ESS 535

CORPORATION, SOLE PROPRIETORSHIP, OR PARTNERSHIP? INCOME TAX COMPARISONS FOR OHIO FARM SITUATIONS

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Traditionally, farm businesses have been organized as sole proprietorships or partnerships. Recently, many farmers have considered seriously the corporate form of farm organization. During the past decade of rising farm income and property values, corporations have been suggested to some farmers as a tool for income tax management and particularly for transferring assets to the next generation.[1] Two corporate forms available are the regular corporation (subchapter C) and the pseudo corporation (subchapter S).

The preferred form of business organization for income tax management purposes depends on several factors including the amount of business income, the number of owners, the annual distribution of earnings among the owners, the net worth of the business, off farm income of each owner, personal deductions and exemptions of each owner, and retirement and insurance program alternatives. After analyzing the income tax implications of alternative forms of organization, the owner(s) should ask which form will -

1. lend itself best to operating efficiency,
2. lend itself best to financing the business,
3. provide the best structure for decision making among the owners,
4. best facilitate the entrance of a young person into the business, and
5. ease the problems of transferring property to the next generation.

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[1]For example, R. H. Baker and J. E. Moore, "Estate Planning Considerations for Farm Families," Cooperative Extension Service, Bulletin 595, The Ohio State University, 1975 and J. E. Moore, "Farm Business Organization Considerations," Department of Agricultural Economics, ESO 206, The Ohio State University.

This analysis is offered as an aid in analyzing the income tax implications of alternative forms of organization.

INCOME TAX DIFFERENCES

Federal Income Taxes

Individuals, partnerships, and subchapter S corporations are treated much the same by the Internal Revenue Service (IRS).[2] Under each of these organization forms, the owner would pay personal income taxes on his (her) share of business income. His (her) share of business income might be in the form of (a) salaries received, (b) distributed earnings received, or (c) his (her) share of undistributed earnings. Undistributed earnings are usually substantial in the growing business as principal payments are made on debt, capital assets such as breeding livestock and machinery accumulate, and inventory build up of inputs such as feeder livestock and feed occurs. Thus, the sole proprietor or partner may be pushed into high personal income tax brackets in years when business earnings are high even though few of these earnings have been distributed to him personally.

The subchapter C corporation may result in lower taxes where earnings are not distributed to the owners. The subchapter C corporation is taxed at rates of 20 percent on the first $25,000, 22 percent on the next $25,000, and 48 percent on earnings above $50,000.[3] This rate structure presents advantages to the subchapter C corporation since <u>average</u> personal income tax rates are 21.5 percent on the first $25,000, 44.1 percent on the next

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[2]The subchapter S corporation is treated similar to a partnership only for federal income tax purposes. The subchapter S corporation is treated like a regular corporation for other tax purposes as described later.

[3]These rate structures have been passed by Congress for 1975-77.

$25,000, and exceed 50 percent above $50,000 income.

When earnings are distributed to the corporation's owners, the form of the distribution is critical in determining tax savings. When dividends are distributed, they would be taxed twice. They would be taxed once as part of earnings on the subchapter C corporation's return. Secondly, they would be taxed as income to the owner. This double taxation of dividends usually causes the subchapter C corporate form of ownership to have higher taxes than partnerships or sole proprietorships if substantial earnings are distributed as dividends.

Tax savings are possible under the subchapter C corporate form when business earnings can be distributed to owners in the form of salaries. Salaries are a deductible expense for the corporation. Corporate taxable income would be reduced by the amount of the salary; thus, salary distributions would escape taxation at the corporation level and only be taxed as personal income to the owner-employee. Of course, these tax savings are possible only when the owner sells labor or other resources to the corporation.[4]

Social security taxes may favor the sole proprietorship and partnership form. The sole proprietor or partner pays 7.9 percent of taxable income up to $15,300 (in 1976). The corporate form (subchapter C and S) require both the corporation and the employee to each pay 5.85 percent on the salary of the employee or a total of 11.7 percent. Again, $15,300 is the maximum salary which is subject to social security taxes. Slightly off setting this increased social security taxation for corporations is

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[4]Farm income may vary widely from year to year. Some year the farm might make $15,000 while another year $150,000. If a subchapter C corporation made wide swings in salaries, IRS would probably deny them as salaries, ruling that they are really dividends.

the fact that the 5.85 percent social security tax paid by the corporation is a deductible expense for the business.

