



## Economic Toolbox

### **A New Form of Business - The Limited Liability Company**

Choosing the form of business organization you operate your farm under has serious consequences on your ability to control management, income taxes, legal liabilities and allocation of profit and assets. The traditional forms of business organization include the sole *proprietorship*, the *partnership*, the *limited partnership*, the *S corporation* and the *C corporation*. Now, there is a newly recognized business form, the *Limited Liability Company* or LLC.

The LLC is now approved by the IRS and most states have authorized its use, although some states have different restrictions. The Limited Liability Company combines the best features of partnerships including flexibility for ownership and management control, income tax management, and allocation of profit and assets. At the same time, the LLC provides the personal liability protection of the corporation.

When two or more individuals share management and ownership responsibility in a business, they must use a form of business arrangement other than the proprietorship, which is a business owned and operated by a single individual. Until now, the only choices were partnerships or corporations.

Edward Bloom, an attorney with Harris Beach & Wilcox, LLP located in Rochester, NY has helped many farmers set up partnerships and corporations. According to Bloom, the LLC has the potential to be the business entity of choice for many farmers looking to enjoy the benefits of single-level taxation, limited liability, and flexibility in management.

### **General Partnerships**

There are two basic types of partnerships, the general partnership and the limited

partnership. Partnerships have long provided the advantages of flexible allocation of management control and distribution of gains and losses among partners. The partnership agreement can spell out responsibilities of partners, the distribution of profit and losses, the value of a partner's interest (assets) in the partnership, and the rights and obligations of partners. In partnerships, taxable income is passed through the entity and is taxed at the personal level. This provides a good degree of tax management capability and avoids the double taxation that can occur with corporations. Disadvantages of the partnership is that partners' personal assets may be at risk if the business is sued. Partners may also be personally liable for the debt of the partnership.

### **Limited Partnerships and S Corporations**

To avoid risk of asset loss without the expense of converting to a full corporation, businesses have used *limited partnerships* and *S corporations*. The limited partnership is composed of the general partner who manages the business, and limited partners which are generally passive investors. Taxable income is passed through to the individual partners and allocation of gains and losses is still flexible. This form of business shields the limited partners from liability similar to the corporation, but still leaves the personal assets of the general partner exposed to loss.

S corporations have the advantage of providing "pass through" tax treatment similar to partnerships. However, owners must share gains or losses according to the percentage of stock they hold in the business because S corporations can have only one class of stock. These restrictions reduce tax management flexibility. Advantages are that the corporate entity provides some level of insulation against personal liability for the owners of the business.

Corporations also provide a vehicle for the transfer of assets between owners through the sale and purchase of stock versus property items as is the case with partnerships. This can be of limited advantage in many farm situations since management control is

based on the ownership of shares. Management control may be lost if ownership falls below 51 percent of the voting stock. Also, when corporations distribute assets to a shareholder, the corporation is treated as if it has made a taxable sale of the asset at fair market value.

### **Advantages of the LLC**

The Limited Liability Company overcomes many of the disadvantages that exist with the other forms of business. For legal purposes, it is treated as a corporation and for tax purposes and management control, it is similar to a partnership.

- Taxable income (or loss) is passed-through to the owners' personal income tax return with the flexibility of a partnership. This avoids income tax on profits at the corporate level *and* at the personal level as with C corporations. The strict allocation of gains or losses based on ownership of shares in the S corporation is also eliminated.
- Protection against personal liability with a LLC is similar to the protection provided by corporations and limited partnerships, except that the personal assets of the general partner are now also shielded.
- Control of management of the LLC is not based on the ownership of voting stock as in corporations. This gives parents the flexibility of being able to transfer a majority of assets to others in the LLC and still retain management control of the business.
- When property is transferred to other owners in the LLC, no tax generally results. Furthermore, for estate planning purposes, assets are transferred to heirs with a *stepped-up basis*. Their basis in the property becomes the value of the item at current fair market value. They can then sell this property without incurring a capital gains tax.

It may be expensive for existing C and S corporations to convert their status to a Limited Liability Company since they would first have to liquidate and pay taxes on

income generated from the sale. Partnerships and individuals can convert their businesses to LLCs without such costly undertakings. This new and exciting form of business may be for you. Consult your tax advisor and attorney to see if you could benefit.