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Tax Characteristics of Business Entities Available to Ohio Farmers

Robert Moore
Attorney, Wright Law Co., LPA, Dublin, Ohio

David Miller
Extension Emeritus, Retired District Farm Management Specialist,
Ohio State University Extension

Ohio farmers have a number of options when determining how to structure their farm businesses. The most common business entities are sole proprietorships, C-Corporations, S-Corporations, Partnerships, and Limited Liability Companies (LLCs). One of the primary factors to consider when determining which business structure to use is tax structure. The purpose of this publication is to provide a brief overview of the tax characteristics of the aforementioned business entities. The reader is encouraged to get professional tax advice before making a final determination on the tax structure that is best for their business.

Sole Proprietorship (SP)

A sole proprietorship is a business owned and operated by an individual. Essentially, the owner and the business are one and the same.

Profits

Any profits made by the business are taxed to the SP owner. This is true even if the profits are not taken out of the business by the owner. For example, a SP makes $10,000 in profit but leaves the profit in its checking account as operating money for next year. The owner will pay taxes on the $10,000 profit even though it stayed in the company.

Tax reporting

A SP reports its net income on a Schedule F or a Schedule C for non-farm businesses. The Schedule F (or Schedule C) is a separate schedule attached to the owner’s 1040. The Schedule F (or C) requires the owner to list all sources of income and all expenses from which the profit (or loss) is calculated. A Schedule SE is required to be filed if net income from the business (F or C) exceeds $400.

Losses

If a SP loses money, the owner can claim that loss to offset other income. If the owner does not have enough other income to offset the SP loss, the loss may be carried over to future years.

Income and Self-Employment Taxes

SP owners pay two types of taxes, income and self-employment (SE). The income taxes are determined by multiplying the profits from the SP by the owner’s personal income tax rate.

The SE taxes are Social Security and Medicaid. SP owners pay 15.3% on the first $97,500 (maximum amount for 2007) of their SE income and 2.9% on everything over $97,500. One half of the SE taxes paid are deductible as an adjustment to income on the owner’s personal tax return.

Estimated Tax Payments

SPs with non-farm businesses must make estimated tax payments four times a year. These payments cover self employment taxes and income taxes. The owner must predict how much he/she will earn ahead of time and make payments accordingly. An easy way to make the estimated tax payments is to make payments equal to the owner's tax liability from the previous year. Some SP owners may not have to make estimated tax payments if his/her tax liability will be small or if the owner is having adequate income being withheld at a regular job.

SPs with farming businesses may not have to pay estimated taxes if they meet certain qualifications. Farmers are not required to make estimated tax payments if two-thirds of their gross income is from the trade or business of farming and they file their tax return and pay any income tax and self employment tax due by March 1.

C-Corporation

Corporations are business entities that have shareholders as owners and are managed by a board of directors and operated on a day-to-day basis by the officers of the company. A corporation is considered to be a separate person (different from its owners) that may own property, enter into business contracts, and borrow money. Corporations can be taxed as C or S Corporations. The C and S refer to the applicable subchapters in the Internal Revenue Code. S-Corporations will be addressed in the next section.

Double Taxation

Before a C-Corporation can pay out any of its profits as dividends to its shareholders, it must first pay tax on the profits at the corporate rate. Any dividends paid out to shareholders are then taxed again at the shareholder level. Taxation at both the corporate level and the shareholder level is the concept known as double taxation. For small businesses such as farms, double taxation is obviously not desirable but can usually be easily avoided.

Avoiding Double Taxation

C-Corporations can avoid double taxation by paying out any profits to the shareholders in the form of wages, bonuses, or consulting fees. Consider the following example:

Ohio Farms Inc. is a C-Corporation that after paying all expenses has a profit of $50,000. If Ohio Farms pays out the remaining after-tax profit of $37,500 ($50,000 minus $12,500 corporate income tax) to the shareholder owners as qualified dividends the following taxes will be paid:

Corporate income taxes ($50,000 @ 25%)	$12,500
Shareholder taxes on qualified dividends ($37,500 @ 15%)	$5,625
TOTAL TAXES PAID	$18,125

Because of the double taxation the corporation and its shareholders will pay a total of $18,125 on the $50,000 or 36.25%.

