A House in Order

How a business is structured can aid, or hinder, succession.

by Troy Smith, field editor

It's a curious thing that might be more understandable if it were done out of pure cussedness. If it were about an iron-fisted old cowman convinced he will never die, the lack of preparation might not be so surprising. But most producers are mere mortals who possess an intense desire to pass the farm or ranch business to the next generation. A 2017 Nebraska survey suggests that 87% of farmers and ranchers expect at least one of their children to carry on with their family operations. The curious thing is that so few actually prepare for it.

So why is it that too many producers do not have a will, an estate plan or a business succession strategy? Oh, they probably think about it, but talking about it is uncomfortable, even depressing. Developing a plan typically requires professional counsel and that costs money. Time must be allocated to the process. Consequently, planning is easily deferred until some critical life event forces the family to address the matter.

According to Norman Dalsted, an agriculture and resource economist at Colorado State University (CSU), the old cliché is all too true.

Producers need to get their house in order. And one of the things to consider when developing a plan for transferring ownership and management of a farm or ranch to a successor is the business structure of the operation.

Depending on a family's goals, the legal organizational structure can be useful in managing current issues related to liability, tax obligation or access to capital.

"Business structure can also be key to succession planning," Dalsted adds, "allowing for the planned transfer of not only business assets but also the transfer of management responsibility to a successor."

Dalsted says the choice of organizational structure is a decision to be made only after weighing both the short- and long-term effects, and after discussion with an attorney and perhaps other qualified advisors. The following is a brief summary of commonly used business structures which may help start the process.

Sole proprietorship

The most common form of business organization is the sole proprietorship. This is the default mode. If no other legal form of business entity is adopted, an operation is considered a sole proprietorship. Simple and straightforward, it consists of an individual running a business alone. Advantages include ease of startup, flexibility and minimal legal reporting requirements beyond income tax filing.

"The vast majority of agricultural operations are sole proprietorships, because it is simple. The owner's social security number is its identifier [to the IRS] and profits flow to the owner's tax return," Dalsted says, noting that simplicity also has disadvantages. "It's not ideal for high-risk enterprises, as the owner is responsible for all of the business's debts and obligations. It also limits certain tax deductions, like medical insurance. And it is the least effective structure for transferring a business across generations because a sole proprietorship terminates with the death of the owner."

Growing requirements for capital and the economies of scale available to larger agricultural operations helped foster increases in numbers

of farms and ranches under shared ownership. Business structures accommodating multiple owners can allow percentage interests to be sold or gifted to members of the next generation while maintaining the business as a single entity. Generally speaking, business entities taking legal form other than sole proprietorship must be registered with the secretary of state in the state where the business is formed.

General partnership

A general partnership consists of at least two people who contribute assets and share management of the business, based on an agreement which designates how responsibilities and income are allocated. A partnership operates similarly to a sole proprietorship, with regard to legal and tax liabilities. The partnership entity must have its own tax identification number and must file a tax return, but the partnership entity pays no tax. Rather, profits and losses flow through to the individual owners in proportion to their respective partnership interests.

Dalsted says a partnership can provide some incentive for a child or an employee to work into a farm or ranch business. It allows, for example, one partner to contribute cash, another to contribute technical skills and another to contribute labor, while all share equally in profits. A senior member can sell or gift partnership interests to a junior member, without the need to transfer specific assets such as land or even livestock.

Dalsted warns, however, that partners are jointly and individually liable for the debts and obligations of the partnership. Say, for example,

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Property title matters

When planning for distribution of assets from an estate or when transferring asset ownership as part of a succession plan, how real property is titled matters. The title associated with a parcel of land and its improvements describes whether it is owned by an individual person, a business entity, or by multiple persons. It also can designate conditions of ownership, currently and in the future. How ownership is defined, legally, on a title really matters.

Sole ownership means the property is owned by an individual or any single entity capable of holding a title, so it could be a business organized as a corporation or even a limited liability company (LLC). The advantage is that a sole owner has the say-so regarding the lease, sale or mortgaging of the property, without permission from anyone else. A disadvantage is that upon the death of a sole owner with no will, transfer of the property will be directed by probate.

Tenancy in common (TIC) is a form of shared ownership. It means that two or more people own the property jointly, each having a separate but undivided interest. Shared interests do not have to be equal but let's say, for example, that two siblings own equal interests in a 160-acre parcel of land, as tenants in common. This does not mean they each own 80 acres. Rather, they each own a half-interest in the entire quarter section. Either sibling is free to sell their respective interest to a willing buyer and either sibling can will their respective interest to heirs. However, the 160 acres remains undivided unless a partition action is taken to divide the property into separately owned parcels. Acting collectively, tenants in common can sell the entire property, as well as lease, mortgage or divide the income from it.

