

Staff Paper

Farm Organization Options

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by

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Introduction

This paper is a summary of the management implications to consider when choosing among multiple owner farm business organizations. These include joint operating agreements, partnerships, limited liability companies and corporations, both subchapter C and subchapter S. We assume the reader has some familiarity with income tax laws and legal terminology.

Background

Someone once said "A little knowledge is a dangerous thing", and few subjects exemplify this more than farm business entities. Many issues must be weighed in proper proportion such as family values, history, relationships; type of farm; conversion, termination or continuity effects; management designations; income, estate, and other tax implications; start-up and maintenance costs, etc.

Before dealing with different organization types specifically, we feel compelled to address what experience clearly shows are three central issues that override discussion on any of these system types. Give particular attention to these issues in any discussion on potential farm business change:

The Human Factor

Any multi-owner system requires a close, on-going relationship with each other. Mutual trust, respect, tolerance and communication are absolute prerequisites to successful operations. All too often, hidden resentments fester and build, fueled by perceived slights or poorly chosen words. Since most farm businesses are closely held by family members, changes in family situations such as new spouses, parents passing away, or disproportionate family members employed on the farm can be highly disruptive. Boiling resentments eventually can blow; harsh words follow, and "lines in the sand" are drawn. Now, it's personal. Lengthy court dates, exorbitant attorney costs, and bitter, broken family relationships often litter this road.

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Monitoring, managing, and nurturing this all-important relationship is more important to the future success of this business than the system chosen or the supporting papers drawn.

The "Liability" Issue

No system protects you from your own wrongful acts, negligence, or misconduct. The limited partners in Limited Partnerships (LP's) or Limited Liability Partnerships (LLP's), members of Limited Liability Companies (LLC's), and shareholders in corporations who are not directors, officers, or employees theoretically have liability limited to their investment in the entity. But how often, in closely-held farm businesses, are the owners NOT involved in some way in management?

Manager-members in LLC's, limited partners in LLP's, and officers in corporations are also supposed to enjoy malpractice/negligence protection from other managing members, partners, or officers. This may be clearly defined in a doctor's office, but is much less clear on a farm. Who is responsible for that accident or injury involving farm property?

Inattention to details, such as not filing your LLC, LLP, LP, or corporation at the state level, or allowing annual filing fees to lapse, etc. usually defaults owners to 100% full liability anyway.

In today's legal climate, it is recommended that:

A) You seriously assess the real liability risks in your business, then isolate that risk and deal practically and realistically with it. Open pits can be fenced and warnings posted, for instance. Over-the-road trucking, processing, or direct consumer sales carry risks that wholesaling to a processor does not, etc.

AND

B) Cover your business with adequate liability insurance, regardless of organization type.

Termination of the Entity

Historically, only one operation in three passes to the next generation without major structural change. Only one in nine passes beyond one generation. Like marriages, enthusiasm and expectations run high when business types are formed. Efforts made to at least initially diminish negative potential effects of termination are most often well founded. It is easy to overlook legal implications and make assumptions that everyone "will be fair". Major irritations, such as one partner, member, or stockholder wanting to sell some land and apply proceeds to other investments or needs cannot do so without signature approval of the other owners, for example. Devote particular attention to what assets will be included in the business and how (and at what price) they can be withdrawn.

Following is a brief overview, highlighting the major benefits and obstacles of multiple owner farm business options. They are discussed in order of least to most complex.

Joint Operating Agreements (JOA's)

This system is defined as two (or more) sole proprietorships working somewhat together, at least on the operational end of the business. They may jointly "share" a milking parlor and free-stall barn, for instance. However, most assets (land, cattle, equipment) are owned individually as a sole proprietor.

