FARM AND RANCH BUSINESS STRUCTURES IN THE UNITED STATES

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Succession planning is a critical part of owning a farm or ranch. It enables a business to continue operating smoothly and effectively as it is passed onto future generations, partners, or successor owners.

Historically, farms and ranches in the United States were operated as sole proprietorships. The land, machinery, livestock, and other assets were owned and used by an individual or husband-wife couple. The farmer or rancher was the business and the business was the farmer or rancher.

A number of organizational structures are now available that may better meet the needs of today's farm and ranch businesses, especially as the retiring generation transitions ownership of the assets and business to the successor generation. Each structure has advantages and disadvantages, beyond its main characteristics, when compared to one another. Farmers and ranchers should determine their risk preferences, as well as long and short term goals before seeking professional legal counsel when establishing their businesses.

A series of fact sheets describing the seven most common business structures and a 2-page chart highlighting the general, formation, operational, liability, tax, ownership, and dissolution characteristics of each of the structures are available at RightRisk.org/RiskConcepts.

Farm Organizational Structures, Succession, Personal Liability, Taxation, Management

FARM AND RANCH BUSINESS STRUCTURES IN THE UNITED STATES

Succession planning is a critical part of owning a farm, ranch, or other small business. It enables a business to continue operating smoothly and effectively as it is passed onto future generations, partners, or successor owners. Because succession planning occurs during the retiring owner's lifetime, there is adequate time to communicate with family members, mentor the successor, and transition ownership of the business assets.

The process can be smoother and the likelihood of future business success can be enhanced by determining one's risk preferences and setting long and short term goals. Additionally, it is critical to understand the basic terminology and tools available for transitioning ownership of the business to the next generation, including the various business structures available to farmers and ranchers, before seeking professional legal counsel when establishing their businesses.

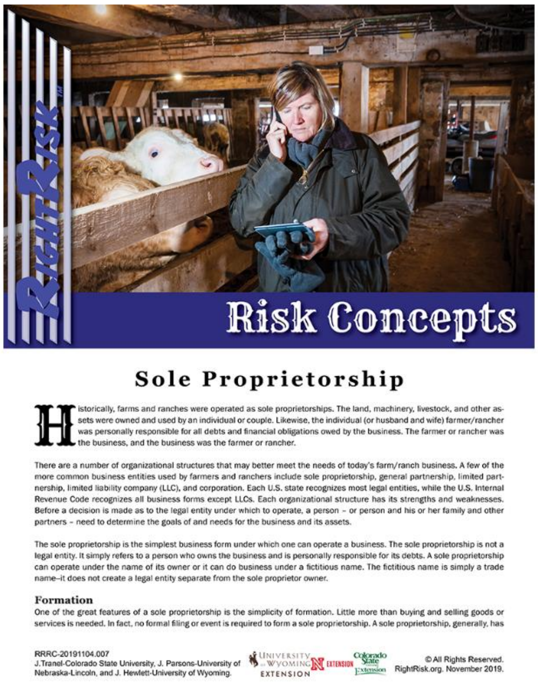
Historically, farms and ranches in the United States were operated as sole proprietorships. The land, machinery, livestock, and other assets were owned and used by an individual or husband-wife couple. Likewise, the individual (or husband and wife) farmer/rancher was personally responsible for all debts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

A number of organizational structures now available may better meet the needs of today's farm and ranch businesses, especially as the retiring generation transition ownership of the assets and business to the successor generation. Each structure has advantages and disadvantages, beyond its main characteristics, when compared to one another. Some are easier to create, some provide greater protection against liability, each are taxed differently, and some allow for greater ease of transitioning business ownership from one generation to the successor generation.

A series of fact sheets developed by RightRisk details the major characteristics of the seven most common organizational structures for farm and ranch businesses. A 2-page chart highlights the general, formation, operational, liability, tax, ownership transfer, and dissolution characteristics of each of the structures. These resources can be downloaded, at no cost, at RightRisk.org/RiskConcepts.

Sole Proprietorship

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 or trade name.



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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.

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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

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Sole proprietors need not observe formalities such as voting and meetings associated with the more complex business forms. Sole proprietorships can bring lawsuits and can be sued using the name of the sole proprietor. The Social Security number of the owner of a sole proprietorship is used on many income tax and other business forms.

