6 Business Organization and Tax Considerations

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Objectives

- **Present types of businesses producers may choose to own.**
- **Discuss tax and non-tax aspects of each business type.**
- **Provide information on fringe benefits for each type of entity.**
- **Direct owners to pertinent IRS publications.**
- **Present tax tips for producers.**

Choice of Business Entity

The choice of entity decision is one of the most important decisions facing individuals who own and operate businesses. There are several forms to choose from, each of which generates different legal and tax consequences. Further, there is no single form that is appropriate for every type of business owner or entity.

Choosing the appropriate form of entity to operate a business is a complex decision. It depends upon many factors, including the owners' needs and desires and the particular characteristics and needs of the businesses. The federal tax consequences of each type of entity also play an important role, especially in closely held entities where the owner's combined tax liabilities should be analyzed as part of the decision-making process.

In the typical scenario, the choice of entity decision requires a comparative assessment of these forms of business entities:

- Regular or C corporation.
- S corporation.
- Limited liability company.
- General or limited partnership.
- Sole proprietorship.

Performing this assessment requires an understanding not only of the major tax and nontax aspects of each form of business, but also how the comparative advantages and disadvantages of each relate to the needs of the individual. Generally, the decision revolves around two questions:

1. To what extent do the owners want to limit their personal liability for the debts and liabilities of the business?
2. Do the owners want the business to be taxed as a separate legal entity, or do they want the items of income, deduction, loss and credit to flow through to them?

Financial conditions or constraints may require use of one form rather than another to provide some investors with limited liability (limited partners) or vest managerial authority in others (general partners). Similarly, if the entity is expected to generate losses, a pass-through entity such as an S corporation, partnership or limited liability company might be the best vehicle to enable the owners to deduct their shares of the entity's losses on their individual tax returns. Finally, if most of the entity's earnings will be due to the efforts of owner-employees who also want to maximize the purchase of fringe benefits with pretax dollars, then use of a C corporation might be prudent because the potential for double taxation of earnings (once at the entity level and again upon distribution to shareholders) can be offset by corporate deductions for reasonable salaries.

In analyzing the choice of entity decision, it is necessary to understand the relative pros and cons of each major form of business as they might apply in the context of a specific individual. This chapter presents an entity-by-entity assessment of the following major forms of business: Regular or C corporation, S corporation, general partnership, limited partnership, limited liability company and sole proprietorship. To facilitate comparisons, the chapter's approach to each entity focuses on these issues: pros and cons as a form of business, formation and operation, transfer of interest and termination. The end of the chapter discusses tax details specific to cow-calf producers.

Regular or C Corporation

Pros and Cons as a Form of Business

The use of a C corporation as a vehicle for a business enterprise affords both the shareholder and the entity a number of benefits. Perhaps the most significant nontax advantage of a C corporation is its limited liability protection for shareholders. Absent an agreement to the contrary, such as a loan guarantee, C corporation shareholders generally are not personally liable for the corporation's obligations.

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In addition to the limited liability afforded shareholders, another benefit of C corporations is that they do not have restrictions on the types of shareholders they may have. Unlike other entities, a C corporation's shareholders may include individuals, corporations, trusts and partnerships. This ability to attract a variety of investors gives taxpayers a great deal of flexibility in forming a C corporation. This flexibility is enhanced by the fact that there are generally no limits on the number of shareholders a C corporation may have or on the type of business it may conduct.

Of all the forms of business organization, a C corporation gives taxpayers the greatest freedom with regard to the transfer of equity interests. Absent contractual restrictions on share transfers, a C corporation shareholder can transfer their interest by merely selling or transferring the stock. This transaction generally has no effect on the corporate entity or other shareholders. Further, because the transfer does not directly involve the corporation, it is not a taxable event with regard to the corporation.

Although a C corporation provides protection and flexibility, its tax consequences are not entirely favorable. Because a C corporation is a separate entity for tax purposes, items of income, loss, deduction and credit are accounted for at the corporate level. For profitable corporations, this means earnings can be taxed twice: once at the corporate level when earned and again at the shareholder level when distributed. Double taxation also can result upon liquidation of the corporation because the corporation is taxed on any gain on the distribution or sale of corporate assets and shareholders are taxed on the receipt of money or other property in exchange for their stock. For an unprofitable corporation, the C corporation is a separate taxable entity, which means that ongoing operating losses are trapped at the corporate level and do not flow through to shareholders.

Another disadvantage of C (and S) corporations as compared to partnerships and limited liability companies is that such corporations do not permit special allocations of tax benefits to owners. In the partnership setting, such allocations often are incentives for individuals to inject additional capital into an ongoing enterprise. A final potential disadvantage of C corporations is that, unlike less formal forms of business, the C corporation is subject to a number of rules and restrictions with regard to its operation. It is also subject to closer supervision by regulatory bodies than other entity forms, thus its operation may result in greater administrative and compliance expenses than other forms of business.

Formation and Operation

A C corporation is a creature of state statute and, as such, is subject to a number of formal requirements. To form a C corporation, the shareholders generally must file a written corporate charter or articles of incorporation with the state in which it is incorporated, adopt written bylaws, elect a board of directors and hold an organizational as well annual business meetings.