Functionally the "joint" business has one checkbook, and one set of the books. These itemized income and expenses are then "split" in appropriate allocations to the separate sole proprietors at years' end, for filing their own tax returns. Hired labor is generally adjusted through one sole proprietor to simplify W-2 and labor processing. Since most assets are owned by the sole proprietors, each maintains their own depreciation schedules. Some parameters are important to mention on JOA's:

Courts in Michigan default 2-or-more working together as General Partnerships, unless clearly spelled out in writing otherwise. Written operating agreements should be signed at inception by all operators defining the "joint" nature, and that no partnership is intended, nor implied. Actual tax filings must coincide.

Any capital purchases (real estate, equipment, etc.) should be paid from personal checkbooks and/or financed individually. "Undivided" shares paid by the joint checkbook implies partnerships.

Some Workers Compensation carriers may have specific rules regarding coverage on father/son situations. Check on this before writing your operating agreement.

Advantages of JOA's

- ___ No filings required; a "doing business as" (dba) is recommended at County Clerks office; no public disclosure.
- ___ Low cost to form; Operating Agreements are necessary, but operators do primary drafting.
- ___ Simple to understand. Everyone knows what they own; No "capital accounts", inside/outside tax basis, or complicated termination effects. Operators typically leave with, or are free to sell, their assets at termination.
- ___ Generally no unemployment, workers compensation or other hidden costs; tax effects identical to sole proprietorships.
- ___ Sole proprietors each have the maximum "direct expensing" available annually.
- ___ Children under 18 working for their parents are not subject to Social Security withholding.

- ___ Conversion to other entities has no adverse tax effects.
- ___ Health Insurance premiums can be fully deductible under certain guidelines.
- ___ Eligible for farm income averaging, individual retirement accounts (IRA's), Savings Incentive Match Plan for Employees (SIMPLE), tax credits.

Disadvantages of JOA's

- ___ Unlimited liability, same as any sole proprietor.
- ___ Cannot rent assets from yourself.

General Partnership

This is what two-or-more operators have unless filings, written evidence and tax returns define otherwise.

No filing is required, but a "dba" and a "Certificate of Co-Partnership" is often filed at the County Clerks office to protect the name and legally define the arrangement. Beyond these elective filings, no other public disclosure is involved.

Partnerships are separate, legal entities which file with their own Federal identifying number (ID), hire employees, own capital, etc. Start-up costs are directly related to complexities in Buy & Sell, Operating, or other Partnership Agreements. Partnerships file their own (Form 1065) tax return, but actual taxes are paid by the individual partners through a (Form K-1) allocation by tax classification from the partnership.

Partnerships cannot be formed if allocated liability exceeds cost basis of contributed assets at inception. Otherwise the partnership owns its own assets, has its own depreciation schedules and its own tax basis. The partners have their own tax equity in the partnership, called "capital accounts". Contributions into and withdrawals out of the partnership, along with allocable taxable gains and losses effect these capital accounts. This is a difficult concept for many partners to understand. They do not legally own part of that tractor or building; they own a share of a partnership interest. Income tax rules are relatively simple in normal operations, but can get very complex in partial or total liquidations. Unintended tax complications can occur, especially where "draws" from the business exceed taxable income reported over time.

Partners have unlimited liability of any partners "in furtherance of partnership activities". This is usually cited as a major disadvantage of partnerships over LLC's or corporations. Each partner is liable for any partners malpractice, negligence, contracts, or criminal activity involving the partnership.

Beyond the "dba" filings, Buy/Sell provisions and Operating Agreements (or Partnership Agreements combining these both) are highly recommended. Disability, death, divorce, or termination (partial or total) of a partner's interest can force division of "undivided" assets in unintended ways. Other operational issues, such as allocation of profits, draws, vacation time, who has authority to sign for what, or whether partners can work off-farm, etc. also should be reduced to writing and signed. Unless otherwise stated in writing, partners have an equal voice in management and a majority vote governs.

The partnership does not terminate automatically unless:

- A) 50% or more of partnership capital and profits change hands within a 12-month period. (However if the "estate" or named successor continues the deceased partner's share, the partnership continues), or
- B) The partnership ceases to operate, or
- C) Only one partner remains. By definition, this is a sole proprietorship.

