WISCONSIN
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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

- Corporation pays 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 in the corporation
  - 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 <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 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 paid not always a deducible 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

Summary Table

Entity	Establishment	Decision Making	Taxation	Financial Liability
Sole Proprietor	Nothing formal	Owner	Owner	Owner
Partnership	Nothing formal	Owners	Pass thru to owners	All Partners
Limited Partnership	Recommended	General Partners only	Pass thru to owners	General Partners only
C Corporation	File with DFI	Officers	C Corp & owners	Corporate assets only
S Corporation	File with DFI	Officers	Pass thru to owners	Corporate assets only
Limited Liability Co	File with DFI	Managers	Pass thru to owners	Company assets only