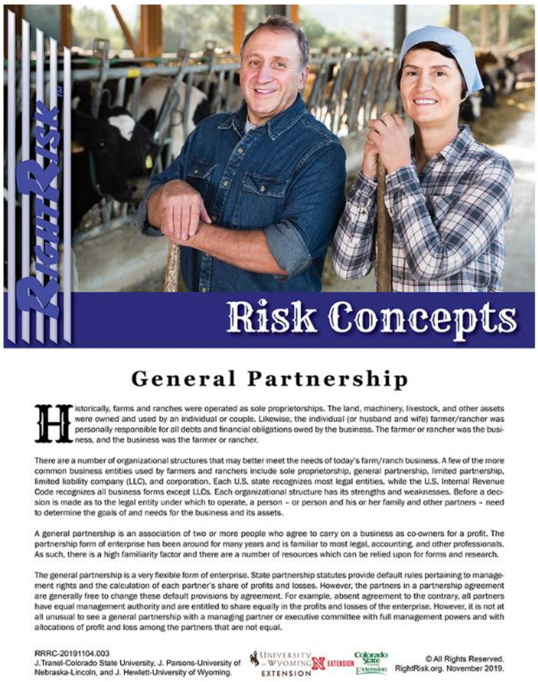
A sole proprietor is personally liable for all debts of a sole proprietorship business and any legal issues and lawsuits brought against the business. Consequently, all business-related liabilities must be paid with assets owned by the sole proprietorship.

Because a sole proprietorship is indistinguishable from its owner, income earned by a sole proprietorship is income earned by its owner. A sole proprietor reports income or losses by filing a business reporting form, such as Schedule C or Schedule F. The bottom-line amounts from all business related tax forms are transferred to the owner’s personal tax return.

There are no specific rules nor strategies for transferring ownership of assets or the business under a sole proprietorship. The farm or ranch owner may simply gift or sell business assets to other people. Additionally, any and all property owned by a sole proprietor includes business property and should be included in his or her individual estate plan.

Partnership

A general partnership is an association of two or more people who agree to carry on a business as co-owners for a profit. The general partnership is a very flexible form of business structure with the partners generally free to decide how they want to manage the business and to share the profits and losses.



General Partnership

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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.

A general partnership is an association of two or more people who agree to carry on a business as co-owners for a profit. The partnership form of enterprise has been around for many years and is familiar to most legal, accounting, and other professionals. As such, there is a high familiarity factor and there are a number of resources which can be relied upon for forms and research.

The general partnership is a very flexible form of enterprise. State partnership statutes provide default rules pertaining to management rights and the calculation of each partner's share of profits and losses. However, the partners in a partnership agreement are generally free to change these default provisions by agreement. For example, absent agreement to the contrary, all partners have equal management authority and are entitled to share equally in the profits and losses of the enterprise. However, it is not at all unusual to see a general partnership with a managing partner or executive committee with full management powers and with allocations of profit and loss among the partners that are not equal.

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Most states have adopted two federal statutes which provide legal context to partnerships – the Uniform Partnership Act (UPA) and the Revised Uniform Partnership Act (RUPA). Under RUPA, the general partnership is explicitly recognized as an entity distinct from the partners. In the event of litigation, the partnership can sue and be sued by others. Under UPA, the individual partners must bring any legal action or be sued in their own names.

No particular formalities are required to form a general partnership. There is no filing requirement and the agreement to form a partnership need not be in writing and need not contain any particular language. In fact, it is possible to form a partnership without ever using the words partner or partnership.

Ideally, a partnership should be documented by a written agreement. The agreement serves as a written record of the parties' actual agreement in the event of future disputes, imperfect memories, or the death of a partner. In addition, a written partnership agreement enhances communications between the partners and their families.

It is assumed that all partners have equal management rights and the authority to obligate the partnership within the normal course of business, unless the agreement contains a statement to the contrary. Further, the partnership agreement should specify contributions made by each partner and how profits or losses will be divided. Federal statutes stipulate that all partners share equally in the profits and losses of the business without an agreement by the partners to the contrary.

One of the most significant drawbacks to a general partnership is that all partners have personal liability for all debts of the partnership. Under UPA, all liability is generally joint, meaning that each partner is liable for his or her own debts or the partner's prorated share of the obligation. RUPA and other statues generally impose joint and several liability on all partners for partnership obligations. Joint and several liability means that any partners can be held liable for the full amount of the debt, particularly if other partners cannot be found or joined in the litigation.

There are at least two alternative types of partnership which provide for different levels of ownership and liability protection, beyond the liability associated with a general partnership. A limited partnership is a partnership with at least one general partner and at least one limited partner. It can only be formed by filing a written document which names the partners, usually with the Secretary of State. The biggest distinction between general and limited partnerships has to do with management rights and limited liability of the limited partners. Management of a limited partnership is vested in the general partners but not the limited partners. Further, limited partners have limited personal liability.

