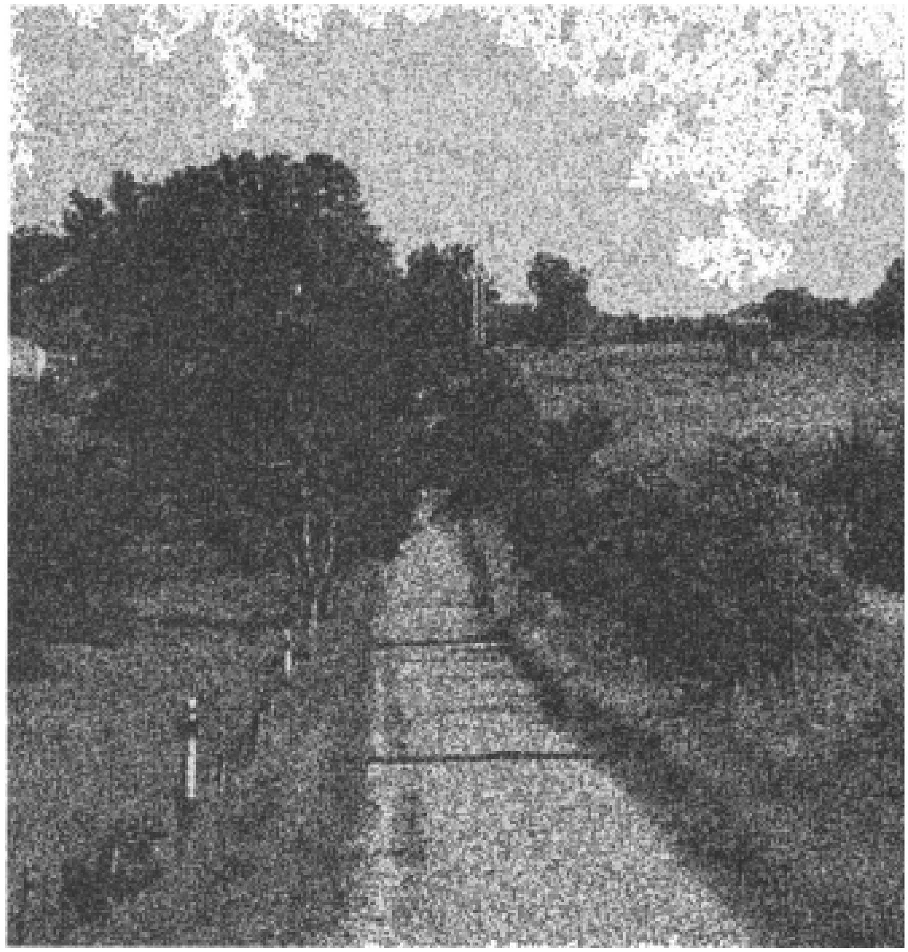
Inc. *vs* LLC

Guidelines to farm business and estate planning in the 1990s.

by Lisa Hawkins Moser



The new year brings about a time of reflection on farming or ranching business and management practices. One resolution every Angus breeder should fulfill is an evaluation of the business structure and its impacts on estate planning. This is a resolution few family businesses address.

Knowing the options

You should begin planning your estate as soon as property is bought and review your plan at least every three years, says Ralph Hepp, professor of agriculture economics at Michigan State University. The first step to creating a plan is to determine the type of legal entity the business is going to operate under.

Hepp cites three options for ranch organization and gives a brief description of each.

1. Proprietorship. With this option, one person owns the business and is responsible for the taxes and liabilities.

2. Partnership. This business organization functions like a proprietorship, only there are two or more people in business together. The profits are transferred to the owners and they pay the taxes for the business.

3. Corporation. In this situation, the legal entity owns the business. The shareholders work for the corporation. This legal entity must be recognized by the state. It has two ways of being taxed — like a partnership where the stockholders pay the tax for the corporation, or the corporation pays its own tax.

Hepp says the best option differs upon the size of the business. "Typically, for smaller operations a proprietorship is best because these businesses are not big enough for a son or brother to come in to the organizations. Often this business is sold or rented when the owner retires," says Hepp. "As operations increase in size, the set-up will depend on taxation — whether the owners want the business income taxed in their own name or a legal entity."

One business structure gaining popularity in agriculture is a limited liability company (LLC). "A limited liability company is similar to both a corporation and a partnership," explains Bill Trenkle, attorney with Foulston & Siefkin, Dodge City, Kan.

According to the USDA General Technical Report SO-97, "A LLC is a hybrid entity that combines the corporate benefit of a limited liability for its owners with the partnership's advantage of pass-through treatment for income tax purposes. It's created under state law, just like a corporation."

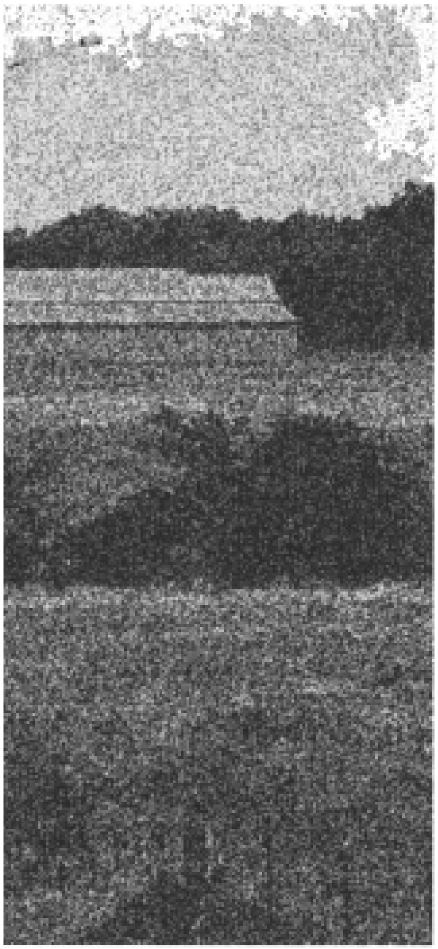
The report further explains, "Instead of filing articles of incorporation, limited liability companies file articles of organization. These notify creditors that, generally, the LLC itself will be the sole source for payment."