A general partner automatically receives a pro-rata share of partnership debt when initially entering a partnership. This pro-rata debt plus their capital accounts generally equals the partner's tax basis in the partnership interest. Loss pass-through which brings this basis below zero must be carried forward, to be used against future taxable gains, paid-in capital, or at-risk added liability.

Partnership interests are presently eligible for "step-up" in basis through an estate. If proper (Sec. 754) election is made, allocations of step-up can be made to underlying assets and depreciated. If a large negative capital account exists, consider keeping that partner in until death; may want to convert to limited partner.

Qualifying income from farm partnerships (and LLC's, subchapter S corporations (S-Corp's), and JOA's) is eligible for "income averaging". All of these structures retain the same "class" of income, taxed through the individual's tax return.

Partnerships allow considerable flexibility in year-by-year allocations through "Guaranteed Payments" and in percentage adjustments. Guaranteed Payments, if used, are generally subject to self-employment tax, however.

Full deductions for partners' health insurance premiums are allowable through partnerships if the spouse is fully employed by the partnership, the partnership pays the premium for the spouse as an employee fringe benefit and such spouse can not be considered an owner (having spouse name on farmstead, or net rental leases may invalidate this employee benefit). Self-employed retirement plans (such as SIMPLE's or IRA's) are available for partners (also true for most other structures except possibly subchapter C (C-Corp's) employees).

Partnerships, LP's, LLP's, and JOA's can convert to LLC's (and vice-versa) with generally no up-front tax effect, unless ownership or liabilities are reallocated. In the case of partnerships, LP's or LLP's converting to LLC's, no termination occurs if ownership remains the same. No new Federal ID number is needed, no "short-year" returns due, or other unwanted tax/depreciation changes occur. A "Certificate of Conversion" must be filed at the state level, and of course, the new LLC must file Articles, etc. For ongoing lines of credit, be careful to provide notice to creditors before conversion occurs.

Conversion of partnerships, LLC's, LP's, LLP's or JOA's to "S-Corp's" or "C-Corp's" generally does not result in immediate tax, per se. However termination of the existing form is mandatory before starting a corporation. The act of termination itself will probably involve tax basis, tax elections, filings etc. and may result in up-front taxation in rare cases.

Because farms usually are closely held by a few family members, valuation of a partner's interest due to sale, death, or termination event is either pre-set under specified terms in the Buy/Sell or Operating Agreement, or are subject to potential "discounting". If a partner can only sell to other partners (or to new entrants acceptable to them) and the departing partner does not have majority or controlling interest, what is that interest worth? This "discounting" can be an advantage in estate planning, since this interest may be successfully valued below "Fair Market Value" if conditions warrant it. The disadvantage, of course, is that departing partners or heirs can lose market value in the transfer or conveyance of these assets.

Tax effects for a departing partner's interest will usually effect only the departing partner if the partnership continues. In most of these cases, the sale price of the interest sold is taxed on a pro-rata allocation of asset type left in the partnership. Therefore, the departing partner may have immediate ordinary income taxation on some of the sale proceeds, while receiving capital gains (and possibly installment sale options) on the balance. Buyers of that interest can add that cost to their respective capital accounts, or possibly elect "Sec. 754" treatment to transfer that cost as basis (for deduction of depreciation) to underlying partnership assets. Special allocation rules apply if the partnership has not owned the asset itself for 7 years.

Particularly troublesome income tax effects can haunt departing partner(s) where either their capital accounts at sale are negative, and/or any allocable debt associated with that partner is assumed by the remaining partners.

