



Bulletin

Extension

Estate Planning Considerations for Ohio Families

Section 8

Business Organization Forms

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Long gone are the days when a partnership or corporation were your primary choices for a farm business. The recognition of Limited Liability Company (LLC) and Limited Liability Partnership (LLP) in Ohio in 1994 increased the types of organizations available to businesses. The LLC and LLP offer new advantages and disadvantages to consider, and create a stronger requirement for business owners to look closely at their business structures.

Partnership

A partnership arrangement may aid in transferring property from one generation or one party to another. The younger partner can secure an interest in either real or personal property by a gift or a purchase, or as compensation for labor and management contributed to the partnership. The partnership is a very flexible ownership arrangement and may be helpful in many ways in planning an estate. This may still be the primary choice of entity if government payment limitations are an issue.

The partnership's flexibility may be a disadvantage if it becomes unstable at the death of one of the partners. In this respect, it is similar to tenancy-in-common. At the death of a partner, the other partner may be forced to settle up and distribute to the deceased partner's estate a share of the partnership assets. In a farm operation, this could result in the disruption or dissolution of the farm business.

Such disruption could be avoided, however, if the deceased partner's heirs are bound by a written buy-sell provision in the partnership agreement, funded by life insurance if needed. Such a provision would prevent much of the instability that may arise in settling the estates of the respective partners.

A limited partnership can facilitate inter-generational transfer, much like a corporation. There must be at least one general partner. Any or all partners can hold shares of the limited partnership, which could be sold or given away but which carry no control rights nor associated liabilities. A limited partnership is often favored over a corporation for holding real estate.

Family Limited Partnership (FLP)

A Family Limited Partnership, or FLP, is a limited partnership in which ownership is restricted to a confined group—family members. This aspect differs from other types of partnerships and corporations where transfers of interest are unrestricted or are publicly traded. The FLP is a valuable tool for centralizing management of a family business and passing limited partnership interests to the next generation.

A Family Limited Partnership is formed with a written Partnership Agreement. Provisions in the partnership agreement can restrict how or if partnership interests are transferred, sold, or encumbered. The FLP consists of general voting partners and limited non-voting partners. Typically, the senior generation acts as the general partners for the FLP and maintains control over partnership activities. The younger generation enters the partnership as limited partners, who hold an ownership interest in the partnership but little or no management authority. Eventually, limited partners transition to general partners.

Advantages of the FLP include:

- limiting ownership interests to family members,
- allowing for an incremental and smooth transfer from one generation to the next,
- having the ability to transfer partnership interests free of gift tax, and
- providing limited financial liability for limited partners.

An FLP must be registered with the state of Ohio. Forms are available from the Ohio Secretary of State. Visit the website <http://serform.sos.state.oh.us/sos/Forms/531.pdf> to see an “Application for Registration of a Registered Partnership Having Limited Liability or Certificate of Limited Partnership.” The filing charge is \$125. You should work with your attorney, accountant, or other qualified counsel to set up any business organization.

Corporation

A corporation is an artificial entity created under state law. It is a separate legal business entity distinct from its owners, who are called shareholders because they own shares in the corporation. The major characteristic of the corporate form of business organization is the sharp line of distinction between the business and the owners. The corporation is a separate taxpayer unless shareholders are qualified and elect to be taxed like a partnership, as a Sub Chapter S Corporation.

One advantage of a corporation is that, as with a partnership or LLC, it is relatively easy to transfer one or more shares of stock by gift or sale from parents to children. Yet, so long as more than 50 percent of the stock is in either or both of the parents’ names, the parents could continue to have the controlling vote in the corporation and in the farming operations.

You may also be able to minimize current income tax liability by retaining some income in the corporation rather than distributing it all as salary or dividends.

It should be noted in this connection that a minority shareholder in a farm corporation is likely to find himself or herself in a weak position. This may happen to the farm-operating child or to the surviving parent if there is more than one heir involved in the estate settlement.

Reducing estate settlement costs and estate taxes by means of gifts of stock is a feature often discussed as an advantage of a corporation. Much the same thing can be done by selling the farm on installments and then making gifts equal to a part or all of the current payments on the contract or mortgage up to the exempted limits. However, the income tax on the sale of the farm is involved if there is a capital gain.

Major disadvantages of using corporations with farm businesses relate to termination of the corporation. In general, the liquidation of a corporation is a completely taxable event, at both the corporation and shareholder levels. If the corporation contains land, the tax liability may be overwhelming. In addition, annual issues of owner compensation, status as a personal holding company, and double taxation at the corporate and shareholder level may be costly or difficult to manage.

Limited Liability Company (LLC)

A Limited Liability Company (LLC) is a form of business organization created by state law that includes aspects of both partnerships and corporations. Many LLCs are established to give the owners protection from business debts (in the same manner as shareholders in a corporation), but to attain partnership tax status for the entity. In this form, business profit or loss, plus other tax attributes, are not taxed at the LLC level, but flow through to the members. The members also have limited liability. In addition, the LLC facilitates gifting assets to heirs in a manner similar to gifting within Limited Partnerships and Corporations.

An LLC is formed by filing Articles of Organization and an Appointment of Statutory Agent with the State of Ohio. The articles are relatively simple—setting forth the name and address of the company, its statutory agent, and a statement of the company’s purpose. Once formed, an LLC may choose to have an operating agreement which governs the company. Ohio law will fill in if there is no operating agreement, or for any provisions that are not addressed in an operating agreement.

Management of the LLC is by members in proportion to their ownership, unless agreed to otherwise. Members may delegate or share in management with managers, who may be either members or non-members. If the LLC is member-managed, any member can bind the company. Single member LLCs are now authorized by Ohio law.

