Farm Business Arrangement Alternatives

AAE 320
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Learning Goals

• To understand the main options available for farmers to legally organize their business

• Focus on four characteristics of each business entity
  1. Establishment
  2. Decision Making
  3. Taxation
  4. 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
  1. General Partnership
  2. 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 Schedule K-1 (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) are not liable for corporation debts
- More legal formalities than a partnership
- Must file Articles of Incorporation with your state’s Department 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 like people, but the 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 the corporation and the shareholder
  - See Example 2
Corporations

- Two Types
  1. C Corporations
  2. 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 to establish
- Still shareholders, directors, and officers
- Income taxed only at shareholder level, so S corps are “pass-through entities” that file Schedule K-1 (Form 1065)
  - Shareholders pay ordinary income, capital gains and SE taxes
  - No double taxation
- When assets are distributed to a shareholder
  - 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 Department of Financial Institutions to establish
  • Annual report to state
  • May create an Operating Agreement

• Has Members and Managers
  • Members are owners
  • Managers can be Members, or they can be hired
Limited Liability Company

• Taxed like a partnership
  • Income flows through to the Members who report it on their taxes
    • No double taxation
  • Pass-through entity that files Schedule K-1 (Form 1065)
    • Members pay ordinary income, capital gains and SE 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 Tax Law

• 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) 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