A limited liability partnership is a general partnership in which all partners have limited liability in regards to other partner's debts and liabilities. All partners have equal management authority, unless otherwise agreed, and all partners retain apparent authority to bind the partnership by acts which are apparently carrying on the usual business of the partnership.

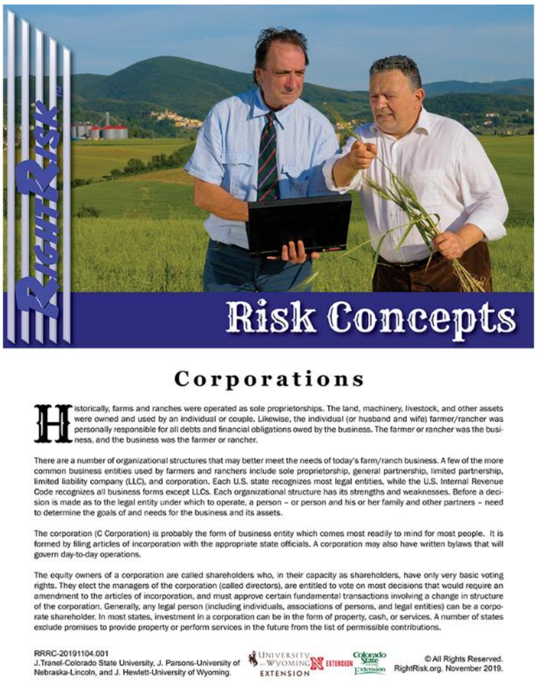
There are no entity-level taxes imposed on partnerships. Each item of income and loss is passed through to the partners equally or in accordance with the partnership agreement. The partnership agreement may stipulate (1) partnership profits or losses are shared equally among the partners; (2) profits are shared differently from losses; and/or (3) particular items of tax income, gain, loss, deduction, or credit are shared differently than overall partnership business profits and losses.

A partner in any type of partnership is generally not entitled to transfer the attributes of ownership to any other person, without the unanimous consent of all other partners. The default rule under federal statute is that a partner can transfer his or her rights to profits and distributions but not any other rights traditionally vested in partners. The person receiving the economic rights have only very limited rights and no ownership nor management rights.

Partners may admit new partners by unanimous consent or via any procedures provided in the partnership agreement. It is common to have partners pre-approve certain classes of transferees for admission to the partnership as partners, particularly family members of the original members.

Corporation

The corporation is probably the form of business entity which comes most readily to mind for most people. It is formed by filing articles of incorporation with the appropriate state officials. A corporation may also have written bylaws that govern day-to-day operations.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The corporation (C Corporation) is probably the form of business entity which comes most readily to mind for most people. It is formed by filing articles of incorporation with the appropriate state officials. A corporation may also have written bylaws that will govern day-to-day operations.

The equity owners of a corporation are called shareholders who, in their capacity as shareholders, have only very basic voting rights. They elect the managers of the corporation (called directors), are entitled to vote on most decisions that would require an amendment to the articles of incorporation, and must approve certain fundamental transactions involving a change in structure of the corporation. Generally, any legal person (including individuals, associations of persons, and legal entities) can be a corporate shareholder. In most states, investment in a corporation can be in the form of property, cash, or services. A number of states exclude promises to provide property or perform services in the future from the list of permissible contributions.

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The articles of incorporation, sometimes called the corporate charter, contain basic information about the corporation but are not intended to govern the day-to-day operation of the business. The initial directors are responsible for authorizing the issuance of shares and enacting the bylaws which govern day-to-day operations of the corporation Shares may be issued for any consideration determined by the directors to be adequate, provided that the amount is not less than the par value of the shares as specified in the articles of incorporation. A relatively low par value (such as $0.10 or even a fraction of a cent) is not uncommon. There is no requirement that all shares must be issued for the same consideration or even consideration having the same value as that accepted in exchange for other shares. All such decisions are made by the directors.

A board of directors, elected by the owners, has full authority over corporate business and day-to-day operations. Some state statutes allow smaller corporations to elect to have shareholders retain management authority because this level of complexity and formality may not be desirable or necessary in a small corporation.

The right to share in a corporation's net profits depends on the type of stock held by each shareholder. Every holder of the same class of stock is entitled to a pro rata proportion of any distribution to the holders of that class of stock, although different classes of stock can have different priorities and claims to distributions. Dividends are ordinary distributions of income to shareholders.

