

So You Want to Invest in an Ethanol Plant

U.S. ethanol plants are currently riding a high tide as a result of strong demand and incentives available for alternative fuel production. Ethanol.org., the official website for the American Coalition for Ethanol (ACE), lists 102 ethanol plants currently in operation and 30 more under construction. In the early years, investors in ethanol plants were generally farmers who were often required to deliver corn directly to the plant. Today, given the growth of the industry, the investor group has broadened to include the general public.

The income tax consequences of ownership in an ethanol plant vary depending on the type of entity under which the plant is organized. Most ethanol plants are organized as Limited Liability Partnerships (LLPs). An LLP is a partnership which offers limited liability to its members. The discussion following addresses aspects of investing in an ethanol plant organized as an LLP.

Income Tax Reporting: The LLP profit or loss passes through to the partners based on the partner's ownership percentage, and is reported on a Schedule K-1. Prior to issuing the Schedule K-1 to the partner, the partnership return must be completed, and in many cases a certified audit is conducted. If the LLP has a calendar year end, the completion of the audit and partnership tax return can push up against the 1040 deadline, and in some cases force the 1040 to require a filing extension. Most self-employed farmers file their tax return by March 1, and this deadline cannot be extended unless special action is taken to make a tax payment by January 15.

Self-Employment (SE) Tax: Income passing through from an LLP is generally not subject to SE tax if the investor does not materially participate in the operation. The material participation test is met if the investor has at least 500 hours of active participation in the operation of the ethanol plant. Generally, most investors other than those on the board of directors will not meet this participation test. As a result, pass-through income is not subject to SE tax. Likewise, a pass-through loss does not reduce other net SE income of the partner.

Passive Activity: Losses passing through from an LLP to a partner who does not materially participate in the operations are subject to the passive loss provisions. Under these provisions, losses are deductible only to the extent of passive income, such as some types of rental income. Without other passive income, the losses will be suspended to future years. These losses become deductible against pass through income from the LLP in future years or when the investment is sold.

It may be possible to make an election in the 1040 return to group the ethanol plant activity with an active farming operation of the partner. If this election is made, the ethanol activity becomes active and is not subject to the passive loss limitations.

Tax Credits: Some ethanol plants are eligible for the alcohol fuels credit. LLPs pass this credit through to the partners as reported on Schedule K-1. The credit offsets federal regular and alternative minimum tax (AMT).

The income tax issues surrounding ownership in an ethanol plant LLP are significant. Pass-through income and losses, SE tax consequences, passive activity limitations and possible tax credits greatly increase the complexity of the investor's personal tax return. We recommend you call us to discuss the income tax consequences prior to making the investment.

Transitioning the Family Farm

One would think that the transition of the family farm would not be a difficult task. After all, it involves family who work together side-by-side every day. By the natural order of things it should almost be like osmosis, with the ownership and responsibilities of the farming operation moving from the older generation to the younger generation seamlessly. Unfortunately, in the real world it does not happen quite so easily. At least two aspects typically play into all transitions: financial and emotional.

Financial

The first component of the farm transition is financial. How does the older generation (parents) move comfortably into retirement without putting an undo financial burden on the next generation (children)? The traditional method, which can work for some families, involves a gradual transition in equipment ownership. As Mom and Dad trade in their depreciated machinery, the children assume part ownership of the new equipment. What often makes this method difficult is that over time the goals of the parents and the children change. Mom and Dad may be reluctant to purchase new equipment when they are trying to scale back their involvement. On the other hand, the children may want to purchase larger, more high tech equipment to grow their operation.

One possible solution to this dilemma is to create a general partnership (GP). Each family member would contribute his or her ownership interest of their machinery and other non real estate assets to the GP. The GP would become the operating entity for the farming operation. A GP would simplify the purchase of crop inputs, repairs, fuel allocation, crop storage, marketing and rental agreements. With a single enterprise, it is not necessary to divide expenses in proportion to ownership, thereby eliminating the question of "fairness". Each member would have an ownership interest proportionate to the contribution of assets net of debt. Generally, the older generation starts with a larger ownership interest. Over time, this interest is either sold or transferred by gift to the next generation. A key threshold is crossed when the ownership interest of Mom and Dad becomes less than 50% and they are no longer in control.

Emotional

The second component of a farm transition is the emotional side. This aspect is often more important than the financial side. The transition of roles and responsibilities from one generation to the next can be difficult in any business. Understanding those changing

roles is an essential part of a successful management transition. Working side-by-side, family members often develop an unspoken understanding of how things are done. Roles are left undefined and this can lead to confusion and even conflict between the parents and the children.