Now consider the same scenario, but with the corporation paying out the $50,000 as a year-end bonus. The year-end bonus is ordinary income to the shareholder-employee(s) and an expense to the corporation, therefore making the corporation's profits $0 for the year. Assume a 28% tax bracket for the shareholders.

Corporate income taxes ($0 profit)	$0
Shareholder taxes on bonus ($50,000 @ 28%)	$14,000
TOTAL TAXES PAID	$14,000

Even though Ohio Farms Inc. is a C-Corporation, by paying out any profits as bonuses or wages, the corporation reduces any corporation profits to zero, therefore eliminating the double taxation problem. By paying out profits as bonuses or wages, the corporation saved $4,125 in income taxes versus paying out profits as dividends.

Corporate Losses

If a corporation incurs losses, the losses must stay within the corporation. Corporate losses cannot be passed along to the shareholders. However, corporate losses in one year can be offset against profits in future years.

Tax Reporting

C-Corporations file annual tax returns on IRS form 1120 regardless of whether the corporation has corporate income to report or not. The due date for the tax return is the 15th day of the third month after the close of the corporation's tax year. If the corporation expects to owe taxes, it must make periodic estimated tax payments.

Retained Earnings

Retained earnings are profits kept in the business to finance the future purchase of inputs or capital assets. Retained earnings are typically most important to small growing businesses that retain much of their earnings to finance the growth of the company. Corporate tax rates for the first $75,000 of profit in a corporation are usually taxed at a lower income tax rate than an individual's tax rate. See the corporate tax rates in Table A.

Table A. Corporate Income Tax Rates

Over	But not over	Tax is	Of the amount over
$0	$50,000	15%	$0
50,000	75,000	$7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333	—	35%	0

Consider the following example:

Ohio Farms Inc. is a C-Corporation that made $50,000 in profits. The company wishes to retain the $50,000 instead of distributing it to the shareholders as wages or dividends in order to finance an upcoming capital purchase. The tax liability for the retained earnings is as follows:

$50,000 @ 15% corporate tax rate = $7,500

The corporation will pay $7,500 in taxes on the $50,000 retained earnings.

If Ohio Farms were a sole proprietorship rather than a C-Corporation, the retained earnings would be taxed at the owner's individual income tax rates. If the owner is in the 28% individual tax bracket the tax liability for the retained earnings would be:

$50,000 @ 28% = $14,000

The total tax liability for the retained earnings for the sole proprietorship is $14,000. The same tax liability would be incurred by partners in a partnership, shareholders in a S-Corporation, or an LLC taxed as a partnership or an S-Corporation.

Tax Benefits of C-Corporations

1. Income Splitting

Income splitting is splitting corporation profits between the corporation and the shareholders to lower overall taxes. Some profit may be retained by the corporation at the lower corporate rates so as to not push the shareholders into a higher individual tax bracket. Conversely, when a corporation has high profits (over $100,000 net income), the corporation may choose to pass on the profits to the shareholders who may have a lower individual tax rate than the higher corporate rates. See the tax rates in Table B.

Table B. Married Individuals Filing Joint and Surviving Spouses—2007

Over	But not over	Tax is	Of the amount over
$0	$15,650	0 + 10%	$0
15,650	63,700	1,565 + 15%	15,650
63,700	128,500	8,772.50 + 25%	63,700
128,500	195,850	24,972.50 + 28%	128,500
195,850	349,700	43,830.50 + 33%	195,850
349,700	—	94,601.00 + 35%	349,700

2. Fringe Benefits

A C-Corporation has the ability to use more fringe benefits than any other business entity. A fringe benefit is any thing of value with a tax advantage given to an employee or owner of the business. Typical fringe benefits for farm businesses include health insurance, medical reimbursements, and retirement benefits.

While all businesses can provide retirement benefits to employees and owners, C-Corporations allow the biggest contribution limits and flexibility. Medical reimbursements allow the corporation to reimburse employees for any out of pocket medical costs. The corporation can in turn deduct these payments as an expense of the corporation. Fringe benefits must be offered to all employees of the company, and cannot be selectively offered to only certain employees.

