# Taxation Issues in Farm Business Transfers


Mike Moloney
Manager of Tax Services
Yankee Farm Credit, ACA


Yankee Farm Credit

# Who is Yankee Farm Credit

- The local Association of the Farm Credit System
- A co-operative that serves full time and part time farmers, timber producers, farm related businesses and rural home borrowers
- A provider of related financial services to the same group including record keeping, tax preparation, payroll services, consulting, crop insurance and appraisal
- We cover all of Vermont, four counties in New Hampshire along the Connecticut River and Clinton & Essex counties in New York

# Where is Yankee Farm Credit

# Today's Topics

- Capital Accounts and Partners Basis
- When do asset transfers cause problems
- Guaranteed Payments and Distributions
- Choice of Entity
- Single Member LLC's
- Tax Implications of NH Distributions

# Capital Accounts and Partners Basis Definitions and tracking

- Capital Account- Value of the partners interest
- Tracked on both book value (inside basis) and Fair Market Value (outside basis).
- Important to track for loss reporting purposes, gain or loss on a subsequent sale, gifting and estate purposes.

Yankee Farm Credit

# Capital Accounts and Partners Basis

- Upon formation the basis of a partners interest is calculated as follows:
  - ATB of assets contributed
  - \- partners liabilities assumed by the partnership
  - \+ the partners share of the partnerships liabilities
  - \+ any income required to be reported due to liability relief.
  - = Basis of a partners interest

Yankee Farm Credit

# Capital Accounts and Partners Basis

- Subsequently a partners basis is affected by the following items:

The ATB of any additional contributions

Plus or minus any profit or loss

Plus any income not included in ordinary income (one common item would be Sec. 1231 gains from livestock sales).

Plus any non-taxable income

Less any losses not in ordinary income and any disallowed deductions (penalties, fines, life insurance).

# Capital Accounts and Partners Basis
## Capital Account Example

Dad and 3 sons form a partnership and each contribute assets with an ATB of $100. Each has a 25% interest in the partnership. The beginning book value capital account for each is $100. Activity in the first year results in net income of $400. The partners ending book value capital account is $200 each.

Beg. Cap. $100+$100 earnings= $200

# When will a transfer of assets into an entity create a taxable event?

- Generally, transferring assets into an entity results in no tax consequences to the contributing partner. (IRC Sec. 721)
- There is one big exception: If the assets transferred are subject to a liability and the liability exceeds the adjusted tax basis of the asset being contributed then the contributing partner will have income in the amount of liabilities he or she is relieved of.

# When will the transfer of assets into an entity create a taxable event?

- The following illustrates the issue:
  - Sons each contribute $100 cash, Dad contributes equipment with an ATB of $100 and associated liabilities of $400.
  - Dad and 3 sons form an LLC with each contributing 25% of the beginning capital
  - Sons beginning capital accounts consist of the $100 in cash plus their share of the $400 in liabilities for a total of $200 each.

# When will the transfer of assets into an entity create a taxable event?

Dads beginning basis is:

| | |
|---|---|
| ATB of assets contributed | $100 |
| Less liabilities assumed | -$400 |
| Plus Dads share of liability | $100 |
| Total | -$200 |

Dad ends up with negative beginning basis requiring him to report $200 in income and resulting in Dad having 0 basis in his partnership interest at formation.

Yankee Farm Credit

# When will a transfer of assets into an entity create a taxable event?

- Things to watch for:
- Contributions of raised livestock having zero basis and associated liabilities.
- Contributions of fully depreciated equipment lines that still have debt tied to them. This can happen if their has been aggressive use of Section 179 depreciation write-offs in the past to reduce tax liability.

# Guaranteed Payments

- Used as a “wage” to partners or members
- Right to pay and amounts should be incorporated into the partnership agreement.
- If used, must be paid irrespective of earnings
- Payments do not reduce a partners capital account.
- Payments are deductible by the partnership and reportable as income by the partner.

# Guaranteed Payments

- Can be very useful when one or more members have higher living expenses than the other members. Consider Dad and 3 sons, Dad has low living expenses, no debt and is cutting back on his workload. Sons are all married, raising families and have mortgages, car loans etc., sons are also doing the bulk of the work in the business. Dad and sons agree that sons will be entitled to “X” as a GP and Dad will be entitled to “Y”. The result is that sons have enough money to live on and pay tax on the money they actually received as does Dad.

# Distributions

- Distributions can be either cash or property
- Are not deductible to the partnership and are generally not taxable to the partner
- Will directly affect the partners capital account i.e., $10,000 taken=$10,000 reduction
- Over time can require income to be reported if the capital account plus liabilities becomes negative.

# Choice of Entity

- What are my choices?
- Most common types are LLC's taxed as partnerships, partnerships, S-Corporations and Limited Partnerships.
- Which one is right for me?
- What's the most common answer to tax questions?
- It depends on what you want to achieve by establishing the entity

# Choice of Entity

- A couple of examples:

  Mom and Dad own a profitable dairy farm and wish to form an entity to bring son and daughter (who have been working for them) into the business as owners. Mom and Dad have substantial assets and might, if things keep going well, have an estate tax problem. Their goal is to let the younger generation build equity and gradually take over the business. They might be best served by forming a partnership or LLC and allocating more of the profits and all of the appreciation to the younger generation.

# Choice of Entity

- When might an S-Corp make sense?
- Father and son start a custom cropping operation, the only assets are machinery and equipment along with vehicles to transport them. The business is very profitable, has no appreciating assets and also supports employees. They wish to pay themselves a good salary and implement a retirement plan for themselves and their employees. Choosing S-Corp status in this situation might be the way to go.

# Choice of Entity

- If there is land involved in the formation of a corporate entity then it should be held in a separate entity, apart from the operating assets. In the case of a farm transfer keeping the land separate can make acquiring the operating assets the first step of the process.

Yankee Farm Credit

# Single Member LLC

- Single member LLC's are disregarded entities for Federal tax purposes. The owner files a Sch C or Sch F as if he or she was a sole proprietor, unless, there has been an election made to be treated as a corporation. In that case either Form 1120 of 1120-S would need to be filed.
- You might see this in a highly profitable business where the owner wants to be paid a salary and wants to fund a retirement plan.

# NH Tax Implications of Distributions

- In NH if an entity has freely transferrable shares then distributions from that entity are subject to NH I&D tax. Distributions from entities with non-transferable shares are not subject to the tax.
- Example:
  - An S-Corp distributes real property with a FMV of $200,000 and a basis of $50,000 to its shareholders. Resulting in a deemed sale with a gain of $150,000 to the shareholders.

# NH Tax Implications of Distributions

- This transaction also results in a distribution of $150,000 which is subject to the I&D tax, ouch!

# Contact Information

- Mike Moloney
- Yankee Farm Credit, ACA

  52 Farmvu Drive

  White River Jct., VT 05001

  800-370-3276

  michael.moloney@yankeeaca.com

# Thank You