Termination of the partnership effects all partners, since they are all "departing". The most common situation seems to be a 2-person partnership where one partner departs. Usually in termination, either assets and liabilities are allocated proportionately to the partners and a new tax basis is established or assets are sold within the partnership, debts are paid, and any remaining cash distributed to partners. Such sale, of course, is a taxable event through the partnership. Under either system, capital accounts must be closed out to zero. Tax effects on partial or total dissolutions of partnerships are often complex, difficult, and poorly understood by the partners. Unintended tax consequences can result.

In distributions of capital assets to partners (breeding stock, land, etc.) there is a 5-year holding period before long-term capital gains treatment can be used in the partners hands.

Contributions of "ordinary income" assets (like feed or hogs) with no tax basis can be required to be allocated back to the contributing partner. Separate depreciation allocation can be done; rules exist to minimize tax avoidance schemes.

Land ownership is often kept out of partnerships because of options to rent these assets, easier for new entrants into the partnership without land equity, complications with property tax credits, and disadvantages of potential conversions out of the partnership later.

Advantages of General Partnerships

- ___ Easy to form; little filings or public disclosure
- ___ Relatively inexpensive to begin
- ___ Conversion to other entities is generally not a problem
- ___ No Unemployment or Workers Compensation on partners
- ___ Taxable income flows through to partners by classification, keeping preferential capital gains treatment for instance.
- ___ No negative effects on farm income averaging, tax credits, health insurance deductibility, or retirement plans for partners.
- ___ Options exist to lease outside assets to the partnership
- ___ All general partners have assumed management responsibility
- ___ Flexibility in allocations/distributions

Disadvantages of General Partnerships

- ___ Jointly and severally liable for business actions of all partners, so you need to know who you're partners with!
- ___ One "direct expense" election for depreciation allowed per partnership
- ___ Partnerships do not have children, so children hired are part of normal payroll, with normal deductions like any other hired worker. (Partnerships where the only partners are

husband and wife can utilize the under-age-18 children employed with no Social Security withholdings).

- ___ Complexity of inside/outside tax basis
- ___ Unintended consequences of liquidation effecting all partners, particularly in 2-person partnerships.
- ___ Partnership interests can be a difficult asset to value or sell without predetermined consideration
- ___ "Guaranteed Payments" are subject to Self-Employment Tax

Limited Partnerships (LP)

These are created by a state filing. General partner(s) have 100% of the management, and thus, unlimited liability. An LP must have at least one general partner with unlimited liability. Limited partners have their liability limited to their investment in the entity, presuming convincing evidence exists that they have no involvement in management in any way. Limited partners, therefore, have virtually no control over their investment, who manages it, or how. Real estate development ventures or gas and oil exploration firms seeking outside investment are occasional users of these.

"Family Limited Partnerships" (FLP's) are unique forms of Limited Partnerships, usually where one family member is the sole general partner. Multiple LP's have been formed to limit overriding lawsuit worries. One such strategy is to hold "safe" assets, such as cash, funds, home, etc. in one LP. A separate LP is set up holding "dangerous" assets, like commercial real estate. Asset exposure is thus limited in a lawsuit action. Such lawsuits may include potential employee actions, no-fault divorce, or guest accidents in your home (including trespassers/punitive damages). FLP's beyond one generation are often untenable.

In LP's, the general partner receives the basis in all non-recourse debt, since limited partners are limited to their investment only. Thus, converting an LP to an LLC will probably involve tax problems, since any transferred debt is equally assumed by all LLC members.

Advantages and Disadvantages of LP's

General partner(s) are usually "locked" into management, meaning they cannot be removed except for "just cause". Unless defined otherwise in an Agreement, profit distributions are allocated based on each partners' percentage of contributions to the LP.

Public disclosure of LP's is highly detailed and extensive. Usually, 10 pages or more of information must be provided in the filing certificate. Such information includes partners names,

value of property and services contributed by each limited partner, detailed identification of the character of this business, timing of additional contributions, terms of assigning or terminating limited partners interest, rights to receive distributions by limited partners, and various rights of general partners, etc. Failure to file, renew, or document changes can invalidate the LP. Costs to form LP's is usually substantial.