Disadvantages of C-Corporations

1. Accumulated Earnings Tax

As discussed above, C-Corporations are ideal businesses for retaining earnings. However, there is a limit to how much earnings can be retained. Typically, retained earnings of over $250,000 incur an additional accumulated earnings tax of 15%.

2. Transferring Assets out of Corporation

Transferring assets out of C-Corporation can cause significant tax liability for the corporation and its shareholders. Transfer of assets can occur upon the sale of assets, distribution of assets to shareholders or the dissolution of the corporation. When an asset is transferred out of the corporation, the corporation owes taxes on any gain of the sale and the shareholders owe taxes on the money received. Additionally, any depreciation claimed by the corporation may be recaptured upon the transfer of assets. It is not uncommon for C-Corporations to incur large tax liability when assets are transferred out of the company, even for minimal amounts.

S-Corporation

S-Corporation Election

All corporations start out as C-Corporations. A corporation choosing to be an S-Corporation must elect S-Corporation status by filing Form 2553 with the IRS within specified time frames.

Pass Through Taxation

An S-Corporation allows for pass through taxation. Any profits or losses made by the S-Corporation are passed through to its shareholders. The corporation itself does not pay taxes. Therefore, an S-Corporation eliminates the double taxation dilemma of a C-Corporation. For example, an S-Corporation that makes $50,000 in profits may distribute the $50,000 to its shareholders if desired. However, the shareholders will pay income taxes on their share of the $50,000 profit on their personal 1040 tax returns. The corporation itself will have no tax liability for the $50,000. Corporate losses are also passed through to the shareholders subject to certain restrictions instead of being held within the corporation.

Limitations on S-Corporations

S-Corporations have unique eligibility requirements. If the corporation does not meet the following requirements, it cannot elect to be an S-Corporation and must remain a C-Corporation:

- No more than 100 shareholders
- All shareholders are U.S. citizens, resident aliens, other S-Corporations, or an electing small business trust
- The corporation has only one class of stock
- All shareholders consent in writing to the S-Corporation status

Tax Reporting for S-Corporations

An S-Corporation must file a form 1120S with the IRS regardless of whether or not it has any income. Any profit or loss attributable to the shareholder (owner) is reported on a K-1 which the corporation sends to each shareholder. The shareholder then reports the K-1 on his/her individual tax return.

Employment/ Self-Employment Taxes

An S-Corporation pays employment taxes on any wages paid by corporation, including wages paid to shareholder owners. However, any distributions paid out to the shareholders are not subject to self-employment tax. Therefore, S-Corporation owners may find it beneficial to transfer some corporate profits out as shareholder distributions. CAUTION: the IRS carefully scrutinizes the owner's salary for reasonableness to determine if any distributions paid to the shareholder owner should be reclassified as owner's wages with additional payroll taxes due.

Disadvantages of S-Corporations

1. Limited Fringe Benefits

An S-Corporation cannot offer the full scope of fringe benefits that a C-Corporation can. Particularly, retirement benefits are more limited in both amount and flexibility.

2. Retained Earnings Immediately Taxed

As discussed above, any earnings retained by the corporation is immediately taxable to the shareholders.

3. Converting C-Corporation to S-Corporation

It is possible to convert a C-Corporation to an S-Corporation. Business owners may most often attempt this when they are transferring assets out of the corporation in an effort to avoid double taxation on gain of the transferred assets. The conversion is a very complicated process that can create unforeseen tax consequences and liability. Converting a C-Corporation to an S-Corporation is a complex activity that should not be done without the assistance of a qualified tax professional.

Partnerships

A partnership is two or more individuals engaged in a business endeavor. Partnership taxation is generally considered to be the most complicated of all the various business entities. Therefore, it is even more important to seek tax advice when considering partnership taxation.

Tax Structure

A partnership has pass through taxation similar to an S-Corporation. The partnership itself does not pay taxes but instead passes on profits (losses) to its partners who then pay taxes based on their individual tax rates.

Tax Reporting

A partnership must file a form 1065 tax return annually with the IRS. This return is an informational return only showing the profits or losses of the partnership. The partnership must issue form K-1 to all partners. The K-1s show each partner's share of the income or loss. The K-1 also goes to the IRS to cross-check with the partners' individual tax returns.

