University of Wisconsin-Madison
Department of Agricultural & Applied Economics

April 2004 **Staff Paper No. 473**

Limited Liability Company: A Farm Business Arrangement Alternative

By

Mary Meehan-Strub
and
Philip E. Harris

AGRICULTURAL & APPLIED ECONOMICS

STAFF PAPER SERIES

Copyright © 2004 Mary Meehan-Strub and Philip E. Harris. All rights reserved. Readers may make verbatim copies of this document for non-commercial purposes by any means, provided that this copyright notice appears on all such copies.

Limited Liability Company:
A Farm Business Arrangement Alternative

Mary Meehan-Strub
Professor, Family Development and Family Living Agent
La Crosse County University of Wisconsin Extension
and
Philip E. Harris
Professor, Department of Agricultural and Applied Economics
University of Wisconsin-Madison/Extension

Limited Liability Company:
A Farm Business Arrangement Alternative

During the last decade of the twentieth century, a new and unique business entity alternative emerged – the **limited liability company (LLC)**. Prior to that the **sole proprietorship**, **partnership**, and **closely held corporation** were the basic ways to organize a farm business.

Effective January 1, 1994, Wisconsin allows the formation of LLCs under chapter 183 of the Wisconsin Statutes. This form of doing business is likely to be the choice of many small businesses that would have chosen the partnership or S corporation form of doing business. When properly formed, LLCs give the limited liability of corporations but the tax characteristics of a partnership, and control over participation in management.

What is a Limited Liability Company (LLC)?

An LLC is a legally recognized business organization under state law. Like a corporation, an LLC is created by filing documents with the Department of Financial Institutions. For an LLC those documents are called **articles of organization** rather than the articles of incorporation that are filed for a corporation. Corporations must file a report annually with the Department of Financial Institutions. Beginning in 2004 LLCs also have to file an annual report.

The owners of an LLC are called members. Members can manage the business activities of the LLC or delegate the management to a manager or managers who can be either members of the LLC or non-members. Generally, members are not liable for LLC debts.

LLCs with more than one member are taxed as partnerships unless the members elect to have the LLC taxed as a corporation. LLCs with one member who is an individual are taxed as a sole proprietorship of the member unless the member elects to have the LLC taxed as a corporation.

One of the principle reasons for forming an LLC is to obtain the income tax treatment as a partnership. Flexibility in distributions, single taxation of income, capital gains tax benefits, and favorable adjustments in the basis of assets are also among the reasons why the LLC should be considered as an option. In comparing the LLC with the partnership, the S corporation, and the C corporation, the LLC offers the most advantages. The LLC is a distinct type of entity, however, it has borrowed heavily from predecessor entity forms. Thus, the legal principles that underlie corporations and partnerships continually appear interwoven and applicable to LLCs, along with the contractual arrangements established by the LLC members. A more complete comparison of LLCs with S corporations, C corporations, and partnerships follows.

Comparison of LLCs and Other Business Organizations

Limited Liability

The liability of LLC members for LLC obligations is generally limited by state statute to their investment in the LLC, including amounts they have pledged to invest but have not yet invested. Members are not personally liable for the debts or obligations of the LLC, unless they become liable through their own actions outside of their membership in the LLC. Members are not allowed to waive their personal protection in the operating agreement. However, nothing in

the law prohibits a member from guaranteeing obligations of the LLC. A member's personal liability protection is not affected by participation in the management of the LLC.

Shareholders of a **corporation** generally have limited liability regardless of their participation in management of the corporation. However, there are some exceptions to this liability protection. Under Wis. Stat. §180.0622(2)(b), corporate shareholders are personally liable (up to an amount equal to their capital investments) for employee wage claims, not to exceed 6 months' service. Members of an LLC have no equivalent liability. Federal and state tax laws impose personal liability on "responsible persons" for unpaid employee income tax and Social Security withholding. Shareholders of a corporation or members of an LLC are "responsible persons" if they have the responsibility of collecting and paying those taxes. Corporate directors and officers may have personal liability for their actions but if they are liable, the corporation usually indemnifies them.

Liability for debts of the entity may be imposed on LLC members under the equivalent of the corporate principle of "**piercing the veil**." Under corporation law, a court will pierce the corporate veil of liability protection if the shareholders of the corporation have abused the corporate rules, for example, by not putting an adequate amount of capital into the corporation or by co-mingling corporate assets with personal assets. Not all the factors applicable to "veil piercing" of corporations may be relevant to LLCs. Piercing the veil because of failure to follow required formalities is less likely in an LLC than a corporation because LLCs do not have the same procedural and documentary formality requirements as corporations.

In a **general partnership** all partners have unlimited personal liability for the debts and obligations of the partnership regardless of their participation in management. By contrast, LLC members are not liable for LLC debt regardless of their participation in management. The obligations of the partnership are satisfied first out of the assets of the partnership. If the partnership cannot pay all of its debts, partners are jointly and severally liable for all debts and obligations of the partnership, including torts and breaches of trust..

A **limited partnership** must have at least one general partner with unlimited personal liability for the debts and obligations of the partnership. Limited partners in a limited partnership generally are not personally liable for the debts and obligations of the entity, but they risk loss of liability protection if they participate in management. By contrast, all members of an LLC have limited liability even if they participate in management.

A **limited liability partnership** is a partnership that has registered as a limited liability partnership. Partners of a limited liability partnership are not personally liable for obligations of the partnership. However, the limited partnership does not protect a partner from liability for the partner's own omissions, negligence, wrongful acts, misconduct or malpractice or the omissions, negligence, wrongful acts, misconduct or malpractice of any person acting under the partner's supervision and control. All partners in a limited liability partnership have limited liability—even if they participate in management.