General partners usually use "Guaranteed Payments" to siphon off compensation before allocating the remainder to limited partners. If losses exceed limited partners' contribution, or losses are due to "non-qualifying" passive activities, they must be suspended and carried forward to offset gains in future years. Keep in mind that general partners have complete control over all decisions, including these guaranteed payments and declared distributions.

Limited partners' distributions are not subject to Self-employment tax.

In most other respects, LP's operate similarly to General Partnerships.

"Discounting" of LP's interests in estates has frequently been allowed, since the general manager controls all assets; IRS can disallow discounting if this is the primary business reason for formation. It has been argued that Family LLC's offer bigger discounts than FLP's.

Limited Liability Partnerships (LLP)

These are General Partnerships that have "elected" by state filing to be an LLP. The primary benefit is that any partner has personal protection from malpractice or negligence of others; no other liability protection exists. Filing must be renewed on time, or protection is lost. Major multi-state professional accounting firms occasionally utilize this entity. Costs to form are substantial. In all other respects, LLP's operate essentially as General Partnerships, plus have the same advantages and disadvantages.

Limited Liability Company (LLC)

This form of entity is state chartered, so different rules apply in different states. In Michigan, an LLC is formed by filing "Articles of Organization", and Annual Reports must be filed with the Corporation, Securities, and Land Development Bureau.

Operating Agreements outlining voting rights, profit splits, named managers, etc. are usually part of LLC formation but are not public record. Failure to finalize Operating Agreements can have disastrous effects: each member is designated a co-manager (eliminating limited liability advantages), and equal voting/profit sharing is statutory among members without Operating Agreements defining other arrangements, for instance. Judges are not allowed any leeway for "fair" or verbal agreements.

Since 1997, IRS has "presumed" partnership (1065-Form) taxation of LLC's if the LLC box on the 1065 form is checked. Legally, LLC's cannot exhibit "more than 2 of 4" features to avoid corporate taxation. Those are Limited Liability, Centralized Management, Continuity of Life, and Free Transferability of Interests. In Michigan, continuity of LLC's is presumed, unless discontinuance is filed.

If the LLC is properly filed, renewed, and adequately internally capitalized all members of an LLC are not theoretically responsible for the malpractice of the other members, or (at least initially) for debts of the LLC itself. Legislation in Michigan was designed so that the liability exposure of LLC members be limited to the entity itself, unless members "are otherwise culpable". All members remain fully liable for their own negligence, wrongful acts, or misconduct in their performance (or those under their supervision).

Advantages and Disadvantages of LLC's

Members personal assets are not obtainable by the LLC's debt creditors unless personal guarantees or other waiver of liability is signed. Similarly, personal-debt creditors cannot generally obtain LLC assets.

Costs to Form LLC's can be substantial; Public disclosure is limited to the filed "Articles of Organization" which generally are not greatly detailed.

Most LLC's are handled very similarly to partnerships. There are, however, some notable exceptions:

LLC's , since 1997, can have one member (not true with partnerships); In single-member LLC's IRS requires the member to file as a sole proprietor (no 1065 or K-1 splits are done) and LLC is treated as a "disregarded entity" for tax purposes.

LLC's have designated (or elected) managers, and voting is formalized; in partnerships management is informally assumed among all partners;

LLC members cannot withdraw unless the Operating Agreement permits it. No statutory restrictions exist on general partnership withdrawals.

Federal law is not yet clear on Social Security taxation effects on pass-through "earned" income from LLC's. Most practitioners recommend the same treatment as partnerships. However, complex schemes involving two classes of membership interests has been done to argue "passive" vs. "earned" income. Non-voting membership interests are allowable in the Operating Agreement, too.

95% of LLC's file taxes as "partnerships". In these cases, members are owners, not eligible for W-2 employee status, no workers compensation, and no unemployment issues. Excess payments

are handled as "Guaranteed Payments". However, in the cases where LLC's are taxed as corporations, a W-2 is required for compensation and C-Corp's rules apply for workers compensation and unemployment.