The solution is to make a list of all the jobs associated with the farming operation and then assign the responsibilities to a member of the team. Given this information, an organizational chart can be developed that illustrates the roles for each member. Often the older generation has the “managerial” roles and children assume the “labor” roles. Over time these roles, like the financial interest in the GP, can be transitioned to the next generation. Generally, about the time that the financial interest crosses the 50% mark in favor of the children, the children assume the managerial roles of the GP as well.

Conclusion

The key to successfully addressing these and other aspects of a farm transition is communication. To operate successfully as a GP (or other business entity), the family members should have defined goals, written job descriptions, and compensation agreements that allow the transfer of roles and ownership in an orderly manner. Communication that goes beyond the unspoken understanding of the parents and the children allows everyone that has an emotional attachment to the farming operation, including in-laws and non-farming children, to understand the transition plan.

A family farming operation can provide a livelihood for many future generations. Proper planning can assure a successful transition from generation to generation.

Life Insurance and Your Estate - A Solution or Problem?

Life insurance is often a subject that arises during estate planning, whether for a multi-millionaire or a person with a small estate. Many aspects must be considered to determine if life insurance is appropriate and beneficial. A common use of life insurance is to provide sufficient liquid assets to pay the estate taxes at death. The amount of insurance, ownership of the policy, and designation of beneficiaries are all extremely important issues in these situations.

An individual’s estate includes any life insurance policy on which the individual has incidence of ownership. Direct ownership, where the decedent is the owner of the policy, and indirect ownership are includable. Examples of indirect ownership include the ability to change a beneficiary, to cancel a policy, and to borrow against the policy. Furthermore, the cash surrender value of any policy on another’s life owned by the decedent is also included in the decedent’s estate, such as a policy that Dad may own on Mom’s life. To illustrate this point, here are some examples.

Example 1: Mom and Dad had combined assets of \$4 million, owned one-half by each. Mom died in 2003 when the federal estate exemption was \$1 million. One-half of Mom’s assets were placed into a credit trust for the benefit of Dad during his lifetime. The remaining \$1 million of Mom’s assets were transferred directly to Dad tax-free as a

marital deduction. Today, Dad has \$3 million of assets in his name which would result in approximately \$500,000 of federal estate tax upon his death.

Being concerned about estate taxes, Dad purchases a \$500,000 life insurance policy to pay the projected federal estate tax. He is the owner of the policy with his estate listed as the beneficiary. This policy is intended to reduce the burden of estate tax to his children and to avoid the liquidation of assets to pay estate tax.

Oops!! Dad has just increased his gross estate from \$3 million to \$3.5 million, as the death benefit from the life insurance policy will be included in his estate. The projected federal estate tax has now increased from \$500,000 to \$750,000!

To avoid this problem, Dad should not be the owner of the life insurance policy and his estate should not be the named beneficiary. Instead, Dad should consider setting up an irrevocable life insurance trust to own the policy and be the named beneficiary. If handled correctly, the insurance proceeds will not be included in Dad's estate.

In some cases, life insurance is purchased to allow an heir to purchase business assets from other uninvolved heirs. A common situation is farm land in an estate, with only one heir actively farming the land and desirous of having complete ownership. The following example illustrates the use of life insurance in this situation.

Example 2: Dad's estate is comprised of \$1.5 million of farm land and \$300,000 of investments. Dad has three children, one of whom is involved in the farming operation. Dad would like Junior to receive the farm land, in order to continue the family farming operation. However, Dad is concerned about an inequitable split of his estate between the children and ideally would like each child to receive an equal share of his net worth.

Dad structures his will so that each child receives 1/3 of all assets, with Junior given the option to purchase the farm land from his siblings. Junior acquires a \$1 million life insurance policy on Dad so that he has the funds to purchase 2/3 of the land from his siblings. In this case, Junior should own the policy, pay the premiums, and be designated as the beneficiary. Junior uses the insurance proceeds to buy the land from his siblings. In the end, Junior owns \$1.5 million of land free of debt. His two siblings each receive \$500,000 from their sale of land to Junior. This is a tax-free sale, as Dad's land received a "step-up" in tax basis when it passed through his estate.

Given the various options and complexity involved, it is best to consult with your attorney and tax advisor when considering a life insurance policy. Important issues include policy ownership, naming of beneficiaries, and the potential of a life insurance trust. The structuring of a life insurance policy should be analyzed and integrated with your other estate planning goals in order to be the solution, not the problem. Please contact us if we can assist with your estate planning needs.