ESTATE PLANNING

Various Forms of Business Organization and Ownership

by Al Lundstrom

What should be considered in determining the most satisfactory form of organization under which to operate your farm or ranch? There are several legal vehicles from which to choose. The form of organization that will best serve your purposes at a particular time in your life will change with relationship to the size and complexity of your operation. What legal entity to use is a difficult question to answer.

The form of business organizations and ownerships to choose from are:

(a) Sole Proprietorships
(b) Father and Son Operation
(c) Partnership
(d) Limited Partnership
(e) Joint Venture
(f) Corporation
(g) Sub-Chapter S Corporation
(h) Trusts

When you, your father or grandfather first started farming or ranching, the reasons for doing so were very simple. The attitude was generally one of providing subsistence for the family—a place to raise food, provide shelter and produce income enough for the needs of the family. Reliance was entirely on the muscle power of man and animal. The land was cheap and need for costly equipment was very small.

Increase and Changes

As time passed, these farms and ranches grew larger. The technology and mechanized agricultural equipment needed increased the farm debt and responsibilities of management.

The original concept of the family farm/ranch is no longer a simple form of life. It has turned into a complex agricultural business organization that requires many of the skills and business practices comparable to the larger business entities in our society. You, the farmer/rancher, have been put in a position of managing and operating one of the most intricate and economically unsound businesses in the world.

Very few, if any, business organizations outside of agriculture have been able to buy their raw materials at retail cost and sell finished products at wholesale values and at times sell at auction. Despite these circumstances, agriculture is the only industry that continues to have the highest increase in productivity per man-hour spent. You invest more capital in your business than any other business entity in the world. For instance, the capital investment per worker of the average grain farmer is 10-15 times that of the auto industry's capital investment per worker.

What does all this have to do with estate planning and tax planning and operating your business? Realizing the changes that have taken place in agriculture for the past decade is very important to you and your family. Trying to understand the different forms of operating entities is a necessity, not a convenience.

Needs Change

Each of the foregoing business forms listed could be the best one for you at this time; yet in a few years, it might be the worst possible entity for you to operate under. In anything you do with regard to farming and ranching, one of the basic rules is "the only thing that is permanent is change." Keeping that in mind, the balance of this article will try to point out some of the features you should consider in choosing a form of organization and make a general comparison. The need for you to consult with your attorney, your accountant and your estate planner is critical when trying to determine which business organization best fits your needs. Unfortunately, our economic and tax structure as well as the legal requirements imposed on us as individuals have increased as fast, if not faster, than the complexities and mechanization of agriculture.

One of the first questions to be answered is, "What business form is most desirable for you and your family?" Certainly the size and age of your family are important. Size of your ranch or farm and value of other assets are also determining factors. Who will control this entity? Who will make decisions? Will operating under this new structure jeopardize your future financial security? What benefits will it really provide for you and your family? These and other questions must be answered to your complete satisfaction before you make a commitment.

Problems Later

Many people have adopted a form or organization only to find that in later years it creates problems. The benefits provided in the early years can turn into very complex problems later. What is the cost of such an entity? Not only the cost of organization and setting up this new entity, but what are the ongoing costs? Are the tax benefits worth the costs? Is it a vehicle by which you can transfer ownership and, if so, is it practical?

The entire ANGUS JOURNAL could be devoted to this topic, and it would still not cover all details and legalities of each entity described. While reading the following paragraphs, do not make hard-and-fast decisions. The information you need for an intelligent decision is much more detailed and complex than this discussion can provide. This is only to help you realize that no one form will solve all problems.

The three entities most commonly used are sole proprietorship, partnership and corporation. (See accompanying chart.) Read and compare these business forms as they pertain to your family.

Father and Son Operation

The most common entity after sole proprietorship is the father and son operation. Although this is the most common arrangement, it serves to be the most troublesome, because frequently the arrangement is oral and vague. Father and son do not take time to clearly define the relationship in writing and to discuss the details of sharing profits, buying into the operation, dividing workload, responsibility for debts, who will provide equity and how ownership will be held. The unspoken word and good faith will grow thin as the years and responsibility accumulate. The necessity for formalizing such a relationship is very, very important.

The other entities less likely to be considered are those of a limited partnership, joint venture, sub-chapter S corporation and, in some cases, trusts.

