | Decide which insurance is paid by new entity - liability, fire, vehicle, comprehensive.  
Notify insurance agent of LLC change.  
Reassign automatic payments to new bank account.  
Workers’ Compensation may need to be changed.  
Alter disability insurance if family members move from workers to owners.  
Term life insurance – take out cross-insured polices on members to protect LLC and allow the fund to purchase farm from heirs.  
Note: For liability insurance, have entity and all individuals involved named as co-insured.  
There should be no extra charge for this. | — |
<table>
<thead>
<tr>
<th>With Whom</th>
<th>To Do</th>
<th>How Long</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vendors</td>
<td>Notify those vendors that utilize the business ID number for tax purposes. Purchase stationary with LLC letterhead. Some vendors (feed, seed, or fertilizer) may require additional paperwork with new LLC due to collateral and credit issues. Vendors who are paid by automatic payments need bank routing numbers.</td>
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<tr>
<td>Payroll</td>
<td>Members of the LLC are no longer employees, so payroll status must change. Employees must be paid with LLC check assigned to Federal ID number.</td>
<td></td>
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<tr>
<td>Farm Service Agency / Federal programs.</td>
<td>Notify FSA office of change in ownership/operator status, new bank account numbers for direct deposit.</td>
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<tr>
<td>Lease agreement between parents of LLC</td>
<td>Clearly define what property is owned by entity and what property is owned by individuals. Determine who is responsible for mortgage, property taxes, insurance, and maintenance. Allow provisions for credit of improvements in case of dissolution. LLC must maintain appropriate insurance as operating expense. Document lease agreement between LLC and parents/family owners.</td>
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<tr>
<td>Credit card for LLC</td>
<td>Set up bank or other entity for purchases. Identify which purchases can be automatic on credit cards (vet, supply vendors, office items, phone, Internet). Set up separate credit card account for entity. Keep personal items from LLC to maintain corporate veil.</td>
<td></td>
</tr>
<tr>
<td>Transferring property</td>
<td>Transfer property that you wish to transfer to entity. Real estate will need deeds and be completed at town office/recorder office. Vehicles can be transferred at your state agency of motor vehicles. Document the sale/transfer of any personal or business property with a bill of sale.</td>
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</tbody>
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FILE RECORDS IN FIRE-SAFE BOX!!!
LLCs offer enormous flexibility in terms of allocating management control, rights to income, and other ownership rights. An LLC operating agreement can create several different types of membership and ownership classes. This flexibility provides some opportunities for using the LLC structure to raise capital from interested investors or even interested community members wishing to support local agriculture.

A class of membership units can be offered that offers only an income or an economic interest but has no rights to management. Transfers can also be restricted. For management and tax purposes, these units may mimic an interest of a limited partner. The operating agreement may dictate a particular holding period for investors or may allow the business to redeem (repurchase) the units at some specified point in the future. Under Vermont law, a membership interest in a limited liability company is considered a “security.” Sales of membership interests in a farm LLC to community members or investors need to comply with the state and federal laws that regulate the sales of securities. The intent of securities regulation, also called Blue Sky laws, is to protect the public from fraudulent sales of worthless securities. The Vermont statute requires that certain securities and certain securities transactions be registered with the Department of Insurance and Banking. The registration process requires detailed financial information about the business and also involves review by the state to ensure that the offering is fair — has merit — for potential investors. Securities brokers and dealers must also register with the state. There are, however, several exemptions from the need to register for certain kinds of security sales. Three exemptions that may cover most small offerings are discussed below. Even if the sales fit within one of the exemptions, however, the law still requires certain disclosures to potential investors in the form of a prospectus or an offering brochure.

### A. The Limited Offering Exemption

Any sale of securities by an issuer to not more than 25 people in the state of Vermont during any period of 12 consecutive months is exempt from registration, if:

- The seller believes the buyer is purchasing for investment — that is, the buyer will hold the interest for a lengthy period as an investment.
- No commission or other remuneration is paid or given directly or indirectly for soliciting any prospective buyer in the state.
- No general advertising is published or circulated with any such sale.

Sales of membership units to fewer than 25 Vermont investors do not require registration, either. You may not solicit investors by advertising in the newspaper or on a list-serve, but you may solicit investors by mail if the solicitation is addressed to specific individuals. There is no limit to how much money can be raised under this exemption, and there is no pre-prescribed form of offering document — called a prospectus — required. However, sellers must disclose “all material information” about the business. That term means all of the information necessary to allow investors to make an informed decision about whether or not to invest. As well, verbal statements made about the business must match the written statements.