Transferees (such as spouses) must be voted in as members, or they can be tax-liable without voting rights on distributions.

"Manager" designation is equally assumed by all members, unless defined in the Operating Agreement.

"Co-mingling" of LLC funds with other business interests can invalidate the LLC benefits.

Majority of voting members decides decisions.

A couple of interesting situations utilizing LLC's:

- A) Have real estate (or other "risky" investments) put into a single-member LLC, possibly even managed by a non-owner manager. These assets, then, can be leased to another operating entity.
- B) Under the 2001 tax reform code, the \$10,000 per person gift-tax exclusion may not be as valuable as in the past. But one use of this that has been successful is to put personal real-estate assets (such as a cottage) in an LLC; 5% is gifted without deed or disclosure changes each year, utilizing the gift-tax exclusion. Discounting of LLC interest is allowed, since members have no right to withdraw. But, potential transfer tax and "uncapping" of state equalized value (S.E.V.) can occur. Define this with a transfer affidavit.

In most all other respects – taxation, filing, capital accounts, distributions, conversions – LLC's are handled virtually identically to general partnerships.

Subchapter "S" Corporations (S-Corp's)

Only about 3% of all farm operations in Michigan are incorporated, either S-Corp's or C-Corp's. Both corporation types are chartered under state law; Articles of Incorporation must be submitted and approved by the state. Annual reports are required. Corporate "Bylaws" are enacted to regulate normal operations. Periodic meetings of directors/officers/stockholders are usually required. Form 2553 should be filed also with the appropriate IRS Service Center.

Corporations are separate, legal entities which exist apart from its stockholders. The corporation is liable for damages from negligence of officers and employees involving corporation activity. In addition, corporation officers, employees, and directors may also be personally liable for tort or contractual actions. Stockholders who are not officers, employees, or directors are not usually personally liable for corporation obligations if the corporation is "adequately capitalized",

properly incorporated, and corporate formalities respected. Of course, personal guarantees signed by stockholders removes their right to personal protection.

Keep in mind that most farm corporations are closely held by family members, where all stockholders usually share duties as officers, directors, and employees.

Be careful also of "implied" corporate officers. A spouse who "keeps books", for instance, can have a perception of apparent authority. This could remove liability protection from that spouse as an "implied" officer. Adhere to your Articles and Bylaws; document meetings and voting, and compensate employees through reasonable wages.

Stock ownership is transferred to stockholders in return for cash, property, or other assets contributed to the corporation. Voting rights generally follow stock ownership. Only one class of stock is allowable in S-Corp's. This is common stock. However differential voting rights within that one class is possible.

S-Corp's are "tax option" corporations, meaning the S-Corp's file a tax return (1120-S) but net income passes through to stockholders (1120-S, K-1) who pay their pro-rata tax. "Reasonable" wages must be paid to all employees, including stockholder employees, for compensation. These W-2 wages are subject to all normal tax deductions. However, the balance of S-Corp's pass-through income is not subject to Self-Employment tax.

S-Corp's can have no more than 75 stockholders. The S-Corp Revision Act of 1982 disallows employee benefits (such as health/accident insurance, life insurance, meals or lodging deductions) if an employee owns more than 2% of the stock.

Non-tax distributions are possible in S-Corp's if stock basis is reduced, but not below zero. (Any excess distributions are then taxed as capital gains). Tax-class retains its identity as a pass through; S-Corp's allocations and wages are eligible for farm income averaging. Wages paid from S-Corp's may be subject to Unemployment Tax, but benefits are restricted if over 50% of stock is owned by a stockholder, their spouse and/or children. Workers Compensation is required on any employee owning less than 10% of an S-Corp's stock.

S-Corp's stock can generally only be owned by "individuals" or "estates", not most trusts. This can be a serious impediment for marital deduction trusts or testamentary trusts, for example.

