# Farm Business Arrangement Alternatives

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## Introduction

If the new and established operators decide to farm together after the testing stage, they are ready to move from the beginning farm business arrangement to a more permanent arrangement. The move to a more permanent arrangement can be done in one step or it can be done in several steps. Whether the move is done quickly or over several years depends on the ability of the beginning operator to obtain financing to buy into the business and the comfort of all of the operators with their working relationship.

This chapter discusses the most commonly used legal arrangements for the more permanent business relationship. In recent years, limited liability companies (LLCs) have become the most common form of newly organized farm entities. However, sole proprietorships, partnerships and corporations are discussed first so that LLCs can be explained by comparing them with the other entities. Combinations of these legal arrangements can be used. For example, an LLC may be formed to own the land or other assets that are rented to the operating entity, which could be a sole proprietorship, corporation or another LLC.

Operators should think through the creation, operation and dissolution of their farm business arrangement before they settle on which arrangement is best for them. In most cases, the goal of the beginning operator is to acquire equity in the business entity and the goal of the established operator is to have a plan for reducing his or her contribution of labor and management and at the same time providing resources for his or her retirement years.

## Sole Proprietorships

A sole proprietorship is owned by one person who has full control of and responsibility for the business. The sole proprietor can hire managers but is ultimately responsible for all management decisions. A sole proprietor is liable for all of the debts of the business. There are no restrictions on the sole proprietor's right to sell the business. There are no agreements or formalities required to form a sole proprietorship.

## Partnerships

### Definition

A partnership is an association of two or more persons contributing their assets to the business and sharing with each other the management responsibility, profits, and losses. Each partner pledges faith in the other partners and stands liable for the actions for all partners, within the scope of partnership activities.

There are two main types of partnership arrangement used by farm businesses. They are the general partnership and the limited partnership.

### General Partnership

The general partnership has only general partners and each of these general partners has unlimited liability. All of these general partners may and generally do participate in the management of the farm partnership.

**Limited Partnership**
A limited partnership is a special partnership permitted by state law to have one or more limited partners whose liability for partnership debts and obligations is limited to their investment in the business. A limited partner is just an investor. The limited partners cannot participate in day-to-day management or else they become liable for all partnership obligations as a general partner. These limited partners can participate in broad management decisions and still maintain their status as a limited partner with limited liability. A limited partnership must have at least one general partner who handles the management of the business and who is fully liable for all partnership debts and obligations.

**Income Taxation of Partnerships**
A partnership is not a tax paying entity. It reports its income and deductions on a Form 1065 and allocates the income and deductions among its partners. Partners report their share of income and deductions on their individual returns. A complex set of tax rules prevent taxpayers from shifting income into lower tax brackets by transferring the income to another partner through the partnership.

Partners pay self-employment tax on their share of the partnership income.

Generally, transferring an asset to the partnership in exchange for an interest in the partnership does not trigger recognition of gain or loss. Similarly, transferring an asset from a partnership to a partner for an interest in the partnership does not trigger recognition of gain or loss. In both cases, the income tax basis of the asset is carried over.

**Example 1.** *If land with an income tax basis of $50,000 and a fair market value of $600,000 is contributed to a partnership by a partner, no gain is recognized. The partnership has a $50,000 basis in the land.*

*If the land is distributed back to the partner, no gain is recognized. The partner has a $50,000 basis in the land.*

The partnership income tax rules make it relatively easy to form, operate and dissolve a partnership without adverse income tax consequences.

## Corporations

**Definition**
Like partnerships, corporations are legal entities that are authorized by state law. However, unlike general partnerships, corporations are not recognized until they are registered with the Department of Financial Institutions by filing articles of incorporation. Corporations must also file annual reports with the Department of Financial Institutions. When the formal requirements have been met, the state recognizes the existence of the corporation and permits it to engage in the activities provided in its charter or articles of incorporation.

**Articles of Incorporation**
The articles of incorporation set forth the general purposes and powers of the corporation. This document is approved by the state and becomes the formal charter under which the corporation exists. The state must also approve amendments to the articles of incorporation. The shareholders or directors enact corporate bylaws to regulate the everyday affairs of the corporation. They establish routine procedures of operation. No

state approval is required for enactment or amendment of bylaws.

