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 **BOTH** 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 not 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