PLANNING FOR THE FUTURE OF YOUR FARM

Legal tools and strategies for farm transition and estate planning

USING BUSINESS ENTITIES IN FARM TRANSITION PLANNING

A formal business entity can be a valuable tool in farm transition planning. Many attorneys advise forming a formal business entity to limit liability and manage taxes, but an increasing number of agricultural attorneys have found that business entities are excellent tools for transitioning the farming operation to the next generation. We explain business entities and how they can be used in farm transition and estate planning in this bulletin.

BUSINESS ENTITY BASICS

The farm business can be an informal structure, such as a sole proprietorship, or can be formally organized, such as a corporation or limited liability company. Each type of entity has its own set of liability protections, tax issues, ownership transfer processes, and other characteristics.

Sole proprietorships and general partnerships. Sole proprietorships and general partnerships are the simplest business entities, and according to the U.S. Census of Agriculture, the majority of U.S. farms are one of these two types. They are business entities that generally require no filing of paperwork with a state. While the details may vary from state-to-state, the characteristics of these types of entities are fairly consistent nationwide. They afford no liability protection to the owners because any liabilities of the business are also the personal liabilities of the owner, and taxes are assessed directly to the sole proprietors or the partners at individual tax rates.

By default, if there is no formal business entity, an individual who owns lands, equipment, and other goods to make a profit will own those assets as a **sole proprietor**. The sole proprietor is the business, and the business is the sole proprietor. The business has no existence beyond the sole proprietor, so when the proprietor dies, the business ends and the assets are divided up through the proprietor's estate. A sole proprietorship has limited usefulness in a transition plan because entities that are separate from the owners are best suited for farm transition planning.

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If two or more people own land, equipment, and other goods to make a profit with no formal business entity, then they own the business as general partners in a **partnership**. A partnership may or may not have a formal written partnership agreement. In either event, Ohio's Uniform Partnership Act provides laws that govern partnerships in Ohio and provides default rules if the partners haven't addressed them in a partnership agreement. In the eyes of the law, a partnership is a "person" and can own assets and conduct business as a person would. Partnerships are typically more flexible and less formal than corporations. A partnership may and often does continue after the death of a partner. For these reasons, a partnership can be an effective component of a farm transition plan.

The simplicity of sole proprietorships and general partnerships come with the tradeoff of **no liability protection**. The sole proprietor is personally responsible for any liability of the business because there is no separation between the proprietor and the business. In a general partnership, all partners can be personally liable for any losses, debts, or mistakes related to the business and the other general partners. For example, if one partner signs a contract for the partnership, the other partners are bound to and personally liable for the contract.

Corporations. A corporation is an organized business entity with a separate legal status from its owners. Corporations have the right to buy and sell property, carry debts, enter into contracts, and more. This is why we hear the phrase "corporations are people." Shareholders own the corporation and typically elect a board of directors who in turn select officers to run the day-to-day operations of the corporation. Shareholders have limited liability and are only liable for losses up to their investment in shares.

State laws governing corporations can be rather complex and burdensome. The shareholders and board of directors must hold annual meetings and keep detailed records of meetings and activities. Corporations are typically governed by majority rule, such that the owners of 51% of voting stock decide how the corporation operates.

There are two primary types of corporations: C-corps and S-corps.

1. **C-corps** are taxed directly, but shareholders are also taxed on any dividend they receive, which results in double taxation. When people think of a corporation, they often think of C-corps.
2. **S-corps** are a sub-set of corporations with special rules. People often refer to these as closely held corporations because they may have no more than 100 shareholders and have pass through taxation. S-corps may not have corporate shareholders and can only issue one class of stock.

Limited liability companies. A limited liability company (LLC) combines features of partnerships and corporations, and many attorneys describe the LLC as the best of both worlds. Like a corporation, an LLC is an organized business entity that has a legal status separate from its owners with personal liability protection for the owners. Like a partnership, owners of an LLC can create flexibility in how the LLC is governed. For taxation, LLCs may choose to be taxed directly like a C-corporation or to pass taxes to the members as in a partnership or S-corporation.