Ownership of a C corporation is through the issuance of shares of stock. C corporations generally are not restricted with regard to the type or amount of stock they may issue. The most common types of stock issued by a C corporation are common and preferred. Common stock normally carries with it voting rights and the greatest potential for appreciation or depreciation in value. In contrast, preferred stock generally has limited or no voting rights but has preferences over common stock regarding payment of dividends and/or liquidating distributions. Because a C corporation may issue different types of stock with different rights associated with each, a C corporation affords taxpayers a great deal of flexibility in its structure and in raising capital.

In general, the act of incorporating is not a taxable event to either the corporation or the shareholders as long as these conditions are met: the shareholders transfer property to the corporation; the transfer is solely in exchange for the stock of the corporation, other than nonqualified preferred stock (see below); and immediately after the transfer, the transferors are in control of the corporation. Thus, it is possible for a taxpayer to transfer appreciated property to the corporation and, provided the above requirements are met, put the asset to use in the corporation yet defer recognition of gain. Conversely, however, since the nonrecognition treatment applies to losses as well as gains, and its application is mandatory, taxpayers ordinarily should not transfer depreciated assets to the corporation because they would be prevented from recognizing a loss on the transfer.

There are three important exceptions to non-recognition treatment:

1. A transferor who receives boot, anything other than stock in the corporation, or nonqualified preferred stock that does not count as stock for purposes of nonrecognition of gain in the exchange must recognize gain equal to the sum of the amount of money received and the fair market value of other property received.
2. A transferor who receives stock in exchange for services must recognize gain because services are not considered property for this purpose.
3. A transferor must recognize gain to the extent that aggregate liabilities of the transferor assumed by the corporation exceed the aggregate basis of assets the transferor transfers to the corporation.

A recourse liability of the transferor has been assumed by the corporation if the corporation agrees and is expected to pay it. The corporation is treated as having assumed a nonrecourse liability if property subject to such a liability is transferred to the corporation.

Note: In general, nonqualified preferred stock is preferred stock that resembles debt, because of a right to purchase it or have it purchased within 20 years, or because of a dividend that tracks interest rates or another index which is likely to have a fixed maturity or reduced risk.

If nonrecognition applies, a shareholder takes a basis in the stock received equal to the basis in the property transferred. If, however, boot is received in the transfer, the shareholder's tax in their stock is reduced by the amount of boot received and increased by the amount of gain recognized on the transfer. The purpose of the latter adjustment is to

prevent double taxation later, such as when the taxpayer sells the stock. The shareholder's basis also is reduced by the amount of liability the corporation is subject to or assumes.

The corporation's basis is computed in a similar fashion. Specifically, the corporation takes a carryover basis in the property received increased by any gain recognized.

Corporations are managed by a board of directors and officers. The president normally controls day-to-day operations, leaving major nonoperating decisions to the board. As a rule, shareholders (in their capacity as such) are not involved in the management of the corporation although certain actions such as mergers require shareholder approval. Often, in closely held corporations, the shareholders also serve as corporate officers and/or board members.

Transfer of Interest

Of all the forms of business, a C corporation offers its shareholders the most flexibility with regard to the transfer of interests. A shareholder's interest in the corporation is manifested by ownership of shares. Thus, a shareholder can transfer this interest simply by selling or otherwise transferring the shares. There is no need for the shareholder or the corporation to worry about the logistics of transferring title to the corporation's underlying assets. Further, the sale of a shareholder's shares has no tax consequences to the corporation. Any and all tax consequences of the transaction are borne by the shareholder; the latter must recognize gain equal to the excess of the amount received over the basis in the stock.

Generally, the transferability of a shareholder's interest is not restricted by the corporation. However, in the case of a closely held corporation, transferability often is restricted through the use of an option, right of first refusal or a shareholder agreement.

Termination

Termination of a C corporation refers to the liquidation and dissolution of the entity. Because this is an organic act, the corporation's decision to terminate requires shareholder approval, and in most cases, requires the filing of articles of dissolution or other documentation, depending upon the state statutory requirements.

A strict hierarchy usually governs distribution of the assets of a corporation in liquidation. Generally, the distribution order is: secured creditors, unsecured creditors, preferred shareholders and finally, common shareholders.

Liquidation is generally a taxable event for both the corporation and the shareholders. The corporation recognizes gain or loss on the liquidating distribution as if the distributed property was sold to the shareholders at fair market value. Thus, the corporation recognizes gain or loss in the amount equal to the difference between its basis in the distributed property and the amount realized on the distribution. Similarly, a shareholder recognizes gain or loss equal to the difference between the value of received property and their basis in the corporation's stock.

S Corporation

Pros and Cons as a Form of Business

An S corporation is essentially identical to a C corporation in the way it functions and with regard to the nontax consequences of doing business in corporate form. For example, it offers investors limited liability and its operation and structure employ a board of directors with officers and shareholders in a manner similar to a C corporation.

S corporations differ dramatically from C corporations with regard to tax matters. Unlike a C corporation, an S corporation is a flow-through entity. As such, the corporation essentially acts as a conduit through which items of tax attributes flow pro rata to shareholders. Double taxation of corporate earnings is avoided because there generally is no corporate-level income tax. Instead, earnings are taxed once at the shareholder level when earned, regardless of when they are distributed.

