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Informing farm families and ag businesses about management issues.

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Utilizing Partnerships & Corporations To Transfer Farm Assets

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Introduction:

Transferring the farm business to the next generation can be a daunting task. However, there are strategies and methods that can help simplify the process.

When operating as a sole proprietorship, it can be challenging to establish a transition plan. There are many individual assets that need to be accounted for such as machinery, equipment, livestock, as well as land. It is difficult and time consuming to transfer separate, individual assets.

One possible solution is to establish a business entity such as one of the many partnerships or a corporation to accomplish the business transition. As members and owners of the entity, the parents are issued ownership shares or shares of stock in the entity. These shares can be sold, gifted or passed through their estate to the entering generation, over time, as a method of transferring the business. This does away with the need to transfer separate, individual assets.

Partnerships: Types & Characteristics:

There are two major categories of partnerships:

1) Partnerships and 2) Limited Partnerships. There are separate entities under each category and each entity functions a bit differently. Each is outlined in this information sheet.

1) Partnerships:

Within the category of partnerships, there are two entities: 1) General Partnerships and 2) Limited Liability Partnerships.

General Partnerships (GP): Two or more people are involved in the GP and are referred to as general partners. All partners are generally liable for all debts and obligations of the GP. There is no liability protection for their personal or partnership assets. MN state law does not

require a written partnership agreement.

However, such an agreement outlining decision making and job responsibilities might be useful. If the name of the partnership is that of the partners (Henderson Family Partnership), the entity does not have to be registered with the State of MN. The entity is taxed as a partnership, pass-through entity with income being allocated to each partner based upon their ownership and included in their personal income tax.

Limited Liability Partnerships (LLP): The LLP is similar to the GP with a few exceptions. All partners are general partners (no limited partners) but their liability exposure is limited to the assets they have placed into the LLP. Their personal assets are protected from liability exposure. The LLP is required to register with the Secretary of State in MN. The LLP is taxed as a partnership, pass-through entity.

2) Limited Partnerships:

Within Limited Partnerships, there are three additional partnership categories: 1) Limited Partnership (LP), 2) Limited Liability Limited Partnership (LLLLP), and 3) Limited Liability Company (LLC).

Limited Partnership (LP): Two or more persons are involved in the partnership. There are both general and limited partners. The general partners have no liability protection on any of their LP or personal assets. The limited partners' assets in the LP are not protected but their personal assets have liability protection under the LP. The LP is required to register with the Secretary of State in MN. The LP is classified differently and operates under a different set of statutes than the general partnership. The LP is taxed as a partnership, pass-through entity.

Limited Liability Limited Partnership (LLLLP): Two or more people enter into the LLLP entity. There are both general and limited partners and they have liability protection of both their LLLP assets and their personal assets. The State of MN requires the LLLP be registered with the Secretary of State. The LLLP has its own set of statutes to comply with. The LLLP is taxed as a partnership, pass-through entity.

Limited Liability Company (LLC): This entity is the newest of the partnership entities. It requires only one person as a member of the entity. From a tax standpoint, the LLC can be taxed as a partnership, pass-through entity or as an S Corporation. The LLC provides liability protection much like a corporation.

The LLC can have both members and managers. Members elect or appoint a board of directors. The State of MN requires that the LLC register with the Secretary of State. The LLC is governed by a different set of statutes from any other of the partnerships.

The LLC can offer one additional level of liability protection by being registered in one of what are referred to as "protective states". Those protective states include: Alaska, Arizona, Delaware, Nevada, New Jersey, South Dakota, Texas, Virginia, and Wyoming. These states have written their LLC statutes to include an additional level of liability protection as long as the LLC members abide by all the statute rules. It is legal to register, for example, your MN farm business in one of these protective states and still operate in MN. This is a very complicated process so seek expert legal help if you decide to develop an LLC in one of the protective states.

As mentioned, partnerships pay no income taxes. All profit/loss, capital gains and credits are passed through to the partners on a prorated basis, depending upon the percent of ownership. However, the partnership must file a Form 1065 informational tax return, which is due each year by April 15th.

An advantage over sole proprietorship is that the owners have ownership units or shares. These units or shares can be sold, gifted or passed through their estate as a means of transferring the business to the next generation.

One disadvantage is that a partnership is not necessarily a stable business structure. Death of a shareholder or willful withdrawal by a partner can seriously disrupt partnership operations. The partnership agreement, if put into place at time of formation, should clearly describe buy-out provisions or state how the remaining

partners are protected, no matter how circumstances change.