Self-Employment Taxes

A partner's share of the partnership profits is subject to self-employment taxes. However, an exception to this rule is a partner that is not active in the management of the partnership (a silent or investment partner) may not have to pay self-employment tax. This is most common for a limited partner in a limited partnership or a non-managing member in an LLC. IRS regulations provide a number of criteria that must be met before a partner is exempt from self-employment taxes.

Estimated Income Taxes

Partners must make estimated income tax payments periodically on their share of the partnership profits. If the partnership loses money, no periodic payments are due. As discussed in previous sections, the periodic payments cover self-employment taxes. Partners involved in a partnership farming business are subject to the same estimated tax payment rules as a farming sole proprietorship discussed earlier.

Calculating a Partner's Income

A partner is taxed on his/her distributive share of the net income from the partnership. Typically, a partner's share is proportional to the partner's ownership in the partnership. If there is no written agreement, the IRS will assume that all partners are equal owners.

A partner may receive a distributive share different from his/her ownership percentage if such provisions are made in the partnership's agreement. For example, Partner A and Partner B may be equal owners in the partnership but they have agreed to distribute 75% of the partnership profits to Partner A because Partner A puts more labor into the partnership. As long as the partnership agreement authorized this distribution, Partner A may receive a distributive share different from his ownership share. This is known as a special allocation distribution.

Special allocations are sometimes used for partners who are in different tax brackets. A partnership may make special allocations so that a partner in a lower tax bracket receives more of the profit distributions so that the total tax liability for the partnership profits is lower. However, any special allocations among partners should have an economic justification and not be done solely for income tax purposes.

Retained Earnings

Partners are taxed on partnership profits regardless of whether the profits are distributed or not. For example, if a partnership makes $100,000 in profits but keeps $50,000 to invest in a capital asset, the partners are still taxed as if they had received the entire $100,000.

Partnership Losses

Partnership losses are treated in the same manner as profits. Losses are distributed in the same proportion to ownership unless special allocation provisions are made.

Partner Contributions

A partner must make a contribution to a partnership in order to receive profit (or loss) distribution from the partnership. Usually, a partner contributes cash, assets, or both to the partnership. Each partner's contribution is divided by the total contributions of the partnership to determine each partner's ownership in the partnership. It is possible for a partner to have ownership in a partnership without contributing cash or a physical asset. Some partners contribute labor, management, and/or other expertise to the partnership. His/her ownership in the partnership is based on the value of his/her labor, management, and/or expertise. The partnership agreement should establish the ownership of the partnership when the partnership is formed, especially when a partner's ownership share is based on contribution of services and not assets. This avoids any confusion or disputes later as to the ownership percentage of the partnership.

Transferring Assets out of the Partnership

A partnership may transfer assets out to the partners without incurring tax liability as long as the partners do not receive assets greater than their share of ownership in the partnership. For example, if a partnership is worth $500,000 and Partner A is a 50% owner, the partnership can distribute $250,000 of assets to Partner A without causing a taxable event. There are additional rules regarding the timing of distributing the assets and the tax basis of the assets that are beyond the scope of this discussion.

Limited Liability Companies (LLC)

LLCs have become the entity of choice for many new business owners. One reason for the popularity of the LLC is that an LLC can elect several different tax structures. A single member LLC can elect to be taxed as a sole proprietorship, C-Corporation, or S-Corporation. A multi-member LLC can elect to be taxed as a C-Corporation, S-Corporation, or partnership. For example, a multi-member LLC can elect C-Corporation tax status to take advantage of fringe benefits and retained earnings tax savings or the same LLC can elect partnership tax status to take advantage of pass through taxation. The LLC elects its tax structure by filing the appropriate form with the IRS.

Seek Professional Advice

The previous discussion is a very basic and general overview of the tax characteristics of the business entities available to Ohio farmers. The tax code and regulations are very technical and are filled with exceptions and ambiguities. Therefore, it is highly recommended to seek professional tax advice when deciding which tax structure to put in place for one's business. A poor initial decision concerning tax structure can have long term effects on the financial performance of the business over many years.

Authors: Robert Moore, Attorney, Wright Law Co. LPA; David Miller, Enrolled Agent, Wright Law Co. LPA
Contact: 4266 Tuller Rd., Dublin, Ohio 43017, 614-791-9112

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