"Minority" stock is of dubious value, since "majority" ownership controls all stock. While this can reduce estate valuations, it also can disenfranchise minority owners from realizing earned equity. Minimum purchase options and terms should be addressed in writing. Minority stockholders also can be forced to pay taxes on their pro-rata pass through income, but distributions or dividends may not be declared to use to pay these taxes by majority stockholders. ("Majority" interest is usually defined as 50%-plus-one-share of voting stock).

S-Corp's cannot generally convert to any other structure without formal termination, liquidation of assets at market value, and paying income tax on the sale.

S-Corp's stock basis is usually limited to stockholders tax basis contributions at inception plus share of retained earnings since. It does not include S-Corp's share of liabilities. Substantively, this limits up-front tax losses for the shareholder against other income. Typically, more losses must be carried forward to future years until offset by other taxable income. In partnerships or LLC's, typically pro-rata liability is added to basis if it is personally guaranteed by the partner/member.

S-Corp's (and C-Corp's) require that at least 80% of stockholders must contribute capital (not just services). Varying capital structures and their direct relationship to allocated stockholder distributions is often a trap for the unwary. How does management decide reasonable returns between capital and services? Without Bylaws/Articles to the contrary, S-Corp's must allocate profits based on capital.

S-Corp's and C-Corp's stock is eligible for basis "step-up" through an estate. However, no underlying depreciation deductions are available; inside corporation basis remains unaffected.

If the S-Corp (or C-Corp) is vested in a company retirement plan, IRA's will be limited or eliminated for employees (whether the employee actually participates in the corporation plan or not).

S-Corp's (and C-Corp's) corporation stock may disallow "Special Use Valuation" and "Extended Payment" options offered in farm estate valuations. Also, transfers of "over 50% ownership" potentially subject all land owned by that entity to the uncapping of real property to State Equalized Value in the year following transfer.

Accounting required in corporations is meticulous; no co-mingling of other "books" are allowed. Funds cannot generally be obtained from the corporation (S-Corp's or C-Corp's) without immediate tax effect to the recipient.

Because of the immediate taxation effects of removal, and the "passive" advantage of outside rental as a full deduction, usually real estate is left out of the corporation, and owned by some other entity. An interesting exception to this rule might be a possible purchase of environmentally contaminated property...In this case limiting the potential liability in cleanup costs, etc. may well be the over-riding concern.

Advantages Of S-Corp's

- ___ Ease of stock transfer
- ___ Can rent assets to S-Corp's

- ___ Limited Social Security tax exposure
- ___ Limited liability if not directors, officers, or employees
- ___ Eligible for farm income averaging

Disadvantages Of S-Corp's

- ___ Only one "direct expense" depreciation deduction
- ___ Corporations do not have "children" - all employees subject to all taxes
- ___ Substantial costs to form; Annual reports/meetings required
- ___ Termination subject to full taxation
- ___ Limited stockholder-employee benefit deductions
- ___ Limited estate options because trust ownership of stock usually disallowed
- ___ Stock and tax effects can be confusing and complex
- ___ Potentially subject to Unemployment and Workers Compensation
- ___ Minority stock ownership limitations/traps
- ___ Losses in excess of stock basis (without inside debt allocation) must be carried forward against future income

Subchapter "C" Corporations (C-Corp's)

C-Corp's pay their own Federal Income Tax – there is no "pass-through" to stockholders. C-Corp's farm corporations are not subject to Michigan Income Taxes or Single Business Tax; However, there is only one tax class (ordinary income) and this is taxed federally by a special corporation table with no standard deductions or personal exemptions. Federal Tax rates are very similar to individual taxable income rates at present. Self-employment tax is paid only on wages to employees. C-Corp's are subject to quarterly estimated tax payments, and are not eligible for farm income averaging. Land owned within C-Corp's is ineligible for the Homestead Property Tax Credit, and benefits from "PA116" Farmland Credits are frequently reduced.