The limited liability protection of an LLC may be lost under one or more of the following circumstances:

- A member is personally involved in a tort, such as negligently causing an accident; the member may be liable as an individual for the damages caused.
- If a member personally guarantees the debts of the LLC, s/he will be liable for the debt.
- A court may "pierce the LLC veil" if the LLC was used in a manner that abuses the limited liability protection.

Formalities

Partnerships and LLCs are required to follow few statutory formalities. By contrast, corporations must comply with various formal requirements, such as filing an annual report. Corporations must also hold an annual shareholders' meeting for the election of directors.

Beginning in January 2004, LLC's must file an annual report. The filing date is based on the quarter of the year of organization. Annual reports will be mailed to the registered agent at the registered office address as listed with the Department. The Department will distribute the reports on the first month of each quarter. The report is due on the last day of the quarter.

The report will include the following information:

- The name of the LLC and the address of the principal office.
- The name of the registered agent and the address of the registered office.
- The nature of the business carried on by the LLC.
- If the management of the LLC is vested in managers, a listing of their names and business addresses.
- The report will be available to file online or in paper form. The filing fee for the report is $25.00

Ownership Restrictions

Number of Owners. An LLC has a significant advantage over an S corporation by not having to meet the restrictions on the number of shareholders allowed in an S corporation. An S corporation may have no more than 75 shareholders. An LLC has no upper limit on the number of members in the entity.

Unless the operating agreement provides otherwise, Wisconsin law requires unanimous approval for the continuation of an LLC's business after an event of dissociation, and for the substitution of an assignee of an LLC interest as a full member. These requirements establish a practical limitation on the number of LLC members. In addition, an LLC with more than 100 members may fall outside the safe harbor that is established for publicly traded partnerships. The 100-member number is also a practical limit for tax and securities purposes.

An LLC and an S corporation can operate with only one owner, whereas a partnership must have at least two owners.

Type of Owner. An LLC can have any "person" –an individual, a general or limited partnership, a domestic or foreign LLC, a trust, an estate, an association, a corporation, or "any other legal or commercial entity" as a member. An S corporation cannot have partnerships and other corporations as shareholders. They may only have 1) individuals who are U.S. citizens or resident aliens, and 2) certain estates and trusts as shareholders.

Classes of Ownership. LLC members and partners in a partnership can structure financial and management relationships among the members to meet specific needs. Flexibility allows an LLC to establish different classes of ownership interests, different priorities within classes of interests, special allocations of income and losses, and any other specific arrangements that members agree on. S corporations are allowed to have only one class of stock, which eliminates any flexibility in creating financial and management relationships among the owners.

Tax Treatment

In many cases, the major reason for forming an LLC is to obtain the income tax treatment of a partnership without the liability of general partners. If the entity wants to be taxed like a corporation, there is no need to use the LLC form of doing business. LLCs are often preferred over a corporation electing to be taxed under subchapter S of the Internal Revenue Code.

In 1997, IRS implemented the check-the-box regulations, which explicitly give taxpayers the right to choose the desired tax classification for LLCs. The taxpayer is now able to elect, within limits, how an entity is taxed. With this default classification, the taxpayer receives the presumptive flow-through tax status, which means that the members of the LLC, and not the LLC itself, will be taxed on the income earned by the LLC. Correspondingly, the members are entitled to use LLC losses to offset other income. In general, contributions to an LLC taxed as a partnership are tax free under I.R.C. §721. There are exceptions and special rules for contributions of debt and contributions of services. If an interest in an LLC is issued in exchange for services, the exchange is taxable if the interest is an interest in capital, and may be taxable if it is an interest in profits only.

If an LLC is taxed as a partnership for federal income tax purposes, the LLC is not subject to income tax at the entity level. Income, losses, deductions, and credits flow through to the LLC members and are included in their personal income. LLCs avoid double taxation.

The operating earnings of C corporations are subject to double taxation. Corporate income is taxed as it is earned at the entity level. The shareholders are subject to income tax when they receive dividend distributions.

S corporations are allowed pass-through tax treatment and therefore, provide some of the tax benefits of LLCs that are taxed as partnerships. However, LLCs have certain tax advantages over S corporations, including greater flexibility in the allocation of profits, losses, and distributions among members and a greater availability of tax-free contributions and distributions of assets.

Management

Flexibility in how the business can be managed is one of the advantages of LLCs. Members of an LLC define how the LLC will operate and the rights of the members. Unless the articles of organization or an operating agreement provide for management by a manager or managers, the management of an LLC is vested in its members.

The members of an LLC may enter into an operating agreement to establish or regulate the affairs of the LLC. The operating agreement may contain any provisions not inconsistent with the enabling legislation or the articles of organization. Subject to the operating agreement or in the absence of a clear specification in the governing documents, several “default” provisions apply:

- Members are authorized to vote in proportion to their capital contributions to the LLC as adjusted to reflect contributions and withdrawals.
- Major decisions such as dissolution, sale of assets, or a merger require a unanimous decision.
- Management of the LLC is vested in the members, and profits/losses and distributions are made on the basis of the members’ respective contributions.

Accounting Method

Farm operations historically have been permitted to use the cash method of accounting even though inventories are a material income-determining factor. An LLC that is taxed as a partnership is a separate tax entity, and therefore it selects its own accounting period or taxable year and accounting method—cash or accrual basis. Each new LLC makes these elections on its first return. Unless the LLC is required to use the accrual method of accounting, it may use either the cash basis or the accrual basis, regardless of the method used by its members. However, if the LLC is a tax shelter or has a corporation that has average gross receipts exceeding $5 million as a member, it must use the accrual method of accounting.

Self-Employment Tax

Generally, a member's distributive share of LLC income is subject to self-employment tax if the member's interest in the LLC has the characteristics of a general partner's interest. Therefore, if a member's share of LLC income is not subject to self-employment taxes if the member's interest has the characteristics of a limited partner, except for guaranteed payments that are remuneration for services.

