AGRICULTURAL TAX PLANNING
FARM C CORPORATIONS
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In the May 2016 issue of the Florida Cattleman Journal our article on Farm Provided Meals and Lodging made reference to C corporations in connection with the federal tax deduction of fringe benefits. The C corporation is the most common type of corporation in the U. S. Most major companies and many small and medium sized businesses are C corporations. Corporations are governed by Subchapter C or Subchapter S of the Internal Revenue Code. Those governed by Subchapter C are referred to as C corporations or regular corporations. Those governed by Subchapter S are referred to as S corporations. <u>Generally, all for-profit corporations are automatically classified as C corporations unless S corporation status is elected</u>. This article will focus on C corporations in general and the income tax advantages and disadvantages of operating a farm or ranch as a C corporation. Corporations must be operated completely as separate entities. Separate accounting, separate bank accounts, and separate operations. There can be no comingling of funds or operating of businesses between a C corporation or another business. All personal assets and funds must be kept separate. The Subchapter S election and its advantages and disadvantages may be discussed in a future article.

Legitimate Business Purpose

There must be a legitimate business purpose for forming a C corporation and operating a business within it. The C corporation advantages listed below provides some sound reasons for adopting a C corporation to operate a business. It provides a good way to keep business assets and operations separate from personal assets and provides a separate structure to account for and pay income and other taxes. It also provides some legal protection for assets owned by the shareholder, but not part of the business.

C Corporation Advantages

There are a number of advantages to operating a family farm business as a C corporation.

- The first $50,000 of taxable income is taxed at 15%; the next $25,000 is taxed at 25%. (See below for the total federal tax rate schedule for 2016)
- Medical expenses and medical insurance, including long-term care insurance premiums of the employee-shareholder and family members may be treated as business expenses and fully tax deductible.
- An employee-shareholder may be provided on-premises meals and lodging, with the value of the meals and lodging considered as a tax free benefit to the employee-shareholder.
- C corporations may generally operate on a fiscal year basis for tax reporting purposes. By selecting a tax year end other than a calendar year end, earnings of the corporation can be deferred to a subsequent year Form 1040 of the shareholder-employee.

- C corporations in most cases provide limited liability protection to directors, officers, shareholders, and employees.
- Operating as a C corporation provides some protection for assets of the owner-shareholder that are not owned by the C corporation.
- There is excellent growth potential as the corporation may sell additional shares of stock to raise capital.
- A rancher or farmer can form a C corporation to operate his business but continue to personally hold the real estate. He can then lease the real estate to the corporation and collect rent. The advantage here is that real estate rental income is not subject to self-employment tax, **an additional tax savings.**

C Corporation Disadvantages

- Double taxation is inevitable as earnings are taxed at the company level and again as shareholder dividends. In other words, C corporations are required to file an annual Form 1120 and pay any tax due. In most cases, the majority of the tax will have been paid throughout the year as estimated tax payments. The double taxation comes into play when dividends are paid to the shareholders and the dividends are taxed at the shareholder level.
- Earnings Retained within the C corporation will be taxed again at sale of the stock or liquidation of the corporation. However, proper planning can minimize the tax.
- The C corporation, as a separate entity, will require the filing of another tax return (for the corporation) and may also require additional state and local reporting.
- More sophisticated accounting systems, reporting, and year end reconciliations may become frustrating and more costly for the family farm owner/operator.
- Switching to another entity form may be difficult for a cash method farm corporation.

Florida Corporations

In Florida, a corporation is formed by filing "Articles of Incorporation" with the Florida Department of State, Division of Corporations and paying the filing fee of $78.75.In addition, a set of governing rules are usually adopted known as "Bylaws". The corporation's existence begins as soon as the articles of incorporation are filed.

In general terms, once the corporation is formed, assets can be transferred into the corporation tax-free under IRS Code Section 351 if the following three conditions are met; (a) The incorporator transfers property into the corporation for stock, rather than receiving stock for services; (b) The corporation issues solely stock to the incorporator, not debt instruments or bonds; and (c) The incorporators, collectively those who transferred property, are in control of the corporation immediately after the transfer. For this purpose, control is defined as at least 80% of the voting stock and at least 80% of all classes of stock. In Florida, all corporations are required to file an Annual Report with the Florida Department of State. The filing fee for profit corporations is $150.00. All states and the District of Columbia have rules for forming corporations and these rules may vary by state.

Transfer of Liabilities to a Corporation Upon Formation

Generally, the transfer of liabilities to a corporation in connection with the transfer of property under IRS Code Section 351 does not result in the recognition of gain to the incorporator. However, if the liabilities of the incorporator assumed by the corporation are in excess of the adjusted basis of the assets transferred by that incorporator to the corporation, the excess is recognized as taxable gain to the incorporator.

Brother/Sister Controlled Group

A brother/sister controlled group exists if more than 50% of the total combined voting power of all classes of stock entitled to vote, or more than 50% of the total value of all stock, taking into account the stock ownership of each person only to the extent the person owns stock in each corporation. A controlled group can also be a Parent-subsidiary group or a combination of both. A basic parent-subsidiary controlled group exists when one or more chains of corporations are connected through ownership with a common parent corporation; and 80% of the stock of each corporation, (except the common parent) is owned by one or more corporations in the group; and the parent corporation must own 80% of at least one other corporation.

