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White paper

Choosing a business entity

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A commitment to agriculture involves a devotion of time, resources and lifestyle to ensure success. You've worked hard to arrive at this point in your life and you have tangible things - land, buildings and equipment — that are a result of that hard work. Those "things" need to be preserved in a way that allows the next generation to follow in your footsteps or add to what you've created. An important question for you to consider when thinking about the ongoing needs of your farm is whether you need to establish a business entity to better facilitate that transition and what kind of entity that should be.

"Why should I do that?" you may ask. "The farm has run fine without one and that sounds complicated and expensive." To answer that question, picture a recipe. You may be able to make a tasty apple pie without one, but you really know what you're going to get if you follow grandmother's tried and true version. With that recipe in hand you aren't likely to forget an ingredient or bake the pie for too long or at too high a temperature (ruining all that hard work in putting it together). Establishing the appropriate entity for your needs and situation with a related operating agreement or buy/sell agreement, can likewise provide a "recipe" or "roadmap" for continuing the farm operations into the future. It will also take into account all the necessary "ingredients", "cooks" and "pie eaters" to properly plan for your desired outcome.

So what are we talking about when we mention business entities? There are several to choose from including:

- Sole propreitor (SP)
- General partnership (GP)
- Family limited partnership (FLP)
- Limited liability company (LLC)
- S corporation (S corp.)
- C corporation (C corp.)

Your next question may be, "How do I choose?" This may largely depend on what your concerns or goals are that you hope to accomplish through the establishment of the entity. These could include:

- Limit individual liability and protect certain assets
- Reduce taxes
- Transfer or gift land, equipment, buildings, etc.
- Bring a family member into the farm operations
- Raise capital or expand operations
- Gain greater access to farm program payments

Once you have determined what your specific objectives may be, consider how those may be addressed through the various types of business entities. Below is a short description of some of the common features, costs, requirements, advantages and disadvantages of the various options.

Sole proprietor

If it's just you and you work for yourself, you are operating as a sole proprietor. There are no entity formation requirements. This is the simplest entity form, but as the name suggests, it generally does not allow for dual ownership of assets. Income passes through to be taxed on the owner's individual tax return and is subject to self-employment taxes. This form of operation also provides no protection from personal liability. This means that if a claim occurs, any personal assets of the individual can be reached. Because of the simplicity of the structure, all assets are held in the individual's name so he or she may transfer assets at will. Any capital needed would come from the owner's own funds. If

you want to bring on other owners into the family farm, assets and income would have to be divided and owned separately by the individuals involved. It would require parallel sole proprietorships working together without an overarching structure to the arrangement.

General partnership

If two or more people do business together (for example, buy equipment in both names) they have created a partnership. This is true whether they have entered into a written partnership agreement or not. Registration with the State is optional. Any partner can bind the partnership. All partners have personal liability for partnership debts. For tax purposes, income and losses pass through to the partners to be reported on the partners' individual tax returns. In addition, partners are subject to self employment taxes. The partnership will also need to obtain a federal tax identification number and file a partnership return each year for the partnership. The partnership issues each partner a Form K-1 to report his or her share of partnership income. This structure allows the partnership to own the assets of the farm, and the individuals will each own a certain percentage of the partnership. Generally, each partner's contributions to the partnership controls his ownership interest. However, partners can have their ownership interest based on their "human capital" reflecting the work they do for the farm or a parent can transfer or gift interests, potentially with discounted values, to provide children or grandchildren with larger interests in the partnership. GP's and joint ventures are the only two forms of business entities that allow for the receipt of multiple Farm Services Agency (FSA) payments. Advanced entity structures or the use of multiple entity structures are typical when dealing with FSA programs to maximize benefits. The biggest disadvantage of a GP is that all partners are equally liable for partnership liabilities, no matter their ownership interest.

Family limited partnerships (FLPs)

FLPs are similar to GPs in most respects; however, they do have some differences. The FLP must register with the State, so there will be set up costs. The FLP requires at least one general partner who has control of the partnership's operations and is liable for all partnership liabilities. An FLP will also have one or more limited partners who have no operational control, but are also protected from partnership liability beyond the value of their ownership interest. Because limited partners are passive investors, they normally cannot deduct partnership losses. FLPs often enjoy greater discounts on the value of a limited partnership interest than an LLC (as discussed below). Limited partners cannot bind the partnership and do not participate in management. An FLP would require a partnership agreement to control the operations of the partnership, but as with the general partnership, the FLP provides an excellent vehicle for the transfer of assets to the next generation through the gifting of FLP interests. The FLP would need to file a partnership tax return and issue K-1s annually, but taxes flows through to the partners.