**Structure of Corporation**
At the time of incorporation, shares of stock are issued to persons who are to be the owners of the corporation. A share of stock represents a share of the total worth of the business of the corporation. It is not an interest in any individual asset owned by the corporation.

Separation of ownership and management is characteristic of the corporate form. A sole proprietor owns the farm business and makes the management decisions. In a partnership, the partners are both owners and decision makers. In a corporation, the shareholders are the owners but not necessarily the managers. Shareholders own the corporation, but the corporation owns and operates the farm. The shareholders elect a board of directors. The directors set policy and make broad management decisions for the corporation. The directors select the officers, who are responsible for the day-to-day operation of the corporate business. In a family corporation, one individual is likely to serve as a shareholder, a director and an officer in the corporation.

In general, larger farms and those involving high risks gain most by incorporating. However, smaller farm businesses may find enough advantages to make the corporation a good choice.

**Limited Liability.** Shareholders are not liable for corporate debts unless they have personally guaranteed the corporate debt or are liable as a result of an individual action other than being a shareholder. Therefore, shareholders generally have no more at risk than they invested in the corporation.

In many cases, a lender will require the shareholders of a farm corporation to personally guarantee loans to the corporation. Consequently, if the corporation is unable to pay off the loan, the lender can force the shareholders who have guaranteed the loan to make the payments out of the assets they own outside the corporation.

The limited liability characteristic of corporations will also not protect a shareholder from legal liabilities that result from the shareholder's negligence. For example, if the shareholder is spraying pesticides and allows the spray to drift onto a neighbor's sensitive crop, the shareholder may be personally liable for the damage to the neighbor's crops. The neighbor can then collect the damages from the shareholder's assets that are outside of the corporation. Similarly, if the shareholder is involved in a car-tractor crash on the highway, he or she may be personally liable for the damages.

**Continuity of Operation**
A corporation exists as long as the shareholders desire it and it continues to fulfill the lawful requirements. The life of a corporation does not depend upon the lives of people. Most states permit perpetual corporations. The actual existence of the corporation and the continuity of farm operations are not affected by the death of a shareholder or by the transfer of stock in the corporation. However, as a practical matter, a small family corporation whose success relies heavily on the management skill of one of its owners may not have the management resources to continue operating the business even though it is not legally terminated.

**Credit Status**
Inadequate capital for expansion and for current financing often limits efficient farm

operation. Because a corporation may be less affected by the death or withdrawal of a member, it may appear as a more stable business to potential lenders. This may lead to better credit opportunities than would be available to the operation under a different business arrangement.

**Income Taxation of Corporations**
Under the general rule, a corporation is a tax paying entity. It reports its income and deductions on a Form 1120 and pays tax on its net income. Salaries, rent and fees paid to shareholders are deducted on the corporate tax return and are reported as income on the return of the shareholder who receives the payment. By contrast, the corporation does not deduct dividends paid to shareholders and the shareholder still has to report the dividend as income.

Wages paid to a shareholder as well as other employees are subject to the FICA tax.

Similar to partnership taxation, assets can be transferred to a corporation in exchange for shares of stock without recognizing the gain or loss on the asset, if some additional requirements are met. However, transferring an asset from the corporation to the shareholder triggers recognition of gain for both the corporation and the shareholder.

**Example 2.** *If land with an income tax basis of $50,000 and a fair market value of $600,000 is transferred to a corporation in exchange for shares of stock, no gain is recognized if other requirements are met. The corporation has a $50,000 basis in the land.*

*If the land is distributed back to the shareholder in exchange for the shares, both the corporation and the shareholder must recognize $550,000 of gain.*

**Employee Benefits.** Shareholders can be employees of the corporation and be eligible for employee fringe benefits that provide tax advantages. For example, corporations may establish employee retirement plans. If a plan qualifies under the tax rules, current payments to the plan are deductible by the corporation. The employees are taxed on the income only at retirement. Employees, including shareholders, can receive tax-free medical benefits from the corporation under a reimbursement plan or a plan for payment of medical insurance premiums. Employees may receive tax-free meals and lodging. Special income tax rules allow a corporation to provide a group term life insurance plan in the amount of up to $50,000 per employee without the insurance being a taxable benefit to the employees.

