



FARM TRANSITIONS

Chapter 3

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Planning for Business Succession

3.1. Planning for retirement

An important component of the succession planning process revolves around the “retirement” of the exiting generation. We often hear the comment that “there is no such thing as a retired farmer,” and there are certainly plenty of examples to back that up. However, planning for all the aspects of retirement – in whatever form it takes – will definitely smooth the family business succession process. One critical question to be answered is how soon the exiting generation plans to begin the retirement process. Often succession plans begin to take place early, and there may be a time period of several years where the exiting generation is still very much involved in (or even in charge of) the operation. In fact, that model would be consistent with a planned and phased-in management transition process. Keep in mind, however, the income realities discussed in the financial section regarding how large the business might need to be in order to financially support additional families if the senior generation is not ready to begin to cut back on both responsibilities to and income withdrawals from the business. Alternatively, the senior generation may desire to partially retire when successors begin to take on responsibilities. Yet another possibility is the “clean break” scenario in which the reins are handed over “all at once” and the business becomes the successors’ to run immediately and the senior generation fully retires.

In any case, serious thought needs to be given to the following issues:

1. How does the exiting generation envision retirement? This involves such issues as the degree of involvement in the helping with the operation and management of the farm, where they desire to live, and what other hobbies or interests they may want to pursue in order to remain active.
2. How much income will they need, and what sources are available to provide that income?
3. What will their expenses look like, and how might they change as they phase into retirement and over time?

The exiting generation needs to honestly anticipate or think about their desired retirement lifestyle. Are they interested in travel, volunteer work, or devoting time to Church related activities. What hobbies or interests are they interested in pursuing? Is it important to them to maintain involvement and decision making control over the farm? Take some time to think through these questions as you work on the succession plan.

Next, consider the sources of retirement income that will be available, and how long those income sources will last. The good news is that people are on average living a long time into retirement. The bad news (financial pun intended) is that people are on average living a long time into retirement. For example, recent data suggest that for a healthy 65 year old couple, there is a 75% chance the at least one spouse will live to be at least 86, there is a 50% chance that at least one spouse will live to be 91, and there is a 25% chance that at least one spouse will live to be 96. The point is retirement income sources may need to last a long time. Potential income sources during retirement include continued wage income from part time or spousal employment, social security income, income from farm assets, savings and investments, or pension income from prior employment. Continued wage income should, in most cases, be considered a short-term income source, often used as a transition while perhaps helping the younger generation get established.

Retirees can elect to begin receiving social security benefits at age 62. The amount of the monthly benefit drawn increases each year that retirement is delayed up until age 70, and wage and self-employment earnings do not count against social security benefits after age 65. These regulations make the decision regarding when to begin drawing social security a bit complicated, but the general rule is that if a person is healthy and can afford to wait it is generally more beneficial over the long run to wait until at least age 65 to begin drawing on social security benefits. A word of caution is in order for individuals who have been self-employed for a significant portion of their career. For some reason (that is hard to understand for those who work in the farm economics

field) business managers have long been tempted to minimize reported social security earnings (net farm incomes) for tax reporting purposes in order to minimize taxes. The massive difference between true accrual calculated management profitability and net farm income often reported for taxation purposes is a topic for another time, but suffice it to say that the ability to perpetually understate true profitability for social security reported earnings works against the accumulation of social security benefits. Put simply, minimizing Social Security taxes paid over a lifetime will also minimize the amount of Social Security benefits available. Check your earnings and projected benefit record periodically at www.ssa.gov to get an idea of your historical social security contributions and what that might translate into in the form of benefits.

Retiring farm owners and operators sometimes mistakenly assume that the business will continue to support them in retirement. Keep in mind that the “operator return” portion of what your business has historically been generating will now likely need to go to someone else.

In retirement the income from farm assets generally comes in two forms, sale or rent/lease. A consideration if you are thinking about selling land or equipment to fund retirement needs is the issue of capital gains and/or income recapture. If the sale price of an asset is more than the tax basis in the asset, then taxes will be owed, reducing the net amount from the sale.

Long-term family wealth accumulation can be enhanced by carefully evaluating which assets to sell between generations, and which assets to transfer through an estate. For depreciable assets such as machinery and breeding livestock, leasing may be a good alternative in the short run; however, keep in mind that these assets wear out and will need to be sold or replaced at some point. Leasing can provide a mechanism for slowly working the next generation into the ownership of the depreciable assets, with the incoming business operators purchasing replacements for those assets as they wear out and are sold by the retiring operators over time. At that time, the leasing income from that particular asset goes away; this poses a financial situation that must be planned for in advance.

Leasing or renting non-depreciable assets such as land provides a common form of steady income for retired farmers. Keep in mind the “rent to value” for agricultural land is fairly low, so in order to generate a significant amount of rental income a large dollar amount of agricultural land must be owned. In addition, any debt payments to be made on land that is not already completely paid for need to be considered.

Other retirement income sources such as employer-sponsored pension plans or investments such as savings accounts, CD's, bonds, or investment accounts also need to be considered. For these sources, time is money. The sooner you start saving the more money you are likely to accumulate. Add up all the potential sources of retirement income, and evaluate the degree of diversification for your particular situation. Statistics show, in general, retired farm operators rely somewhat more on income from business (farm) assets, and somewhat less on income from traditional retirement accounts and social security than average retirees, which is certainly understandable given their life devotion to building up the farm business. That does, however, make conventional retirement planning tools (and rules of thumb) used for non-business-owning retirees less applicable.

Finally, think about a realistic spending plan. Will you still be involved in the farm, and therefore need to consider farm expenses and/or perhaps capital investments well into retirement? Consider family living needs and how those might change as you get into retirement. Don't forget inflation influences. At 2% inflation, in approximately 35 years it will take twice as many dollars to pay the same bills as today, but if inflation were to increase to an average of 4% the time it takes to double the dollar requirements is reduced to about 18 years. Remember, health and health insurance costs become a larger share of the total expense pie as we get older, and those costs have risen at a rate much higher than the general rate of inflation in recent years. Depending on your situation, it may be appropriate to consider tools such as long-term-care insurance and life insurance (see discussion in section 4.6.1)

Develop a retirement budget based on retirement income and spending projections so see if the

retirement you have in mind is possible. Common mistakes that can lead to retirement shortfalls include planning too late, miscalculating how much income will be needed or the level of retirement expenses, and failing to protect assets late in life.

Following is an example retirement planning budget, available from TIAA-CREF (available at https://www.tiaa-cref.org/public/pdf/advice-planning/tools-calculators/A125820_budgeting_worksheet.pdf).

Essential budget items	Per month	Discretionary budget items	Per month
Household expenses		Household expenses	
Mortgage/rent	\$	Home improvement	\$
Utilities/cable/internet	\$	New purchases	\$
General maintenance	\$		\$
Household supplies	\$		\$
Property tax & insurance	\$		\$
Credit card debt payments	\$		\$
Meals		Meals	
Groceries	\$	Dining out	\$
Beverages	\$	Entertaining	\$
Essential entertaining	\$		\$
Personal care		Personal care	
Clothing	\$	The extras	\$
Products/maintenance	\$	Products/maintenance	\$
Healthcare		Healthcare	
Medicare/supplemental insurance	\$	Other out-of-pocket insurance	\$
Out-of-pocket payments	\$		\$
Dental	\$		\$
Eye doctor/glasses	\$		\$
Other essential expenses	\$		\$
Transportation		Transportation	
Car payments/auto insurance	\$	Discretionary travel	\$
Maintenance and fuel	\$	Vacations	\$
Taxes, registration, etc.	\$	Upgrades	\$
Essential transportation costs	\$	Other	\$

Essential budget items	Per month	Discretionary budget items	Per month
Leisure & hobbies		Leisure & hobbies	
Essential spending	\$	Discretionary spending	\$
Gifts and holidays	\$	Gifts and holidays	\$
Tax considerations		Tax considerations	
Charitable contributions	\$	Charitable contributions	\$
Income tax	\$	Gifts	\$
Other	\$	Other	\$
Miscellaneous		Miscellaneous	
	\$		\$
	\$		\$
	\$		\$
	\$		\$
	\$		\$
	\$		\$
TOTAL ESSENTIAL	\$ 0.00	TOTAL DISCRETIONARY	\$ 0.00

3.2 Who's in charge?

Organizational structure is one of the three primary “structures” of the business.¹ Organizational structure, sometimes referred to as leadership structure, is the framework within which decisions are made within the organizations. Lines of authority and responsibility need to be clearly established, with each stakeholder having a clear understanding of the various leadership and responsibility roles within the organization, and how those roles will change over the course of the transition. The most successful decision-making authority transitions are usually done through a gradual process, though sometimes, unforeseen events trigger a much faster transition. Successful large businesses often devote several years to the selection and preparation of management successors.

