



Ag Business Management

Informing farm families and ag businesses about management issues.

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Utilizing Partnerships, Corporations & Limited Liability Companies to Transfer Farm Assets

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General Partnership:

General Partnerships have been used for years in agriculture. They are used when two or more people wish to run a business jointly. The individuals pool their capital and labor and form the partnership. Partnerships are most successfully used for the operating side of the business. Often land is owned individually and kept out of the partnership.

There are different types of partnerships: general partnership and limited liability partnership. Each functions a bit differently and will be discussed in this information sheet.

Forming a Partnership:

To form a partnership, it is required that two or more people are in the act of business together. A name may be selected and a bank account opened. Partners contribute cash or assets to get the partnership going. The partnership may then begin borrowing money to operate. It is best to have a written partnership agreement. It should state the purpose and detailed functions of the partnership. It should cover contingencies such as what happens at the death, disability or withdrawal of a partner. Details of capital contributions, labor involvement, decision-making, check writing authorization and partner responsibilities should be included.

Partnership Operations:

A partnership pays 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. The partnership must file a Form 1065 informational tax return, which is due April 15th each year.

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 should clearly describe buy-out agreements or state how 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.

Partners 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 costs less to form a partnership than a corporation and partnerships are less formal to operate.

Transferring Assets in a Partnership:

A partnership can be a valuable transfer tool. Each partner holds partnership units, equal to their percentage ownership. These units can be sold, gifted, or passed through your will or trust to gradually transfer assets to the entering generation. The entering generation can gradually purchase partnership units from the parents. They may initially purchase or receive, as a gift, a percentage of the partnership and gradually buy out the remaining percent as the parents retire.

Farm partnerships can provide a lot of flexibility in transferring to the next generation. Creative use of rents, wages, draws, and sales can aid a successful transfer.

Partnership Types:

A General Partnership involves one or more individuals in the farm business. Each is held liable for all the debts and obligations of the partnership – called unlimited liability. Ownership can be different percentages of the business entity. To be a legal entity, the individuals must be in business and for profit.

A Limited Liability Partnership (LLP) may be formed to protect one or more of the business partners. The LLP must have one or more general partners and one or more limited partners. The general partner is solely responsible for management of the partnership and is solely responsible for satisfying debts incurred by the partnership. A limited liability partnership, available in many states, alleviates anyone from being a general partner. A limited partner usually contributes capital and does not manage the partnership. The limited partner's liability exposure is limited to their capital contribution.

The LLP can also be implemented for the purpose of transferring or gifting property. When establishing the LLP, there is generally a substantial discount in the value of the asset due to lack of marketability and lack of business control. This helps in the transfer of assets. A caution here is that the profit or loss distributions from operation of the LLP must be the same as the LLP ownership percentages.

Two cautions regarding all types of partnerships: 1- the business entity does not protect the partners (other than limited partners) from lawsuits and other adverse actions and 2- the possible loss of multiple FSA payment limits.

Corporations:

A corporation is a separate and distinct entity from the individuals who own it, operate it or work for it. Corporations provide operating and tax advantages as compared to operating your business as a self-employed individual or as a partnership.

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.

Two different taxation structures are available to corporations. A "C" corporation pays income taxes. An "S" small business corporation pays no tax itself, but can elect to pass all profit/loss through to shareholders on a proportionate basis. The shareholders pay the tax. Generally, operating assets should be put into the corporation, while capital assets such as land should be kept out.

Why Do Farms Incorporate?:

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

- It is easy to transfer shares. Shareholders can gift or sell 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.
- Many farms lower their income taxes when they form a "C" corporation. They, in effect, create a new taxpayer who is taxed at 15% on the first \$50,000 of income.
- 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. The corporation can also rent land from shareholders. Recent court rulings maintain that land rent received from your partnership or corporation is not subject to SE tax when received by a shareholder, if the rent is fair and reasonable (subject to change).
- 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.
- 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.
- A corporation provides some liability protection not available to self-employed individuals. Generally, assets owned individually by shareholders (except for corporate shares) are protected from liability claims made against the corporation.

- 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.

Concern with Farm Corporations

- 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 excess profits. Profits paid out to shareholders as dividends are taxed twice, once as income to the corporation and again as dividend income to the shareholders. Excess profits retained by the corporation may be subject to accumulated earnings tax or an IRS mandated dividend distribution.
- 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.
- Possible loss of multiple FSA payment limits.

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.

Limited Liability Company (LLC):

A Limited Liability Company (LLC) is in essence a hybrid business structure. It is a business entity that has the limited liability of a corporation and the taxation option of a partnership or S corporation. However, taxation as an S corporation requires the extra reporting and legal work not present with the partnership. The LLC can have one or more members called shareholders. They own and operate the business entity.

The LLC structure protects the business assets from law suits and other adverse actions that can threaten the business. To accomplish this, the LLC must be registered in one of the "protective states" which include Alaska, Delaware, Nevada, South Dakota, and Wyoming. If constructed properly, the LLC can also protect personal assets from law suits and adverse actions as well. These are the biggest strengths of this type of business structure.

The LLC is also valuable in the business transfer process. Exiting and entering generations can be shareholders. The exiting generation can sell, gift, or pass as an inheritance LLC shares to the entering generation.

One caution is that the LLC structure has yet to be tested in court. However, the LLC has a better track record for discounting than does the FLP. As with any business structure, get legal and tax assistance when utilizing one of these structures.

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