Tax advantages of an LLC are comparable to that of a Subchapter S Corporation. It is easy to give away shares of stock to reduce your estate and it may be possible to get the value of shares of stock in a closely-held LLC discounted in an estate. See Discounting Business Interests below for more information.

For federal income tax purposes, the LLC may be treated as either a partnership or as a corporation. If treated as a partnership, income is only taxed at the individual level, thus avoiding the “double taxation” of a corporation. Where an LLC meets the federal tax requirements for partnership taxation, Ohio will also tax the LLC as a partnership.

Liability advantages include the fact that the LLC member will not be personally liable for the debts, obligations, and liabilities of the company, except for tax liabilities. Members can still be personally liable for damages resulting from their own acts or omissions. A member who is a manager can be personally liable for management actions only if there is clear and convincing evidence that the manager acted with reckless disregard or intent to injure the company. As with corporations, the members can also be liable under a legal theory called “piercing the corporate veil” if a court would find that the entity really did not have a true existence in fact. Therefore, it is prudent to follow all of the formalities of the entity including signing contracts and other documents in your representative capacity on behalf of the company rather than just your individual name.

Operating advantages include the fact that an LLC offers great flexibility for a farm business. The Operating Agreement can be written with a minimum of formalities to operate as a partnership, or with maximum formalities to operate as a corporation. Management can be all members, by designated managing members, or by nonmembers. Non-managing members can have more management involvement than they would in a limited partnership, and retain their liability protection.

Disadvantages include the fact that payment limitations for government payments may be affected by forming an LLC. The number of “persons” eligible to receive program payments may decrease under Farm Service Agency rules. Where there are many members, management may prove more difficult in an LLC than a corporation if management is reserved to all of the LLC’s members. Those making gifts of their interest in an LLC may not get as much discount in value with an LLC as with a limited partnership or LLP.

Limited Liability Partnership

The Limited Liability Partnership is very similar to a general partnership, but offers its partners liability protection for the acts of other persons in the partnership. This entity is not to be confused with the Limited Partnership which limits a partner’s liability for partnership debts to the amount of the limited partner’s interest in the partnership. If a person wants limited liability for the partnership’s obligations, then the limited partnership is the appropriate tool. The limited liability partnership does not offer that type of protection.

An existing partnership becomes an LLP by registering with the State of Ohio. Registration involves filing an application setting forth the name and address of the partnership along with a brief statement about the business.

As with the general partnership, an LLP may or may not have a written partnership agreement. Where there is no partnership agreement, Ohio law dictates the terms of the partnership. Unless agreed otherwise, each partner has joint control and the sharing of profits is equal.

Liability advantages include protecting the partners from the acts or omissions of other partners, employees, agents, or representatives of the partnership. This immunity applies to wrongful acts, errors, and misconduct, whether or not the act or omission is intentional. The liability protection offered by the LLP does not apply to debts or obligations of the partnership itself, and a partner is still liable for his or her own acts, negligence, errors, misconduct, or omissions.

Management advantages include the fact that partners in an LLP (unlike the Limited Partnership) are not required to limit their involvement in the management of the business. Each partner may participate as a general partner.

Disadvantages include the fact that the LLP registration must be renewed annually. The decision on which type of business structure to choose for your farm business requires analysis of many factors. An LLC, with its tax and operation flexibility, can be used for a number of purposes—to operate an active business, to isolate property, or as a vehicle for gifting assets. But an LLC is not always the best option when there is only one member or there are many members, where members may not want limits on transferability of their interests, or where the business will operate in a number of states. An LLP may be the optimum choice where partners desire the less formal flexibility of a partnership and seek some liability protection without forfeiting management involvement.

These factors are best analyzed with the assistance of an accountant and an attorney. Farm businesses may want to seek out professionals who are experienced with the specific legal and tax provisions that apply to their businesses. Selecting the best business entity can be confusing and consuming, but a business will surely benefit in many ways from the process.

Discounting Business Interests

When the owner of interests in a closely-held (family) partnership, corporation, LLC, or LLP dies, the

value of the interests owned by the decedent are included in the estate. One of the common objectives in estate planning is to value these closely-held interests in the business at a lower value than one would get if one simply divided the fair market value of the business assets by the number of business interests outstanding. You are usually more likely to obtain a discount on the business value when the owner of the business interests does not own a majority or controlling interest of the business. There are a number of different discounting techniques, but the most common are discounts for lack of marketability, for lack of control, and for built-in gains in a corporation.

The fair market value of any interest of a decedent in a business is the net amount that a willing purchaser would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. Because of the limited market for interests in closely-held businesses, the value of the interests frequently qualify for discounts of 20-30% more. The valuation is often affected by whether the decedent had a “controlling interest” at the time of death and by the existence of restrictive agreements as to transfer. Although dependent on an appraisal, combined discounts for both lack of marketability and lack of control may commonly total 35%.

Because corporations do not get a step-up in basis for assets owned by the corporation on the death of a shareholder, there are usually built-in capital gains due to appreciation in value or tax depreciation. The taxes on these built-in gains will be incurred whenever there is a liquidation, so a buyer is not willing to pay as much for the corporation as for the same assets outside of the corporation. Therefore, corporations may end up with greater discounts because of the greater tax costs on liquidation.

As one might expect, considerable effort and ingenuity are frequently used to make sure that the interests qualify for such substantial discounts. The IRS continues to develop arguments to limit the discounts, to disallow the gifts for the annual exclusion and to pull gifts back into the taxable estate.

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November 2003

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