

BUSINESS STRUCTURES, FORMATION, AND STRATEGIES FOR FARMS

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Disclaimer

- Information presented here is VERY general information.
- Choice of the right legal strategies for your specific farm depends on your fact situation and how the law and market conditions apply to that situation.
- Consult professional advisors such as your accountant, insurance professional, and business attorney.

Choice of Business Entity for Farms: Legal Forms (Pros and Cons)

Business Forms a Farm May Take

- Sole Proprietorship
- Partnerships
 - General Partnership
 - Limited Partnership
 - Limited Liability Company

Business Forms a Farm May Take

- Corporations
 - 'S' Corporation
 - 'C' Corporation

Sole Proprietorship

- Sole Proprietorship
 - Default for one person “owning” their own business
- Unlimited Personal Liability!
- No way to reduce self employment tax
- No way to discount farmland value except IRC 2032A.
- Hard to transfer to next generation
- **No reason to use, considering allowance of one-member LLC in Idaho**

Advantages of Sole Proprietorship

- Ease of starting and ending the business
- Being your own boss
- Pride of ownership
- Retention of profit
- No special taxes
- Easy to calculate step up basis in land at death

Disadvantages

- Unlimited liability
- Limited resources
- Few fringe benefits
- Limited life span (your life)
- No discount on farmland value for estate tax purposes
- Subject to self employment tax
- Difficult to make life time gifts of the farm to the next generation

General Partnership

- An association of two or more persons to carry on as co-owners a business for profit.
- All parties are equally “involved”
- All partnerships have the benefit of flow-through taxation (i.e. entity does not pay tax itself, with some exceptions)
- Farmers often times form a partnership without even knowing it.

General Partnership

- In a general partnership, all partners subject to personal liability!
- Should create a written partnership agreement, otherwise at-will and subject to default rules of state of formation
 - Revised Uniform Partnership Act (RUPA) in Idaho

Advantages of Gen. Partnership

- Pool resources
- Shared management
- Longer survival than sole proprietorship
- Can use to make life time gifts of the farmland to the next generation

Disadvantaged of Gen. Partnership

- Unlimited liability
- Informal arrangements
- Disagreements among partners
- Difficult to terminate
- Profits subject to self employment tax
- No discount for fair market value of land for purposes of estate tax

Limited Partnership

- Still need at least one general partner (unlimited liability)
 - Can be a corporation, another limited partnership, etc.
 - Control issues (use of name)
- Usually a “farm parent” general partner and a “child coming into farm” limited partner

Limited Partnership

- Some liability protection – still minimal
- Gives limited liability to the “passive investor”
 - Only liable to extent of capital contribution
- Additional filing = additional cost
- Should create separate partnership agreement
- Can be used to transfer farm to next generation
- Can be used to discount value of the farmland for estate tax purposes

C Corporation

- Default whenever a corporation is created
 - Taxed at corporate level – income, including dividend income, of shareholders is also taxed (Double Taxation!) Watch out and never put land and other capital assets in C corp.
- Corporate Formalities
 - Annual meetings are a must
 - All actions requiring board approval must in fact have such written approval following motion and meeting
 - Just a great deal more work than other entities

C Corporation

- Management structure fixed
 - Shareholders, Board of Directors, and Officers
- Deductible Benefits to Employees
 - Can cut tax liability and might be helpful on a very large farm
 - Losses incurred by C Corporation do not flow through to owners

S Corporation

- Tax Election of a C Corporation **or Limited Liability Company**
 - Protection still the same



S Corporation

- Four relatively confining requirements
 - Must be corporation of state or U.S. territory;
 - Partnerships and corporations cannot be shareholders;
 - No more than 100 shareholders;
 - Only certain trusts, citizens or residents of U.S. may be shareholders; and
 - Only one class of stock (can not have voting/non-voting)

Limited Liability Company

- Management – Members and managers
- Limited Liability – Even for one member
- Ability to Elect Federal Taxation as Corporation or Partnership
- Very Flexible Organization
- Some Risk Because Newer Entity Form
- No Annual Reports

Deeper Detail: Idaho Sec. of State, Tax, Good, Bad & Ugly

Idaho Secretary of State

- www.sos.Idaho.gov
- Search Corporations, LLCs, Trade Names, & Trademarks
- Check Name Availability
- Forms, Instructions, and Fees

Idaho Secretary of State (cont.)