Joint tenancy, often referred to as joint tenancy with right of survivorship (JTWROS) is another form of shared ownership where, like tenancy in common, each owner has an undivided interest in the property. The difference is the "right of survivorship" part. It means that when one joint tenant dies, that person's interest goes to the surviving joint tenants. Eventually, ownership is held by the last man standing. Joint tenants cannot sell or mortgage their ownership interests without permission of the other joint tenants. And a joint tenant cannot bequeath an ownership interest to an heir. The law of joint tenancy takes precedence.

Tenancy by the entirety (TBE) is yet another way of titling property under shared ownership, but use of TBE is limited to spouses sharing undivided ownership of property. The right of survivorship applies. Neither spouse can sell or transfer his or her ownership share without permission of the other spouse. Another aspect of TBE is that creditors of one individual spouse cannot attach a lien against the shared property in an attempt to satisfy debts of that one spouse. Not all states recognize TBE.

A **life estate** is a way for a person to possess and control property during his or her lifetime, while transferring ownership interest to another. A life estate is created when a property owner (grantor) deeds property to another person or persons, but reserves a life estate for the grantor or a third party (life tenant). That means the grantor or life tenant has possession of the property, pays the applicable real estate taxes and receives income it generates for the duration of the life tenant's life. The person to whom the property was deeded (remainderman) receives possession and rights to its income upon the death of the life tenant. Property held in life estate avoids probate because transfer of ownership is already designated. Because the life tenant had full use and enjoyment of the property during life, however, it is included in the life tenant's taxable estate.

When farm and ranch families ponder which organizational structure might best facilitate goals for business transition or estate planning, they'll want to consider whether the way property is titled will help or hinder the process.

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young Joe holds a 10% interest in a general partnership faced with a large financial obligation. If the partnership is out of assets and so are the other partners, then Joe is liable for the entire bill. (A more formal limited partnership structure may be adopted to protect partners from the debt or liability of other partners involved in the business. Requirements for limited partnerships vary by state).

Another disadvantage is the limited life of a partnership. Most dissolve upon the death of one partner. Admittance of a new partner to the business requires dissolution of the old partnership and creation of a new partnership. Dalsted recommends that anyone considering entering a partnership should also know how to get out. Personal situations, relationships and business dynamics can and do change, so having an exit strategy makes good sense.

Corporations

A corporation is a business entity unto itself, separate from its owners and managers, having its own legal obligations, rights and fundraising options. A corporation issues shares (common stock) and shareholders choose a board of directors to manage the corporation. As a legal entity, a corporation can own property, conduct business in its own name and shareholders are not liable for debts of the corporation. Their individual liability is limited to the amount of money they have paid into the corporation.

Two types — C corporations and S corporations — differ in how they are treated by the IRS. Every C corporation must pay business income tax *and* shareholders must pay income tax on dividends they receive from the corporation. So that income is taxed twice. In contrast, an S corporation is not subject to income tax. Its business income passes through to shareholders who report it on their respective income tax returns.

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Dalsted says avoiding double taxation is a major reason families choosing to incorporate their farm or ranch businesses typically favor the S corporation. By incorporating, the business may also take advantage of certain business deductions, including employee benefits such as health and accident insurance.

Another advantage is the limited liability afforded to shareholders, thus protecting private assets. However, the main reason that many family farms and ranches incorporate is for estate planning. The corporate form allows for the transfer of stock to other family members, either by sale or gift.

On the downside, corporations require more work and expense to organize. A corporation must hold annual shareholder meetings and there can be considerable ongoing paperwork to satisfy reporting requirements. Many advisors warn against placing appreciating assets, like land, under a corporation's ownership due to the tax consequences associated with pulling the land out or dissolving the corporation in the future.

Limited liability company

Sometimes referred to as the third type of corporation, a limited liability company (LLC) is a separate form of business organization. The owners are called "members" and, like a corporation's shareholders, receive some protection against liability for the company's obligations. The extent of that protection varies from state to state.

LLC members can choose whether, for tax purposes, the company is to be treated like a corporation or a partnership. Most farm and ranch LLCs favor the latter, choosing to have the IRS treat the company as a pass-through entity. A return must be filed but no tax is imposed on the LLC itself. Members include income from the LLC on their personal tax returns.

"A single individual can organize an LLC or it can have many members," Dalsted explains. "An LLC is governed by an operating agreement adopted by its members [even if that's only one individual]. It can specify how and when management, ownership and control of a business is transferred from one generation to the next."

Farmers and ranchers have multiple options for establishing a business structure that best fits their respective situations. Legal and tax experts can help with specific questions regarding which legal form can help accomplish the goals desired for an operation. Dalsted emphasizes the importance of starting with straightforward communication among family members. He cautions against putting it off. If the process hasn't begun, start now. AJ