For self-employment tax purposes, an LLC member's share of income is subject to self-employment tax if the member is a manager or if the LLC has no designated managers. Non-manager members are treated as limited partners, and those members' shares of income are not subject to the 15.3 percent self-employment tax, if other LLC members are designated as managers.

Federal Farm Programs

Presently, LLCs are treated as **limited partnerships** for federal farm program purposes. This means an LLC will be considered as a separate "person" if the LLC has a separate and distinct interest in the land for the crop(s) involved, exercises separate responsibility for this interest, and maintains funds or accounts separate from that of any other individual or entity for the interest. Also, the LLC must be actively engaged in farming. Thus, the LLC is separately required to make a significant contribution of capital, equipment, land, or a combination of the three; collectively, members must hold at least 50% of the interests in the LLC; the LLC's share of profits/losses from the farming operation must be commensurate with the contribution to the farming operation; and, the LLC's contributions must be at risk.

Anti-Corporate Restrictions

According to Wisconsin Statute §182.001, **no corporation or trust** may own land on which to carry on farming operations or carry on farming operations unless the corporation or trust meets three standards:

1. The number of shareholders or beneficiaries does not exceed 15. Lineal ancestors and descendants and aunts, uncles and first cousins thereof count collectively as one shareholder or beneficiary, but this collective authorization shall not be used for more than one family in a single corporation or trust.
2. It does not have more than two classes of shares.
3. All shareholders or beneficiaries, other than any estate, are natural persons.

These corporate restrictions do not apply to LLCs engaged in farming operations in Wisconsin, unless one of the members is a corporation.

Dissolution

An LLC dissolves at the end of the fixed period as established in the operating agreement. At any time prior to the end of the fixed period, the members can voluntarily choose to terminate the entity by written consent of all of the members. Other events such as death, withdrawal, expulsion, bankruptcy, or dissolution of a member can force the dissolution of the entity, unless there is unanimous consent of all remaining members to continue the business.

Tax Considerations When Choosing To Form An LLC

An existing entity must determine the feasibility and tax consequences before making the decision to change a business form and operate as a different business entity. Is it feasible? The entity will need to review and consider the state's enabling legislation, the allowable number of owners, and the cooperation of creditors with respect to the transfer of assets.

If the feasibility requirements are met, does the decision to form this entity make good tax sense? Do the tax and non-tax strengths out-weigh the tax and non-tax costs of the conversion? Tax costs are dramatically different for each of the different tax entities. In general, proprietorship and partnership conversions can be accomplished tax-free. Conversions from a corporation to a different entity can involve a corporate liquidation. This means two possible levels of tax for either a C or S corporation. However, if the assets and stock have depreciated rather than appreciated, it may be advantageous to liquidate.

Establishing an LLC – Getting In or Starting

Forming an LLC requires about the same amount of formalities as forming a corporation. Articles of Organization are filed with the Department of Financial Institutions and the members agree upon and sign an Operating Agreement.

Contributing assets to the LLC in exchange for an ownership interest is not a taxable event so there usually are no income taxes to be paid as a result of forming the LLC. The LLC's income tax basis in assets contributed to the LLC in exchange for an interest in the LLC is the same as the member's income tax basis in the asset before the exchange. The member's income tax basis in his or her interest in the LLC is also equal to his or her basis in the asset before the exchange.

Situation 1.0: *Jack and Jill operate a grain farm in Wisconsin as Jack's sole proprietorship. The fair market value of their land is $700,000 and it has a $100,000 income tax basis. Jack paid $400,000 for his machinery, which is now worth $360,000. He has claimed $180,000 of depreciation on the machinery and has a $400,000 - $180,000 = $220,000 basis in it.*

Jack and Jill's son, Jeff, wants to farm with them so Jack and Jeff set up an LLC. Jack contributes his $360,000 of machinery to the LLC for a 90% ownership interest and Jeff contributes $40,000 of cash for a 10% ownership interest.

The income tax consequences of forming the LLC are as follows. Jack's contribution of his machinery to the LLC is a tax-free exchange of the machinery for his 90% interest in the LLC. Jack does not have to recognize any gain, but Jack has a $220,000 carryover basis in his

90% interest in the LLC (his basis in the machinery at the time he contributed it to the LLC). The LLC's basis in the machinery is also a carryover of Jack's $220,000 basis in the machinery. The LLC continues to depreciate that $220,000 basis using the same depreciable life that Jack used before the contribution.

Jeff has a $40,000 basis in his 10% interest in the LLC.

Note. Forming a partnership and in most cases forming a corporation for Jack and Jeff's farming business would have the same income tax consequences as described above for the LLC. However, there can be significant income and self-employment tax differences in operating and dissolving an LLC compared to operating and dissolving a corporation as discussed below.

Operating an LLC

An LLC that is taxed as a partnership does not pay income taxes on its income. Instead, each member pays income and self-employment taxes on his or her share of the LLC profits. Members are not eligible for tax-free fringe benefits, but spouses of members are treated as employees.

Situation 2.0: *Assume the same facts as in Situation 1.0, but assume it is now one year later. The LLC had income and expenses from the first year of its grain operation as follows.*

Gross income		$ 450,000
Expenses:		
Rent paid to Jack and Jill	$ 46,000	
Salary paid to Jill	25,000	
Depreciation	43,000	
All other operating expenses	242,000	
Health insurance for Jack and Jill	8,000	
Health insurance for Jeff	6,000	
Total		370,000
Net profit		$ 80,000

The LLC has a health and accident plan that pays for health insurance for employees and members of the employee's families. That plan allows the LLC to deduct the$8,000 cost of the health insurance for Jack and Jill as a business expense on Schedule F since Jill is an employee and Jack is a member of her family. Since Jeff is no longer a dependent, he is not member of an employee's family for purposes of the health insurance rules and therefore, the LLC cannot deduct the $6,000 cost of health insurance for Jeff on its Schedule F. That $6,000 is treated as a guaranteed payment to Jeff, which means the $6,000 is deducted from the LLC profits and is included in Jeff's income for income tax and self-employment tax purposes. Jeff can claim the self-employed health insurance deduction on line 28 of his 2003 Form 1040.