Family businesses need to agree on what type of organizational structure they want to evolve out of the transition. Options include the traditionally common command and control structure, where decisions are all made by one, or a very few, key individuals. This system provides order and security, but may impede the organizations ability to respond to evolving opportunities. This top-down model works best for smaller businesses where there is someone with very strong leadership and decision-making skills. On the other end of the spectrum, some businesses seem to be organized as somewhat of a bureaucratic system, where responsibility and decision making is very spread out and so many approval layers are required that nothing seems to get done. Under this type of a system, an agricultural business might find it very difficult to make progress and respond to evolving opportunities. In the middle would be a hybrid organizational structure where day-to-day decisions are spread among several managers or even employees who have the authority to make decisions, and along with that are willing to accept responsibility. At the same time the big decisions remain under the purview of the top decision maker or makers in the organization. No one organizational structure will fit every farm family business, so as the transition planning process takes place the advantages and disadvantages of various alternatives need to be discussed in the context of the overall vision and mission of the organization.

With the exception of the sudden transitions that are triggered by unforeseen events, most business successions follow a transfer time line, where ownership, decision-making authority, and income sharing arrangements move through the phases of testing, commitment, establishment, and withdrawal of the senior generation.

- **Testing:** During the testing phase, the successors may only be working for a wage or wage-incentive compensation plan, may only be sharing or leasing assets from the senior generation, and may be somewhat limited in decision making authority. This phase may be necessary to see if the business is a good fit in terms of commitment, skills, and interests for the successor and his or her family.
- **Commitment and establishment:** During the commitment and established phases the successor progressively acquires more of an ownership interest in the assets of the business, takes on more management and decision-making authority (and responsibility), and the compensation plan changes along with the responsibilities and ownership interests in the business.
- **Withdrawal:** The withdrawal phase is where the senior generation turns over the reins of the business to the successor, but may maintain varying degrees of ownership interests.

Questions always come up regarding the length of time that should ideally be allocated to each of the phases of the transfer time line. The answer, of course, it depends on the situation. The scenario to avoid, however, is the one where the various stakeholders, especially the successor, do not know what the transfer time line is and do not see any progress being made along the process. Imagine the frustration that develops when a young couple returns to the farm under the understanding of becoming the family business successor, and finds themselves still stuck in the testing phase of the transfer time line working for a wage (often below market wage rates, under the “someday son this will all be yours compensation plan”), gaining no ownership interest in the business, and being given no decision making authority after several years of working in the business. Having had no discussions regarding the transfer time line, they (especially the spouses) lose faith in the process and become frustrated, often causing disharmony among the family.

So, what can family businesses do to smooth the organizational structure transition of the business? Once again, it boils down to communication. As part of the succession planning process, have open, honest discussion among all the stakeholders about management transfer plan. We suggest the following exercise as a starting point. In a family meeting environment (discussed in Chapter 2), provide each stakeholder with two blank pieces of paper (or use front/back of one sheet). Have each stakeholder portray their perception of the current decision making (organizational) structure of the family business on one sheet.

```

graph TD
    A[Level A] --> B1[Level B]
    A --> B2[Level B]
    B1 --> C1[Level C]
    B1 --> C2[Level C]
    B2 --> C3[Level C]

```

Our Farm Organizational Structure

Today _____

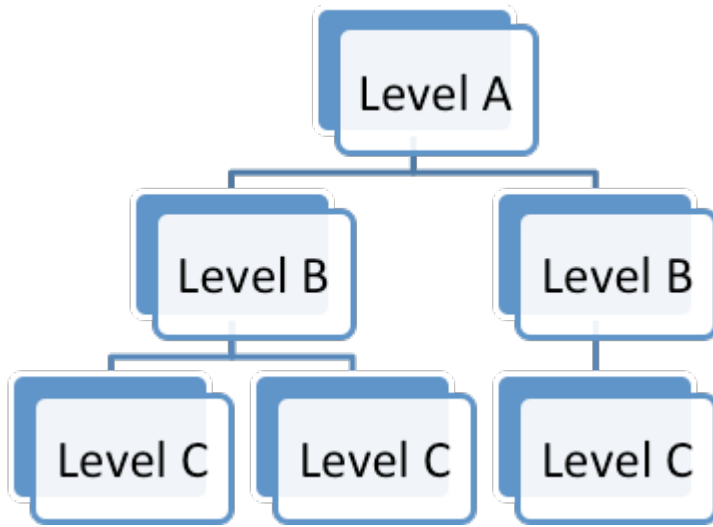
On your worksheet, graphically depict the current organizational (decision making) structure of your business. Fill in names, specific responsibilities, money spending authority, etc., for each significant stakeholder or stakeholder group.

Then, ask them to portray their perception of what the organizational structure of the business should look like at some chosen time in the future (two years, five years, ten years, etc.) on the other sheet. Use these simple tools to begin discussions regarding the development of the projected management transition time line.

Our Farm Organizational Structure

Future _____

On your worksheet, graphically depict the organizational (decision making) structure of your business as you see it at the specified future date. Fill in names, specific responsibilities, money spending authority, etc., for each significant stakeholder or stakeholder



This simple exercise will help begin the process. Once you have these two pictures (what the organization looks like today versus what it will look like in the future), you can then develop a plan to prepare successors with the necessary leadership skills to move from where each individual is now to where they need to be.

3.3. Human resource evaluation

People are an essential resource for any business. People are needed to do the daily work, to manage, and to plan, among other things. The skill sets required for each function of business management and operation are different, though some individuals may possess skills that match more than one function. Relative to other resources, labor is somewhat unique in that it cannot be stored for future use. As a part of the transition process, it is important to document who is involved in the current business and what roles they play, what skills are needed (and what skills the business potentially lacks), and how the human resource situation might change over the course of the transition.

Begin with a simple list of all the people currently involved in the operation and positions they fill. This might include a brief description of the duties and responsibilities required for each enterprise and activity of the farm, and how those labor and management requirements are being filled. These needs may be very seasonal in nature, so think in terms of task that need to be done, as well as the timeline within which the work needs to be accomplished. Don't overlook the general management and coordination of the entire operation in this assessment process. You could develop a "human resource diagram" much like the decision making diagram from the previous section to visually portray the current human resource situation for the business.

This examination may reveal critical shortfalls in the current human resource mix, or may reveal that there are times of the year when there appears to be an excess of labor available. It is not just about "hours of labor available" but also how well-suited the various stakeholders are for the roles they are currently filling in the operation. We suggest both a "self-assessment" on the part of the current workforce, and a manager's assessment of each individual currently involved in the operation to gauge the fit between current skills and interests and the duties currently being performed.