### B. The Vermont Small Business Offering Exemption (VSBOE)

For sales of LLC units to more than 25 investors but fewer than 50, the Department of Insurance and Banking has provided another exemption by administrative rule. The requirements, however, are a little more onerous and complex. Some of the requirements are as follows:

- The LLC’s principal place of business and 80 percent of its assets are in the state of Vermont, and at least 80 percent of the proceeds from the offering will be used for Vermont operations.
- The aggregate offering may not exceed $500,000.
- The duration of the offering may
Legal Structure of the Farm Business

Raising Capital Using the LLC Structure (continued from page 28)

not exceed 12 months – unless an extension is filed.
• No commission, fee, or other remuneration may be paid to any person for soliciting potential purchasers.
• The offering document must contain certain pre-prescribed language in bold print warning that the investment carries significant risks and that there are restrictions on transfers.

The LLC must also file copies of all advertising and a report on the sales that were made with the Department of Insurance and Banking and pay a $200 filing fee.

C. The Accredited Investor Exemption

By rule, the Commissioner of Banking, Insurance Securities and Health Care Administration has also exempted the sales of securities to certain types of investors, called “accredited investors,” from the registration requirements. This rule exempts sales to purchasers deemed sophisticated enough to evaluate the merits of the particular investment on their own. A sale is exempt if you reasonably believe that:

• The purchaser is a person whose individual net worth, or joint net worth with that person’s spouse or civil union partner at the time of his or her purchase, exceeds $1,000,000, or
• The purchaser is a person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with a spouse or civil union partner in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

You must also reasonably believe that the accredited investors are purchasing the interest as an investment and not for resale. For this exemption, you may publish a general announcement of the offering but it may contain only the following information:

• The name, address, and telephone number of the issuer of the securities;
• The name, a brief description, and price (if known) of any security to be issued;
• A brief description of the business of the issuer in 25 words or less;
• The type, number, and aggregate amount of securities being offered;
• The name, address, and telephone number of the person to contact for additional information; and
• A statement that:
  — Sales will only be made to accredited investors;
  — No money or other consideration is being solicited or will be accepted by way of this general announcement; and
  — The securities have not been registered with or approved by any state securities agency or the U.S. Securities and Exchange Commission and are being offered and sold pursuant to an exemption from registration.

You may provide additional information to the investor only if, after inquiry, you reasonably believe that the potential purchaser is an accredited investor. You must also file a notice of the transaction, a copy of the general announcement, and a $200 filing fee with the Commission of Banking, Insurance Securities and Health Care Administration.

Federal Exemptions from the Registration Requirements

The federal exemptions from registration with the Securities and Exchange Commission (SEC) mirror the state exemptions to some extent, but they are enormously complicated. It’s simplest to stay within the federal “intrastate offering exemption.” If most of your business is conducted in Vermont and you make offers and sales only to residents of Vermont, you don’t have to register at the continued on page 30
Raising Capital Using the LLC Structure (continued from page 29)

federal level. The purchasers, however, may not resell to anyone out of state. The LLC units should specify these restrictions on re-sale and include other restrictive language intended to keep the sale within federal regulations.

If you intend to sell securities outside the state of Vermont the federal Securities and Exchange Commission provides a wealth of advice for small business at: http://www.sec.gov/info/smallbus.shtm. A description of the federal exemptions from registration can be found at: http://www.sec.gov/info/smallbus/qasbsec.htm#eod6.

Additional Anti-Fraud Provisions

Even if the offering fits within one of the exemptions listed above, it is still subject to the general anti-fraud provisions of the Vermont Securities Act. This act prohibits:

(a) In connection with the offer to sell, a sale, an offer to purchase, or the purchase of a security, a person may not, directly or indirectly: (1) employ a device, scheme, or artifice to defraud; (2) make an untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; or (3) engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon a person.

Except as noted above, there is no particular format required for the information (prospectus) that you give to prospective investors but the SEC says that issuers should “attempt to balance any discussion of the potential rewards of the offering with a discussion of possible risks.” In addition, “issuers should take care to ensure that oral statements to prospective purchasers about the offering are consistent with the disclosures contained in the offering document.”

A Farm Prospectus

An offering prospectus for a farm LLC might contain the following:

• A general description of the farm operation.
• Farm plan for the next 5 years.
• Goals of the farming enterprise.
• Management practices that distinguish the enterprise.
• Financial aspects including the offering cost of each unit to be sold, terms of the sale, and specifically how the proceeds from the sale will be used. Expected return on the investment from both income and appreciation. Potential tax aspects of income/expenses to LLC members.
• Expectation with respect to holding period of the investment. Rights to transfer and any restrictions on right to transfer interest (only to Vermont residents, for example). How the interest will be valued. Potential risks associated with expectations for income and appreciation.
• How the LLC will be managed. Voting rights and how decisions will be made.
• Risks to operation and to the investment.
• Requirements that investors must meet to comply with state and federal securities regulation (income, assets, residence, sophisticated investors).

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• Farm plan for the next 5 years.
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• Management practices that distinguish the enterprise.
• Financial aspects including the offering cost of each unit to be sold, terms of the sale, and specifically how the proceeds from the sale will be used. Expected return on the investment from both income and appreciation. Potential tax aspects of income/expenses to LLC members.
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