LLCs are the entity of choice for most new farm businesses, for many reasons. We discuss the usefulness of LLCs in transition planning in the rest of this bulletin, but be aware that there are times when a partnership or corporation may be a better choice than an LLC. The concepts we discuss below can apply similarly to partnerships and corporations.

USING THE LLC FOR FARM TRANSITION PLANNING

LLCs allow for considerable creativity when designing a farm transition plan. Here are several roles an LLC can play in carrying out the goals of a farm transition and estate plan.

1. **Protecting farmland**

No asset is more important to a farmer than the land. An LLC can protect the land for future generations by preventing any one family member from forcing the sale of the land and making it difficult to transfer land unless the family collectively agrees to do so. But leaving land to family members outright to own jointly exposes family land to risk**.** That's because Ohio's **partition law** allows a co-owner of land to ask the court to sell the land and divide sale proceeds among the owners. A co-owner can seek partition regardless of what share they own, as can successor owners and creditors. With partition rights, the original co-owners and their spouses, heirs, and creditors all have the ability jeopardize the goal of keeping land in the family.

An LLC removes the risk of partition. Ohio law grants partition rights only to co-owners of land, not to co-owners of an LLC. When land is placed in an LLC, partition rights are extinguished because the LLC owns the land rather than the individuals co-owning the land. The owners of the LLC do not have the ability to use the partition law to force the sale of the land. **Consider the following examples!**

*Example 1***.** Mom and Dad want to leave their farmland to their three children. They have a simple will that gives all the land to the three children as co-owners. After the parents die, Arthur, one of the children, decides that he would rather have money than continue to own the land. The other two children are unable or unwilling to buy Arthur out at his asking price, so Arthur files a partition action. The court orders the land to be sold at a Sheriff's sale and the sale proceeds to be divided among the three children. The family no longer owns the land.

Example 2. As above, Arthur is a co-owner of the land given by Mom and Dad to the three children. Arthur gets into financial trouble and must sell his one-third of the land to pay his creditors. Arthur files for a partition so that he can receive his value of the land in cash to pay the creditors. The family no longer owns the land.

Example 3. Mom and Dad put their land in an LLC. Their three children inherit the LLC. Now, when Arthur wants to sell, he does not have partition rights. Arthur is an owner of the LLC, not a direct owner of the land. The only way Arthur can cash out is if one of the other owners agree to purchase his ownership. If Arthur gets in financial trouble, his creditors do not have partition rights and cannot force the sale of the land. At most, the creditors are only entitled to Arthur's share of the profits from the LLC. The family continues to own the land.

2. Discounting value

An LLC can be used to decrease the value of assets. This is important when a person's net worth exceeds the federal estate tax exemption. All wealth exceeding the federal estate tax exemption is taxed at 40%, so it is important to make all efforts to minimize the negative effect the estate tax can have on the goal of transitioning the farm to the next generation.

An LLC can decrease net worth with a concept called **discounting**. Essentially, the value of the ownership in a closely held company is discounted to be less than the value of the assets in the company. This is due to minority ownership, shared management, and transfer restrictions of the LLC ownership, all factors that reduce values. Discounts can be as high as 30-40%, which can minimize the risk of estate taxes being assessed on farm assets. **Consider this example**:

Mom and Dad own a farm and their net worth exceeds the federal estate tax exemption by $1 million, so their heirs will owe $400,000 in estate taxes upon their death.

Mom and Dad own 500 acres of land valued at $5 million. They put the land in an LLC, and each holds 50% ownership in the LLC. They also set up the LLC so that a decision requires a majority vote and ownership interests can only be transferred to direct family members. Neither Mom nor Dad have majority ownership or control, and each is limited as to whom they can transfer their ownership – all important factors to obtaining a discount.

Let's assume a 35% discount applies to Mom and Dad's LLC ownership interest because the discounting factors exist. Now, instead of owning land valued at $5 million, they co-own an LLC worth $3.25 million. Mom and Dad have reduced their net worth by $1.75 million by placing their land in the LLC. They have given up little to receive a significant reduction in the value of their estate.