For the self-assessment, have each person involved in the operation seriously consider his or her own skills, abilities, and interests. Do they enjoy working and/or living on the farm? What do they enjoy or look forward to the most? How do they feel about conflicting farm and family demands on their time? Do they enjoy certain production activities such as crop production, livestock production, or machinery management, or do they enjoy management activities such as record keeping, marketing, or planning? Key managers in the business

should also conduct their own human resource assessment, consisting of an evaluation of the skills, interests, and abilities of each person involved in the operation. A list of criteria like the following could be utilized, and don't forget to have various members of the management team evaluate each other so that everyone in the operation is included.

Person	
Skill/Trait	Comments (Assessment, self or by others)
Crop Production Management	
Livestock Production Management	
Machinery Management and Repair	
Technology Adoption and Aptitude	
Financial Management	
Marketing Management	
Personnel Management	
Organizing and Scheduling	
Creativity and Innovation	
Decision Making	
Logical Thinking	
Communication /Listening	
Overall work ethic	
Other	

These assessments will provide critical information to facilitate discussions among stakeholders regarding the human resource situation, and will provide background information as transition plans evolve.

The focus will then change to questions regarding who will be leaving or joining the operation and the mix of skills and abilities that will change. Plans can be made to either develop the skills that will need to be replaced, or to begin seeking outside expertise in those areas. One fact of life on the modern farm with the increasing technology and complexity in the industry is that it is much more difficult to fill all of the necessary roles on the farm with one individual. The modern farm will likely require a management team where skills are spread around among several stakeholders. As a part of the transition process, develop job descriptions to help focus on the skills needed and the qualifications of various individuals to fill those roles. Begin developing the necessary skill set in the successor team early so that the transition process can proceed smoothly.

3.4. Beginning Farmer Issues and Bringing New Stakeholders into the Operation

As discussed throughout this workbook, transition planning means creating a path forward both for the existing members of the farm business, as well as creating roles for new members. Part of this process may include helping the current members understand the capabilities of those who will be joining the business. Another part will be selecting tools to integrate these new members and facilitate the transfer of management, ownership, and economic participation in the business. This subsection will present tools for both groups to accomplish their goals

3.4.1. Presenting your farm experience through a farm resume

The competition for basic resources in agriculture is always intense. It is especially important for beginning farmers to help distinguish themselves from competitors. A farm resume is a tool that can help a farmer to market themselves and their operation. Much like a traditional resume designed to help convince a potential employer that they should hire someone, a business resume (farm resume) is designed to convince others that they should be interested in doing business with the farm.

Important points that could be emphasized in a family farm resume might include information about the family itself, goals and objectives (or even the broader vision of the business), and specific experiences, skills, and history associated with the business. Also one might elaborate on unique equipment, technology, or farming practices that position the farm to be more efficient, productive, or resource friendly. Knowledge in important areas such as risk management or farm program implementation may also be pointed out. Focus on characteristics or resources that outside stakeholders would find appealing. It might also be appropriate to include references, such as current landlords or others who have an interest in your business. Keep the farm resume short and to the point, and make it an attractive easy to read document.²

3.4.2. Transactional tools for changing roles

There are a wide array of transactions that can be used to help beginning farmers and ranchers begin their ownership and/or management of farm assets. Three primary tools are discussed here: the buy/sell agreement, the leasing of assets, and installment sales.

3.4.2.1. Buy-Sell Agreements

The process of transitioning the current business to the next generation will often result in the creation of a new entity with multiple owners. For example, a limited liability company (LLC) may be formed with the founding generation holding a significant majority of the ownership units with an agreement that units will be sold and/or gifted to the successor generation over time. However, unexpected events can happen. In order to make sure the new entity structure survives an unexpected death such as the a shareholder death, departure, disability, or divorce, a buy-sell (buyout) agreement should be drafted to take care of the business in such contingencies.

A buy-sell agreement is a legally binding agreement between the owners of the business clarifying who can buy the departing individual's share of the business and at what price this transfer will occur. The agreement should also explain the events that will trigger a buyout of an individual. These could be a partner's death, disability or incapacity, divorce (in which the ex-spouse would get a portion of the business as a settlement – this can point to the need of both a buy-sell agreement and a pre-nuptial agreement), bankruptcy or foreclosure on debt secured by business assets, or desire to exit the business.

It is important to keep in mind that the reason for transition planning is to keep the business viable for

future generations. Proper planning is needed to make sure that an external event does not destroy these plans. It is much easier to determine the provisions of the buy-sell agreement before the transition takes place versus after everything is in full operation and then try to fix it.

3.4.2.2. Leasing of Assets

Frequently, the incoming generation is “cash poor” and the older generation needs cash to cover the revenue foregone by exiting the farm business, as well as retirement expenses. Leasing of assets by the older generation to those that are entering the business often aids in this cash flow problem for both groups. Leasing business assets does have some income tax consequences depending upon the lease contract and the assets being leased.

A lease may be categorized as a rental of property (an operating lease or tax lease) or an acquisition of property (a capital lease or conditional sales contract) financed through a lease agreement. If the lease agreement transfers essentially all ownership rights and risks to the lessee, there is an acquisition of property occurring as specified in the lease contract. If ownership rights and risks do not transfer to the lessee, the lessee is simply renting the property. The distinction must be made when accounting for the asset on the books of both parties.

A capital lease is an arrangement that is termed a lease but has the qualities of a purchase. This is why this type of lease is sometimes referred to as a conditional sales contract or a lease-purchase agreement. The lessor may then be considered a dealer who also sells assets or a lender financing the lease. The lessee takes possession of the property and is usually responsible for repair expenses. The lessee is also required to make periodic lease payments which are similar in amount to loan payments that would be required to purchase the asset during the term of the lease. The lessee acquires an ownership interest in the property and also incurs a liability for the principal amount which was financed.

The Farm Financial Standards Council (FFSC) recommends the application of four rules to which are used to determine if a capital lease exists. If any of the four rules apply, a capital lease exists for the lessee and the asset must be capitalized and depreciated in the same manner as if it had been purchased, which can have important tax implications for both the lessor and the lessee.

1. The lease transfers ownership of the property to the lessee by the end of the lease term.
2. The lease agreement contains a bargain purchase option. In this case the lessee has the option to purchase the property at the end of the lease term for an amount which would be significantly less than the value of the property at that time.
3. The lease term is equal to 75 percent or more of the estimated economic life of the property.
4. The present value of the lease payments at the beginning of the lease term is equal to or greater than 90 percent of the fair market value at that time.

If none of the above four rules apply, the agreement is an operating lease. The asset is rental property and the lease payments are treated as operating income by the lessor and operating expenses by the lessee. In addition, ownership of the leased assets does not change.

An operating lease is much simpler to establish and the tax treatment of the payments by both parties is less complicated. In an operating lease the lessee treats the payment as an operating expense and the lessor reports the payment as income. Since the lessor retains ownership of the assets, depreciation deduction is also retained by the lessor.

There is also one tax issue that occurs when only machinery and equipment are leased. In this situation,

the assets are personal property and the IRS considers the lessor of personal property to be in the business of leasing which results in the payment being subject to self-employment tax. To avoid this self-employment tax situation, real property (land and buildings) are the only asset leased or the land, buildings, machinery and equipment are all leased as one unit that is in one agreement.

For additional information refer to fact sheets [AGEC-935: “Capital Leases”](#) and [AGEC-940: “Tax Aspects of Leasing.”](#) You can also find numerous leasing resources at www.aglease101.org and www.aglandlease.info. Be sure to discuss the options of leasing with your tax advisor.

3.4.2.3. Installment Sale of the Farm

The decision to retire from farming may lead to the desire to sell the assets and invest the proceeds which are to be used as a retirement fund. Usually the sale of a farm business involves the disposition of farm land, machinery, equipment, marketable inventory plus all the remaining tools of the trade. Special tax rules apply to the sale of depreciable assets and the land that is sold under an installment contract. The sale decision may result in a large income tax liability if all the farm assets are sold in one tax year.