Ohio Taxes

The owner's share of earnings (distributed and undistributed) from the proprietorship and partnership is subject to Ohio personal income taxes. Only corporate distributions in the form of salaries or dividends would be subject to Ohio income taxes.

Ohio corporations are subject to a state franchise tax. The tax is equal to (a) 5 mills on the net worth or (b) an income tax of 4 percent of the first $25,000 and 8 percent on all income above $25,000 whichever is the higher tax figure. The net worth computation may be a book value concept rather than a market value concept. Thus, the tax on income would probably prevail on most Ohio farms where the cost basis of land is relatively low.

Also, workman's compensation tax is levied against owners' salaries paid by the corporation (subchapter C and S). The rate in 1976 for general farm labor is 9.32 percent of employees salaries. Sole proprietorships and partnerships would not pay this tax on distributions to the owners.

Subchapter S Corporation

While federal income tax laws treat partnerships and subchapter S corporations similarly, Ohio tax laws and the federal social security system view the subchapter S corporation much different than the partnership or sole proprietorship. Like the subchapter C corporation, the subchapter S corporation is subject to Ohio corporation tax, employee social security taxes, and employee state workman's compensation tax. Thus, the subchapter S corporation always has higher income taxes than the partnership; both organization forms pay similar federal income taxes, but the subchapter S corporation bears additional costs for Ohio corporation tax, workman's compensation tax, and added social security taxes.

Due to these tax disadvantages of the subchapter S corporation, our analysis ignores the subchapter S corporation since it would not be the preferred organizational form for income tax purposes.

ANALYSIS OF SUBCHAPTER C TAX SAVINGS

Three representative businesses were chosen to analyze the tax savings through incorporation. The owners of each business have uniform personal characteristics - each has three personal exemptions, has $2,000 in personal deductions, and does not have non-business income. The first business is owned by one individual, the second business by two, and the third business by three owners. All the owners of the second and third businesses have equal ownership and income is distributed equally.

While a number of factors are important in determining tax advantages, this analysis focuses on three variables - annual business earnings, annual distributed earnings per owner, and number of owners. The amount of corporate distributions are allowed to vary, and all corporate distributions to the owners are assumed to be in the form of salaries with only nominal dividends issued. The analysis assumes fixed amount for the other variables - personal exemptions, personal deductions and nonbusiness income.

One Owner Business

Business earnings are allowed to range from $20,000 to $100,000, and distributed earnings are allowed to range from $10,000 to $40,000. Figure 1 illustrates those combinations of business earnings and distributed income which produce tax savings by incorporating.

If the business earnings are $50,000 per year and distributions to the owner total $30,000, approximately $2,100 per year can be saved by incorporating (figure 1). If business earnings are $80,000 and distributions are $40,000, savings through incorporation are approximately $9,000 per year.

Some tentative conclusions may be drawn concerning the one owner business. First, considering the added costs of filing fees, attorney fees, and increased bookkeeping, the owner business should be earning at least $25,000 to $30,000 before incorporation would save taxes. Secondly, for most sizes of one owner businesses, high distributions of earnings reduces corporate tax advantages.

