Getting Started in Ag:
Which Business Structure is Best?

Bruce and Becky Johnson* are excited. They have just agreed to purchase a farm in the area where Becky grew up after working and saving for twenty years. They plan to raise club cattle and sell alfalfa hay. While both have experience in the day to day operations of what they plan to do, they have little knowledge on how to establish the structure of their new business. They are very concerned about protecting what they have worked so hard to purchase, as well as an interest in setting up a manageable business that can be passed down to their children.

There are many aspects to consider when establishing a new agricultural business: ownership, taxes, liability, and estate planning concerns should all be carefully studied when deciding on a business structure. Putting in considerable time to plan and consult with trusted advisors will go a long way towards achieving long term goals and stability. There are many alternative forms of business structure to think about.


Risk Concepts

Sole Proprietorship

Historically, farms and ranches were operated as sole proprietorships. The land, machinery, livestock, and other assets were owned and used by an individual or couple. Likewise, the individual (or husband and wife) farmer/rancher was personally responsible for all debts and financial obligations owed by the business. The farmer or rancher was the business, and the business was the farmer or rancher.

There are a number of organizational structures that may better meet the needs of today's farm/ranch business. A few of the more common business entities used by farmers and ranchers include sole proprietorship, general partnership, limited partnership, limited liability company (LLC), and corporation. Each U.S. state recognizes most legal entities, while the U.S. Internal Revenue Code recognizes all business forms except LLCs. Each organizational structure has its strengths and weaknesses. Before a decision is made as to the legal entity under which to operate, a person – or person and his or her family and other partners – need to determine the goals of and needs for the business and its assets.

The sole proprietorship is the simplest business form under which one can operate a business. The sole proprietorship is not a legal entity. It simply refers to a person who owns the business and is personally responsible for its debts. A sole proprietorship can operate under the name of its owner or it can do business under a fictitious name. The fictitious name is simply a trade name--it does not create a legal entity separate from the sole proprietor owner.

Formation

One of the great features of a sole proprietorship is the simplicity of formation. Little more than buying and selling goods or services is needed. In fact, no formal filing or event is required to form a sole proprietorship. A sole proprietorship, generally, has

RRRC-20191104.007
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Sole proprietorship

A sole proprietorship is the most simple and common business organization used in production agriculture. Under this structure all assets, such as land, machinery and livestock, are owned by a single individual (or couple in our example). This individual is also responsible for all debt and liabilities associated with the business. The business itself is either operated under the name of the owner or a trade name; there is no separate entity formed.

Simplicity is one of the main advantages of a sole proprietorship. No formal paperwork is required to form one in most states and the sole proprietorship can be dissolved by selling the assets and paying down any liabilities. There are no special tax considerations under this form of business, as the owner files individually for both business and personal tax liabilities. The business can generally be passed to heirs as part of an estate plan without special steps. The main disadvantages of a sole proprietorship come in the form of business liability and protection. The owner, as the guarantor of the business, is at legal risk along with all business assets for any and all obligations assumed by the business.

General and limited partnerships

Partnerships are generally formed when two or more parties come together and agree to own and operate a business. A general partnership is similar to the sole proprietorship: owners have full say over the business management and are responsible for debts and obligations. General partnerships can be as complex as desired by the parties involved. This could be two equal partners simply sharing profit and management or a multi-layered structure with a managing partner and other unequal partners. There are generally no entity level tax considerations under a general partnership, as partners are taxed at the individual level like a sole proprietorship.

Risk Concepts from RightRisk.org

-- Detailed overview of the most common business structures used in agriculture

-- Includes a chart summarizing the options and tradeoffs between various organizational structures

-- View at: RightRisk.org/RiskConcepts

General partnerships, if formally organized, limited partnerships and limited liability limited partnership are considered separate entities for both legal and taxation purposes. Parties involved are classified as either general or limited partners. Managers and general partners usually receive a larger share of any profits since they assume a higher level of personal responsibility. Limited partners contribute to a capital account defining level of ownership and are generally liable for debts and obligations up to that level.