The use of installment sale contract simply means that the income from the sale will be received over a period of two or more years. Therefore the use of an installment sale for a farm liquidation allows for the sale proceeds to be taxed in the year that the payment is actually received. An installment sale is a tax management strategy that can be helpful for the seller to manage taxable income.

In order to fulfill the requirements of an installment sale, the buyer may be obligated to make future payments under a deed of trust, note, land contract, mortgage or some other evidence of indebtedness. It is necessary to properly record the debt, transfer ownership, and charge a reasonable interest rate on the note. The minimum interest rate that must be charged to avoid the “sale” being regarded as a “gift” by the IRS can be found with the help of your tax professional.

The main benefit of an installment sale is that the seller is able to spread the tax resulting from the gain on the transaction over the life of the contract. In addition, the buyer is able to obtain immediate possession of the property. The buyer also does not have to go through the process of acquiring a bank loan or other traditional financing.

A drawback of using an installment sale for all the farm assets occurs with the sale of depreciable assets. Depreciation taken on machinery, equipment, buildings, purchased breeding livestock, and any other depreciable asset must be recaptured as ordinary income in the initial year of sale. This can create a problem in the situation where the sale proceeds received in that year are not sufficient to cover the tax liability.

The sale of non-depreciable assets using an installment sale contract works well. Since there is no depreciation to be recaptured, only the gain from each annual installment is taxable. Therefore an installment sale of land and raised breeding livestock can help manage the income tax liability resulting from the sale since both of these assets are not depreciable.

An installment sale will spread the seller’s income tax liability over multiple years. However it does create risk to the seller in the event that the buyer fails to make good on the contract. Sellers need to evaluate the credit worthiness of the buyer before entering into a sale agreement. In the event that a buyer defaults, the seller may have additional costs of foreclosure and repossession of the property. Be sure to seek proper legal counsel when considering an installment sale.

3.5 Business Entities

The term “business entity” refers to an organized business that exists, at least to some extent, separately

from its owners. Often, people think of a business entity as something only used for large corporations, but business entities can be used for any size of operation. Business entities can be important tools for business succession. In this subsection, a variety of business entities and their characteristics are presented. Then, using a family farm example, the use of the various entities as transition tools (and the tax consequences of those choices) explored.

As the discussion proceeds, it will examine four basic entity forms: the sole proprietorship,³ the general partnership (including general and limited partnerships), the corporation (including “C corporations” and “S corporations”), and the LLC.

3.5.1. Forming the Entity

Sole Proprietorship: There really is no formation process for a sole proprietorship. Whenever a person starts a business activity without forming any other type of business entity, a sole proprietorship is created. There are no filing requirements necessary to start a sole proprietorship, although if the person operating the business wants to use a trade name, they will need to file a “trade name registration” or “Doing Business As” (DBA) registration.

Partnership: Partnerships require some form of “partnership agreement” among the people forming them, though the requirements for the partnership agreement are very low. All that is needed is for there to be evidence that one or more people intended to engage in some sort of business activity together. That being said, it is a good idea to carefully think through the partnership agreement (including what each partner will contribute to the business, how items of income and loss will be allocated among the partners, how decisions will be made, etc.) and to put the agreement in writing.

In a general partnership, there is no need for a government filing to start the partnership, although, as with the sole proprietorship, a DBA filing will be needed if the business will be using a trade name. On the other hand, creation of a limited partnership does require the filing of a registration form with the Oklahoma Secretary of State. This is because (as discussed below) a limited partnership has at least one “limited partner.” In exchange for the limited partner’s liability protection, the limited partner must register with the Secretary.⁴

Corporation: Both C corporations and S corporations must register with the Oklahoma Secretary of State. The filing made with the Secretary is called the Articles of Incorporation. In addition to the Articles of Incorporation, a corporation must also have a set of bylaws. These bylaws should cover the classes of shares the corporation can issue, the officers of the corporation, how decisions will be made, the rights and obligations of shareholders with respect to the corporation and each other, what happens if the corporation decides to end its business, etc. The owners may also consider restrictions on who can be a shareholder and/or whether the corporation or the other shareholders will have the right (or obligation) to buy the shares of another shareholder if they choose to sell their shares.

LLC: LLCs must also register with the Oklahoma Secretary of State. The filing made with the Secretary is called the Articles of Organization. In addition to the Articles of Organization, the owners of the LLC should create an operating agreement for the LLC. The operating agreement addresses the same issues as the bylaws of a corporation although, as discussed in the following sections, LLCs have much more flexibility in many aspects of the business than corporations do.

3.5.2. Liability

Sole proprietorship: The owner of a business operated as a sole proprietorship is personally liable for all of the liabilities of the business. For example, say the sole proprietorship is a custom wheat harvesting business. While harvesting wheat, a fire starts on the combine. The fire spreads to the field and eventually damages several nearby buildings. If the owners of the buildings sue the sole proprietor and win, not only are all the business

assets (such as the harvesting equipment) at risk; all of the owner's personal assets such as his or her home, vehicles, and savings are also at risk. This is referred to as "unlimited liability" and is often a reason that people operating businesses chose a limited liability entity such as a corporation or LLC.

Partnership: In a general partnership, all of the partners have unlimited liability. While someone suing the partnership is generally required to take the partnership assets first to satisfy their claim, if those assets are not enough, they can then take the personal assets of the general partners. Further, partners also have what is called "joint and several liability." This means that if someone sues the partnership but one of the partners manages to evade the suit, the remaining partner is liable for the entire amount of the judgment in the suit. That partner can, in turn, sue the other partner(s) to contribute their "fair share" but if the other partners cannot be found or successfully sued, there is no recourse for the partner that paid the full amount of the suit.

In contrast, the limited partner in a limited partnership has what is called "limited liability." This means the liability of the limited partner is limited to what they have invested in the business. For example, consider the custom harvesting business mentioned in the section on sole proprietorships above. Say that the business was organized as a limited partnership, and that the limited partner contributed \$250,000 to the partnership for the purchase of equipment and payment of other expenses. In this case, when the limited partnership is sued for the damages caused by the fire, and the partnership assets are exhausted, the liability for the limited partner is limited to the \$250,000 he or she invested in the business. If the assets of the business are not enough to satisfy the claims in the suit, the general partner's personal assets will still be at risk, but the limited partner's personal assets are not. This is an important consideration for the limited partner. It is also another reason why the limited partner must be careful not to violate the restrictions on involvement in the day-to-day operations of the partnership, for doing so risks losing the limited liability protection.

Corporation: All shareholders in a corporation enjoy limited liability – only their investment in the business (through their purchase of shares or contribution of assets to the business) is at risk for any liabilities of the business. Corporations are the original limited liability business entity form, as their limited liability was one of the original features of the corporate form when it was established centuries ago. Importantly, though, shareholders can lose their limited liability protection if they fail to respect the boundaries between shareholders and the corporation. One common way this happens is the commingling of personal and business assets, most frequently when shareholders treat the corporation's accounts as their own (making payments that are not salaries, dividends, or documented loans) or vice-versa. Another way limited liability can be lost is when the shareholders fail to follow proper business formalities such as holding regular shareholder meetings, documenting meetings through the recording of minutes, voting on actions of the business, or paying the annual fees for the corporation's filing with the Secretary of State. These actions can enable parties suing the corporation to "pierce the corporate veil," meaning they can destroy the limited liability protection of the shareholders and can thus claim both the corporation's assets and the assets of the shareholders to satisfy their claims.

LLC: As the name "limited liability company" implies, LLCs have the same limited liability features as corporations. Importantly, though, the LLC holds some advantages over the corporation in this regard. For example, an LLC could choose to operate and be taxed like a partnership (even to act as a limited partnership) but all of the members would have limited liability. Thus, it is possible for LLCs to combine all of the liability protections of the corporation but to operate like a partnership if it so chooses. Further, the LLC is somewhat less susceptible to "piercing the corporate veil" since there are fewer formalities required of the LLC than of the corporation. This being said, though, LLC members should still use caution to respect the separateness of the LLC and its members.