Example: A C corporation and an S corporation both have $100,000 of taxable income in year one (2020). C's $100,000 is reduced $22,250 by the corporate-level income tax, leaving $77,750 to distribute to shareholders. If C distributes the $77,250 as a dividend to shareholders in the 22% bracket, the latter pays $11,587.50 (qualified dividends taxed at a maximum of 15%) in income tax. As a result of this double tax, C's owners take home $66,162.50 ($100,000 minus $33,837.50). In contrast, S's taxable income flows through to its shareholders and there is no entity-level tax. Thus, if the shareholders are in the 22% bracket, they take home $86,420, which is $20,257.50 more than C's owners.

Thus, an S corporation often is a preferred choice of entity because of the single level of tax and the ability to limit personal liability of shareholders. Furthermore, for startup corporations expected to generate losses in the early years, use of the S corporation often is preferable to a C corporation because losses from an S corporation flow through to shareholders and can be used to offset other income of the shareholders or their spouses.

Despite its advantages, the S corporation is limited in use because of the restrictions imposed on such entities by the Internal Revenue Code. Unlike a C corporation, an S corporation has limits on the number and types of permissible shareholders. For example, it cannot have more than 100 shareholders; issue more than one class of stock; or have corporations, partnerships, nonresident aliens and most types of trusts as shareholders. These restrictions, in turn, limit the transferability of shareholder interests in the corporation since a transfer to an ineligible shareholder would cause the S corporation to lose its S status. Thus, while an S corporation has distinct tax advantages over a C corporation, many enterprises may not be able to qualify for its use.

Formation and Operation

Like a C corporation, the formation of an S corporation generally requires the filing of a written corporate charter or articles of incorporation, adoption of written bylaws,

election of a board of directors and the holding of an organizational meeting. The contents and requirements regarding these items are dictated by state statute.

Unlike a C corporation, an S corporation faces significant restrictions regarding the number and type of shareholders it can have. To qualify as an S corporation, the enterprise must meet the following tests:

1. It can have only one class of stock (the stock may, however, carry different voting rights).
2. The shareholders may only be individuals, estates and certain trusts (corporations, partnerships, many trusts and nonresident aliens may not be shareholders).
3. It must have no more than 100 shareholders.
4. It must not be an ineligible corporation (defined as certain financial institutions, insurance companies and Domestic International Sales Corporations).

Note: Qualified retirement plan trusts and certain charitable organizations may be shareholders in S corporations.

In addition to these restrictions, if a C corporation seeks S status, the shareholders must consent to the S corporation election. This election must be filed with the IRS by day 15 of the third month of the taxable year in which the election is to take effect. If the election is filed after such date, S corporation status takes effect at the beginning of the following taxable year.

The formation of an S corporation, or the conversion of a C corporation to S corporation status, is generally a nontaxable event. However, the conversion of a C corporation with appreciated assets to an S corporation may result in taxation on the built-in gain relating to the assets, measured on the conversion date, if the assets are disposed of within 10 years from the first day the entity is an S corporation.

The operation of an S corporation is similar to that of a C corporation. An elected board of directors and officers manage and control the corporation. Day-to-day decisions are made by the president, and organic decisions, such as the termination of the S corporation, are subject to shareholder approval. Although these entities are similar in management, the results of their activities are taxed very differently from each other.

The taxation of an S corporation is similar to that of a partnership in that both entities pass through their tax attributes, items of income, loss, deduction and credit to their owners. Consistent with this principle, items retain the same character at the shareholder level as at the entity level. Thus, for example, if the corporation's sale of an asset generates capital gain, the character of that gain is capital when it flows through to the shareholders.

Generally, an S corporation that has always been an S corporation pays no entity-level tax. The same treatment applies to C corporations that convert to S status with two exceptions. First, if a former C corporation had appreciated assets when it converted to S status and disposes of those assets within 10 years after its first day as an S corporation, the corporation pays a tax (using the highest corporate rate) on the built-in gains. Second, an S corporation with accumulated earnings and profits from C corporation years may be liable for a corporate-level tax if it has excessive passive investment income.

The tax treatment of nonliquidating S corporation distributions to shareholders differs markedly from, and is more favorable than, the treatment of similar C corporation distributions. A C corporation distribution, if made with respect to the corporation's stock, is ordinarily a dividend to the extent of corporate earnings and profits. Thus, individual shareholders must report it as ordinary income and the corporate distributee cannot deduct the payment. Conversely, such distributions from S corporations get favorable treatment. There is no corporate-level tax, and the distribution is nontaxable to the shareholder to the extent of the recipient's basis in their stock. The amount of the distribution reduces the shareholder's stock basis dollar for dollar until the latter reaches zero. To the extent a distribution exceeds a shareholder's stock basis, it is generally treated as capital gain. Further, when an S corporation shareholder receives proceeds in a redemption that is characterized as a distribution, the entire redemption is treated as a distribution that reduces the corporation's accumulated adjustments account (AAA).

In the case of pass-through items that are not distributions, the shareholder's basis is increased for income items and decreased for loss and deduction items. Losses are deductible by shareholders only to the extent of their basis in the stock and debt owed the shareholder by the corporation. However, the disallowance of a loss deduction in one year may be carried over into subsequent years and later deducted if the shareholder's basis in the stock or debt increases.

Transfer of Interest

Absent restrictions on share transfers, an S corporation shareholder, like a C corporation shareholder, is free to transfer their stock interest to anyone. However, the S corporation shareholder can inadvertently cause the entity to lose its S status by transferring stock to an ineligible shareholder such as another corporation, a partnership or a nonresident alien.