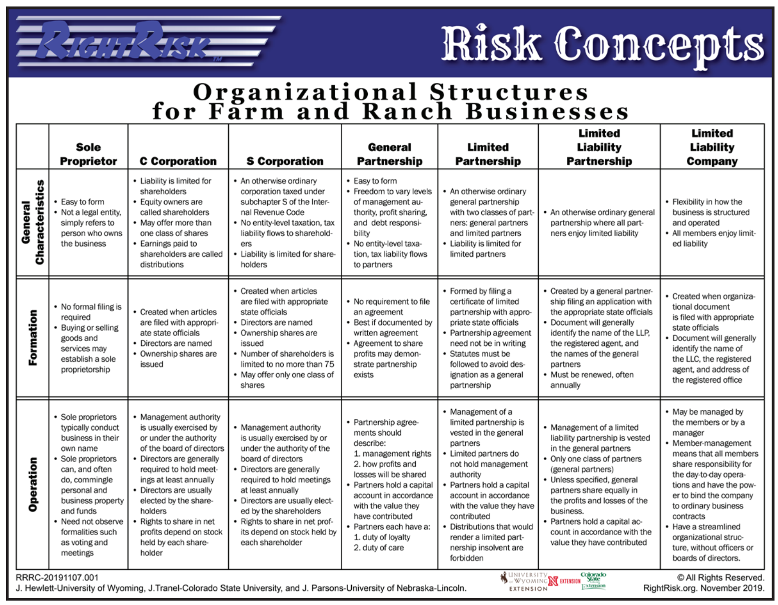
One of the most important points to consider when forming a partnership is the agreement itself. Most states require no written agreement to form a partnership. However, it is vital to put time and forethought into drafting a written agreement outlining expectations, duties and profit allocations for each party involved. The main disadvantage of general and, to a lesser extent, limited partnerships is the level of personal liability. From an estate planning perspective, partnerships require more careful planning, depending on the structure and wishes of all the parties involved.

Corporations

A corporation is a business entity formed by submitting articles of incorporation within a given state. There are two main types of corporations, C- Corporation (C- Corp) and sub-chapter S- Corporation (S- Corp). C- Corp ownership is defined by shareholders who own equity shares in the company backed by cash, property, or services. S- Corps, so named because of the relationship to subchapter S of the Internal Revenue Code, differ from C- Corps mainly in that they are taxed at the individual shareholder level and limit personal liability to shareholders.

The C- Corp structure can be one of the more complicated types of business organization. Management is generally under the authority of a board of directors, elected by shareholders, who decide the day-to-day operations and flow of any profits back to shareholders. The complexity of a C- Corp generally depends on an operation's size and scope and is defined in the articles of incorporation. In addition, there may be different classes of stock, reflecting differing levels of liability. One of the biggest advantages of a C- Corp is the limit on personal liability, as compared to partnerships and sole proprietorships. C- Corp income is taxed at the business level and any distributions of earnings or dividends to shareholders are taxed a second time at the individual level. Generally, shareholders cannot be held personally liable for debts and liabilities of the corporation itself, unless it is determined that the corporation was used for fraud or other illegal activity. C- Corp shareholders may sell their shares at any time to anyone, making this an important estate planning consideration. The termination of a C- Corp is generally defined by the rules of the state where it is formed and can take considerable time.

S- Corporations are governed by different IRS rules than C- Corps and can be more complicated than C- Corps. They can have a maximum of 75 shareholders, who may only be individuals, with certain exceptions for trusts, estates, and tax-exempt corporations. The main advantage of an S- Corp is from a tax perspective: there is no entity level taxation, any income or losses flow through to individual shareholders. An S- Corp stockholder's liability is usually limited to the level of their investment in the business and not the overall debts and liabilities incurred by the business.