If Jack and Jeff have no other arrangement for dividing the profits, 90% x $80,000 = $72,000 will be included on Jack's joint income tax return with Jill and 10% x $80,000 = $8,000 will be included on Jeff's individual income tax return. Those amounts will be taxed to Jack and Jeff whether or not the LLC distributes part, all or none of the profits to them. Jack and Jill must also report their $46,000 of rent on their joint tax return.

Jack and Jeff could agree that the LLC will pay each of them a guaranteed payment each year to compensate them for their labor and management. Those guaranteed payments would reduce the profits that are reported on the LLC's Schedule F and therefore the amount of profit that flows through to each of the members. However, the guaranteed payments are taxable income to the members for both income tax and self-employment tax purposes.

For example, if the LLC pays a $30,000 guaranteed payment to each Jack and Jeff, the LLC's Schedule F profit would be reduced to $20,000. Jack would report 90% x $20,000 = $18,000 of that profit and his $30,000 guaranteed payment on his joint income tax return with Jill where it is subject to both income tax and self-employment tax. Jeff will report 10% x $20,000 = $2,000 of that profit and his $30,000 guaranteed payment on his individual income tax return where it is subject to both income tax and self-employment tax.

Situation 2.1: *Assume the same facts as in Situation 2.0 except that Jack and Jeff formed a corporation that is taxed as a C corporation. Jack and Jeff are employees of the corporation and each receives a $30,000 salary. The income and self-employment tax differences from Situation 2.0 are as follows:*

1. *The $30,000 salary payments have almost the same tax consequences as the $30,000 guaranteed payments. The salary payments reduce the corporation's taxable income but are subject to employment taxes (FICA, FUTA and worker's compensation) as well as income taxes for the recipients.*
2. *Because Jeff is an employee of the corporation, the corporation can deduct the $6,000 it pays for Jeff's health insurance in addition to the $8,000 it pays for Jack and Jill's health insurance. The $6,000 is not taxable income to Jeff and the $8,000 is not taxable income to Jack and Jill.*
3. *The $20,000 profit is taxed at the corporation's 15% income tax rate and will be taxed again at the shareholder's individual income tax rate if and when the profit is distributed as dividends.*

Situation 2.2: *Assume the same facts as in Situation 2.1 except that Jack and Jeff elected to have the corporation taxed as an S corporation. The income and self-employment tax differences from Situation 2.1 are as follows:*

1. *Because Jack and Jeff each own more than 2% of the shares of the S corporation, they are not treated as employees. Furthermore, because Jack's ownership is attributed to Jill she also is not treated as an employee for purposes of the health insurance payments. Consequently, the corporation's payments for the health insurance is treated as additional compensation to Jack and Jeff that is subject to income tax but not FICA taxes or self-employment taxes.*
2. *The corporation does not pay income tax on its $20,000 of profit. Ninety percent of the corporation's $20,000 profit ($18,000) is taxable income to Jack and 10% x $20,000 = $2,000 is taxable income to Jeff whether the profit is distributed or not. Jack and Jeff* ***do not*** *owe self-employment tax on their respective shares of profit.*

Dissolving an LLC – Getting Out

Generally, distributing assets from an LLC to its members to dissolve the LLC does not trigger recognition of gain on the assets that are transferred. To avoid recognition of gain, each member must receive a share of capital assets and a share of assets that result in ordinary income equal to his or her share in the LLC. Each member's income tax basis in the assets that are distributed is equal to the member's income tax basis in his or her interest in the LLC.

Situation 3.0: *Assume the same facts as in Situation 1.0 above except that fifteen years have passed since Jack and Jeff formed the LLC to operate their grain farm. Over the years, Jack and Jeff have each become 50% members of the LLC through purchases and gifts of interests in the LLC from Jack to Jeff. They have decided to divide the assets between them so that Jeff can rent Jack's assets and continue to farm on his own..*

At the time of the dissolution, Jack has a $200,000 income tax basis in his 50% interest in the LLC and Jeff has a $300,000 income tax in his 50% interest in the LLC.

The LLC owned the following assets at the time of the dissolution.

Asset	Fair market value	Adjusted basis
Cash	$ 50,000	$ 50,000
Grain	150,000	0
Machinery	600,000	200,000
Total	$ 800,000	$ 250,000

Jack and Jeff each receive half of the cash, grain and machinery in exchange for their respective 50% interest in the LLC. Neither the LLC nor Jack and Jeff will recognize any gain as a result of the exchange. Jack's and Jeff's income tax bases in their LLC interests are allocated first to the cash they receive and then to the other assets. However, the basis allocated to the grain cannot exceed the LLC's basis in the grain. Therefore, after allocating basis to the cash, the entire remaining basis is allocated to the machinery each of them receives as follows.

Jack's basis in the assets he receives:

Jacks basis in his membership interest	*$200,000*
Basis allocated to cash	*25,000*
Remaining basis	*$175,000*
Basis allocated to grain	*0*
Remaining basis allocated to machinery	*$175,000*

Jeff's basis in the assets he receives:

Jeff's basis in his membership interest	*$300,000*
Basis allocated to cash	*25,000*
Remaining basis	*$275,000*
Basis allocated to grain	*0*
Remaining basis allocated to machinery	*$275,000*

Note. If Jack and Jeff each sell the grain they received from the LLC for its $75,000 value, they will each have $75,000 of income to report. Jack can depreciate his $175,000 basis in the $300,000 of machinery he received and Jeff can depreciate his $275,000 basis in the $300,000 of machinery he received.