3. Designating management

An LLC can also designate the future managers of the farming operation or its assets. Not all beneficiaries of a transition plan may be qualified or willing to manage the farm's assets, or maybe the beneficiaries don't get along well and wouldn't make joint asset management decisions easily. An LLC can address these issues by determining who will have management and decision-making authority. **Consider this example:**

Mom and Dad want their three children to jointly inherit their farmland. Two children live out-of-state and have never been involved with the farm while the third child lives locally and has been involved. Mom and Dad's transition plan transfers the land to an LLC, makes the children owners of the LLC, and designates the local child to be the manager of the LLC.

The management provisions help ensure that the land will be managed properly and the out-of-state children's unfamiliarity with the land will not cause disruptions or poor decision making.

4. **Removing the need for a trust**

Many farm transition plans include a trust as the primary estate planning document, as we explain in other bulletins in this series. Using a trust can avoid probate and include terms and conditions for the distribution of assets at death. But in some cases, an LLC can negate the need for a trust. Like a trust, an LLC can avoid probate and contain ownership restrictions, management responsibilities and other terms and conditions. An LLC may also save time and legal fees. An LLC can replace a trust, or sometimes LLCs and trusts are used in combination in a transition plan. Before assuming that you need a trust, explore the possibility of using business entities instead. **Consider this example**:

Mom and Dad want their children land to inherit their farmland. They don't want the land sold outside of the family and want one specific child to manage the land. Instead of a trust, Mom and Dad establish an LLC with their required terms and conditions and make ownership of the LLC "transfer on death" to their children. The children inherit the LLC without going through probate and are subject to the transfer and management terms of the LLC. Mom and Dad accomplished their transition plan without the use of a trust.

5. **Balancing assets between heirs**

LLCs can also be used to balance assets between farming heirs and non-farm heirs. For farm families, it can be difficult to provide a fair inheritance to non-farm heirs without including at least some farm assets. Farm assets, such as land, can be put into an LLC. Then, the non-farm heirs are provided ownership in the LLC, perhaps even a majority. The farming heir is provided at least a small percentage of ownership and may have the ability to prevent the sale of the land or have an option to buy out the non-farm heirs. LLCs can provide non-farm heirs ownership of farm assets without the risk of those assets leaving the farm. **Consider this example:**

Mom and Dad own a farm business that includes machinery, livestock, and land. They have three children–Bill, Chris, and David. Only Bill is involved with the farm and will continue it after Mom and Dad's deaths. Like most farmers, Mom and Dad's wealth is almost entirely wrapped up in the farm. If Bill were to inherit all the farm assets, little value would be left for the inheritance of Chris and David. However, if Chris and David were to inherit two-thirds of the farm assets, it could jeopardize Bill's ability to continue a viable farming operation.

Mom and Dad establish an estate plan where Bill will inherit all the machinery and livestock. They form an LLC for the land and grant ownership shares to Bill, Chris, and David, with Chris and David receiving a larger share to offset the machinery and livestock Bill received. The LLC names Bill as the Manager and allows the land to be leased back to Bill.

In this scenario, the land LLC allows Chris and David to inherit farm assets without being able to interfere with Bill's farming operation. Chris and David will receive their share of the land rent, but Bill will retain control over the land. This strategy provides farm assets to non-farm heirs while leaving control of the farm with the farming heir.

FORMING A BUSINESS ENTITY

The internet is full of advice and fill-in-the-blank forms for forming a business entity. It's a decision that requires more than an internet search, however. Your attorney is a necessary resource not just for selecting an entity that carries out your goals, but for designing your entity so that it does what you want it to do. An attorney can tailor the legal documents for your business entity to your goals, ensuring that they contain the appropriate provisions and mechanisms to achieve those goals.

Choosing the right business entity for you, your family, and your farm is an important step in the farm transition planning process. An LLC is one type of entity that can help protect farmland, minimize estate tax risk, designate management authority, and keep assets out of probate. If any of these goals are in your farm transition plan, be sure to review them with an attorney who can help you design the entity that fits your plan for the future of your farm.

REFERENCES

Ohio Revised Code, Title 17, Corporations-Partnerships
https://codes.ohio.gov/ohio-revised-code/title-17

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Find all our **Planning for the Future of Your Farm** resources at https://go.osu.edu/farmplanning

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