Partnership tax laws are similar to individual tax laws. A partnership can generally take over the depreciation schedule of contributed machinery or buildings. A partnership can claim the Section 179 depreciation expense which is passed on pro rata to the partners. Each partner can claim depreciation, which includes his or her portion of the partnership allocation plus any other personal Section 179 depreciation.

Partnership members are self-employed individuals and must pay self-employment tax on their share of earned partnership profits. Partnerships do not receive the favorable tax treatment on fringe benefits (medical, accident and life insurance, housing and meals) as do "C" corporations. However, it generally costs less to form a partnership than a corporation and partnerships can be less formal to operate.

Corporations: Types & Characteristics:

There are two corporation entities available to farm businesses. They are; 1) S Corporation and 2) C Corporation. Each will be outlined in this information sheet.

1) S Corporation: The S Corporation offers a higher level of asset liability protection than a sole proprietorship and some of the partnerships. It must be registered with the Secretary of State in MN. The S Corporation is taxed as a pass-through entity with profits being allocated to the stock shareholders based upon their ownership. The income then shows up on the shareholders personal income tax. There is no double taxation issue.

Business operating assets can be placed into the S Corporation or they can be left out with only the corporate checkbook as part of the corporation operating entity. Placing assets into the corporation is a non-taxable event but getting them out is not. For that reason, it is a general rule of thumb not to place land into the corporation.

2) C Corporation: The C Corporation also affords a higher level of asset protection than the sole proprietorship or some of the partnership entities. The C Corporation offers longevity to the business because it is technically an entity onto itself with a life of its' own. That is, people can enter and leave the C Corporation and it continues on without interruption. It also affords many tax advantages regarding deductible expenses.

The C Corporation however, can be subject to double taxation. The dividends paid to shareholders are taxed. If the corporation is not growing or acquiring new assets resulting in the corporation retaining earnings, those earnings can be taxed as well. Corporate tax rates are generally higher than other tax rates. Business operating assets can be placed into the C Corporation or they can be left out with only the corporate checkbook as part of

the corporation operating entity. Placing assets into the corporation is a non-taxable event but getting them out is not. For that reason, it is a general rule of thumb not to place land into the corporation.

One additional point that applies to both S and C Corporations. Shareholders have to maintain an employer-employee relationship with the corporation. If the shareholders maintain personal ownership of what they consider corporate assets, charge corporate business expense against those assets, are audited by the IRS, they may be denied those expense deductions because the assets were owned by the shareholders, not the corporation.

A corporation is established under state law. Each state permits corporations the right to do business. A corporation consists of owners who are called shareholders. The shareholders are the basic decision making group. They elect a board of directors to act for them on most operational decisions. Majority vote governs corporate decisions. Ownership of 51% or more of the stock gives you control. Minority shareholders have little if any decision making control unless permitted to do so by the majority shareholders.

Once a corporation is created, it functions much as a self-employed individual might. Corporations must establish their own name and bank accounts. The corporation can become an employer, a lessor or lessee, a buyer or seller, or engage in any other business activity.

Farms incorporate for many reasons. Here are a few of those reasons.

- It is easy to transfer shares. Shareholders can gift, sell, or pass through their estate, shares to others as they see fit. A majority shareholder can transfer up to 49% of the outstanding shares without losing control of the business.
- A corporation may simplify estate settlement in that it is easier to value shares than individual farming assets.
- Self-employment (SE) tax can sometimes be reduced with a corporate structure. Instead of paying SE tax on all the Schedule F income as a self-employed individual would, the farmer becomes an employee of the corporation and social security taxes are paid only on wages they receive.
- A portion of meals and lodging furnished to employees of a "C" corporation are generally deductible to the corporation, but not taxable income to the employee. If lodging is provided on the farm and is a condition of employment, the home's depreciation, heat, electricity and interest become deductible to the corporation. Remember the employer-employee relationship issue.
- Fringe benefits are deductible by "C" corporations. Health, accident, and up to \$50,000 of term life insurance are deductible to the corporation, but not taxable to employees.

- The corporation offers perpetual life, some economic efficiencies regarding capital acquisition, and provides income and social security tax flexibility. It can also provide continuation of a farm business through several generations.

There can be concerns related to the corporation. Some of those are listed here.

- Getting into a corporation is generally a tax-free event. Getting out is a taxable event. Don't start a corporation unless you plan to continue it for many years.
- If the "C" corporation is profitable, but is not growing and acquiring new assets, it can be troubled with retained earnings or excess profits. This can result in a tax obligation.
- Corporations have a different set of rules. Corporate meetings, extra record keeping, corporate income tax returns, reporting requirements, and quarterly tax estimates are part of corporate life. Complying with extra legal and regulatory requirements cost time and money each year.
- Minority shareholders have no power in directing the corporate business and can be easily "frozen out". A majority shareholder (farming heir) can direct that no dividends be paid. Minority (non-farm heirs), may own shares that generate no income, and hence have no practical value.
- Corporate ownership of a house eliminates the use of the exclusion of gain or a sale of personal residence.
- Corporate ownership sometimes reduces independence and individual pride of ownership.
- It can be very difficult for a retired shareholder to receive any retirement income from an operating corporation. This is especially true if the retiree has no rental property, discontinues working for the corporation, and the corporation pays no dividends.

The farm corporation can be a valuable tool in tax planning and in the transfer process. However, it is a major commitment and a complex task to start a farm corporation. Before starting a corporation, make sure it fits your goals, objectives, and business personality. Developing any business entity is a complicated process so seek expert legal assistance when doing so.

Self-Employment Tax on Land, Buildings, & Facility Rent Regarding Entities:

The U.S. Court of Appeals for the Eighth Circuit has ruled that if you are a member of any business entity (such as a partnership or corporation explained above); own land, buildings, or facilities that are outside that entity; and rent those items to the entity; the rental income is exempt for Self-employment tax **IF** the rent is fair and reasonable.

This applies only to those states in the Eighth Circuit which include Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota. With any of

these laws, they are subject to change so seek legal advice on this matter.

Discounting Business Entity Assets:

An additional strategy that may be useful is the discounting of assets being placed into a business entity, such as any of the partnerships or corporations described earlier.

When you place business assets such as machinery or livestock into the business entity, you can elect to discount those assets. Generally a 25-35% discount is readily accepted by the IRS but some individuals have received larger discounts.

The main reason for discounting assets being placed into the business entity is to reduce the size of an estate in order to get below the federal and perhaps even the state estate applicable exclusion amounts. Doing so will eliminate any estate tax.

If you can afford to do some gifting of assets as a means of beginning to transfer the business, another advantage is you can gift more than the \$13,000 annual gifting amount if you have discounted the assets. Assume you were granted a 25% discount on assets you placed into an LLC. You decide to gift assets in the form of ownership shares. Because of the 25% discount, you can then gift an actual amount of approximately \$17,344, not the required \$13,000.

One disadvantage of discounting is that you have artificially lowered the basis of the assets in the entity. This can be a problem if the entity is discontinued and the assets are sold as a result. This could result in a tax obligation.

Assets being discounted and placed into an entity should be appraised. If, at a future date, the entity is audited by the IRS, you can document the value of the assets placed into the entity. For machinery and equipment, simply take the depreciation schedule to the local implement or equipment dealer and ask them to put a value on all machinery. Have them put the values in writing on their dealership letterhead along with a signature and date. For livestock you can take a list to a livestock auction facility or someone who deals in livestock and would have a grasp of the values. The values should be put in writing and listed on their letterhead with a signature and date. For land, seek the help of a realtor who deals with ag land. Simply have them do an estimate or appraisal of the land, put it in writing on their letterhead, with a signature and date.

With tax laws changing constantly, the discounting provision might be taken away by Congress. Seek legal assistance if you plan to use this strategy.

FSA Payments & Business Entities:

Under the current farm bill, there are some restrictions regarding Direct and Counter-Cyclical (DCP) payments

made to individuals and entities. For individuals, you are limited to \$40,000 maximum on DCP payments. Entities that limit member's liability exposure (all entities except the general partnership), are limited to one DCP payment limit of \$40,000.

A sole proprietor can receive a DCP as a sole proprietor and a DCP payment as a member of an entity. However, the individual is limit to a maximum DCP payment of \$40,000.

Example: Jeff has a farm that he operates as a sole proprietor. His DCP payment for that farm totals a maximum of \$25,000.

Jeff is also a member of an LLC and a 50% owner. The LLC is large enough that it's total DCP payments are \$60,000. However, the LLC is limited to a maximum of \$40,000 so the LLC has to leave \$20,000 of DCP payments on the table.

Of the LLC's collectable DCP payments, Jeff can collect a maximum of only \$15,000 of his eligible \$30,000. The reason is he personally is limited to \$40,000 maximum and he has already received \$25,000 from his sole proprietorship. Therefore, he can only receive \$15,000 from the LLC, bringing him to his maximum limit of \$40,000 (\$25,000+\$15,000=\$40,000).

This is a complicated issue. If you have any questions or concerns related to your situation, check with your FSA Office.

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