Situation 3.1: *Assume the same facts as in Situation 3.0 above except that instead of forming an LLC, Jack and Jeff formed a corporation that is taxed as a C corporation. The corporation is dissolved by distributing its assets to Jack and Jeff in exchange for their shares of stock. That will trigger recognition of gain to the corporation and to the shareholders as follows.*

Asset	Fair market value	Basis	Gain	Gain reported by:
Cash	$ 50,000	$ 50,000	$ 0	Corporation
Grain	150,000	0	150,000	Corporation
Machinery	600,000	200,000	400,000	Corporation
Jack's shares	400,000	200,000	200,000	Jack
Jeff's shares	400,000	300,000	100,000	Jeff

The gain on the grain is taxed as ordinary income because the grain is inventory. The gain on the machinery is taxed as ordinary income because it is recapture of depreciation. The gain on Jack's and Jeff's shares of stock is taxed as long-term capital gain.

Jack and Jeff will each have an income tax basis in their grain and machinery equal to its fair market value at the time of the distribution. Therefore, if they sell their grain for that value, they have no gain or loss to report. They can each depreciate their $300,000 basis in the machinery.

Situation 3.2: *Assume the same facts as in Situation 3.1 except that Jack and Jeff elected to have the corporation taxed as an S corporation. The distribution of the corporation's assets in exchange for the shareholder's stock will trigger recognition of gain at the corporate level but that gain is taxed to the shareholders as follows.*

Asset	Fair market value	Basis	Gain	Gain reported by Jack:	Gain reported by Jeff:
Cash	$ 50,000	$ 50,000	$ 0	$ 0	$ 0
Grain	150,000	0	150,000	75,000	75,000
Machinery	600,000	200,000	400,000	200,000	200,000
Total	$ 800,000	$ 250,000	$ 550,000	$ 275,000	$ 275,000

Each shareholder increases the basis in his stock by the gain he reports from the corporation as follows.

Shareholder	Basis in shares before distribution	Gain recognized from distribution	Basis in share after distribution
Jack	$ 200,000	$ 275,000	$ 475,000
Jeff	$ 300,000	$ 275,000	$ 575,000

Those increases in bases cause each shareholder to recognize a capital loss from the exchange of his shares for the assets as follows.

Asset	Fair market value	Basis	Loss
Jack's shares	$ 400,000	$ 475,000	$ 75,000
Jeff's shares	$ 400,000	$ 575,000	$ 175,000

Unfortunately, the loss is a long-term capital loss, which can offset only $3,000 of the $275,000 of ordinary income that passed from the corporation to each shareholder. The remaining capital loss is carried forward to future tax years where it can be deducted to the extent of capital gains in those years and $3,000 of ordinary income.

Observation. If Jack has no capital gains, it will take 15 years for him to deduct the full $75,000 of capital losses. If Jeff has no capital gains, it will take him 58 years to deduct the full $175,000 of capital losses.

In the event of Death

Most taxpayers do not face a gift or estate tax liability because the current $1,000,000 lifetime exemption is greater than the value of their estates. Consequently, planning to transfer assets in a manner that minimizes income tax liability is more important than minimizing gift and estate taxes for most taxpayers.

The amount of income taxes that will be due upon an eventual sale of farm business assets is affected by:

1. How assets are transferred from one generation to the next, such as:
   a. By sale
   b. By gift
   c. By transfer at death
2. The type of business entity that owns the assets at the time of an owner's death

Transfer by sale. Transferring an asset by selling to members of the next generation will cause the seller to recognize the full gain.

Situation 4.1: *Assume Jack and Jill from Situation 1.0 above sell their land to Jeff for its $700,000 fair market value. They must recognize the $600,000 difference between its $100,000 basis and the $700,000 as long-term capital gain. Jeff will then have a $700,000 basis in the land.*

Transfer by gift. Transferring an asset by gift does not trigger recognition of gain or loss. However, the donor's income tax basis in the asset is carried over to the donee, so the gain or loss will be recognized if the donee makes a taxable transfer of the asset.

Situation 4.2: *Assume Jack and Jill from Situation 1.0 above give their land to Jeff. Jack and Jill do not have to recognize the $600,000 of gain, but Jeff's income tax basis in the land is $100,000. If he were to sell it for $700,000, he would have to recognize the $600,000 gain.*

Transfer at death. Transferring an asset at death does not trigger recognition of gain or loss. Unlike a gift, the decedent's basis is not carried over to the person or entity that receives the asset at death. Instead, the income tax basis is adjusted to the value of the asset on the date of death. Consequently the gain or loss that the decedent would have recognized if the asset were sold during the decedent's life is never recognized.

Situation 4.3: *Assume that Jack from Situation 1.0 above died and his will transferred his half of the land he and Jill own to Jeff. The $300,000 of gain on Jack's half ($350,000 fair market value - $50,000 basis) does not have to be recognized. Jeff's basis in that half is adjusted to its $350,000 value on Jack's date of death. If Jeff sold his half for $350,000 he would have no gain or loss to recognize.*

Note. If Jack and Jill owned the land as marital property, Jill's half interest in the land also gets a new basis equal to the $350,000 date of death value.

Type of Business Entity. The type of business entity has a significant effect on the income tax basis in the assets after the death of the owner. The general rule is that on death of the owner of an entity, the basis in the ownership interest is adjusted to the value of the interest o nht edate of the owner's death. Except as noted below, the bases in the assets owned by the entity are not adjusted upon the death of the owner of the entity.

