

Exploring Tax Implications and Farm Succession Options of an LLC

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1

Why form an LLC?

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- Operate the farm business
 - Provide liability protection to the LLC member(s)
 - Manage estate taxes and to transfer assets
 - Hold real estate
 - Transfer business assets for succession planning

2

What is this Limited Liability Feature?

- Generally limited to their investment, even if they participate in management
- Provides more protection compared to a general partnership
- A Limited Liability Partnership (LLP) has similar protections to an LLC

3

However.....

Wrongdoing, negligence causing an accident – a member may be liable as an individual for damages

A member personally guarantees the debts of an LLC

“Pierce the LLC Veil”

- If the LLC was used in a manner that abuses the LL protection
 - Example: undercapitalizing the LLC from the beginning, not treating it as a separate entity, comingling funds and not documenting loans to the LLC
- Important to have separate accounts and act as third party

4

History of LLCs

1977 – Wyoming first state

1988 – the IRS allowed LLCs to be taxed as partnerships

1994 – Wisconsin allowed LLCs

5

Primary characteristics of an LLC

Choice of organization

- Member managed
- Choose a manager or mgmt. team

Choice of tax structure

- Single member LLC is taxed as a sole proprietor
- A multi-member LLC is taxed as a partnership
- Unless either of these elect to be taxed as a corporation

6

Considerations when choosing a tax structure for your LLC

Does this change how I would file my annual tax returns?

What are the differences in

- Self-employment,
- Income tax,
- Can an owner be an employee?
- Making a spouse an employee?

7

Questions

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8

Allocations and Distributions of earnings

Distributions are generally made relative to

- prior or current year's earnings
- or in liquidation of a member's interest in the LLC

The LLC taxed as a partnership allows for the "special allocation" of profits-- the disproportionate splitting of member profits and losses (in different percentages than their respective percentages of ownership).

9

What are guaranteed payments and how are they taxed?

Guaranteed payments are made irrespective of earning considerations

Can be compared to a salary and you pay SE tax and ordinary income tax

10

Questions

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11

Establishing an LLC

Determine what assets to put into the LLC

How will distributions be made?

Will there be guaranteed payments?

Develop an operating agreement

- Not required by the Dept. of Financial Institutions,
- But is an important document
- If there is no operating agreement state statutes provide for certain default provisions.

12

Operating agreement components

Determine management structure

Procedure for liquidation and dissolution

Procedure for settling conflict

How are interests handled in the event of a death of a member

- How can interests be transferred to others
 - Buy-sell agreements
 - Who can become a member
 - Options to purchase
 - Discounting of interests
 - Internal financing of a purchase of interest

13

Questions

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14

Who should you talk to?

Farm Partners/potential LLC members

Accountant or tax specialist

Attorney

Lender

The Farm Service Agency –

- Will this affect any program payments the farm business is eligible to participate in?
- Beginning Farmer Loan eligibility

15

Registering with the WI Dept. of Financial Institutions

Recommend working with a professional to develop the operating agreement and register your LLC

LLC may need to obtain an Employer Identification Number (EIN)

16

Registering with the WI Dept. of Financial Institutions

Things required by DFI:

- Name
- Registered agent
- Management structure
- Organizers
- Drafter
- Signature
- Contact
- Payment - \$170 if by paper, \$130 if completed online

Annual reports are required and cost \$25/year to file

17

Other steps to take

Checking account

Written communication with vendors/service providers
“doing business as”

Licenses – do they need to be under the LLC’s name

Income paid to the LLC (milk checks, etc.)

18

Questions

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19

Situation 1: Jack & Jill and Son Jeff

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 the original purchase price was \$100,000.

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

Jeff contributes \$40,000 of cash for a 10% ownership interest.

20

Situation 1: Jack & Jill and Son Jeff – Tax Consequences

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.

21

One year Later

Gross income		\$450,000
Expenses		
Rent paid to Jack/Jill	\$ 46,000	
Salary paid to Jill	\$ 25,000	
Depreciation	\$ 43,000	
All other operating expenses	\$242,000	
Health insurance for Jack/Jill	\$ 12,000	
Health Insurance for Jeff	\$ 9,600	
Total		\$377,600
Net Profit		\$ 72,400

22

15 years later – decide to distribute assets

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

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.

23

15 years later – decide to distribute assets

Jack's basis in the assets he receives

Jack's basis in 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

24

15 years later – decide to distribute assets

Jeff's basis in the assets he receives

Jeff's basis in 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

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.

25

Questions

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26

Transferring LLC interests

Sale

Gift

By transfer at death

27

Death of a member (Jack)

Asset	Fair Mkt 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 interest in LLC	\$400,000	\$200,000	\$400,000
Jeff's interest in LLC	\$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.

28

Conversions to LLCs

Sole-proprietorship to an LLC

Conversion of C or S corporation to an LLC

Conversion of a partnership to an LLC

29

Questions

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30

Resources

Limited Liability Company: A Farm Business Arrangement Alternative. Mary Meehan-Strub & Philip E. Harris. UW-Madison Agricultural & Applied Economics Staff Paper Series. Staff Paper No. 473. April 2004.

LLC Formation Checklist. Charles A. Wry, Jr., Morse Barnes-Brown Pendleton. <http://www.mbbp.com/uploads/1436/doc/LLCFormationChecklist.pdf>

Starting, Organizing, and Managing an LLC for a Farm Business. Robert Moore and Barry Ward. The Ohio State University Extension. 2008.

Wisconsin Department of Financial Institutions – Wisconsin Limited Liability Company – Directions.

Wisconsin State Statutes on Limited Liability Companies. Chapter 183. updated and published August 2016.