- Search Partnerships, Trade Names & Trademarks
- Checklist for Limited Partnership Filings
- Applications for Trade Names & Trademarks
- Forms, Instructions, and Fees

First steps to form an Inc. in Idaho

- Takes approximately 1 week for the Idaho Secretary of State to file Articles of Incorporation the filing fee is \$100.00.
- Other states will vary
- Should seek advice of legal professionals
- Check/Reserve Name (\$20.00)
- Name appropriately
- Do not forget the Internal Revenue Service (EIN and perhaps S Election of SS-4 form)

C Corporation

- Articles of Incorporation (\$100 filing fee)
- Organizational Meeting Minutes (Attorney)
- Bylaws (Attorney)
- Certificate of Good Standing (\$10.00)
- Shareholders' Agreement (Attorney)

C Corporation

- Keep Originals – Corporate Book
- Employer Identification Number
- Annual Report (No fee at the State of Idaho)

Powers of Corporation

- Separate legal entity (sue & be sued)
- Continuity of life
- Make & amend Bylaws
- Hold interests in other entities
- Make contracts, borrow money, issue notes and other obligations
- **Establish fringe benefit plans**

S Corporation

- Very Similar to C Corporation
- Tax Election – Flow-through Taxation (almost)
- Make Sure to Meet All Requirements

Taxation Highlights of an “S” Corp.

- Pass-thru tax entity
- No Self-employment tax only FICA
- Taxable benefits to shareholders
- Calendar tax year

C Corporation Advantages

- Limited liability
- More money for investment
- Business continuity
- Ease of ownership change
- Separation of ownership from management
- Tax-free fringe benefits (C-Corp. only)

C Corp. Employee Benefit Plans

- Qualified Retirement Plans
- Educational Assistance Program
- Meals & Lodging
 - - In corporate cafeteria
 - - Nature of business
 - - Proximity to business
 - - Condition of employment

Plans (Cont.)

- Group-term life insurance premium cost
- Disability Income & Accident Insurance
- Health insurance premium costs
- Dental insurance premium costs
- Medical cost not covered by insurance
- Qualified dependent care costs
- Contributions to a qualified 401(k) plan

C Corporation disadvantages

- Initial cost
- Extra paperwork
- Termination difficult
- Double taxation (big problem with farm land)
- Capital loss restrictions

Disadvantages (Cont.)

- Business more open to public
- Charitable contribution limitations
- No stepped-up basis of assets (big problem when passing land down to heirs)
- Accumulated Earnings Tax
- Children's wages subject to FICA
- Built-in Gains Tax

Limited Liability Company

- Articles of Organization (\$100 filing fee at Sec. State)(Attorney)
- Operating Agreement (Attorney)
 - Member-Managed
 - Manager-Managed

Partnership

- Default entity for two or more persons
 - An association of two or more persons to carry on as co-owners a business for profit forms a partnership, *whether or not the persons intended to form a partnership.*
- Partnership Agreement! Must have this or the state of Idaho Partnership laws will apply.

Partnership Agreement

- General information statements
- Capital contributions
- Contributions of labor & management
- Records and accounts
- Partnership income, expense, annual statement

Elements (Cont.)

- Partnership dissolution: business
- liquidation or continuation
- Miscellaneous provisions

Limited Partnership

- Certificate of Limited Partnership (\$100 fee at Idaho Secretary of State)
 - File Certificate with Secretary of State
- Partnership Agreement (Attorney)

Choosing a Business Entity for Your Farm?

- No easy one-size fits all but here are some things to think about

Which entity should you use?

- Only consider the C-corporation entity after thorough consultation with a competent tax advisor.
- If your primary concern is the availability of tax deductible employee benefits, seriously consider a C-Corp. but this is not often the case for a family sized farm.

Choosing (Cont.)

- If you place a high emphasis on reducing self - employment taxes, then an Sub-S corporation tax election should be discussed with your tax advisor. (Recall this can be Corporation or LLC).

Choosing (Cont.)

- If you rule out the C-corporation, the LLC, taxed as a partnership, is probably your best alternative.
- If your primary concern is achieving limited liability, seriously consider an LLC.
- You desire to transfer your farm between generations then you should seriously consider LLC.

QUESTIONS?

- There will be many.



Legal Mumbo Jumbo (but you do need to read it and understand it)

- The information in this presentation and accompanying material is provided for educational purposes only. It is not a substitute for competent legal advice. Farmers and ranchers need professional legal and financial counsel in evaluating alternatives for legally structuring the farm business. This information is provided to help you better communicate with your professional advisors in analyzing your specific situation.