Farm Business Arrangement Alternatives

AAE 320

Based on work of

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Goal

- To understand the main options available for farmers to legally organize their business
- Focus on
  - Establishment
  - Decision Making
  - Taxation
  - Liability

Alternatives for Farm Business Arrangements

- Sole Proprietorship
- Partnership
- Corporation
- Limited Liability Company

Sole Proprietorship

- One owner who has full control
- Liable for all debts of the business
- No legal formalities required to form a sole proprietorship
- Owner pays tax on all business income

Partnership

- A partnership is an association of two or more persons sharing the profits and losses from a business
- Two Types
  - General Partnership
  - Limited Partnership

General Partnership

- All members make the decisions
- All members liable for all partnership debts
- No legal formalities required to form a general partnership

Limited Partnership

- Limited Partnership has two types of partners: General Partners and Limited Partners
- General partners actively manage partnership activities, liable for partnership debts
- Limited (silent) partners cannot actively manage day-to-day activities, just general or broad management
  - Not liable for partnership debts

Taxes and Partnerships

- Partnerships do not pay taxes
  - Partnerships file IRS Form 1065 that reports all income and deductions allocated to partners
  - Partners pay ordinary income, capital gains, and self-employment taxes on income earned as partners
- Transferring assets into or out of partnership does not trigger recognition of gain
- Basis carries over with the transfer

Corporations

- Limited liability: owners (shareholders) not liable for corporation debts
- More legal formalities than a partnership
- Must file Articles of Incorporation with the your state's Dept. of Financial Institutions
  - Shareholders
  - Directors
  - Officers

Corporations

- Corporations separate Management and Ownership
  - Sole Proprietorship and Partnerships do not
- Shareholders: owners of corporation
- Directors: elected by shareholders, make broad management decisions, hire Officers
- Officers: run the business, report to Directors
- Family Farm Corporations: same person may be all three: shareholder, director, and officer

Income Taxation of Corporations

- Corporations pay taxes on its income
  - Previously had tax brackets, 2018 law made 21% flat tax for corporations on taxable income
- Dividends paid to shareholders are
  - Taxable income for shareholders
  - Are not a deductible cost by the corporation
  - Often called “Double Taxation”
- Shareholders can be employees, and so their wages deducted from Corporation income
  - Shareholder cannot be “fake” employee just to avoid double taxation

Asset Transfer and Corporations

- Assets can be put into a corporation in exchange for ownership interest
  - Does not trigger recognition of gain
  - Basis transfers to the corporation
- When assets are distributed to a shareholder in exchange for shares
  - Triggers recognition of gain
  - For <u>BOTH</u> the corporation and the shareholder
  - See Example 2

Corporations

- Two Types: C Corporations and S Corporations
- We have been talking about C Corporations

S Corporations

- Restrictions on the number and type of shareholders, but farms usually qualify
- Still the same legal formalities, plus have shareholders, directors, and officers
- Income taxed only at shareholder level (thus S corps are “pass-through entities”)
  - No double taxation
- When assets are distributed to a shareholder
  - Still triggers recognition of gain, but tax is paid only at shareholder level

Limited Liability Company (LLC)

- Still requires filing Articles of Organization with state’s Dept. Financial Institutions
  - Annual report to state
  - May create an Operating Agreement
- Has Members and Managers
  - Members are owners
  - Managers may or may not be Members

Limited Liability Company

- Taxed like a partnership
  - Income flows through to the Members who report it on their taxes (form 1040)
  - Pay ordinary income, capital gains and self employment taxes
  - Transferring assets in/out of LLC does <u>not</u> trigger recognition of gain
  - Basis carries over with the transfer
- Limited Liability like a corporation
  - Members not liable for the debts of the LLC

Changes in 2018

- Corporate tax rates now a flat 21%
  - Before were brackets, with rates from 15% to 35%
- Pass-through entities (Sole proprietors, Partnerships, S Corps and LLCs) that pass income through to owners now can qualify for up to a 20% deduction of this income
  - Qualifications and limits depending on type of entity (service vs non-service), your AGI and amount of your W-2 wages, etc.
  - Business interest not always deducible as cost
  - Net operating losses can only be carried forward and only up to 80% of income in one year

Summary

- Described Sole Proprietorship, Partnerships, C-Corp, S-Corp, and LLC as options for farmers to legally organize their business
- What to know
- How to Establish each
- How Decision Making works for each
- How each deals with Taxes
  - Ordinary income, capital gains, self-employment
  - Transfer of assets in/out and recognition of gain
- How each deals with Liability