3.5.3. Entity Ownership

Sole proprietorship: Entity ownership for a sole proprietorship is very straightforward. The sole proprietor of the business is the one and only owner of the business and all of its assets.

Partnership: The partnership is, not surprisingly, owned by the partners. The partnership agreement may specify the contributions of property to business by the partners, and this property may be referred to as “partnership property.” Defining partnership property may be important if the partnership is dissolved, and to some extent if the assets of the partnership are at risk for some liability (though, as discussed below, the risks are different for limited partners in a limited partnership).

Corporation: A corporation is owned by its shareholders. It is important to note the property of the corporation is owned by the corporation itself, not by its shareholders. For example, if a corporation owns a piece of land, the shareholders do not have the right to possession of the land itself. Similarly, the funds of the corporation belong to the corporation and not directly to the shareholders. It is important for the shareholders to respect this separation and not treat corporation property as their own, or vice versa. Failing to do so, or comingling personal and corporation assets can lead courts to rule that the corporation did not exist as a separate entity, thus allowing creditors and others claiming a liability against the corporation to reach the personal assets of the shareholders.

S corporations must have 100 or fewer shareholders. However, in Oklahoma, if any type of corporation (C or S) is going to own agricultural land, it is limited to 10 shareholders unless all of the shareholders are lineal descendants.⁵ Other states that limit corporate ownership of farm land include South Dakota, North Dakota, Iowa, Minnesota, Wisconsin, Nebraska, Missouri, and Kansas.⁶

LLC: As with a corporation, an LLC is owned by its members.⁷ Property of the LLC is owned by the LLC itself, rather than the individual members. As with corporations, it is important for LLC members to avoid comingling assets. In Oklahoma, if the LLC is going to own agricultural land, the LLC can only have 30 members unless all the members are lineal descendants. Most other states with corporate ownership laws also include LLC’s in the restrictions of those laws.

3.5.4. Management and Control of the Entity

Sole proprietorship: Sole proprietors have exclusive control over all aspects of the business.

Partnership: In a general partnership, all of the partners can have the right to participate in all decisions of the business. Partners can, through the partnership agreement, choose one of the partners to serve as a “managing partner” who oversees the day-to-day operations of the business, while all partners share in the “big picture” or strategic decisions of the business. In a limited partnership, the general partner(s) have the right to participate in all decisions of the business. On the other hand, the limited partner(s) cannot participate in the day-to-day decisions of the business; doing so creates a risk that courts would determine them to be general partners and thus lose their liability protection.

Corporation: In a corporation, shareholders have control over the business, but do not directly participate in most decisions of the business. Instead, the shareholders elect a board of directors. The board makes major decisions, chooses when to declare dividend payments to the shareholders, and sets the long-term goals of the business. The board also selects officers for the corporation (who do not have to be shareholders) to manage the day-to-day operations of the corporation. Shareholders still hold ultimate control over the business through their power to vote out officers or directors, to overrule their decisions, or to vote to dissolve the corporation.

LLC: LLCs can choose to be either “member-managed” or “manager-managed.” In a member-managed LLC, all of the members have functions like those of shareholders, directors, and officers in a corporation in that they directly participate in all decisions of the business. This model is typically used only when there is a small number of members who all wish to have an active role in the business. Alternatively, the members of the LLC can choose to be manager-managed; this approach means one or more managers are selected, and function like the officers of a corporation to manage the day-to-day operations of the business. This model is

sometimes chosen by LLCs with many members or when some members do not wish to be part of the day-to-day operations of the business. As with a corporation, the members still retain ultimate control over the LLC with the power to vote out managers, overrule decisions, or to dissolve the LLC.

3.5.5. Continuity

Sole proprietorship: There is no business continuity with a sole proprietorship. Since there is no separation between the business owner and the business itself, the loss of the owner means the business ceases to exist in its current form. For this reason, sole proprietorships cannot survive the death of the proprietor, and the sole proprietorship in and of itself cannot be used as an estate planning tool. Sole proprietorships can sell assets and can even transfer clients or “books of business” but doing so dissolves the original sole proprietorship and creates a new one in the purchaser.

Partnership: Partnerships have slightly more of an ability to survive the loss of someone involved in the business than a sole proprietor. Technically, a partnership does not survive the loss of one of the partners, but rather becomes a new partnership. However, for most practical purposes, the partnership is regarded as “surviving” so long as 50 percent or more of the original partnership interest remains in the partnership. If a family-owned business is using the partnership form, it is very important that the partnership agreement include rules governing who can be a partner, including to whom a partner can transfer their interest (if they are even allowed to transfer their interest), if there are certain events that will require them to sell their interest (such as bankruptcy, divorce, inability to participate in the business due to illness, a requirement that a partner’s estate sell the interest if the partner dies, etc.), and if the other partners must approve the addition of a new partner.

Corporation: Corporations can have unlimited continuity if properly constructed. In Oklahoma, the corporation’s articles of incorporation can specify the corporation’s existence as either limited to a set period of years, or to be perpetual (this is the case for most other states as well). The potentially unlimited existence of corporations (as well as LLCs) gives them a significant advantage as a business transition tool. Corporations can add or lose owners simply through the purchase or sale of stock. For large, publicly-traded corporations, this happens thousands of times per day, with no impact to the business. For smaller corporations, though, adding or losing owners can have more of an effect, since the shareholders are likely more directly involved in the business. Thus, for small corporations, it may be advisable to have rules such as those discussed for partnerships governing who can (and who cannot) be shareholders. Corporate law imposes more restrictions on these rules, and requires certain rights for shareholders, than is the case for LLCs, giving LLCs more flexibility in this area. Given this, and the fact that it can be difficult for shareholders in small corporations to sell their shares, the shareholders should consider whether “redemption” or “buy-sell” agreements (discussed in subsection 3.4.2.1 above) should be enacted. These agreements govern how either the corporation itself (in a redemption agreement) or other shareholders (in a buy-sell agreement) will purchase shares in case a shareholder wants or needs to sell them. Such agreements can also be triggered by the death, divorce, disability, or bankruptcy of a shareholder.

LLCs: As with corporations, LLCs can have potentially unlimited existence if properly constructed. This gives them much flexibility as a business transition tool. Just like corporations, LLCs can change members by the purchase and sale of membership units. LLCs do have an advantage over corporations, though, in that they have much more flexibility in setting restrictions on only on who can and cannot be members of the LLC, but also in restricting the transfer of units. While this can be beneficial in crafting an LLC specifically to hold and transfer a family business, it also requires the business members to use extra caution in crafting the operating agreement, along with any redemption and/or buy-sell agreements associated with the business.

3.5.6. Salaries, Dividends, and Other Distributions of Income

Please note that a fuller discussion of some of the issues regarding the distribution of salaries, dividends, and other distributions of income can be found in the discussion of the tax implications of the various entity

forms in the following subsections.

Sole proprietorship: Salaries, dividends, and other distributions of income are irrelevant to sole proprietorships, as there is no separation between the business and its owner. While the business owner may maintain separate bank accounts and accounting records for the business and his or her personal accounts, the law makes no distinction between the two. As a result, transfers of payments between the business and individual carry no legal consequences.

Partnership: Partnerships have some flexibility in allocating payments among the partners. Partnerships can pay salaries to the partners (though care must be used in a limited partnership; remember that a limited partner is not allowed to participate in the day-to-day operation of the partnership). Another payment that can be made to partners is a “guaranteed payment,” which is similar to a salary but is made regardless of the amount of income of the partnership (as opposed to other payments which may depend on both the income of the partnership and the partner’s percentage of ownership in the partnership). Partnerships technically do not have “dividends.” However, partnerships also have the flexibility to distribute the income of the partnership either in proportion to the partners’ percentage of ownership or out of proportion to that percentage. Making distributions out of proportion to the ownership requires language permitting such distributions in the partnership agreement.