Situation 4.4: *Assume the same facts as in Situtation3.1 above except that instead of dissolving the C corporation, Jack died and his will transfers his shares in the corporation to Jeff.*

Asset	Fair market value	Basis before death	Basis after death
Cash	$ 50,000	$ 50,000	$ 50,000
Grain	150,000	0	0
Machinery	600,000	200,000	200,000
Jack's shares	400,000	200,000	400,000
Jeff's shares	400,000	300,000	300,000

If Jeff sold the shares in received from Jack for their $400,000 date of death value, he would have no gain or loss to recognize. However, if the corporation sold the grain it owned for its $150,000 date of death value, it would have to recognize $150,000 of gain.

A special rule for partnerships and LLCs that are taxed as partnerships allows the partnership or LLC to make an election that adjusts the basis in assets owned by the partnership or LLC to reflect the increased basis in the ownership interest. That election gives the taxpayers the full benefit of the basis adjustment to the date of death value.

Situation 4.5: *Assume the same facts as in Situation 4.4 except that the entity is an LLC rather than a C corporation. If the LLC does not make the special election, the bases in assets after Jack's death are the same as in Situation 4.4. Therefore, Jeff would have no gain or loss to recognize if he sold the interest he received from Jack for $400,000 and the LLC would have to recognize $150,000 of gain if it sold the grain for $150,000.*

If the LLC makes the special election, the bases in half of the grain and machinery will be adjusted to their date of death value. The bases in the assets will be as follows.

Asset	Fair market value	Basis before death	Basis after death
Cash	$ 50,000	$ 50,000	50% of $50,000 + 50% of $50,000 = $50,000
Grain	150,000	0	50% of $0 + 50% of $150,000 = $75,000
Machinery	600,000	200,000	50% of $200,000 + 50% of $600,000 = $400,000
Jack's shares	400,000	200,000	$400,000
Jeff's shares	400,000	300,000	$300,000

If the LLC sold the grain for its $150,000 date of death value, it would have only $75,000 of gain, which would be reported by Jeff as the sole owner of the LLC.

Observation. The income tax result for the LLC that has made the special election is the same as the income tax result that would occur if Jack and Jeff each owned half of the assets as individuals outside the LLC. For example, if Jack and Jeff each owned half of the grain outside the LLC, the basis in Jack's one-half of the grain would be adjusted to its $75,000 date of death value. If Jeff sold all of the grain for $150,000, he would have to recognize $75,000 of gain on his half but no gain on the half he received from Jack.

Conversion of Business Organizations to an LLC

Farm business owners may want to convert their current farm business entity to an LLC. A conversion requires a number of actions including the formal conveyance of assets, the assignment of certain intangible rights, and the assumption of liabilities. The conversion may have significant income tax consequences.

Conversion of Sole-proprietorship to an LLC. Converting a sole-proprietorship to a one-member LLC is a relatively simple transaction that has no adverse income tax consequences.

Since the one-member LLC is disregarded for income tax purposes unless the member elects to have it taxed as a corporation, the main difference between the sole-proprietorship and the one-member LLC is the limited liability of the LLC. To form the LLC, the sole-proprietor contributes part or all of the business assets to the LLC in exchange for a 100% ownership interest.

Situation 5.0: *Joe Smith operates a vegetable growing enterprise. He grows and delivers vegetables to the local grocery. He has operated as a sole-proprietor reporting taxable income and expenses on Schedule F (Form 1040). He is considering starting a pick-your-own enterprise and wants the added liability protection of an LLC. Joe's state statute provides for a one member LLC. He has the following assets and liabilities:*

Asset	Fair Market Value	Liabilities	Tax Basis	Potential Gain
Cash	$25,000	0	$25,000	0
Land & Improvements	$200,000	$100,000	$125,000	$75,000
Machinery	$45,000	$15,000	$32,500	$12,500
Total	$270,000	$115,000	$172,500	$87,500

With the approval of Joe's creditors, Joe will contribute the above assets and liabilities to Joe's U-Pick, LLC. Joe will not recognize any of the $87,500 potential taxable gain by forming Joe's U-Pick. Joe will continue to report income and expenses on Schedule F (Form 1040), unless he elects to be taxed as a corporation. His tax basis and potential gain from transferring assets do not change.

Conversion of a C or S corporation to an LLC. Conversion of a **C corporation** to an LLC can create significant negative tax consequences because the conversion is treated as a liquidation of the corporation followed by the creation of the LLC. Liquidation triggers recognition of gain or loss for both the corporation and its shareholders. If the corporation's assets and/or stock have appreciated in value, the tax cost of liquidation can be prohibitive. Each situation must be analyzed to determine feasibility. Assuming that state statutes allow the conversion and creditors are agreeable, the tax cost of liquidation must be weighed against the benefits from conversion to an LLC.

Liquidation of a corporation is generally a taxable event for both the corporation and its shareholders. A liquidating corporation recognizes gain or loss on the distribution of property and recognizes depreciation recapture as if the corporation had sold each of its assets at its fair market value. The corporation's shareholder(s) also recognize gain or loss on the distribution equal to the fair market value of the distribution received minus the basis in the shareholder's stock.

Situation 5.1: *Assume the same facts as in Situation 5.0 except that Joe Smith operated his vegetable growing enterprise as a C corporation, reporting income and expenses on Form 1120. Joe's basis in his stock is $100,000. He converted his business to an LLC.*

Conversion from the C corporation to an LLC is treated as if the corporation distributed the assets to Joe in a liquidation and Joe contributed the assets to the new LLC. The deemed

liquidation triggers the recognition of $87,500 of gain by the corporation. The corporation will pay $18,000 of income tax on that gain. The deemed distribution of the remaining $7,000 ($25,000 - $18,000) of cash and the assets to Joe in exchange for his stock triggers the recognition of $252,000 - $100,000 = $152,000 of gain on his individual tax return. Joe will owe $30,400 of tax on that gain. Because all of the gain has been recognized, the LLC's basis in the assets will be their fair market value ($200,000 for the land and improvements and $45,000 for the machinery) and Joe's basis in his LLC interest is $252,000. There is no further potential gain to be recognized immediately after the LLC is formed.