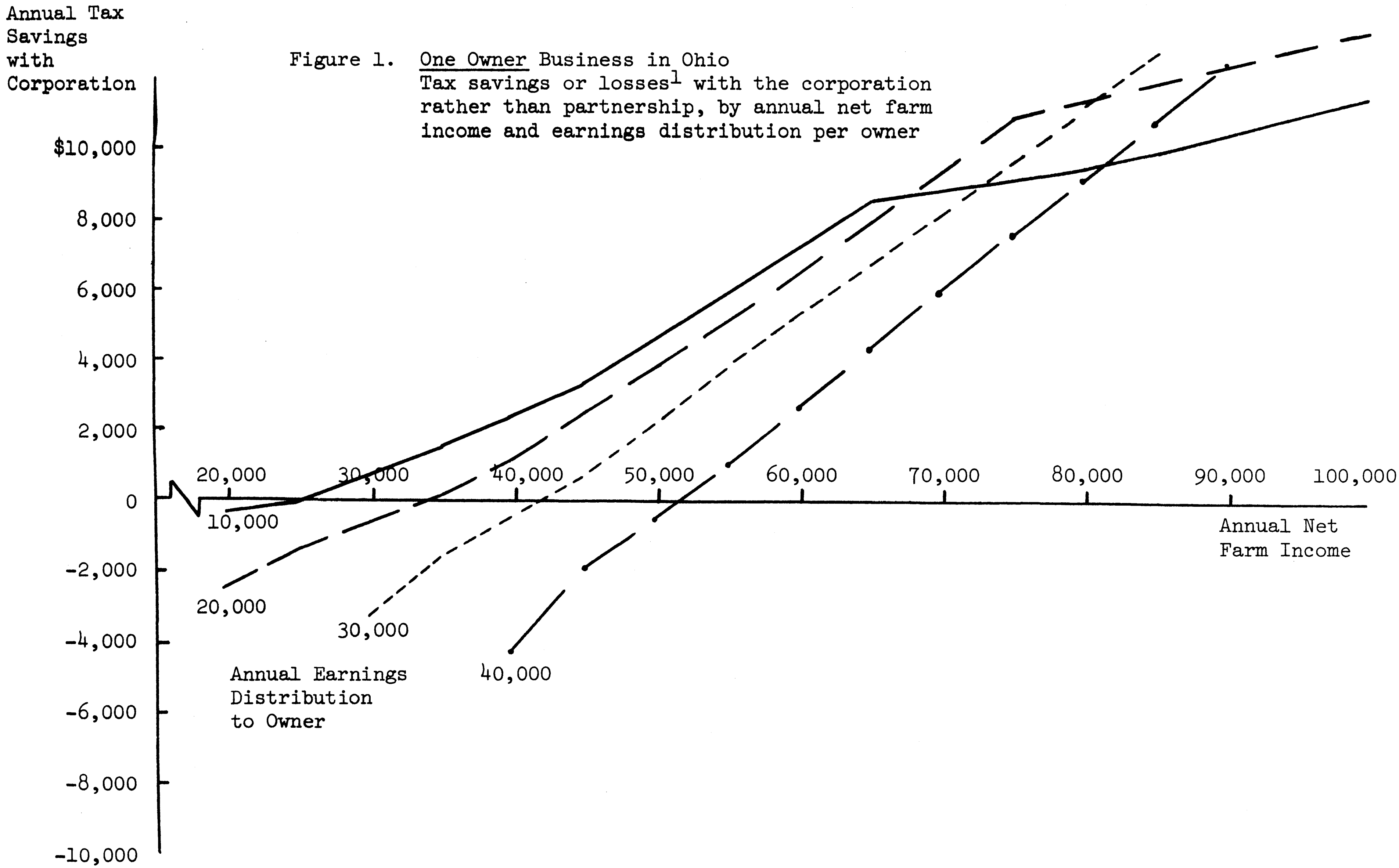


Figure 1. One Owner Business in Ohio
Tax savings or losses[1] with the corporation rather than partnership, by annual net farm income and earnings distribution per owner

Annual Tax Losses with Corporation

[1]Tax savings or losses refer to the difference between taxes paid by the corporation and the partnership. Taxes considered include the federal personal income tax, federal corporate income tax, federal social security tax, state workman's compensation tax, state personal income tax, and state corporation tax.