Corporation: Corporations can pay salaries to their officers, and can also pay stipends to their boards of directors. Salaries are also deductible in the case of C Corporations, since they are taxed as a separate entity, but salaries are not tax-deductible for S Corporations. Unlike partnerships, neither C corporations nor S corporations are allowed to make distributions of income, such as dividends, out of proportion with the shareholders’ ownership. However, corporations can create different classes of stock (such as “preferred” stock and “common” stock). These classes of stock may be treated differently; for example, preferred stock might receive a dividend in some years that common stock does not. However, within each class of shares, each shareholder must be treated the same in proportion to their share ownership.

LLC: LLCs can pay salaries to their offices and stipends to boards of directors. The tax deductibility of these payments depends on whether the LLC chooses to be taxed like a C corporation or as a partnership (discussed in subsection 3.5.7.3 below). The ability of the LLC to pay dividends and other distributions of income (and to make such distributions out of proportion to the member’s ownership percentages) also depends on the tax treatment chosen by the LLC. Generally, though, LLCs have more flexibility than corporations in choosing how to make payments to their members.

3.5.7. The Business Entity as Farm Transition Tool

How can a business entity serve as a farm transition tool? As discussed earlier in this handbook, the three reasons so many farms fail to successfully transition from one generation to the next are inadequate estate planning, inadequate capitalization, and a lack of communication and opportunities for those involved with the operation to grow into their new roles. When used carefully, a business entity can help address all three of these concerns.

Business entities can help deal with the estate planning issue by providing another estate planning tool. For example, as discussed below, business entities can be used to help property get an increased tax basis before its contribution to the farm business, thus reducing the future tax liability for the business. Entities can also be used to gradually gift portions of the business to potential heirs without incurring gift tax liability.

Business entities can also help deal with the capitalization of the farm business. Since having a business entity requires a separate set of accounts, it can clarify recordkeeping and make the profitability (or lack thereof) more easily determined. It can also allow for more transparency in how the members of the business invest in it, which can actually encourage additional investment.

Last, but certainly not least, a business entity can create more opportunities for family members to gradually increase their involvement in the farm business. If the founding generation is reluctant to “hand over the reins” to the next generation because they are concerned they don’t have enough management experience to profitably lead the operation, a business entity can create the opportunity to slowly increase the amount of management responsibility the next generation has. Gifting or selling small amounts of stock will increase the investment and decision power the recipient has over time, rather than transferring all of the assets at death, as is typically the case.

To explore how the business entity can be used as a farm transition tool, consider the following example. Ward and June currently operate their farm business as a sole proprietorship with Ward as the sole proprietor. They have three children: Tom, Dick, and Harry. Two of them (Tom and Dick) want to come back to the farm while the third (Harry) has little interest in the farm business but has a sentimental attachment to it. Ward and June have decided that they wish to transition the business and now must consider the types of business entity to select based upon a variety of tax and non-tax items. They are considering a partnership, S corporation, C corporation, or Limited Liability Company.

The assets in the business include land, buildings and improvements, machinery and equipment, and livestock. Their home is on the land, but since it will continue to be their home even as the rest of the assets are transferred in the transition plan, it is to be kept separate. In addition to the issue of how to best transition the farm business to the next generation, the family must also consider the income tax implications for the transfer of the assets to the various types of entities.

3.5.7.1 Basic Tax Considerations with Business Entities as Transition Tools

Ward and June must decide what assets they are going to contribute to the entity of choice. The farm’s asset information is as follows:

Asset Description	Fair Market Value	Cost Basis	Accumulated Depreciation	Adjusted Basis
Land	\$3,500,000	\$750,000	–	\$750,000
Buildings & Improvements	\$500,000	\$800,000	\$650,000	\$150,000
Machinery & Equipment	\$400,000	\$700,000	\$400,000	\$300,000
Raised Breeding Livestock	\$350,000	\$0	–	\$0
Purchased Breeding Livestock	\$20,000	\$25,000	\$15,000	\$10,000
Market Livestock	\$80,000	\$0	\$0	\$0
Totals	\$4,850,000	\$2,275,000	\$1,065,000	\$1,210,000

The first item they consider is the land. The contribution of the land into an entity must be carefully evaluated, because it will have some long-term tax implications. The land has considerably appreciated in value since it was purchased for \$750,000 (here, the purchase price is the “cost basis” of the land) and is currently worth \$3,500,000. This means the land has increased in value (“appreciated”) by \$2,750,000 (\$3,500,000 current market value - \$750,000 cost basis = \$2,750,000). If Ward and June were to sell the property right now, they would pay capital gains tax on the \$2,750,000 appreciation (or capital gain) on the property. Capital gains are taxed at much lower rates than ordinary income⁸ but the capital gain still represents a tax cost. On the other hand, if Ward and June held on to the property until their death, the property’s cost basis would be “stepped up” to its fair market value at the death of the last party to hold the property. For example, if Ward and June were to die today, the cost basis in the property would be stepped up from \$750,000 to the current fair market value of \$3,500,000. If the property were then sold, there would be no capital gains tax, since the capital gain on the property would then be zero (\$3,500,000 fair market value - \$3,500,000 cost basis).

Now, what if Ward and June contribute the land to a business entity? In such a case, the property would

keep its cost basis of \$750,000 (instead of receiving a stepped up basis at Ward or June's death). If the entity were eventually to sell the property, it would have to pay capital gains tax on the excess of the property's fair market value at the time of the sale over the \$750,000 cost basis. In addition, if the entity of choice is a C corporation, capital gain is taxed at the same rates as ordinary income which is much less beneficial than the capital gain treatment received by an individual. None of this may be a problem if the entity is never terminated or if none of the land is ever sold. However, what if Ward and June keep the land in their name and rent it to the entity, they will have source of income as well as the opportunity to allow the cost basis of the land to be stepped up to market value at their date of death. This will allow the transfer of the land to obtain a significant tax advantage at that time. Ward and June could let their estate plan contribute the land into the existing entity with this higher basis.⁹

If Ward or June contribute assets to a business, they likely will receive an interest in the business in return. As discussed above, once assets are contributed to a business, it is the business that owns them, not the people who own interests in the business. Thus, the tax treatment of the assets contributed and the business interest received are handled differently. For example, say June contributed a piece of land to the business entity that was worth \$250,000 at the time of the contribution, and that the land was purchased for \$200,000. She receives an interest in the business entity valued at \$250,000, and the business entity gets a piece of land with a cost basis of \$200,000. Further, assume that due to the success of the business and the appreciation of its assets, the value of June's interest at death has grown to \$300,000. June's business interest will receive a stepped up cost basis of \$300,000. However, the business' cost basis in the asset June contributed will remain at \$200,000 (June's cost basis in the property at the time it was contributed).

Should Ward and June decide that they need some additional cash at the time the entity is established, they could sell some assets to the entity instead of contributing them for ownership interest. For example, if they sell all of their machinery and equipment to the entity at its fair market value of \$400,000 they would get \$400,000 of cash but would have a tax liability since the assets have been depreciated to the point that the adjusted basis is \$300,000 ($\$700,000 \text{ cost} - \$400,000 \text{ depreciated value} = \$300,000 \text{ adjusted basis}$). If Ward and June are in the 20 percent ordinary income tax bracket, the sale of all the machinery and equipment will result in a tax liability of \$20,000 due to a taxable gain from the sale of \$100,000 [$(\$400,000 \text{ sale value} - \$300,000 \text{ adjusted basis} = \$100,000 \text{ taxable gain}) \times 20\%$]. It is important to work with a tax advisor to evaluate all the potential income tax consequences of the sale transaction.

Partnerships, corporations, and LLCs each carry their own unique tax considerations when family members contribute assets to the business entity. These considerations are discussed with each business form below.