Planning Pointer: Due to the pass-through nature of an S corporation, a shareholder who wishes to sell or otherwise transfer their stock should give careful consideration to the timing of the transfer. As a general rule, a shareholder must report their share of corporation income, losses, deductions and credits for a given year based on the number of days the shareholder owned stock during the year. Thus, without careful planning, it is possible for a shareholder to recognize income under flow-through principles even though the corporation distributes the cash relating to the income after the date the shareholder sells the shares. However, a shareholder's basis in the stock is increased by their share of income, thus reducing gain or increasing loss on a sale of the stock.

Termination

In the context of S corporations, the word termination usually refers to loss of an entity's S status, not to a liquidation of the corporation. An S corporation will lose its

S status, and thus be taxed as a C corporation, if any one of these events occur:

- The shareholders affirmatively revoke the S election.
- The entity fails to meet eligibility requirements, for example, by transferring stock to an ineligible shareholder.
- The entity has passive investment income in excess of the permissible amount for three years and has Subchapter C earnings and profits.

When an S corporation liquidates, in contrast to when a C corporation liquidates, there is only one level of tax. The shareholders recognize gain to the extent their share of the liquidating distribution(s) exceeds their stock basis. However, if the S corporation has appreciated property, the gain becomes taxable to the shareholders but increases their stock basis. This results in the liquidating distribution producing far less taxable gain to the shareholders than a comparable liquidation of a C corporation.

General Partnership

Pros and Cons as a Form of Business

A general partnership provides taxpayers seeking a vehicle for their enterprise with the least costly and simplest choice. A partnership is a noncorporate entity comprised of two or more owners. Unlike a corporation, it requires no formalities to exist. Further, there is generally no limit on the type or number of owners in a partnership. However, unlike a C or S corporation, partners in a general partnership are personally liable for the partnership's obligations. This is the primary nontax disadvantage to general partnerships.

General partnerships are pass-through entities, and while the partnership must file an information return and characterize certain tax items at the partnership level, the partners, not the entity, deduct partnership losses on their income tax returns. Further, the use of a partnership avoids the earnings double taxation problem found in C corporations.

A general partnership also is preferable over other business forms because of the flexibility in the composition of the partnership and the fact that tax benefits can be specially allocated to specific partners.

However, unlike C and S corporations, the transferability of a partner's interest in a partnership is greatly restricted. For example, a partnership terminates for federal tax purposes if, within a 12-month period, there is a sale or exchange of at least 50% of the total interest in partnership capital and profits.

Formation and Operation

A partnership generally is formed by at least two people owning equity interests in an enterprise to be conducted with the intent of making a profit. Unlike an S or C corporation, the formation of a general partnership does not necessarily require the filing of formal documents. A partnership generally is deemed to exist when the parties' conduct evidences intent to engage in business as a partnership. Although not required, written documentation is a good idea. Like the formation of a C or S corporation, the formation of a partnership is usually a tax-free event to the entity and its owners. No gain or loss is recognized upon the contribution of property to a partnership in exchange for a partnership interest. However, if a party transfers services to the partnership in exchange for a partnership interest, the partner must recognize income to the extent of the value of the partnership interest received.

An individual receiving an interest in the partnership takes a basis in the interest equal to the basis of the asset contributed to the partnership. Similarly, the partnership takes a basis in the property received equal to the contributing partner's basis in the asset.

If the contributed asset is subject to a liability at the time of contribution, the liability allocated to other partners is treated as a cash distribution to the contributing partner. This distribution reduces the contributing partner's basis in the partnership interest dollar for dollar, but the other partners' bases are increased by the amount of the liability allocated to them. Although the contribution of an asset does not, by itself, cause gain to be recognized, if the amount of the liability allocated to the noncontributing partners exceeds the contributing partner's basis in the partnership, the excess is taxable as capital gain to the contributing partner.

A partnership is governed by a written or oral partnership agreement. Unlike a C or S corporation, this agreement can contain whatever terms the partners agree upon, providing they fall within any restrictions imposed by state law. Many partnership agreements, however, do not cover all of the issues regarding operation of a partnership. In such cases, the provisions of the state's version of the Uniform Partnership Act (UPA) will govern with respect to these issues.

Generally, a partner in a general partnership may participate in the management of the partnership to whatever extent allowed by the partnership agreement. Day-to-day management often is vested in either the managing partner or a committee. Many decisions, however, require a majority vote by partners, and in the case of organic acts, such as the admission of new partners or liquidation, unanimous consent may be necessary.

Because the partnership is a pass-through entity, all items of income, deduction, loss and credit pass through the entity to the partners and are allocated in accordance with the partnership agreement. Any item that passes through the entity retains its tax character in the hands of the partner. A partner's share of these items is called the partner's distributive share, even though these items are not actually distributed.

As a general rule, a partnership recognizes no entity-level gain or loss on a nonliquidating distribution of property or money to a partner. The distributee partner recognizes no gain as well, except to the extent that the amount of money distributed exceeds the partner's basis in their partnership interest immediately before the distribution, in which case, the excess is treated as capital gain. A distributee partner who receives property other than money in a nonliquidating distribution recognizes no gain. Instead, the distribution

reduces the partner's basis in their partnership interest by the partnership's basis in the asset immediately before the distribution.

