Which Entity is Best for My Estate Plan?

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It is time to do estate planning and one of the decisions that you will have to make with the help of an attorney is what entity, if any, you should use to hold the investments to protect it and allow you to transfer it to the next generation. While this discussion is centered around a farmer, it has application to anyone doing estate planning. This discussion only covers the basics and observations I have seen in the many estate plans I have worked on with FBFM clients and their attorneys. Further in depth discussion is needed in your specific case.

Prior to the 1970's, most farms operated as a combined business and personal accounting (sole proprietorship) because farming was a business and the family life. The problem was the estate plan had to include the business and the family life in the same plan. Lawsuits could take all assets. Self employment tax was owed on all income produced, but it was such a small amount of tax back then! While step up valuations were available in estates, difficulties arouse when two farmers combined their operations to better share machinery and labor.

Thus, general partnerships came about as a popular choice to combine farmers. However, the disadvantage was that the partner's were liable for the actions of his partner(s). The advantage was that we now had a means to separate the business from the personal life. We could still step up basis of assets when an estate occurred. General partnership partners generally pay self employment tax on all their earnings.

Often, the farmer wanted to specifically control his assets from the grave…thus we bring in a trust. The trust follows the instructions in the trust document, or if not covered, it follows state law. If still not covered, it will follow federal law. Trusts generally do not have any self employment tax unless the trustee pays on his trustee fee, but only if he is in the business of managing many trusts. Once a person gifts his assets into a trust while he is still alive (irrevocable trust) the trust has his original basis and does not get step up basis on his death.

A revocable trust is created before death and the stepped up basis of the assets are what goes into the trust.

Corporations can be either a "C" or an "S". They do a good job in splitting the management and labor returns from the investment side of the business. Thus, self employment taxes are reduced because the farmer only owes FICA and Medicare taxes on the wages he pays himself. Shares can be gifted to the next generation for transitional planning. They create a good shell for liability protection. A disadvantage is that the money in a “C” corporation will get double taxed if you want to pull it out. A “C” corporation does not get preferable capital gain tax rates.

An “S” corporation offers a liability shell, but the advantage of preferable individual tax and capital gain tax rates. Basically, the individual shareholders pay the taxes for the “S” corporation so the corporation should distribute at least the cost of taxes out to the shareholders.

LLC’s (limited liability companies) are like a modern version of the partnership in that it can be one individual or a combination of several persons to carry on a business or hold assets. It has a shell to protect it; thus protecting the individual members. It can be used to gift an interest to the next generation. Individuals should pay self employment tax on their earnings if it is an active business. They do not pay self employment tax if it is a rental/investment business. This is a very popular entity to put a trucking business in to protect the farm and other personal assets in case of an accident on the road.

The LLLP (limited liability limited partnership) is a newer version of the FLP (family limited partnership) and is superior in the area of cross liability between the members. Basically, either entity is a good choice if all the children have moved off the farm and the parents want to start gifting shares of the farm to them now, but are not ready to retire and still want to manage the farm. The parents would have a small percentage of ownership as general partners (active management) and most of their percentage ownership is in limit shares which they gift annually over to the children. The limit for this year is $13,000 but you can have a discount if the gift is a minority share. You need to get a land appraisal and a discount appraisal every time you make the annual gifts. Liability protection is maintained from outside lawsuits and accidents. This is important as the children grow up and move away and have families. Only the general partner(s) owe on self employment taxes …not the limited partners (unless they work on the farm). And the limited partners do not get a “pass thru loss”– as it is passive income and subject to those rules.

By the way, IRS is very critical of discounting done on these entities. You have to cross every “T” and dot every “I” . You should not get a cheap appraisal, but only one from a reputable Appraiser that has done these “Discounts” before. These are generally done by a CPA firm. So you first get a Land appraisal from a Real Estate Appraiser licensed in your state; then get a Discounting appraisal from a CPA firm. Then those are given to your tax preparer for the reporting to IRS on the changes in ownership. This whole process is not cheap, but then you are saving substantially more than this cost on future estate taxes.

This chart below should help to summarize the issues:

Entity	Liability Protection	Management Separate from Investments	Could Reduce Self Employment Tax Owed	Estate Step Up Basis Available	Minority Discount Available
Sole proprietor	No	No	No	Yes	No
General partnership	No	No	No	Yes	Yes
Trust - irrevocable	Yes	Yes	Yes	No	No
Trust - revocable	No	No	No	Yes	No
"C" Corporation	Yes	Yes	Yes	No	Yes
"S" Corporation	Yes	Yes	Yes	No	Yes
LLC	Yes	No	No	Yes	Yes
FLP/LLLP	Yes	Yes	Yes	Yes	Yes

*Note: This article is by no means a complete discussion of all the advantage and disadvantages of one type of entity over another. For example, do you know there are over 160 different types of trusts on the books?! I hope this article does get you to think about your estate plan and lead you to discussing it with an FBFM Fieldstaff, accountant, estate planner, or attorney. Remember, there are new tax court cases and laws happening all the time, year after year.