Conversion of an **S corporation** to another entity such as an LLC has similar tax consequences at the corporate level—gain or loss is recognized on the deemed sale or distribution of assets at fair market value. However, that gain or loss is reported by the shareholders and is taxed on their individual income tax return. Gain recognized by the shareholders will increase their bases in their stock, which will decrease the gain (or increase the loss) they must recognize on the distribution of the assets in exchange for their stock. Loss recognized by the shareholders will decrease their bases in their stock, which will increase the gain (or decrease the loss) they must recognize on the distribution of the assets in exchange for their stock.

Situation 5.2: *Assume the same facts as in Situation 5.1 except that Joe Smith operated his vegetable growing enterprise as an S corporation, reporting income and expenses on Form 1120S.*

As in Situation 5.1, conversion from the S corporation to an LLC is treated as if the corporation distributed the assets to Joe in a liquidation and Joe contributed the assets to the new LLC. The deemed liquidation triggers the recognition of $87,500 of gain by the corporation but that gain is taxed on Joe's individual income tax return. Joe will pay $18,375 of income tax on that gain. Recognition of that gain increases Joe's basis in his stock to $100,000 + $87,500 = $187,500. The deemed distribution of the $270,000 of cash and assets to Joe in exchange for his stock triggers the recognition of $270,000 - $187,500 = $82,500 of gain on his individual tax return. Joe will owe $16,500 of tax on that gain. Because all of the gain has been recognized, the LLC's basis in the assets will be their fair market value ($200,000 for the land and improvements and $45,000 for the machinery) and Joe's basis in his LLC interest is $270,000. There is no further potential gain to be recognized immediately after the LLC is formed.

Conversion of a partnership. A conversion from a general or limited partnership to an LLC has no income tax consequences if there are no changes in ownership percentages and the LLC is taxed as a partnership. The LLC continues to file a partnership income tax return as it did before the conversion. Each of the members continues to report his or her share of the LLC income on his or her individual return.

Situation 5.3: *Assume the same facts as in Situation 5.0 except that Joe Smith's daughter, Sally is a 50% partner in the business and it was operated as a partnership, reporting income and expenses on Form 1065.*

Converting the partnership to an LLC has no income tax consequences. The LLC will continue to report its income and expenses on Form 1065 and the net income or loss will pass through to Joe and Sally to be reported on their individual income tax returns.

Converting a partnership to an LLC may require negotiation with creditors or other third parties. Creditors that entered into a relationship based on the understanding that the partners have unlimited liability may be reluctant to see the contractual relationship shifted to an entity in which the owners have limited liability. In many cases, the partnership's contractual relationship with third parties may not be assigned without the consent of the parties, and there may be tax consequences associated with shifting liabilities among members.

Summary

LLC's with one or more members may be the entity of choice for farming businesses because they provide the beneficial tax treatment of partnerships, the limited liability protection of corporations and control over participation in management. LLCs are relatively easy to set up, operate and dissolve. They must be registered with the state when they are created but they do not have to file annual reports with the state. Generally, setting up and liquidating an LLC does not trigger any income tax liability. Consequently, if the owners decide to liquidate the business or change to another form of doing business, the costs are not prohibitive.

Appendix

Definition of Terms

Articles of Organization: Documentation filed with the Department of Financial Institutions to create an LLC. The equivalent of the partnership agreement for a partnership and the articles of incorporation for a corporation.

C Corporation: A corporation that is taxed as a separate entity subject to the tax rules contained in Subchapter C of the Internal Revenue Code. Profits that are distributed as dividends are taxed a second time as income to the shareholders. However, profits that are retained are taxed only once at the corporate tax rate. Another advantage over the S corporation, LLC, and partnership is that C corporations can deduct fringe benefits paid to employee-owners, who can exclude these benefits for tax purposes from their gross incomes. Gains from distribution of appreciated assets may trigger significant tax liability—at both the shareholder and entity levels.

Closely Held Corporation: A corporation whose voting stock is owned by one or a few shareholders and is operated by this person or closely-knit group. Directors and officers are owners of the company.

Distribution: A direct or indirect transfer by an LLC of money or other property, other than an interest in the LLC, to or for the benefit of its members in respect of their interests.

Limited Liability Company (LLC): A business entity that must be registered with the state. The LLC provides its owners (called members) limited liability for business debts. A one-member LLC is taxed as a sole-proprietorship and an LLC with two or more members is taxed as a partnership unless the LLC elects to be taxed as a corporation.

Limited Partnership: A business entity that must be registered with the state. It must have at least one general partner and at least one limited partner. Limited partners are usually liable for partnership debt only to the extent of their capital contributions to the partnership. They are not allowed to participate in management and control of the partnership business and are not subject to self-employment taxes on partnership business earnings.

Manager: The person who has the statutory powers of a manager of a manager-managed LLC. Manager can be an individual or group of individuals acting as a board of directors or board of managers, or, an entity.

Members: Owners of the LLC. They are the equivalent of the partners in a partnership and the shareholders of a corporation.

Operating Agreement: Written agreement among all of the members of an LLC relating to the LLC's business and its relationship to/with its members.

Partnership: A business entity that **does not** have to be registered with the state. It must have two or more owners (called partners) and at least one partner must be fully liable for the debts of the partnership. Income is taxed at the partner level only.

S Corporations: A corporation that has elected to be taxed under Subchapter S of the Internal Revenue Code. It does not pay income taxes on its income. The corporate income is taxed as income to the shareholders. Generally, gain or loss is recognized upon liquidation of an S corporation.

Sole Proprietorship: Simplest form of business ownership. There is no separate entity from the owner who is liable for all debts, has all management control and pays taxes on the proprietorship income.