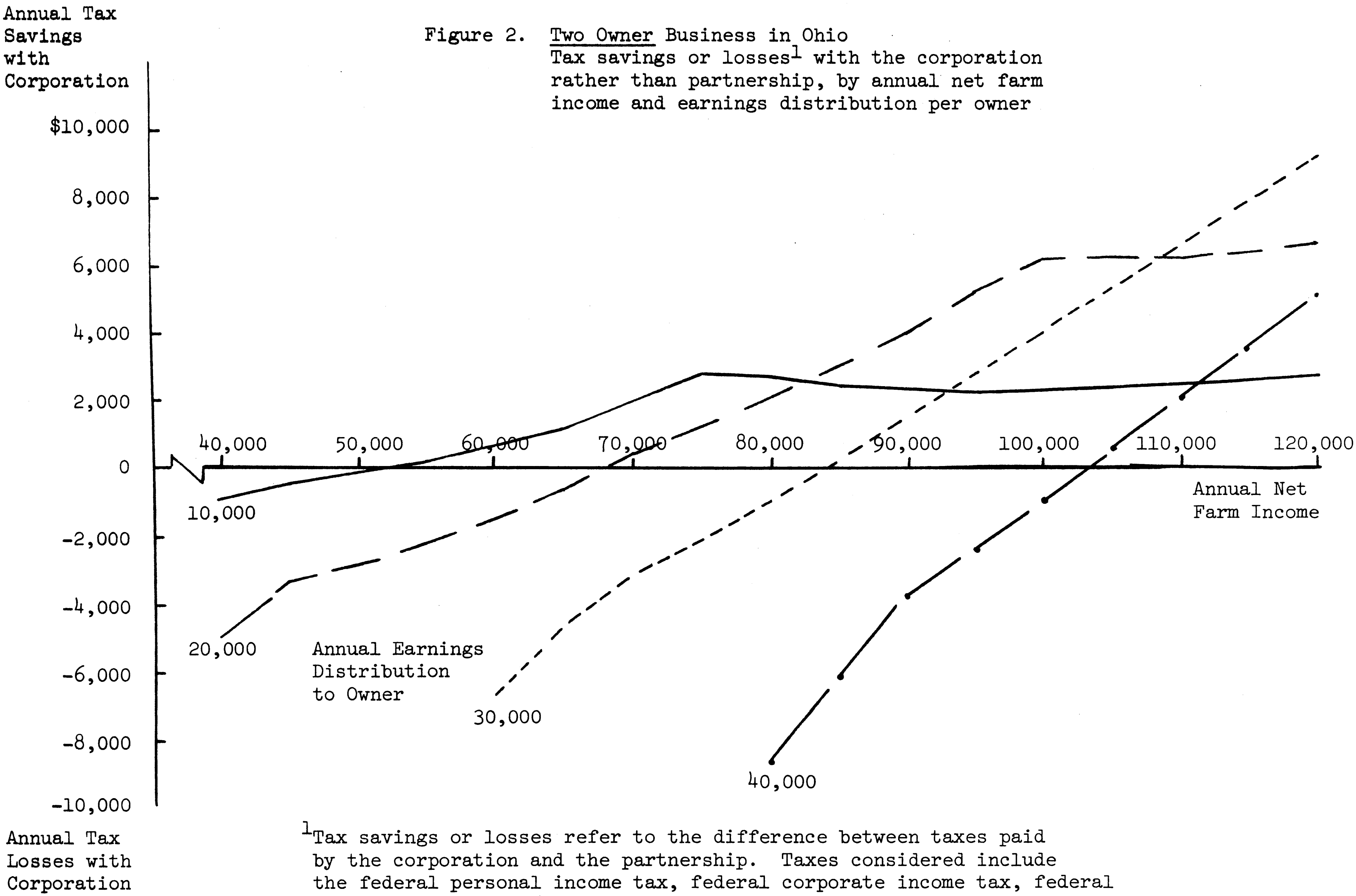
Two Owner Business

Business earnings are allowed to range from $40,000 to $120,000 and distributed earnings from $10,000 to $40,000 for the two owner business. Tax savings through incorporation are illustrated in Figure 2.