Example: Marc, a 25% partner, has a basis in his partnership interest of $60,000. The partnership distributes to Marc $25,000 in cash plus a vacant lot of real estate worth $30,000 (in which the partnership's adjusted basis is $20,000). Marc recognizes no gain; instead, he takes a carryover basis in the lot of $20,000 but must reduce the basis in his partnership interest by $45,000 ($25,000 + $20,000).

To prevent double recognition of gain or loss, a partner's basis in their partnership interest is increased or decreased, as the case may be, to account for items that flow through the partnership and for distributions made by the partnership. For example, a partner's basis is decreased by the amount of losses or deductions passed through and increased by income items.

Transfer of Interest

One of the biggest drawbacks to using the general partnership as a choice of entity is the limitations on the transferability of a partnership interest. A partner may transfer their economic interest in the partnership without restriction. However, a transfer of this nature only entitles the recipient to the economic rights of the assigning partner. If, however, a partner wishes to transfer their entire interest to a third party, the transfer will be subject to substantial restrictions.

Generally, a transfer of a partnership interest as a whole requires the unanimous consent of the partners unless the partnership agreement provides otherwise. If a partner gains permission to sell their interest, the sale generally produces a capital gain or loss measured by the difference between the amount realized and the selling partner's basis in the partnership. However, the amount of gain, if any, attributable to unrealized receivables or inventory is ordinary income.

A partner acquiring a transferred interest will generally pay a price that is roughly equal to a proportionate share of the value of partnership assets. This value may be higher than the transferring partner's actual basis in the assets. Thus, if the partnership later sells an appreciated asset for its fair market value (FMV), part of the gain is taxable to the incoming partner. This can be a somewhat harsh result because the incoming partner paid full FMV for the partnership interest, thus did not reap any real economic gain with respect to the asset. To minimize this problem, the partnership can elect to step up the basis of partnership assets with respect to the incoming partner.

If the new partner is admitted to a partnership with outstanding liabilities, the existing partners may recognize income. Specifically, the admission of a new partner may result in a constructive distribution of cash. In addition, the admission may result in the constructive sale of the existing partners' interests in the partnership's unrealized receivables and substantially appreciated assets.

Termination

Technically, a general partnership has no continuity of life. It dissolves for nontax purposes when a partner ceases to be associated with the partnership. This can occur, for example, when the partner withdraws, dies, becomes bankrupt or gets expelled. Generally, a practical solution to this problem is to put a provision in the partnership agreement providing that, upon the happening of certain events of dissolution, the remaining partners may continue the business and succeed to its assets and liabilities.

For tax purposes, a partnership terminates only when at least one of the following occurs:

- No part of the business is carried on by any of the partners in a partnership (in other words, a total cessation of business).
- Within a 12-month period, there are sales or exchanges totaling 50% or more of the total interest in the partnership capital or profits.

When a partnership is liquidated, distributions to a partner usually consist of interests in partnership assets. As with nonliquidating distributions, the tax consequences depend on the type of assets distributed and the partner's basis in their partnership interest before the distributions. Cash distributed reduces the partner's basis in their partnership interest dollar for dollar. Any basis remaining is allocated first to the partner's share of unrealized receivables and inventory based on the partnership's basis in each and then to any other assets distributed based on the partnership's basis in each. If the partnership continues business after a termination resulting from sales aggregating 50% or more of the partnership interest in capital and profits within one year, the partnership is treated as a new partnership for tax purposes. The old partnership's taxable year, accounting method, depreciation allowance and other elections do not carry over to the new partnership.

Limited Partnership

Pros and Cons as a Form of Business

A limited partnership offers the benefit of a partnership with the liability protection of a corporation. Like a corporate shareholder, limited partners in a limited partnership are not personally liable for the obligations of the partnership; instead, their liability is limited to their financial investment in the enterprise. The only members of a limited partnership who remain personally liable are the general partners and possibly limited partners who participate in management. In addition, limited partnerships are pass-through entities with no restrictions on the number or types of partners who may participate.

In some cases, use of a limited partnership might be preferable to a C corporation because the former has no entity-level tax. Thus, in contrast to a C corporation, its earnings are only taxed once—in the partners' hands based on their respective distributive shares.

A major drawback to limited partnerships is the inability of the limited partners to participate in the management of

the partnership in any significant manner. A limited partner who participates can lose the benefit of limited liability. Because of this prohibition, a limited partner ordinarily may not vote on issues affecting the partnership's ordinary course of business.

Another drawback is that the limited partners are subject to the passive loss rules. This severely restricts their ability to benefit from the tax credits and losses the entity may generate. For this reason, from an investor's perspective, the limited partnership may be a poor choice if the goal is to use the entity's losses to shelter other income.

Formation and Operation

Unlike a general partnership, which does not require formal documentation to exist, a limited partnership is a creature of state statute. The formation of a limited partnership generally requires the filing of a certificate of limited partnership and a partnership agreement. These must comply with the relevant state statutes and be filed pursuant to the state's version of the Uniform Limited Partnership Act (ULPA).

A limited partnership is formed by one or more parties with at least one designated as the general partner. The general partners remain personally liable for the obligations of the partnership and generally manage partnership operations. A corporation, as well as an individual, may be a general partner. The remaining participants are those who wish to participate in the partnership as inactive investors. These are the limited partners.

A limited partnership operates in a manner similar to that of a general partnership except that the general partner makes all the decisions regarding management of the partnership. Limited partners may not participate in the management of the partnership without losing their limited liability. With regard to federal taxation, limited partnerships afford its general partners the same tax treatment as general partnerships discussed above. However, limited partners are subject to special rules.