Limited Partnership

The advantages of a limited partnership as compared to a partnership (see chart) are that it can be a less intimate vehicle and can include people outside the family. It is less costly and easier to create than a corporation but is more complex than a partnership. The income tax and tax loss or gain consequences are similar to a partnership in that they do pass through to the in-

The seventh in a series of articles in ANGUS JOURNAL offering readers a systematic procedure they can use in designing their own estate plans.

dividuals. Unlike the disadvantages of a partnership, generally one or more persons are involved in the planning and operating —not all the partners. Unlike a regular partnership, farm continuity *may* continue after the death of a partner. Unlike the disadvantage of a partnership, a limited partnership will not have any difficulties in involving off-farm heirs. They can be included. Certainly this is a form to be considered.

Joint Venture

The joint venture is very similar to a partnership. It is an entity formed for a specific purpose. That purpose generally will terminate at a specific time or after certain things have been accomplished. It is a form of organization for two or more people to engage in a venture to make and share profits and losses. The working arrangement should be written in clear and concise language understood by both parties. Even though the joint venture is not technically a partnership, it does file partnership tax returns. This type of entity sometimes can be used to purchase a bull, a specific piece of land, a horse or any investment asset than can be clearly defined and has clear objectives.

Sub-Chapter S Corporation

The sub-chapter S corporation is very similar to the corporation in structure but has many of the tax advantages of a partnership. (See chart.) The number of shareholders in a sub-chapter S corporation can have only one class of stock. From an estate planning point of view, there were *positive* changes made to sub-chapter S corporation by the Tax Reform Act of 1976 and through the Revenue Act of 1978.

Trusts

Some people have promoted trusts as the cure-all in operating, tax and estate planning. Some say a trust is the answer to eliminating income and estate taxes. Such cannot be the case without eliminating control and initiating gift taxes. Certain types of trusts are very advantageous in estate and tax planning, but they certainly are not cure-alls. Be sure to get more than one qualified legal opinion.

Having dealt with farm and ranch families for several years, we find limited partnership to be the business form of the future. It has been used sparingly in the past; but as more and more complications, dissatisfactions and problems confront the partnership, joint venture, corporation and sub-chapter S corporation, the limited partnership assumes a greater share of new entities formed. Unfortunately, very few attorneys, accountants and estate planners have worked with and become familiar with the limited partnership in farm and ranch situations. It is unique but not the cure-all.

Next month's article will answer several specific questions received from readers whose situations may be similar to yours.

Please direct your letters and comments to Lundstrom & Associates, P.O. Box 1077, Janesville, Wis. 53545, or to ANGUS JOURNAL.

SOLE PROPRIETORSHIP

ADVANTAGES

1. This is the simplest and most common form of farm operation.
2. The owner can buy, sell, mortgage.
3. Profits and losses accrue to proprietor alone.
4. One man makes decisions.

DISADVANTAGES

1. It is fraile in relation to continuity upon death.
2. Owner may possibiy bear heavier federal and state taxes.
3. Owner cannot enjoy fringe benefits of employee.

PARTNERSHIP

ADVANTAGES

1. This is the most intimate vehicle, a sort of family affair.
2. A partnership is easy to create and less costly than a corporation.
3. Income tax is paid by the partners.

DISADVANTAGES

1. More than one person is involved in planning the operations.
2. Farm continuity may not survive the death of a partner.
3. Partnership has difficulty in involving off-farm heirs.

CORPORATION

ADVANTAGES

1. The corporate form limits personal liability.
2. It encourages family involvement.
3. Its flexible ownership may be transferred by shares.
4. It simplifies estate settlement.
5. It provides a way to involve off-farm heirs.
6. It necessitates decision-making by family stockholders as a group.
7. It simplifies farm continuity from one generation to the next.
8. It encourages orderly habits of record keeping.
9. It makes fringe benefits possible with share-owners as employers.
10. It provides for farm growth.
11. It offers possible income tax savings.
12. It enables parents to divest ownership and retain majority control while son takes over step-by-step.

DISADVANTAGES

1. Some believe the corporate form creates red tape, delay, too many reports, too much bookkeeping.
2. Legal establishment of a corporation is expensive.
3. The corporation may entail increases in self-employment and workman's compensation taxes.
4. It may subject shareholders to double taxation unless sub-chapter S is elected.
5. It may require the burdens of franchise taxes.
6. It may establish a rigid framework for planning, accounting, record keeping.