Limited liability company (LLC)

One of the newer entities available to businesses is the LLC. It provides a great deal of flexibility and is available for one or multiple members. LLCs require registration with the State and can include high fees. All states charge an initial filing fees ranging from $50 to $520. Some require ongoing registration fees, while others, like California, impose an annual franchise and/or entity tax. LLC income passes through to the owners to be reported on individual returns and is subject to self employment tax. Multi-member LLCs must file an informational return for the LLC. Importantly, all members of the LLC enjoy liability protection beyond their interest in the LLC. In addition, all LLC members can participate in the operation of the LLC without losing liability protection. Like partnerships, LLC units can be transferred or gifted to family members to facilitate the transfer of assets. As an LLC you will also have the ability to choose the type of taxation that best fits your business needs.

S corporation

S corporations are corporations that elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes. S corporations must be registered with the State. Like partners and LLC members, S corporation shareholders report the pass-through of income and losses on their personal tax returns. However, passive losses may only be offset against passive income. In addition, the S corp. shareholders are not subject to

self employment taxes. This allows S corporations to avoid double taxation on the corporate income. An S corporation is a corporation in form, so owners of the corporation are shareholders. To be treated as an S corporation, the corporation must make an S election and file annual information returns with the IRS. As a corporation, shareholders are shielded from personal liability for debts of the corporation. An S corporation can have no more than 100 shareholders. S corporations may be subject to franchise or income taxes in certain states and annual corporate tax returns will need to be filed.

C corporation

Unlike the other entities listed above, C corporations have two levels of taxation applied to them. The corporation itself pays corporate taxes, and shareholders pay taxes on dividends that are distributed to them. C corporations must be registered with the State. As a corporation, shareholders are shielded from personal liability for debts of the corporation. The number of shareholders a C corporation may have is unlimited and the entity remains intact even when a shareholder leaves a C corporation. C corporations must file corporate tax returns annually. They are also able to take advantage of deductions for business expenses that may not otherwise be available to other entity forms. While perhaps not desired in a family owned business, C corporations do offer the ability to raise capital through the sale of corporate stock.

More generally

With any of the entities discussed above (except the sole proprietorship), parents may transfer ownership interest in the entity initially or over time. If they do so as a gift, the transfer is gift tax free up to the annual gift exclusion limit ($15,000 for 2018 per person). Another important benefit in setting up one of these entities is the possible valuation discount that may be available. Because there is no ready market for the ownership interests of the closely held business, owners may be able to take a lack of marketability and/or a minority interest discount in determining the value of the interest.

No matter which entity you ultimately decide works best for you, you should spend the time and money at the onset to have governing documents drafted (i.e. an operating agreement, partnership agreement, buy/sell agreement). The specific terms of these documents are part of ensuring a successful outcome for the business. The best governing documents are tailored to your situation, clearly written and all-inclusive in their details. You and your attorney (yes, you should spend money up front to have an attorney draft the documents to potentially save money, hurt feelings and relationships in the long run) should focus on current and potential family members that may be involved and consider everyone's role. Questions to consider include: Who gets an interest? How much? How will decisions be made? How can people be added or removed? How will disputes be resolved? Who has the ability to make changes to the structure and how will this be done? If there is a buy/sell, what triggers it? How is it funded? How is the value of the assets determined?

Once you settle on a type of entity and work through your governing documents, take the time to understand what ongoing tasks will be required to maintain the entity. Understand what federal and state returns or filings will be required and whether you will need to send K-1s or other forms to partners or owners of the entity. Understand what fees or taxes are applicable to your entity. Most importantly have a plan for staying compliant. Determine if a family member is capable of handling this responsibility or whether you need to hire an accountant.

How complicated or simple your situation needs to be really depends on your goals and objectives. Regardless of what your preferences are, your farm is more likely to enjoy continued prosperity and produce expected outcomes if you invest now in creating a recipe for success. Establishing a business entity to hold farm assets and having a written agreement in place for the ongoing operation of the farm that plans for future contingences should be the basic elements of your plan.

Important Note: All of the business entities discussed above are created by state law. Some entity forms may not be available in all states. You should consider working with an attorney or tax advisor in establishing your business entity who should be able to guide you through the specific requirements and rules in your state.

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