**S Corporation**. A corporation that meets the qualifications can elect to be taxed under subchapter S of the Internal Revenue Code. Those rules treat the corporation as a conduit for the business income and expenses. The shareholders are required to report their share of the income and expenses on their individual income tax returns but they do not pay self-employment tax on their share of the income. The corporation does not pay income tax on the income.

Shareholders of an S corporation generally do not qualify for the income tax advantages of employee fringe benefits discussed above because they are treated as owners of the business rather than as employees for purposes of those fringe benefits.

**Ownership Transfer**
The increasing size of farm businesses poses significant problems in transferring property to the next generation. Shares of stock provide a simple and convenient way to make lifetime

and death transfers. A share of stock may be sold, given away, or transferred by a will at death. Transfer of shares of stock result in the shift of ownership interests in the farm corporation without necessarily disrupting the continuity of the business.

## Limited Liability Companies

**Definition**
Like corporations, limited liability companies (LLCs) are formed by registering the LLC with the Department of Financial Institutions by filing articles of organization. LLCs also file annual reports. When the formal requirements have been met, the state recognizes the existence of the LLC and permits it to engage in the activities provided in its charter or articles of organization.

An LLC provides the limited liability advantages of a corporation and the tax advantages of a partnership.

**Members**
The owners of the LLC stock are referred to as members, similar to shareholders in a corporation or partners in a partnership. An LLC can have one or more members.

**Management**
Members make management decisions unless they delegate management decisions to one or more persons. Managers do not need to be members. A member cannot transfer his or her right to participate in management to some other person without the permission of the other members unless the LLC accepts that person as a member.

**Operating Agreement**
An LLC is fairly easy to create. Articles of Organization are filed with the Department of Financial Institutions along with a registration fee to have the LLC legally recognized. As with corporations, the LLC must file annually with the Department of Financial Institutions. The name of the company, purpose of the company, mailing address, duration, and who will manage it are the main information requirements. Members can also draw up an operating agreement to establish operating rules.

**Property Transfer**
Property transferred to the LLC is property of the LLC. A member's interest in the LLC is personal property. A member can transfer the right to receive his or her own economic interest in the LLC to some other person. This can be done without the permission of the other members.

**Taxes**
An LLC that has only one member is taxed like a sole proprietorship unless the LLC elects to be taxed as a corporation. If the LLC does not elect to be taxed as a corporation and its business is farming, the sole member reports the LLC income and expenses on his or her Schedule F (Form 1040) as if the LLC did not exist.

An LLC with more than one member is taxed like a partnership unless it elects to be taxed as a corporation. Income flows through directly to the individual members based on their interest in the LLC. The members are taxed at their individual rates, like a partnership.

The income that flows through to members is generally subject to social security and Medicare taxes. Exceptions are rent distributions of certain types, gain/loss from property disposal, or investment income. Each individual member pays his or her own social security and Medicare taxes as self-employed individuals.

If a member is not in management, then he or she may be treated the same as a limited partner for income and self-employment tax purposes. That means his or her share of income is not self employment income.

The limited liability applies to all members. Each member can participate in management of the LLC if it is in accordance with the operating agreement. This is a distinct advantage over limited partnerships because limited partners cannot participate in day-to-day management.

**Termination of LLC**
The LLC can technically be dissolved under the operating agreement similar to a partnership. In the event it is to be liquidated, the property is distributed according to share percentage of the members. In the case of death of a member, the LLC ends. In such cases, the remaining members can vote without creating any legal or financial liabilities beyond those associated with satisfying the interests of the decedent heirs. Features offered by LLCs have made it a more popular choice of Wisconsin farm families compared to partnerships and corporations.

## Planning for the Farm Business Arrangement

Planning for the farm business arrangement is discussed in the context of an LLC in this section because LLCs are the most commonly used form of organizing new farm businesses. The same planning issues arise if a partnership or corporation is used to organize the farm business.