Transfer of Interests

Like a general partnership, a limited partner has an unrestricted right to transfer their economic interest in the partnership. The substituted partner acquires the right to receive the assigning limited partner's share of the profits and assets upon dissolution. A limited partner cannot assign their interest in the partnership as a whole without unanimous consent of the partners or a provision allowing assignment of all of a partner's rights in the limited partnership agreement.

Termination

Generally, the death, withdrawal or assignment of a limited partner's interest will not cause dissolution of the partnership. However, the death, withdrawal or incapacity of the general partner will dissolve the limited partnership for nontax purposes, unless a provision is included in the partnership agreement or unanimous consent is given for the business to continue.

As discussed above, the rules for terminating a limited partnership for tax purposes are the same as those for terminating a general partnership.

Limited Liability Company

Pros and Cons as a Form of Business

A limited liability company (LLC) is a hybrid entity: it is treated like a corporation for limited liability purposes, but for tax purposes it may be treated like a partnership. Like C corporations and limited partnerships, LLCs afford members limited liability. However, unlike a limited partnership, a member of an LLC can participate in day-to-day management without losing limited liability. Equally important, an LLC, like an S corporation and a partnership, is subject to only one level of taxation if properly structured. However, unlike an S corporation, there are no restrictions on the type or number of members and the tax rules are arguably less burdensome.

Despite all of the positive tax and nontax aspects of LLCs, there are some drawbacks. Because LLCs are creatures of state statute, the legislation establishing and regulating these entities varies from state to state. This lack of uniformity results in some unresolved tax and nontax issues. In addition, an LLC, like a partnership, must meet certain characteristic requirements to receive pass through tax treatment. Some LLCs may be deemed to possess a sufficient number of corporate characteristics to be taxed as a corporation. However, others will be considered to possess less than the requisite amount of characteristics necessary to be taxed as a corporation, thus will be taxed as a partnership.

With regard to nontax issues, the lack of uniformity presents some questions as to the treatment of LLCs in states whose provisions differ. Specifically, the uncertainty centers on whether there is a risk of personal liability in states that impose limits that are not imposed by the entity's state of incorporation.

Formation and Operation

The state statute in the jurisdiction of organization dictates the requirements regarding the formation of an LLC. However, as a general rule, members or their representative must file Articles of Organization with the state. These documents usually include the name of the company, a provision addressing the duration of the enterprise, a provision addressing the membership and new members, a statement of business purpose, management provisions and a provision with regard to the regulation of internal affairs.

Because an LLC is usually taxed as a partnership, a contribution of property to the LLC in exchange for a membership interest ordinarily will not result in the recognition of gain or loss. However, like partnerships, if the member contributes services, nonrecognition does not apply and the member will recognize income equal to the value of the interest received. The member's basis in their interest in LLC is equal to the basis of the asset contributed, increased by any gain recognized on the transfer.

Most state LLC statutes require distributions by the company be made in accordance with the Operating Agreement or, if there is no provision provided, on the basis of the value of the member contributions. Because members are taxed as partners, they generally do not recognize gain or loss on distributions, but reduce their basis accordingly. Further, like a partnership, items of the company's profit and loss may be specially allocated among members. These allocations should also be set forth in the Operating Agreement.

Transfer of Interest

Like a partnership, the transfer of a member's interest in an LLC is usually subject to substantial restrictions. Specifically, a member who wants to transfer their interest as a whole, which includes economic, management participation rights and voting rights, may have to receive unanimous consent from the other members. The only interest a member may transfer without their fellow members' consent is their economic interest in the company.

Like a partner in a partnership, if a member is successful in transferring their interest, the sale generally produces a capital gain or loss, except to the extent the interest represented unrealized receivables or substantially appreciated inventory measured by the difference between the amount realized and the member's basis in the company.

Termination

Like all other aspects of LLCs, state statutes dictate the situations in which a company is considered terminated. However, as a general rule, an LLC will automatically dissolve upon the death, retirement, resignation, expulsion, bankruptcy, dissolution of a member or upon the occurrence of any other event terminating the membership of a member in the company. Further, some states limit an LLCs duration to a specified number of years. An involuntary dissolution may occur upon the application of one member to do so. Despite these methods of termination, in some states, the members of the company may elect to continue the business upon a terminating event if the Articles of Organization provide for such a right.

If an LLC is treated as a partnership for tax purposes, then the tax consequences stemming from its termination are identical to those associated with the termination of a partnership.

Sole Proprietorships

Use of this business form is the simplest noncorporate method. It requires no documentation with regard to its formation. To be considered a sole proprietor, a party must merely commence business. The simplicity involved in forming this type of business is its primary advantage over other business forms.

Unlike other entities, the operation of a sole proprietorship is vested solely in the business operator. However, because the business and its owner are a single legal entity, the owner is personally liable for the debts and other liabilities of the business. Thus, as a practical matter, practitioners representing sole proprietors should work with the owner to attempt to procure enough liability insurance to minimize the prospect that personal assets could be forfeited to satisfy business liabilities.

Formation of a sole proprietorship is not a taxable event. Thereafter, all tax attributes of the business are reported on the owner's individual return.