Comparison of Four Business Structure Alternatives for Closely-Held Joint Ventures

	Partnership	Limited Liability Company	S Corporation	C Corporation
Decision-Making and Management	*Decision-making authority is allocated and structured differently among the business forms. Some involve a more formal process, some distribute power more equally than others, some require anonymity while others require simple majority approval. Which of these alternatives is more advantageous will depend on the situation.*			
Distribution of voting power	Usually, one vote per partner.	Usually in proportion to investment, although each owner enjoys veto power in consensus-based decisions.	One vote per share of stock. While only one class of stock is permitted, differences in voting rights are permissible.	One vote per share of voting stock.
Decision-making body	The partners as a whole. Less formal, more flexible. No board of directors.		Board of Directors, elected by a majority vote of the voting shareholders. More formal than partnership or LLC.	
Majority rule or consensus	Unanimous consent.	Majority of ownership interest rules, except for major decisions that specifically require consensus approval.	Majority of voting shareholders elects the board of directors, and majority rules on the board.	
Management	Owners may manage collectively or appoint and/or hire a manager.		Usually, the Board of Directors hires a manager, and management is centralized. In a tightly held corporation or small cooperative, however, owners may effectively manage collectively and/or divvy out management responsibilities.	
Taxation	*Closely-held joint ventures often involve complex contributions of capital, working and non-working owners, and many other complications. Minimizing the tax burden under these complex circumstances can lead to elaborate and cumbersome models involving numerous business forms.*			
"Pass through" income taxation	Yes		Built-in gains and passive net income are taxed at entity level. Otherwise, yes.	No. Income is taxed at the corporate and shareholder levels.
Deductions for fringe benefits	These "pass-through" business forms are not considered separate employers from their owners, and the entity cannot therefore deduct fringe benefits paid to employee-owners.			Entity level can deduct fringe benefits, and employees may exclude benefits received when determining their gross income.
Basis adjustment when distributing ownership interests	Enjoys favorable adjustments in the basis in its assets when ownership interests are sold.		No adjustment in the basis of assets when there is a transfer of ownership.	

	Partnership	Limited Liability Company	S Corporation	C Corporation
Capital gains taxes on distribution of appreciated assets [1]	Appreciated assets can be distributed back to original contributors without recognizing gains.		Capital gains are taxed at the shareholder level.	Taxable gains may be recognized at both the individual and entity levels.
Federal and state income taxes and tax rates	None at partnership level; Individual rates	None at LLC level; Individual rates	None at S corporation level; Individual rates	Taxpaying entity; Corporate rates
Deductibility of losses	Limited to partner's basis; at-risk and passive loss rules apply	Limited to member's basis; at-risk and passive loss rules apply	Limited to shareholder's basis; at-risk and passive loss rules apply	No loss pass-through; can be carried forward or back
Self-employment tax	Ordinary trade or business income passes through as SE income; limited partnership has possible exemption[2]	Ordinary trade or business income passes through as SE income but possible exemption[3]	Taxes paid on salaries to shareholders/employees; may be in their self-employment income	
Cash disbursements	Tax-free if distribution is less than partners' tax basis in their partnership interests	Tax-free if distribution is less than members' tax basis in their membership interests	Tax-free if distribution is less than shareholders' tax basis in their shareholder interests	Dividend taxable to recipient unless in liquidation or redemption
Distribution of appreciated property	Tax-deferred		Taxable	
Death of an owner	Assets in the entity can get the date of death value basis.		Assets in entity do not get an adjusted basis at death.	

[1] Example: An entity owns land with a $100,000 basis and a fair market value of $500,000. If the entity is a partnership or LLC and the entity dissolves by distributing the land to its partners
(members), the gain is not recognized. The partners (members) simply have the land with the $100,000 basis so the gain is still waiting to be recognized. If the entity is a corporation, both the
corporation and the shareholders recognize the gain when the land is distributed to the shareholders and the shareholders then have $500,000 basis in the land. An S corporation may enjoy an
advantage over C corporations, but clearly the partnership and LLC are better.

[2] See I.R.C. § 1402(a)(13)

[3] See I.R.C. § 1402(a)(13)

	Partnership	Limited Liability Company	S Corporation	C Corporation
Nontax Characteristics				
Limited Liability	All general partners are jointly and severally liable for entity's obligations; Limited partners who do not participate in management are protected from entity's obligations; Partners of limited liability partnership have limited liability	All members protected from entity's obligations even if they participate in management	All shareholders protected from entity's obligations even if they participate in management	
Participation in management	No restrictions; Limited partners participating in management lose limited liability protection	No restrictions	No restrictions	No restrictions
Number of equity owners	At least two	No restrictions	1-75	No restrictions
Class of ownership interests	Multiple classes permitted	Multiple classes permitted	One class; however there can be differences in voting rights	Multiple classes permitted
Types/qualifications of owners	No restrictions; limited partnerships need a general partner	No restrictions on types of members	Shareholders limited to U.S. residents and citizens and to certain trusts and tax-exempt organizations	No restrictions on types of shareholders
Filing Fees	No filing required for general partnership; $70 filing fee for limited partnership	$130 on-line; $170 by paper; $25 for annual report beginning in 2004	$90 minimum, $10,000 maximum on filing; $25 with annual report	
Legal and administration costs	Lowest legal and administrative costs.[4]	Relatively easy and low cost.	More complicated and costly than partnership and LLC. The greater the number of owners, the more the legal and administrative costs can be spread out.	

[4] The partnership business form can be "deceptively simple". Separate books must be kept for accounting and tax income, and partners must keep track of their individual basis or the IRS may rule that partners started with no basis and hence all asset appreciation could be counted as gain. These "income tax traps" can be avoided with proper counsel, but the point is partnerships are not always as simple as they may appear on the surface.