**Decision-Making**
One of the most difficult issues to deal with is the actual process of decision-making. In most LLCs there are at least three to four people involved, including the spouses of married members. A well worked-out, detailed, and disciplined decision-making process will become an absolute necessity to keep LLCs together and functioning. Suggestions for a smooth LLC relationship include the following:

- Keep others informed of what's going on in the LLC and always request their presence at meetings
- Use an agenda and provide written documentation when possible (for example: financial statements, cost proposals for capital expenditures, and quarterly comparisons of expenses).
- Allow everyone to openly discuss any issues they feel are important and may have concerns about.

LLC written agreements usually begin with preliminary statements that set the stage for later provisions relating to LLC formation, operation, and dissolution. The preliminary statements identify the document as an LLC agreement, introduce the members and their addresses, establish the name and place of business of the LLC, present the general purpose of the business, and indicate the beginning and ending dates of the LLC.

**Formation**
The next major step in developing an LLC agreement involves deciding who is going to contribute which resources (cash, personal property, real estate, labor and management) and how are they going to be compensated for their contributions. Members can be compensated for their contributions in several different ways.

1. The LLC can purchase assets from members. This is a taxable transaction that requires the member to recognize gain for income tax purposes and pay income taxes on that gain. If the transaction results in a loss, the member is not allowed to deduct the loss because the sale is to a related party.

2. The LLC can rent assets from members. The rent paid is a deductible expense for the LLC and is taxable income to the member.

3. The LLC can make guaranteed payments to members for their contributions of assets, labor or management. Guaranteed payments are taxable income to the members for both income tax and self-employment tax purposes. The payments reduce profits of the LLC.

4. Profits of the LLC can be divided in a manner that compensates members for their contributions of assets, labor or management. Each member's share of profits is subject to both income tax and self-employment tax unless the member is inactive in the LLC and can be treated the same as a limited partner in a partnership.

The income tax rules become quite complex if profits are divided in any manner other than in proportion to the ownership interest of the members. Therefore, in most cases, guaranteed payments are used if the members want to share income other than in proportion to ownership.

**Example 3.** *Anne has contributed 90% of the assets to A&A, LLC and Andy has contributed 10% of the assets. Anne and Andy each provide half of the labor and management that is required by A&A, LLC and the labor and management are significant factors in generating income. The LLC typically has $100,000 of net income each year before any compensation is paid to Anne and Andy.*

*Because Andy's labor and management contribute significantly to the income, it would not be fair to Andy if his only compensation from the LLC were 10% of the profits. Consequently, Anne and Andy agree that the LLC will pay a $45,000 guaranteed payment to Anne and Andy and that the remaining profits will be divided according to the member's ownership interests.*

*If the LLC has $100,000 of net income before compensation is paid to Anne and Andy, they will each get their $45,000 guaranteed payment and $9,000 of the remaining $10,000 of profits will be allocated to Anne and $1,000 of the profits will be allocated to Andy.*

*If the LLC has only $80,000 of net income before compensation to Anne and Andy, they will each still get their $45,000 guaranteed payment and $9,000 of the resulting $10,000 loss will be allocated to Anne and $1,000 of the loss will be allocated to Andy. The loss will reduce their respective capital accounts.*

If the plan for contributing resources and the compensation for those resources is not fair to all members, the LLC is not likely to survive in the long run. Similarly, if compensation to one or more members does not meet his or her living needs, he or she will not be able to remain as a contributing member of the LLC in the long run.

**Operating LLC**

A farm operating LLC could be used as a transitional entity. In the beginning of an operating LLC there are few assets included in the LLC or contributed to the LLC by the members.

The operating LLC could begin with each member owning an equal share in the LLC. It can be used when the established farm operator with large asset ownership wants to enter into an LLC with a beginning operator who owns little or no farm assets. Another option is to start the LLC with members owning unequal interests in the LLC. Over the years the ownership in the LLC could be adjusted until each member has an equal interest. A difficulty of changing member shares over time is the additional records needed to accurately reflect the partner's capital accounts.