Another tax issue is the self-employment tax. Most taxpayers working for an employer have FICA and Medicare withheld from their wages. The amount withheld is matched by their employer. Consequently, they will receive retirement and medical benefits when they reach retirement age. They are also entitled to disability and survivor benefits. The self-employed individual must pay self-employment (SE) tax to be entitled to similar benefits. This is paid when they file their federal income tax return. The SE tax rates equate to both the employer's and employee's share of FICA and Medicare.

Any income other than salary or wages is "earned income." Therefore, a person operating a farm or ranch they own or rent must pay SE tax on the profits. A person must "actively participate" in the operation to have SE income. Individual taxpayers that are involved in a business entity that is a sole-proprietorship, partnership, an S corporation or an LLC electing to be taxed as a single member LLC, partnership or S corporation will be subject to the SE tax. Individuals that are employees of a C corporation or an LLC electing to be taxed like a C corporation are not subject to the SE tax since the corporation pays the employee's portion of the FICA and Medicare tax due. For more detailed information concerning the SE tax and rules visit the [RuralTax.org](http://ruraltax.org) website using the following link: <http://ruraltax.org/htm/tax-topics>.

3.5.7.2. Partnerships as Transition Tools

The creation of a partnership – specifically a limited partnership – between Ward, June, Tom, Dick, and Harry is one possible solution. A limited partnership would allow the non-farming son (Harry) to have an interest in the business without the issue of his personal assets being at risk. The general partners will include Ward, June, Tom, and Dick but not Harry. Harry would instead be the limited (non-managing) partner. Harry could receive a guaranteed payment from the business or he could receive a share of the profits; since he is a limited partner, his income will not be subject to self-employment tax since limited partners will generally not be participating in the business.

The partnership agreement formed by the family will need to include the terms for the sharing of partnership profits, gains, losses, deductions, and tax credits among the general partners. It will also explain how Harry will benefit from the business. The income generated from the business will be taxed to the partners, not the partnership. Income received by the partnership will be taxed even if the partnership retains the income and does not distribute it to the partners. In addition, losses and tax credits will be passed to the partners as well. The partnership agreement can also provide special allocations of income items such as rent for the land versus ordinary income from the sale of crops or livestock.

When the partners contribute assets to the partnership, the contribution is not a taxable event. For example, consider again June's contribution of a piece of land with a cost basis of \$200,000 (her original purchase price) and a current fair market value of \$250,000. If June were to sell the land to the partnership, she would have a taxable capital gain of \$50,000 (the \$250,000 current fair market value minus her \$200,000 cost basis in the property). However, if she only receives a partnership interest in return for her contribution (that is, she does not receive cash for the sale but only an interest in the partnership), there is no taxable event, and no capital gains tax is owed.

The contribution of machinery, equipment, and the breeding livestock plus the value of any assets contributed by Tom and Dick would then be used to determine the partnership interest for the various parties. It must be noted that no partner would want to own 50 percent or more of the interest in the partnership since the sale, exchange, or estate transfer of the 50 percent partner's complete interest will terminate the partnership.

A partner may acquire a partnership interest by providing services. If the contribution of services allows the partner to get an interest in the assets or capital that has been contributed the partner will be taxed on the value of the interest received but if the contribution of services is to be paid from future profits the taxes are assessed when profits are received as payment.

It is important to work with a qualified accountant when establishing a partnership since the tax law associated with partnerships is extremely complicated. It is also important to work with a qualified attorney to make sure the partnership agreement is drafted properly to ensure that the desires of all the parties involved are met.

Finally, it is important to note that only Harry, the limited partner, has any liability protection through the limited partnership arrangement. Ward, June, Tom, and Dick are all jointly and severally liable for the partnership. It should also be noted that Harry runs the risk of losing his limited partner status if he becomes too involved with the day-to-day operations of the business.

3.5.7.3. Corporations as Transition Tools

Much thought must go into the decision to establish a corporate entity. For the purpose of farm business transitions the discussion will be limited to C corporations and S corporations. Both entities will result in the owners receiving stock representing their ownership. A corporation will also limit the liability of all shareholders unlike a partnership. The creation of a corporation requires the filing of articles of incorporation, the creation of by-laws, and the holding of regular corporate meetings with minutes of those meetings being kept. In addition,

an annual franchise tax must be paid.

Corporate shares, whether C corporation or S corporation shares, can facilitate the transfer of the business from parents to children as well as others such as grandchildren over time. It is quite simple to transfer shares of stock to others since the signing of a share certificate accomplishes the transfer. C corporation stock can be sold, gifted, or inherited as well. Creating a sizable number of shares will make gifting easier as well as making sure that the gifts are below the annual gift tax excludable amount. Further, a large number of shares provides more flexibility to gradually increase family members' ownership over time, giving them the ability to slowly grow into more and more important roles in the corporation.

C corporation: A C corporation is taxed separately from its shareholders. This provides some advantages and disadvantages for tax purposes. One issue is the impact of "double taxation." If the corporation makes a profit, that profit is reported on the corporation's tax return at the corporation's tax rate. Then, if the corporation pays dividends and/or salaries to shareholders, those shareholders report those payments on their personal tax returns and pay tax at their personal income tax rate. Thus, payments to the shareholders effectively have been "double taxed" – once at the corporate level, and again at the individual level. Upon learning this, many people wonder why anyone would choose the C corporation form, but there are potential tax advantages to it. One of the major benefits of a C corporation is that fringe benefits such as health plans and retirement plans paid for the benefit of the employees are deductible by the corporation. To deduct these costs, the corporation must pay reasonable salaries to all employees but the salaries paid are deductible by the corporation, avoiding self-employment taxes. Thus, depending on the circumstances, the shareholders might actually receive more after-tax value by using a C corporation than an entity that is not separately taxed.

If and when the family contributes assets to the C corporation, the contribution of assets will result in the contributor receiving shares in the business. Shareholders can be given voting or non-voting shares. The voting shares can be held by those family members active in the day to day business operations (Ward, June, Tom, and Dick) and non-voting shares to the inactive members (Harry). The shares of stock then represent the ownership by the shareholders.

The contribution of property in exchange for shares of stock does not necessarily result in a taxable exchange. A taxable exchange occurs when the transferor receives shares as well as other property in the exchange. If shares are the only items received, no taxable event occurs. If everyone, as a group, that transfers assets into the corporation controls at least 80 percent of the voting stock and at least 80 percent of all other classes of stock then the basis of all the assets contributed will be the same after the transfer as the basis before the transfer which also ensures that a taxable event is avoided. It is a rare situation where the individual shareholders will not control at least 80 percent both voting and other classes of stock. This rule is most often triggered when one corporation owns another corporation; this is not common in a closely-held corporation as presented in this material.

S corporation: An S corporation avoids the double taxation issue since it is not taxed separately. All the income, expenses, gains, and losses pass through to the shareholders, who report these items on their individual tax returns. Thus, an S corporation is taxed, in effect, like a partnership. For this reason, the use of an S corporation can have an advantage over a C corporation if the business will experience periods of losses (as can happen in agriculture), since those losses can be passed along to the shareholders and deducted from their taxes.

Like a C corporation, the contribution of assets to the S corporation most often results in the contributor receiving shares of stock. However, an S corporation can only have one class of stock, which is common stock. This generally implies that all shares of stock have exactly the same rights for each of the holders. In other words, each share will receive the same distribution of profits in the corporation. Therefore there cannot be any discrimination from one shareholder to another. In our example, this might be problematic since Harry is probably playing a much different role and making different contributions to the operation and growth of the farm than Ward, June, Tom, and Dick.

This common stock can be either voting or non-voting. The voting shares can be held by family members active in the day to day business operations (Ward, June, Tom, and Dick) and the income that is generated will be subject to self-employment tax for those individuals who “materially participate” in the farm business. “Material participation” requires that the individual be actively involved in the production of crops and livestock, take a management role, and be actively involved in the business. The non-voting shares are again received by Harry and his income is not subject to self-employment tax since he is not materially participating in the business.