Withdrawing Money from a C Corporation

Paying a salary to an employee-shareholder is one method of withdrawing money from a C corporation. For closely held corporations, one that has only a single or several shareholders, an owner who works on the farm or ranch must be paid a salary. The salary can be set at what a comparable salary would be for the job the owner is doing and the projected profits of the business. The tax rules require this so that Social Security and Medicare taxes are paid for the owner. Also, an employee/shareholder would reasonably expect to be paid a salary for work performed.

Dividend payments are another method of distributing money to shareholders. Sole owners or a controlling shareholder can control the timing and the amount of dividend payments. Often, a closely held corporation will pay one dividend a year, after the profits for the year have been determined. However, as a controlling owner, you can spread the dividend payments throughout the year.

Draws available to partners are <u>not allowed</u> for corporations. Larger corporations sometimes make low-cost loans to corporate officers, but these types of loans are not looked upon favorably by the IRS and the rules and restrictions placed on these types of loans makes this option unattractive.

Federal Corporate Income Tax Rates for 2016 - Estimated

Taxable income over	Not over	Tax rate
$ 0	$ 50,000	15%
50,000	75,000	25%
75,000	100,000	34%
100,000	335,000	39%
335,000	10,000,000	34%
10,000,000	15,000,000	35%
15,000,000	18,333,333	38%
18,333,333	------------	35%

Note; The highest **individual** federal income tax rate is **39.6%** and for married joint filers applies to taxable income in excess of $466,950 as estimated for 2016.

The rates are shown as estimates as the IRS adjusts the individual rates each year for inflation and any of the tax rates may be changed by law.

Florida Corporate Income Tax and Rates for 2016 - Estimated

The Florida state income tax is based on federal taxable income with some Florida modifications. The tax rate is 5.5%. An exemption of up to $50,000 is allowed against Florida taxable income.

Why Operate a Ranch or Farm as a C Corporation?

As stated above there are a number reasons why to operate a ranch or farm as a C corporation.

- There is generally an overall tax advantage to operate a ranch or farm as a C corporation. As an example, the Federal corporate tax rate for income over $335,000 but not over $10,000,000 is 34%. The Federal personal income tax rate for taxpayers married filing jointly is 39.6% for taxable income over $466,950. Additionally, C corporations can pay dividends which are taxed at capital gains rates (highest is 23.8%). However, Florida, has a state income tax that somewhat reduces this benefit.
- Tax dollars saved can be used to expand the owner/shareholder's farm or ranch business.
- The C corporation offers asset liability protection for the owner's assets outside the corporation. An individual proprietor's assets used in his business as well as personal assets **outside the business** do not have this limited liability protection.
- A rancher can separate his business operations into separate C corporations, providing separate asset protection to each of his corporations, and possibly more tax savings.
- C corporations can provide tax deductible fringe benefits such as medical insurance, life insurance, retirement benefits, and meals and lodging to employees, including a shareholder-employee and other family members working on the farm.
- Upon retirement, the stock can be sold to the owner's children, providing retirement income to the parent, while keeping the ranch in the family. Properly planned, the sale can be spread over a number of years. Dividends can also be distributed before the sale that could produce additional tax savings.
- For larger farms and ranches, proper planning and the use of dividend distributions, could reduce any estate tax that may be due upon the death of the owner.

Summary

The main purpose of this article is to discuss, in very general terms, the legal entity referred to as a C corporation. We have discussed the general aspects of C corporations, a classification derived from the Internal Revenue Code. The C corporation is the most common type of corporation in the U. S. and as mentioned above has unlimited growth potential. The adoption of a C corporation in operating a ranch, farm, or any business depends on a number of factors and most likely will be a complicated decision. C corporations have no limits on whom or what can be a shareholder; and no limits on the number of shareholders. S corporations however, are limited to 100 shareholders. Also, S corporations cannot be owned by a C corporation, other S corporations, LLCs, partnerships, or many trusts. With the prominence of multi-member Limited Liability Corporations (LLC's), C corporations may not be as popular as they once were. The most distinguishing factor that separates C corporations from other types of legal entities is that it is taxed at the entity level. Partnerships, S corporations, and multi-member LLCs are pass-through entities. Thus, earnings are taxed at the partner, S corporation shareholder, and LLC member level only. Depending on your particular set of factors a C corporation may or may not be the best legal entity to use in operating your ranch or farm. Selecting a legal form to operate your ranch or farm or changing the legal form in today's economy requires professional assistance.

For more information on this topic and other tax planning for ranching, please contact me at (863) 640-2008 or Tom@beasleybryantcpa.com and/or Ryan Beasley at (863) 646-1373 or Ryan@beasleybryantcpa.com . Please visit our website at www.beasleybryantcpa.com for information on other relevant topics.

We at Beasley, Bryant & Company, CPA's, P. A. are experienced in agricultural business problems, tax issues or concerns, and are here to help you.

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06/06/2016 Cattleman Journal