If an operating LLC commences with each member having an equal interest in the LLC, the members may want as few assets as possible to be owned by the LLC to minimize the initial capital investment by the beginning operator. For example, the LLC could initially own only feed and supplies. The LLC could be started during the time of the year when feed inventory is at a minimum. Several options are available to transfer one-half of the feed and supplies to the beginning operator. They are:

1) The beginning operator could be gifted one-half interest in the feed and supplies. This is an option only if the established operator is willing and able to make the gift. Family circumstances may not permit this option.

2) The beginning operator could purchase a one-half interest in the feed and supplies. This option may have to be financed by the established operator and repaid over time by the beginning operator. The difficulty with this option is that it creates taxable income for the established operator at the time the feed and supplies are sold to the beginning operator.

3) The feed and supplies could be contributed to the LLC by the established operator. The repayment to the established operator could be accomplished whereby the established operator receives all of the initial income in the operating LLC until one half the value of the original feed and supplies inventory value has been received. After this time all future income is split equally. The largest problem with this option is that initially the beginning operator does not receive any income and still pays his or her share of expenses.

All other assets such as livestock, machinery and real estate are leased or rented to the LLC. Any market livestock owned by the established operator could be produced and sold outside the LLC. Livestock born after the operating LLC commences is included in the LLC.

Approximately five years later the LLC would own nearly the entire dairy herd. Existing machinery would continue to be leased by the LLC until the time it needs to be traded or replaced. The established operator could either gift or sell half interest in the machinery and then the LLC would purchase all future machinery and equipment. After approximately eight to ten years, the LLC would own nearly all the personal property. Real estate may be leased for several years or for the entire duration of the LLC.

Care must be taken in establishing the lease payments by the LLC to the owner of these assets. The lease payments must be fair for all members yet such that all members have adequate cash to meet all farm and family needs. It is the beginning operator that receives the smaller portion of the net income including lease payments so he or she is the one with greatest concern. He or she must receive adequate income from the LLC to meet all the cash flow needs for both farm and family.

Over time, the lease payment must be adjusted downward as the LLC gradually owns more of the assets and leases less of the assets. This needs to be done at least annually.

## Summary of Advantages and Disadvantages

### Sole Proprietorships

**Advantages:**

- No formal action needed to set up business
- Owner is his or her own boss
- All profits go to sole owner
- Few legal or tax limitations to transfer funds from or into a business
- Flexible
- One level of income taxation at individual tax rates

**Disadvantages:**

- Personally liable for debts, taxes or claims
- All losses accrue to the sole owner
- Fewer after-tax fringe benefits
- Capital acquisition limited to personal credit rating
- Not perpetual

### Partnerships

**Advantages:**

- Easy start-up
- Income is divided among partners and tax is paid once at partner level
- Limited liability for limited partners
- Relatively easy to dissolve

**Disadvantages:**

- Creditors can get personal assets if business assets are not sufficient
- Terminates if either partner should die or declares bankruptcy
- Unlimited liability, except for limited partners
- Must have complete trust in partners
- Few after-tax fringe benefits
- Reporting requirements can be quite complicated.

### C Corporations

**Advantages:**

- Limited liability of shareholders
- Perpetual existence
- Easy transfer of ownership
- An additional low income tax bracket
- After-tax fringe benefits for shareholders who are also employees

**Disadvantages:**

- More paperwork to establish corporation compared to sole proprietorship or partnership
- Double taxation
- Gain is recognized when assets are distributed to shareholders

## S Corporations

**Advantages:**
- Limited liability of shareholders
- Perpetual existence
- Easy transfer of ownership
- Income is divided among shareholders and taxed only at shareholder level

**Disadvantages:**
- More paperwork to establish corporation compared to sole proprietorship or partnership
- Restrictions on the number and type of shareholders
- Only one class of stock is permitted
- Fewer after-tax fringe benefits
- Gain is recognized when assets are distributed to shareholders

## Limited Liability Companies

**Advantages:**
- Taxed like a partnership
- Limited liability for members

**Disadvantages:**
- More paperwork to establish an LLC compared to sole proprietorship or partnership
- Fewer after-tax fringe benefits