The primary advantage to a corporation form of business structure is that all shareholders have limited liability for corporate debts. In other words, a shareholder stands to lose his or her investment in the corporation if the corporation acquires debts greater than its assets, but only in highly unusual circumstances would they be compelled to pay additional sums to make good on those debts. If a shareholder signs a personal guarantee, the shareholder has personal liability and personal assets that may be subject to entity-level debt.

Limitation of personal liability is not absolute, however. A shareholder may incur personal liability in the event that a court elects to “pierce the corporate veil” or, in other words, to disregard the existence of the corporation in order to impose such liability. Instead, the corporation is viewed as an association of persons, exposing the personal assets of the stockholders and often the individuals connected with the wrongful activity such as corporate directors, to claims by creditors seeking compensation.

There are two basic types of corporations for taxation purposes: *S Corporation* and *C Corporation*. The net income of a C Corporation is subject to an entity level tax. When corporate income is distributed to shareholders in the form of dividends, the dividends become ordinary income to the shareholder and are also subject to personal income tax. To prevent the corporation from retaining earnings endlessly and thereby deferring the second level of tax indefinitely, the Internal Revenue Code imposes a special tax on excess retained earnings.

The benefit of electing subchapter S status is that there is no entity level tax. Items of income and loss flow through to the shareholders and are taxed only at the shareholder level. A disadvantage of subchapter S status is less flexibility than C corporations. An S corporation can have no more than 75 shareholders, and with only limited exceptions only individuals can be shareholders in an S corporation. Also, an S corporation can have only one class of shares which limits the corporations' ability to structure different rates of return for different classes of investors.

If a shareholder is also a primary employee of the corporation, the shareholder/employee may be paid salaries or receive bonuses in lieu of dividends. Employee compensation is an expense for the corporation and is paid out of pre-tax dollars, although the salaries are still taxable at the shareholder level. Similarly, shareholders may lend money to the corporation. Interest payments by the corporation are deductible to the corporation and, as a result, the only tax imposed is at the shareholder level. Rental payments are also subject only to tax at the shareholder level if the shareholder rents property to the corporation.

Corporate losses are not deductible at the shareholder level. The corporation can carry forward losses to offset future income and, under certain circumstances, a shareholder may be able to declare a loss on the value of his or her shares if the corporation is liquidated at a loss. However, it is not generally possible for a shareholder in a C corporation to utilize corporate losses to offset personal income on a regular basis.

There are very few limits on a shareholder’s right and power to transfer shares. The buyer or transferee becomes a shareholder, with all the rights that such a position entails. A shareholder who has control over the corporation cannot knowingly sell the controlling shares to someone who intends to come in and "loot" the corporation.

Unlimited transferability may not be completely desirable in many close corporations. A corporation may be concerned that such sales might violate the federal or state securities laws and compromise the corporation’s sales of its own shares. Additionally, primary shareholders may worry about losing control to those who do not have an immediate connection with the business. They may want to limit share ownership to employees of the company or family members or to prohibit sales to those with a significant ownership interest in or management responsibilities to competing enterprises.

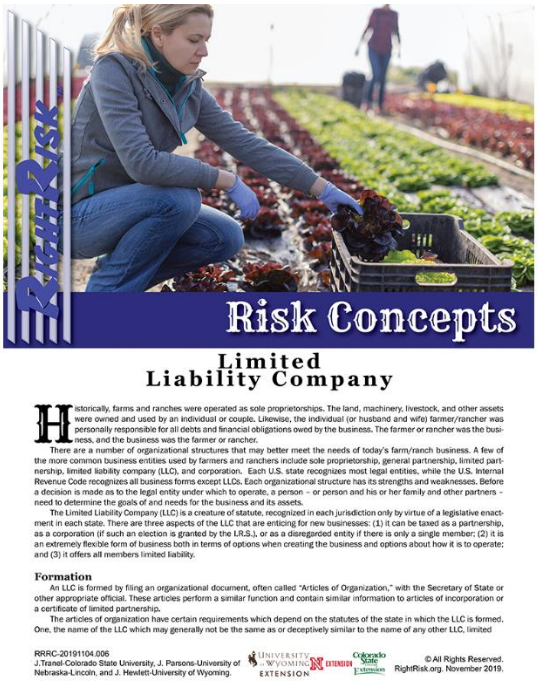
Limited Liability Company

The Limited Liability Company (LLC) is an organizational structure that is a creature of statute, recognized in each jurisdiction only by virtue of a legislative enactment in each state. 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 an election is granted by the I.R.S., 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 about how it is to operate; and (3) It offers all members limited liability.

An LLC is formed by filing an organizational document, often called Articles of Organization, with the appropriate official in each state. These articles perform a similar function and contain similar information to articles of incorporation or a certificate of limited partnership. