ESTATE PLANNING — EMPHASIS ON CORPORATIONS

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Two of the more important aspects of estate planning for farmers and ranchers are business planning and family planning.

The business management facets of estate planning include such items as (1) continuity of management, (2) high-quality management, (3) continuous financial flow and (4) continuity of life of the business. The form of business organization utilized — sole proprietorship, partnership or corporation — may decidedly affect the degree of success achieved in both business and family planning. While these three forms of business organization are compared in the brief chart at the end of this publication, only corporations are presented in detail in the text discussion.

OVERVIEW OF A CORPORATION

Of the forms of business organization available to farmers, the corporation is probably one of the types least understood. First of all, a corporation is a creature of statute and cannot exist apart from the law that gave it authority to exist. A corporation is also a legal entity. It can acquire, hold and transfer property in its own name. It can sue and be sued. It can make contracts with its own owners as well as with others. But it is not affected by the death, withdrawal or disagreements of its members. And, unlike a partnership, it does pay taxes. As will be discussed later, it may be taxed in either of two ways, depending on whether it is subject to either subchapter **C** or **S** of the Internal Revenue Code.

Although a corporation is a legal entity, it does not, however, have all of the rights, privileges and obligations of an individual. For example, it cannot vote except in some elections such as an irrigation district where it votes as a member of the district rather than as an individual. Even though a corporation cannot be imprisoned, this does not protect its owners and officers from such treatment. A limiting feature of a corporation, particularly as a farming venture, is that it cannot go freely from state to state doing business in each state on the same terms as the businesses in that state. A corporation must be registered in each state in which it does business, and it must operate within the laws of each state regulating such business.

The ownership interest in a corporation is represented by stock. This ownership may be transferred by endorsing and delivering the stock certificate to another entity. This is particularly helpful, for example, where land is owned by the corporation. The corporation holds title to the land. The individuals hold title to the corporate stock, and the stock can thus be exchanged without reference to any change in the ownership of the land.

If the ownership is widespread, the management of a corporation can be concentrated in a relatively few persons (such as an elected board of directors). This may be advantageous in family situations where certain members do not wish to participate in the operation of the business but would still like to retain some ownership, leaving the actual management to other members.

CORPORATE CHARACTERISTICS

It is hard to discuss corporations in terms of advantages or disadvantages. What is a plus to one family could well be a disadvantage to another. Families face different circumstances. Though the specific circumstances might differ, some of the more common reasons for forming corporations are summarized below:

1. **Estate Planning.** For an individual or group faced with substantial federal estate taxes, incorporation may be attractive. It is possible to lower the size of one's estate for estate tax purposes by making lifetime transfers of stock (shares) in the corporation. However, so long as 51% of the *voting* stock is retained, the individual or group has the power to control the management of all corporate assets. Since the opportunity to decrease estate taxes while retaining control is more difficult to achieve with other forms of business organization, this is a major reason that many farms and ranches are now incorporating.
2. **Limited liability.** That stockholders are not personally liable for corporate debts and obligations is well known. Only limited partners in a limited partnership share this

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distinction. However, the aspect of limited liability is not very important to many farmers and ranchers because they have the vast majority of their assets invested in their businesses. Limited liability is of primary importance when someone has extensive assets in other areas (that is, *outside* of the business) which they want to protect. Additionally, lenders may require major farm and ranch stockholders to co-sign corporate obligations. This practice effectively eliminates the possibility of limited liability.

3. **Continuity of business life.** A corporation may have perpetual life. The death of a stockholder has no effect on the life of the corporation, nor on its day-to-day operation except as membership on the corporate board of directors is changed. This situation is not true for the sole proprietorship, and it is also more difficult to achieve with a partnership.

4. **Credit availability.** If they are willing to pay the price (interest rate), corporations may have more ready access to capital than the other forms of business organization because they are not subject to state usury laws. In addition, off-farm and off-ranch family members may, in some cases, be encouraged to invest in the farm business. These investments can be made either by stock purchases or by loans.

   But some lenders place limitations on loans to corporate borrowers and, particularly in smaller farm and ranch corporations, may require principal shareholders to co-sign corporate obligations personally. Thus, before incorporating, each individual should analyze and investigate how incorporation would affect his or her ability to obtain both operating and real estate credit.

5. **Retirement planning.** A corporation can be used to set up an attractive retirement for older family members. This may be done through coordinating social security, annuity and or "Keogh" plans, "baby group" insurance purchases etc.

6. **Minority-shareholder problems.** Minority shareholders in a small family corporation may be "locked-in" the business because outside investors may not be interested in purchasing shares in a corporation in which they will have no effective voice in management. Thus, these minority stockholders may be unable to get their money out of the farm or ranch business to make desired investments elsewhere. This problem may be somewhat alleviated by creating binding "buy-sell" agreements designed to treat both majority and minority shareholders equitably.

7. **Red tape.** Corporations must keep some records not generally required of sole proprietorships and partnerships. These include recording the minutes of meetings of shareholders and the board of directors. Of course, *to the extent* that such records give additional information to improve decision-making, they are a help rather than a disadvantage.

   Compliance with the corporate charter and the somewhat rigid state laws is necessary for a corporation. Mergers, consolidations, reorganizations, issuance of stock, etc. must follow legal rules and regulations.

8. **Income taxes.** Since most Texas farm and ranch corporations have 10 or fewer shareholders, they have the option of being taxed under either subchapter **S** or **C** of the Internal Revenue Code, Incorporation not only need not appreciably increase the firm's income tax bill, but it can even decrease it in some cases. Income taxes are discussed in more detail later.

9. **Additional costs.** Some costs are or may be higher with the corporate firm — such as attorney's fees, annual filing fees, franchise taxes, social security taxes and fees for accounting services. These must be evaluated in conjunction with the benefits of incorporating under the individual's particular circumstances.

OPERATIONAL PROCEDURES

The services of an attorney should always be secured in creating and operating a corporation. The following information describes the general requirements and procedures for incorporating, filing fees and the franchise tax.

The general requirements include:

1. A minimum of three people over 18 years of age, at least two of whom are Texas citizens, are required to incorporate a Texas corporation, but one person may own all corporate stock.
2. Articles of incorporation must be prepared and filed with the Secretary of State, and the required filing fees must be paid.
3. Thereafter, the Secretary of State will issue a certificate of incorporation, indicating the creation of a valid corporation.
4. After paying in the required capital minimum, the corporation can commence business.
5. An organizational meeting must be called with at least 3 days' notice to the incorporators. The organizational meeting must satisfy the following requirements:
   - Be called by a majority of the incorporators.
   - Adopt by-laws.
   - Elect officers.
   - Conduct other business as may be appropriate.

The *Articles of Incorporation* must include (but not be limited to), the following:

1. Name of the corporation.
2. Life of the corporation (may be perpetual).
3. Purpose or type of business to be conducted by the corporation.
4. Total shares, class and par value of stock authorized.
5. Rights or privileges of incorporators or others to each class of stock.
6. Statement as to date of starting business as a corporation.
7. Limit or pre-emptive right of incorporators or others to treasury shares of stock.
8. Specific regulations of internal affairs of the corporation.
9. Name and address of the agent and office of the corporation.
10. The number and name of initial directors.
11. Name and address of each incorporator.

Filing fees are determined by the state legislature. Current rates are as follows:

Fee	Amount
• Initial articles and certificate	$100
• Amend articles	$100
• Articles of merger or consolidation	$200
• Foreign corporation certificate	$500
• Amend foreign corporation certificate	$100
• Restated articles	$200
• Reserve corporation name	$ 10
• Change of registered office or agent	$ 10
• Cancellation or withdrawal of shares	$ 10
• Reduction of capital or dissolution	$ 10

(Note: A *foreign corporation,* as cited above, is any corporation doing business in Texas that is franchised in another state.)

Every corporation doing business in Texas is required to file annual reports and pay a franchise tax to the State Comptroller for the period of May 1 each year through April 30 of the following year. The franchise tax can be computed either on the basis of taxable capital or by an optional method based on total assets. The initial franchise tax must be paid 90 days after the end of a year following the date of filing its charter or of granting its certificate of authority, at which time the second year's tax is paid in advance. Both the first and second year's tax is based on the first year's business.

Since the franchise tax may be substantial, it may be high enough to lead some to decide against incorporating the farm or ranch business. Space prevents a full discussion of it here. However, for a fuller discussion of this tax, refer to MP-1158, *Incorporating the Texas Family Farm or Ranch Business,* available at your local county Extension office.

CORPORATION TAX CONSIDERATIONS

Most corporations are subject to the income tax rules of subchapter **C** of the Internal Revenue Code. Under these rules, the corporate income tax rates are 22% on the first $25,000 of ordinary (non-long-term capital gain) corporate profits and 48% on any additional ordinary income. Deductions are given to the corporations for salaries paid shareholder-employees so long as they are reasonable and are for work actually done. Such salary is, of course, taxable for those who receive it. On the other hand, dividends paid to shareholder are ***not*** deductible to the corporation but are taxable to receiving shareholders. Subchapter **C** corporate income tax rules are also discussed in more detail in MP-1158, *Incorporating the Texas Family Farm or Ranch Business,* available at your local county Extension office.

"Tax Option" Corporation

Incorporation under "tax option" or "subchapter **S**" results in a corporate creation of federal income tax law that allows small corporations to elect to be taxed in a manner similar to partnerships, provided the corporation meets all of the following conditions:

- Has only one class of stock outstanding
- Has no more than 10 shareholders, all of whom must be individuals or estates (that is, another corporation or trust cannot be a shareholder)
- Has had all shareholders consent to the election to be taxed as a partnership
- Does not have more than 20 percent of the corporate income derived from rents, royalties, interests, dividends or other "passive" investment income sources
- Does not have more than 80 percent of the corporation's income from sources outside the United States

When shareholders have elected to be taxed as a partnership, they must include their pro rata share of the corporation's ordinary taxable income for their taxable year, whether distributed or not. The excess of net long-term capital gain over net short-term capital gain of the corporation is treated as long-term capital gain and is generally passed through to shareholders. (Other subchapter **S** corporation rules are discussed in a more comprehensive Texas Agricultural Extension Service publication, *Incorporating the Texas Family Farm or Ranch Business,* which is also available at your local Extension office.)

CONCLUDING COMMENTS

Before creating either a partnership or a corporation, make sure that the form chosen can help meet the desired financial, business and estate planning objectives. Discussion with others already in partnerships or corporations will help to bring out the major problems they experienced, as well as the major benefits they enjoyed. While this publication sets out some items to consider, each individual should be cautious and as well-informed as possible. (For a more detailed discussion of corporations, obtain MP-1158, *Incorporating the Texas Family Farm or Ranch Business,* from your county Extension office.) Sole proprietorships, partnerships and corporations are briefly compared in the following summary chart on the back of the present publication.

COMPARISONS OF FARM AND RANCH BUSINESS ORGANIZATIONS

Category	Sole Proprietor	Partnership	Corporation
Ownership	Single individual	Two or more individuals	A legal separate entity separate from shareholders (but made up of individual stockholders)
Life of the organization	Death terminates and there is liquidation; there may be transfer of intent during life	Business terminates with death of partner or at agreed time; sale to surviving partner or partners; liquidation	Forever, or for fixed number of years; in case of death, stock passes by will or inheritance
Liability	Proprietor liable	Partners are liable for all of partnership obligations	Corporation is liable for obligations; (in some cases, individual stockholders may be asked to sign separate payment notes)
Capital	Personal investments; loans	Partner contributions; loans	Shareholders' stock, sale of stock and loans
Management decisions and limits on business	Proprietor fully responsible	Ability and agreement of partners	Directors' decisions, Articles of Incorporation and Texas Law
Taxes	Tax on income of individual and related tax laws	Each partner pays his or her own income tax based on his or her income and related tax laws at tax time; partnership does file IRS Information Report	*Regular Corporation:* Corporations file a tax return and pay tax on income; salaries to shareholders and employees deductible; Rate: 22% on first $25,000 and 48% on excess capital gains offset by capital losses, and no 50% deduction on capital gains; shareholders taxed on dividends received *Tax-Option Corporation:* Each shareholder reports shared income, operating loss and long-term capital gain; IRS Information Report filed by corporation
Taxes (estate)	Based on value of proprietor's estate, both separate and his or her community part of property and assets	Based on each partner's estate value, considering not only all separate property, but also his or her share of community property; his or her part in the partnership must be included in the above	Based on value on shares of stock and other assets, including other separate and shares of community property

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