Compensation to stockholder employees is in wages, much like S-Corp's. Wages paid must be "reasonable" and "consistent" and are subject to all federal, state, and FICA withholdings. Workers compensation is required on anyone owning less than 10% of corporate stock; Above

10%, workers compensation can be excluded upon request. Wages are subject also to Federal and State Unemployment if otherwise triggering that premium. Like S-Corp's, if over 50% of corporate stock is owned by the stockholder, their spouse, and/or children, benefits are restricted to 7 and 1/2 weeks and eliminated if under age 18.

Losses within the C-Corp's are generally carried forward, until usable against future income. Retained earnings within the C-Corp's cannot exceed \$250,000 without either declaring dividends (which is taxed by receiving stockholders after the C-Corp paid income tax on it), or is subject to an "Accumulated Earnings Tax". As a practical matter, dividends issued on farm C-Corp's are rare; income accumulations are usually disbursed through rent or wages to limit this "double taxation" exposure. Undeclared dividends, however, give IRS a powerful argument to disallow C-Corp's stock transfers under the \$10,000 per year gift-tax exclusion, since stock is not "of present value".

C-Corp's can deduct health and accident insurance, group term life insurance, meal, lodging, and vehicle expenses to employees. However, other considerations such as on-road liability for corporation owned vehicles, or personal residence tax exclusions today may minimize some of these deductions.

C-Corp's structure may actually enhance certain tax credits that are limited by type or amount of income (such as the Earned Income Credit, Child Tax Credit, or Hope Credit) since only stated wages, etc. are taxable on the stockholders returns (no pass-through of other allocable income).

Do not form C-Corp's if they are likely to dissolve in a short time. In addition to the S-Corp's rules that liquidation must be at "Fair Market Value" and taxed, C-Corp's must also distribute out all cash to stockholders, who must declare that income again if it exceeds their stock tax basis. Rules exist to offset tax advantage of converting C-Corp's to S-Corp's before liquidation.

Advantages and Disadvantages of C-Corp's

Farm C-Corp's function very similarly to S-Corp's in liability issues, stock ownership, filing, formation, estate/minority interest concerns, workers compensation, unemployment and direct expensing limits. C-Corp's can, however, have two classes of stock (common and preferred), stock can be owned by trusts, and there is no limit on number of stockholders.

Since most C-Corp's in farming rarely pay dividends, stock ownership is of little value in current cash flow; emphasis is on building "equity" instead. Like S-Corp's stock, even this "equity" is of dubious value if held by a minority interest stockholder. Careful thought should be given in the Articles or Bylaws on stock sale price options, terms and conditions.

C-Corp's exceeding \$1,000,000 gross annual receipts and where family members do not own at least 50% of the stock must use accrual accounting. Accrual is required also for any C-Corp's

exceeding \$25,000,000 annual gross receipts. C-Corp's can have fiscal (non calendar) tax years. S-Corp's generally cannot.

Many detailed and complex rules exist in C-Corp's to limit "tax shelter" schemes. For example, setting up a group of corporations wholly owned by 80% of the same ownership is allowable, but is treated as one corporation for income tax purposes (controlled corporation rules). " Personal Holding Company" rules charge additional taxes to offset income tax rate advantages from "personal investment" holdings. Strict rules apply on stockholder loans to the corporation to keep IRS from arguing loans are, in effect, a second class of stock. Other rules restrict stock sales back to the corporation, etc.

C-Corp's appear best suited on farms where there is substantial, consistent and stable (non-capital gains) income filtered through multiple owners in multiple generations. Capital held by the corporation is usually (non-land) operating assets designed for internal expansion; significant outside investment (private or public) in readily tradable stock is usually involved.

In Conclusion: Every system has its pros and cons, and every situation out there is different. Like any good management decision, give this topic the attention it deserves.

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