The transfer of a sole proprietorship is accomplished by simply selling the assets used in the business. Thus, while termination of the business is not, by itself a taxable event, the owner must recognize gain on each asset sale to the extent the amount realized exceeds the owner's basis in the asset. Characterization of gain or loss is determined separately for each asset.

Fringe Benefits

C Corporation

When a corporation provides a fringe benefit, such as medical insurance to an employee, the best result occurs when the corporation can deduct its cost and the employee does not have to include the value of the item in income. In this situation, the employer realizes a tax benefit and there is no offsetting tax cost to the employee.

Tax codes provide for a significant number of benefits not taxable to the employee, but deductible by the corporation if the compensation can be characterized as an ordinary and necessary expense. The most significant of these is the payment of premiums for health insurance. Others include the cost of providing up to $50,000 of group term life insurance, payments for injuries or sickness directly paid by the employer and meals or lodging furnished for the convenience of the employer. In addition, the employer may set up a cafeteria plan under which the employee can choose from among a variety of taxable and nontaxable benefits and cash. In each case, the fringe benefit qualifies for favorable tax treatment only if various statutory requirements are satisfied.

Contributions to a qualified pension plan also receive favorable tax treatment. The employer generally is entitled to an immediate deduction, but the employee does not have to include the item in income until received in a subsequent year. Qualification of a plan is complicated, but provides substantial tax benefits.

Planning Pointer: Individuals should be aware that the tax treatment of fringe benefits such as medical insurance is not as favorable if a partnership, LLC that is taxed as a partnership, or S corporation, rather than a C corporation, is carrying on the business. The favorable treatment of fringe benefits can be an important reason for using a C corporation. On the other hand, the rules for a qualified pension plan are substantially the same for all the entities.

Partnership and S Corporation

As discussed, C corporations can deduct the cost of various employee benefits and the employees do not have to include the value of these benefits in income.

This favorable tax treatment generally does not apply to partnerships. Furthermore, for purposes of determining the tax consequences with regard to employee fringe benefits, a 2% shareholder of an S corporation is treated as a partner of a partnership. A 2% shareholder is defined as any person who owns (directly or by attribution) more than 2% of the corporation's outstanding stock or more than 2% of the voting power on any day during the year. Consequently, a partnership or S corporation can deduct the cost of the benefit, but the partner or employee-shareholder must include the value of the benefit in income.

Note: Partners of more than 2% shareholders of S corporations, and sole proprietors are allowed to deduct up to 100% of the cost of medical insurance to the extent of any income from the business that maintains the plan providing the insurance.

In the case of qualified pension plans, an entity can deduct amounts contributed to the plan on behalf of employees. Further, the employee recognizes income only upon its actual receipt. The rules for a plan established by an S corporation, partnership or sole proprietorship are generally the same as those for plans established by C corporations. Thus, a deduction is allowed for a contribution to a qualified plan, and the beneficiary, which may include the S corporation shareholder, partner or sole proprietor, recognizes income only upon receipt of the benefit. Because the rules with regard to these plans are so similar, pension plans seldom affect the choice of entity decision.

Limited Liability Company

An LLC may be classified for tax purposes as either a partnership or as an association taxable as a corporation. Tax treatment of fringe benefits are furnished by an LLC, therefore, should depend on proper classification of the LLC.

Oklahoma Law

Oklahoma law and federal tax elections yield essentially a choice between two entities: sole proprietorships and limited liability companies. Unlike a C or S corporation, a limited liability company is not subject to franchise tax. After a limited liability company is established in Oklahoma, the Internal Revenue Code allows that limited liability company to elect to be taxed as a C corporation and then, if desired, it can change the election to be taxed as an S corporation.

Tax Issues and Tips

Not carefully deciding what type of business entity to create and not taking care of business has doomed more cattle ranches than drought or cattle prices. If labor is hired, ranchers must comply with Internal Revenue Service, Social Security Administration, Department of Immigration and Labor as well as state and local taxing authorities. Payroll taxes, self-employment tax and the possibility of having a ranch declared a hobby are the most likely problems for new and existing ranchers, especially if they have formed a sole proprietorship or a partnership. IRS Publication 225, Farmer's Tax Guide, is an excellent reference, which explains many of the income tax rules that apply to farmers and ranchers.

Payroll Taxes

If an employee is paid more than $150 per year or total payments to all employees exceed $2,500 per year, the ranch business must get a federal ID number and report payroll taxes. A Taxpayer Identification Number (TIN) can be obtained by filing form SS-4 with the district Internal Revenue Service center. Federal and State income tax and Social Security and Medicare taxes must be withheld and deposited. Forms W-2, W-3 and 943 must be filed by Jan. 31 for the previous calendar year. See IRS Publication 51, Circular A, Agricultural Employer's Guide for complete details.

Self-Employment Tax

Individuals who are employed by a company should receive a W-2 Form stating their wages and withholdings. Based on a W-4 withholding form, employers withhold income tax for each employee and pay the withholding to state and federal tax authorities. Individuals who are in business for themselves must report income and expenses from that business on IRS Schedule C or Schedule F if the net income is at least $433.13. This net income is subject to 15.3% self-employment tax up to the maximum for 2020 of $137,700. Net income above that level is subject to only Medicare taxes of 2.9% without limit. These self-employment taxes are in addition to income tax due when net income from self-employment is combined with the individual's income from other sources on Form 1040. Self-employed individuals also must make quarterly deposits of estimated income tax to avoid tax penalties. If more than 2/3 of total gross income from all sources is from farming or ranching, quarterly estimated tax payments are not required if the individual's tax return is filed by March 1. Please refer to IRS Publication 533, Self-Employment Tax for complete details.