"A lot of people are using LLCs as a method of handling the ownership of their properties and their estate because it seems to have few disadvantages," says Trenkle.

One Angus ranch that has recently converted its business to a LLC is Austin Land & Cattle, Seminole, Okla. This 250-cow registered Angus ranch is owned by Guy Austin and his grandfather Jimmie. Prior to shifting to a LLC, the Angus operation functioned as a legal partnership,

"The main reason we set up a LLC was to shield us individually from liability outside of the cattle operation," says Guy Austin.

The Austins employed the assistance of attorneys and accountants to advise them on the best organization option. During thi process they discovered other advantages t forming a LLC. "The LLC set-up is also an estate planning tool," says Austin.



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The estate element

Part of Guy Austin's confidence in making the correct business and estate plan choices comes from his trust in his attorneys and accountants. Both Hepp and Trenkle believe farm and ranch owners need to involve outside consultants when making a business and estate plan.

"Generally, you will need a lawyer because there are legal documents involved. The lawyer may want to consult with your insurance agent and accountant because there are a lot of insurance and income tax ramifications in estate planning," says Trenkle.

Costs for the lawyers' services will vary according to the type of plan. "Fees can vary from $100 for a simple will to $1,000 for a complex estate plan. If they are forming corporations or LLCs, the fees could be several thousand dollars," says Trenkle. "The federal estate taxes can be very expensive and can cause family members a great deal of grief and problems. It's money well spent to have a good plan in place and minimize those taxes."

To help keep fees at a minimum, Trenkle recommends you gather the in formation personally rather than paying the lawyer to do the tracking. The estate plan should accomplish several objectives in respect to federal estate tax., he says.

First, the estate plan should be structured in such a way that the farmer can make use of the exemption equivalent to $600,000 worth of property available through federal estate tax. Each individual is granted a $600,000 exemption. In the case of a husband and wife, together they have a $1.2 million exemption. It's important that the property is held properly in a spouse situation because it's unknown which of them will die first.

Also, you should look into the benefits of making gifts as a way to reduce the taxes. Trenkle says the gifts can be in the form of cash or property, or the givers can create an entity like a corporation to handle the distribution.

In addition, the couple should consider establishing durable powers of attorney. This would apply if the husband or wife became incompetent.

Finally, Trenkle recommends couples look into ways of taking life insurance out of the estate. The life insurance will be taxed if the husband or wife has an incident of ownership, which means they have the right to control the policy or name the beneficiaries. It might be possible for the children to own the life insurance and keep it out of the estate. Then the children can use the life insurance to help pay taxes.

All these measures are taken so that the estate value remains lower than $600,000. "The moment an estate passes the $600,000 exemption, the beginning tax rate is 37 percent. It goes up to a maximum of 55 percent, depending upon the size of the estate," says Trenkle.

The political climate

Hepp has seen pressure on Congress from small business people and trade associations to change the exemption. "The federal estate tax exemption of $600,000 for each individual hasn't changed since 1987. There is a lot of discussion in Congress to change that amount," says Hepp.

Alan Sobba, a director with the National Cattlemen's Beef Association based in the Washington, D.C., office, has noticed a change in the attitudes toward family-owned businesses.

"There is a recognition in Washington, D.C., that family-owned businesses are more dramatically affected by estate taxes than someone who owns stocks and bonds when they die," says Sobba.

Leaders of NCBA have joined with the National Federation of Independent Businessmen (NFIB) leaders to form a Family Business Estate Tax Coalition. This coalition of 100 organizations is working to reduce or eliminate estate taxes and seek additional relief for family-owned businesses, says Sobba.

An overview

Regardless of the estate tax status Sobba, Trenkle and Hepp agree it's important to continually re-evaluate your estate pldn.

"You should review your plan every time there is a structural change in the way you do business, such as a retirement or if there is a change in the estate tax laws," says Sobba. "It's easier to correct the estate at the time of change rather than down the road."

Sobba stresses the role of the estate tax in a total business plan by saying, "An estate tax plan is part of your total business plan. The less complicated you make the process the easier it is to set it up to your advantage."

While many farmers and ranchers plan for the distant future, Hepp emphasizes the importance of planning for the next few years. "A lot of people I work with are 50 years old and want to create an estate plan for the rest of their lives. Often they will put in a lot of tax minimization schemes that they won't need for 10 to 15 years," says Hepp. His advice is to do estate planning for the next five years rather than trying to anticipate business growth and potential changes in the tax laws.

As Hepp sees it, there are six steps to estate planning:

1. Get information and learn what the issues are.
2. Evaluate what you have now. Every state has a will written for a person if they haven't written their own will. Investigate what would happen to your property if there were a premature death.
3. Think through your and your family's goals and objectives.
4. Evaluate alternatives. Calculate the tax different ways. Once you have the alternatives laid out, start talking with the professionals.
5. Create the necessary documents.
6. Review and update the documents as needed.

Sobba sums up estate planning the following way: "The ideal estate tax plan goes from point A to B without hindering the next generation and the generations that follow."

By following the above steps and recommendations, Angus breeders should be able to create a business and estate plan that will enable them to build a program for future generations. AJ