One issue with an S corporation is the need for more detailed bookkeeping to document each individual’s basis in their stock, document adjustments in their capital accounts, and to determine the tax liabilities associated with their distributions. This is due to the fact that S corporation income is not taxed at the corporate level. All the income, deductions, losses, and gains flow from the entity to the shareholders. The amount of losses and deductions that a shareholder can take is limited the adjusted basis of the shareholder’s stock. A variety of items will increase and decrease a shareholders basis. Therefore it is necessary to do a good job of bookkeeping because income will increase the basis while losses will decrease the basis. Basis is increased when a shareholder contributes cash or other assets to the entity. All of these must be documented and the tax information provided to all shareholders must contain this information as per IRS regulations.

Again, the contribution of property in exchange for shares of stock does not necessarily result in a taxable exchange. A taxable exchange occurs when the transferor receives other property as well as stock in the exchange. If stock is the only item received, no taxable event occurs. If everyone, as a group, that transfers assets into the corporation, controls at least 80 percent of the voting stock and at least 80 percent of all other classes of stock then the basis of all the assets contributed will be the same after the transfer as the basis before the transfer which also ensures that a taxable event is avoided (this is the same 80 percent rule as discussed with C corporations above).

3.5.7.4. LLCs as Transition Tools

As discussed above, LLCs are very flexible entities. The creators of an LLC can choose to have the entity taxed as an individual (a single member LLC also referred to as a disregarded entity),¹⁰ a partnership, or separately taxed like a C corporation. Thus, an LLC allows for a greater level of flexibility in management, control, income distribution, and taxation than either partnerships or corporations.

An LLC may be most beneficial in the transition of the farm business when it chooses to be taxed as a partnership. This avoids the double taxation issue of a C corporation, the S corporation limitations,¹¹ and compensation and income distributions can be disproportionate among the various members if they so choose. An LLC’s operating agreement can establish that each individual member can receive specific types of income or payments, receive voting or non-voting rights, and management rights can be reserved for only certain members. The operating agreement can easily be amended as the business transition progresses.

LLCs do not have stock that is issued to owners contributing property; instead, they issue membership units. As with corporations, the contribution of property to the LLC is not a taxable event so long as the member receives an ownership interest instead of receiving other property. Managing members in the LLC will be subject to self-employment taxes.

As with corporate stock, the membership units in an LLC can facilitate the transfer of the business from parents to children and grandchildren over time. It is simple to transfer a percentage of a person’s interest and also keep the value below the annual gift tax exclusion amount. The interest can also be sold, gifted, or inherited as well. Thus, as transition tools, LLCs have virtually all the advantages of corporations, with additional flexibility.

3.5.7.5 Single-Member LLCs with Land and Minerals

Land and mineral interests can present special challenges in transition planning. Since these assets

can sometimes appreciate significantly in value, the tax treatment of that appreciation is an important factor to consider. At the same time, many land and mineral owners also want to protect such assets from liability risks. The following discussion examines the use of an additional entity – the single-member LLC – to hold assets that would benefit from a step-up in fair market value at the date of death of the owner, and that also require some measure of liability protection.

Before discussing the advantages of the single-member LLC, it is useful to examine the potential problems posed by other entity forms in this context. Using a partnership, corporation, or a multi-member LLC to transfer land or minerals can “trap” the low cost basis of the assets in the entity. If there is a need or desire to sell the assets, the capital gain tax can be significant.

To illustrate the capital gain issue, assume that a 160 acre parcel that was contributed to the entity when it was created is to be sold. The fair market value is now \$2,500 per acre (for a total current fair market value of \$400,000 for the entire 160 acre parcel) and the cost basis of the parcel was \$500 per acre (for a total cost basis of \$80,000). If the property were to be sold, the amount subject to capital gain tax treatment is \$2,000 per acre (\$2,500 current fair market value per acre minus \$500 cost basis per acre) or \$320,000. If the capital gain tax rate for the partners is 20 percent, the amount of tax owed on the sale would be \$64,000.

Now, what if the contributor did not contribute the land when the entity was created, but held it until his or her death and transferred it to the entity as part of his or her estate plan? In this scenario, the property would receive a stepped-up basis to the fair market value at the date of death of the contributor. Assume that the fair market value of the land was \$2,250 per acre at the date of death; this now represents the stepped-up basis of the property. If the partners now sell the land for \$2,500 per acre (and assuming the same 20 percent capital gain tax rate), the capital gain per acre would be \$250 per acre (\$2,500 fair market value per acre minus the \$2,250 cost basis per acre). Now the total amount of tax on the gain would be \$8,000 compared to the \$64,000 without the stepped-up basis.

While holding onto the land until death allows for stepped-up basis, there may be a desire to obtain the liability protection provided by an entity like an LLC. The creation of a single-member LLC (a disregarded entity for tax purposes) allows the land to be held by the parents and still have the LLC’s liability protection. From the standpoint of both income and estate taxes, the assets put into a single member LLC are still controlled by an individual (the transferor) who pays the income tax generated from the assets and also controls them from an estate tax perspective. As a result, the property in the single-member LLC is eligible for a step-up in basis at the date of death.

3.6. Conclusion

Business entities can provide a number of advantages for a farm business, both in and of itself, and in the context of preparing the business for a transition. As this discussion has demonstrated, there are many, many factors to consider in selecting a business entity for the farm business. It is critical to determine what the goals and objectives of those that will be involved in the business as well as the other heirs. The selection of an entity should be thoroughly analyzed with the help of a qualified legal and tax professionals. With careful work, the farm business entity can help preserve the farm business for generations to come.

For More Information:

Internal Revenue Service – Business Structures

<http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Business-Structures>

Small Business Administration – Choose Your Business Structure

<https://www.sba.gov/category/navigation-structure/starting-managing-business/starting-business/choose-your-business-stru>

Small Business Taxes & Management: Choosing the Best Entity--A Practical Approach

<http://www.smbiz.com/sbfaq023.html>

Business Entities Journal

<http://store.tax.thomsonreuters.com/accounting/Finance/Business-Entities/p/100200619>

ENDNOTES

- ¹ [The other two structures are financial structure \(debt versus equity financing, discussed earlier in section 1\), and legal entity structure, discussed later in this chapter.](#)
- ² [An example of a farm resume template that outlines the approach discussed here is University of Missouri Extension Farm Management Fact Sheet G-420, “Designing a Farm Resume.”](#)
- ³ [It could be argued a sole proprietorship is not technically a business entity since it has virtually no existence apart from that of its owner. However, it is useful to contrast the sole proprietorship with the other entity forms, and thus it has been included in this discussion.](#)
- ⁴ [For limited partnership registration forms and procedures, visit the Oklahoma Secretary of State’s website at <https://www.sos.ok.gov/business/forms.aspx>.](#)
- ⁵ [“Lineal descendants” here means all of the shareholders must be descendants of the same people – for example, all the shareholders would have to be part of the same family of parents, children, grandchildren, great grandchildren, etc.](#)
- ⁶ [See National Agricultural Law Center, “Corporate Farming Laws,” available at <http://nationalaglawcenter.org/research-by-topic/corporate-farming-laws/>.](#)
- ⁷ [Owners of a portion of a corporation are referred to as “shareholders,” whereas owners of a portion of an LLC are referred to as “members.”](#)
- ⁸ [Capital gains are taxed at rates ranging from 0% to 20% depending on the tax bracket of the taxpayer, compared to rates ranging from 10% to 39.6% for ordinary income.](#)
- ⁹ [This subsection will discuss more considerations regarding land and minerals later.](#)
- ¹⁰ [For purposes of a farm transition the following discussion will not cover the single member LLC.](#)
- ¹¹ [That is, being limited to one class of stock and having no more than 100 shareholders.](#)