	Sole Proprietor	C Corporation	S Corporation	General Partnership	Limited Partnership	Limited Liability Partnership	Limited Liability Company
General Characteristics	• Easy to form • Not a legal entity, simply refers to person who owns the business	• Liability is limited for shareholders • Equity owners are called shareholders • May offer more than one class of shares • Earnings paid to shareholders are called distributions	• An otherwise ordinary corporation taxed under subchapter S of the Internal Revenue Code • No entity-level taxation, tax liability flows to shareholders • Liability is limited for shareholders	• Easy to form • Freedom to vary levels of management authority, profit sharing, and debt responsibility • No entity-level taxation, tax liability flows to partners	• An otherwise ordinary general partnership with two classes of partners: general partners and limited partners • Liability is limited for limited partners	• An otherwise ordinary general partnership where all partners enjoy limited liability	• Flexibility in how the business is structured and operated • All members enjoy limited liability
Formation	• No formal filing is required • Buying or selling goods and services may establish a sole proprietorship	• Created when articles are filed with appropriate state officials • Directors are named • Ownership shares are issued	• Created when articles are filed with appropriate state officials • Directors are named • Ownership shares are issued • Number of shareholders is limited to no more than 75 • May offer only one class of shares	• No requirement to file an agreement • Best if documented by written agreement • Agreement to share profits may demonstrate partnership exists	• Formed by filing a certificate of limited partnership with appropriate state officials • Partnership agreement need not be in writing • Statutes must be followed to avoid designation as a general partnership	• Created by a general partnership filing an application with the appropriate state officials • Document will generally identify the name of the LLP, the registered agent, and the names of the general partners • Must be renewed, often annually	• Created when organizational document is filed with appropriate state officials • Document will generally identify the name of the LLC, the registered agent, and address of the registered office
Operation	• Sole proprietors typically conduct business in their own name • Sole proprietors can, and often do, commingle personal and business property and funds • Need not observe formalities such as voting and meetings	• Management authority is usually exercised by or under the authority of the board of directors • Directors are generally required to hold meetings at least annually • Directors are usually elected by the shareholders • Rights to share in net profits depend on stock held by each shareholder	• Management authority is usually exercised by or under the authority of the board of directors • Directors are generally required to hold meetings at least annually • Directors are usually elected by the shareholders • Rights to share in net profits depend on stock held by each shareholder	• Partnership agreements should describe: 1. management rights 2. how profits and losses will be shared • Partners hold a capital account in accordance with the value they have contributed • Partners each have a: 1. duty of loyalty 2. duty of care	• Management of a limited partnership is vested in the general partners • Limited partners do not hold management authority • Partners hold a capital account in accordance with the value they have contributed • Distributions that would render a limited partnership insolvent are forbidden	• Management of a limited liability partnership is vested in the general partners • Only one class of partners (general partners) • Unless specified, general partners share equally in the profits and losses of the business. • Partners hold a capital account in accordance with the value they have contributed	• May be managed by the members or by a manager • Member-management means that all members share responsibility for the day-to-day operations and have the power to bind the company to ordinary business contracts • Have a streamlined organizational structure, without officers or boards of directors.

RRRC-20191107.001
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RightRisk.org. November 2019.

Limited Liability Companies

Limited liability companies (LLCs) are legal entities recognized by State statute but not by the Internal Revenue Service (IRS). LLCs combine many features of the sole proprietorship with those of a general partnership and limited liability partnerships. There are three aspects of the LLC that are enticing for new businesses: 1. It can be taxed as a partnership, as a corporation (if the election is granted by the IRS), or as a disregarded entity if there is only a single member; 2. It is an extremely flexible form of business both in terms of options when creating the business and options for how it is to operate; and 3. It offers all members limited liability.

Summary

Clearly the Johnsons have many options and tradeoffs to consider for organizing their farm business. Risk Concepts is a series of publications compiled by the RightRisk team and made available at: RightRisk.org. The series offers a separate, 4-page bulletin covering each of the most common forms of business organization. A summary chart compares and contrasts the alternatives to provide an overview of the choices involved, Figure 2. The Johnsons should carefully consider their long term goals for the business, as well as consult with trusted professionals about the tax, accounting, legal, and other implications as they form a plan that best fits their operation.

** The Johnson's operation is a case study example created to demonstrate RightRisk tools and their application. No identification with actual persons (living or deceased), places, or agricultural operation is intended nor should be inferred.*