One tentative conclusion which may be drawn from Figure 2 is that business earnings should be at least $55,000 (27,500 per owner) before tax savings are possible. A second observation is that the structures of corporate taxation and personal income taxation confound generalizations about "best" levels of distributed earnings. However, it appears that for smaller two owner businesses (business earnings between $40,000 and $80,000) higher earnings distributions adversely affect the corporate tax savings.

For the large two owner business (business earnings greater than $110,000), tax incentives clearly are visible to use the corporate form. For example, if business earnings are $120,000 for the two owner business and earning distributions are $30,000 per owner, nearly $9,000 would be saved by substituting the subchapter C corporation for the partnership (Figure 2).

Figure 2. Two Owner Business in Ohio
Tax savings or losses[1] with the corporation rather than partnership, by annual net farm income and earnings distribution per owner



[1]Tax savings or losses refer to the difference between taxes paid by the corporation and the partnership. Taxes considered include the federal personal income tax, federal corporate income tax, federal social security tax, state workman's compensation tax, state personal income tax, and state corporation tax.

Three Owner Business

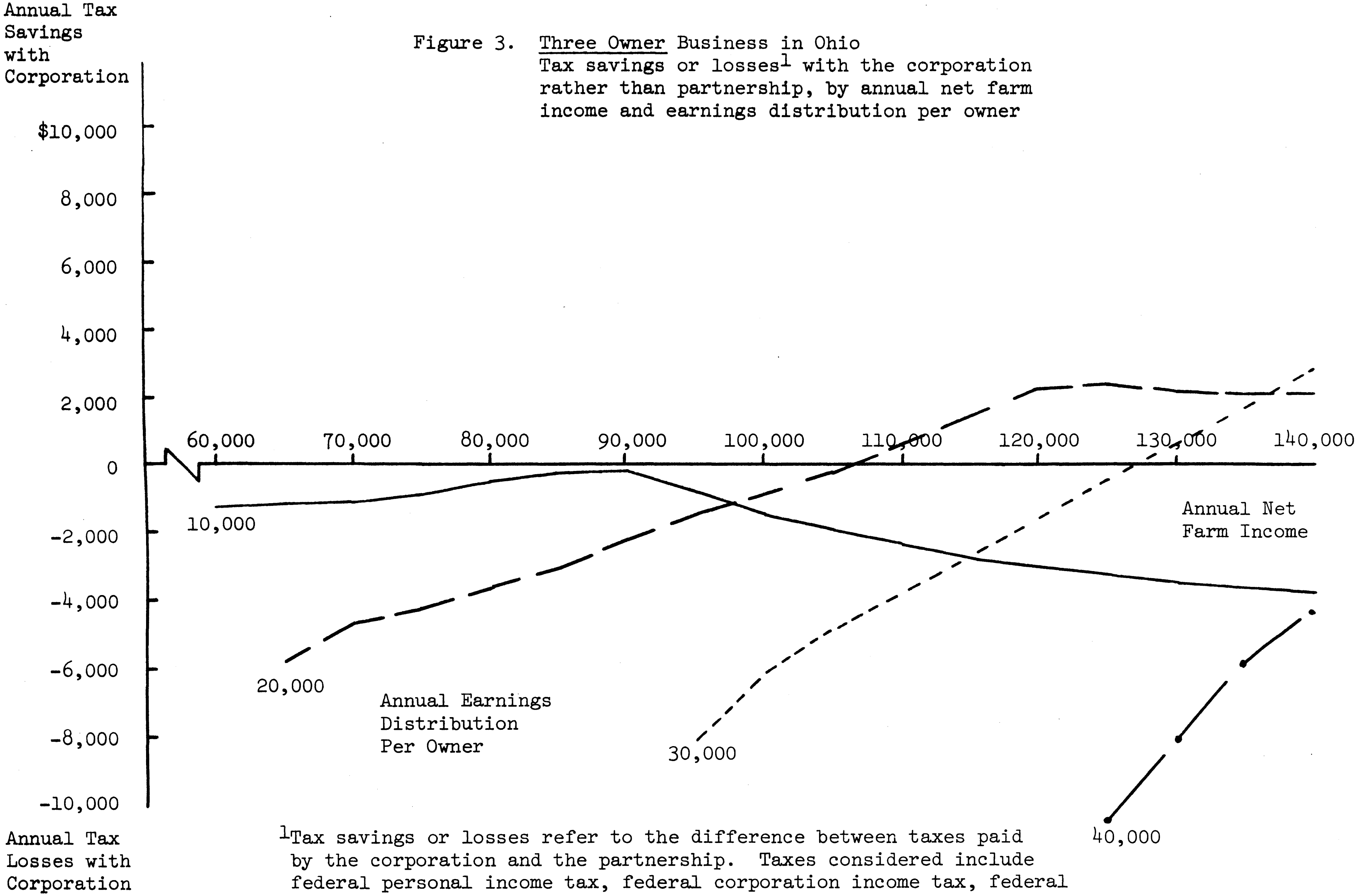
Business earnings are ranged from $60,000 to $140,000 and annual distributed earnings per owner are ranged from $10,000 to $40,000 per owner for the three owner business. Results are illustrated in Figure 3.