Hobby Loss

An often misunderstood area of taxation causing worry to the taxpayer involved in a business is the hobby loss, which is to deduct expenses in excess of income for a given venture, one must be engaged in that venture for a profit. These rules were originally developed by Congress to set up an objective standard to determine whether a taxpayer has a legitimate business operation or is merely attempting to generate tax losses to offset other income. If there is no intent to make a profit, IRS assumes that the activity is a hobby and will disallow the deductions in excess of income. The general test to measure the profit motive is whether the activity has generated a profit in any three out of five consecutive tax years. If the activity deals with breeding, training, showing or racing horses, the test is any two out of seven years. For the struggling rancher whose business venture is not showing a profit, the worry that the IRS will disallow all deductions can be stressful. More information is available to help the taxpayer in this situation. Once the business has failed to show a profit in three out of five (or two

out of seven) years, the IRS may look at the business. This does not automatically mean that the IRS will, only that they might. In addition, the test does not automatically determine whether a business should be considered a hobby, only that the IRS can look at it. The actual decision of whether a business has been operated with a profit motive is based on all facts and circumstances. Nine factors are set forth in IRS regulations to be used as a guideline. These relevant factors are used only as a guideline – no one factor or group of factors determines the outcome. It is a subjective judgment call where all facts are taken into account. However, taxpayers can protect themselves by being aware of these nine factors and using them as a guideline. Most importantly, taxpayers can further protect themselves by keeping good records to document actions that indicate a profit motive based on the following nine factors:

1. **Is the activity carried on in a businesslike manner?** If the taxpayer keeps businesslike books and records, changes methods of operation that are not working, tries to use techniques of profit-making ventures to increase efficiency and profitability or even abandons a business venture that is going nowhere, the profit motive may be indicated.
2. **Can the producer take advice? What is the expertise of the taxpayer or their advisers?** The taxpayer should be able to show that they have studied the accepted practices of the venture—in this case, ranching—and/or has sought advice from experts in the field. This may include reading books, taking classes, paying advisers and taking their advice. If the producer has gotten advice and information and has operated in a completely different manner, they should be prepared to explain attempts to develop new practices, which could result in profit.
3. **Is the taxpayer spending any time here? How much time and effort is expended by the taxpayer?** If the producer is spending significant personal time and effort on the activity, it can indicate a profit motive. Employing competent persons to run the activity for the taxpayer also may indicate profit motive.
4. **Does anything have value? Are the assets expected to appreciate in value?** Overall profit could be reasonably expected from increase in value of land, cattle or other assets even if operations of the business are not showing a current profit.
5. **Has the taxpayer been profitable in carrying on this or similar activities in the past?** If the taxpayer has carried on similar activities in the past and turned them from unprofitable to profitable, a profit motive could be assumed.
6. **What is the history of income or loss?** Are losses mainly a start-up situation or have they been sustained beyond a reasonable length of time? If there have been unforeseen circumstances beyond the taxpayer's control such as drought, fire, theft, war, depressed market conditions, etc., the reasonable length of time for loss could be extended. Again, very good records would help back up this type of claim.
7. **Has the operation made any money?** What is the amount of profit, if any, that has been earned? The occasional small profit from a venture offset by persistent high losses would probably indicate that there is no profit motive. A solid profit, though infrequent, or a reasonable opportunity to achieve an eventual profit, might back up the taxpayer's profit motive.
8. **Is the taxpayer making any money doing anything else? What is the financial status of the taxpayer?** If there is no substantial income from other sources, it is a good bet that the activity is meant to generate a profit. However, the presence of other income, especially during the startup period of a venture, only shows good planning and would not necessarily negate the profit motive.
9. **The presence of personal pleasure or recreation in an activity has often been used by the IRS to claim that an activity is a hobby.** However, the other factors mentioned in this list also are taken into consideration by the courts. The fact that a person enjoys a business is not sufficient cause to disallow the profit-making motive.

If taxpayers choose to engage in beef production for a profit, they must keep good records. If producers take a class related to the business, consult with an accountant or business expert or buy a book, they must keep the receipts. If producers have taken advice and changed a method of operation to improve efficiency, they must write it down. If there has been flood, drought, disease or other natural disasters in the area affecting business profits, write it down, cut out any news articles, keep records, count hours, record mileage and keep receipts.

Conclusion

Producers must consider carefully what type of business entity to form for the operation. Each type has both pros and cons associated with it. Producers should consult with the area OSU Extension economist, state OSU Extension tax specialist or an income tax preparer to make wise decisions regarding the formation or changing of a business entity.

The above general tax information is provided to educate taxpayers about the income tax consequences of hobby losses. If specific detailed information is needed, or if a farm or business operation is in danger of being declared a hobby by the IRS, please contact the area OSU Extension economist, state OSU Extension tax specialist or an income tax preparer.

References

To access the most current versions of the following referenced publications, go to irs.gov. In the search box, type in Publication followed by the publication's number to download it. For example, type in Publication 225 to get to the current version of the Farmer's Tax Guide.

Circular A, Agricultural Employer's Guide. IRS Publication 51
Farmer's Tax Guide. IRS Publication 225
Self-Employment Tax. IRS Publication 533