As in the one and two owner businesses, substantial tax savings may occur in the three owner business. For example, the three owner business generating $140,000 per year in income and distributing $30,000 per year to each owner can save approximately $2,700 per year by incorporating.

Generally, the higher the proportion of business income distributed to the owners, the lower the tax savings by incorporating for the small three owner business. The corporate business earning $130,000 per year with $120,000 distributed each year ($40,000 per owner) looses nearly $8,000 by incorporating. However, this same business distributing only $20,000 per owner enjoys nearly $2,100 in tax savings.

The three owner business must be generating net farm income in excess of approximately $110,000 before the subchapter C corporation offers tax savings. If Figure 3 would be expanded to include three owner businesses with net farm incomes larger than $140,000, we would find substantial corporate tax savings at most owner-employee salary levels.

Figure 3. Three Owner Business in Ohio
Tax savings or losses[1] with the corporation rather than partnership, by annual net farm income and earnings distribution per owner



[1]Tax savings or losses refer to the difference between taxes paid by the corporation and the partnership. Taxes considered include federal personal income tax, federal corporation income tax, federal social security tax, state workman's compensation tax, state personal income tax, and state corporation tax.

Summary

Advantages gained by incorporating the family business may include easing property transfer between generations, income tax savings, facilitating the entrance of others into the business, operating efficiencies, and financial efficiencies. This analysis considers only income tax savings from the regular (subchapter C) corporation. The tax savings do not include some other costs of incorporation. Attorney's fees, filing fees, or accountant's fees may be other costs faced by the business when incorporating. However, these costs are usually minor in relation to tax considerations.

If the business is generating earnings of more than $25,000 to $30,000 per owner, the corporate form of ownership may be preferable from the income tax management perspective. Regardless of the level of business earnings, distribution of all of the business earnings to the owners will result in taxes being lesser under the sole proprietorship or partnership form of organization.

Corporate tax advantages are greatest when distributions to the owners are in the form of salaries or other deductible expenses (e.g., interest) rather than dividends. Dividends lead to double taxation (corporate and individual level) of some of the business earnings while the deductibility of salaries make these distributions taxable only to the individual.

Exemptions and deductions of owners are important determinants in tax comparisons. Generally, the higher the personal exemptions and deductions the less favorable is the corporation. The corporation structure enables high business earnings to be taxed at lower rates than under the individual's tax structure. However large exemptions and deductions are able to remove much of the income from taxation on the individual's return when organized as a partnership.

The analysis considers the tax impacts of alternative forms of organization for a unique set of circumstances for the one, two, and three owner business. Owners should use this analysis as a guide to selecting between organization forms. An analysis of the individual's situation needs to be made before an organization form is selected.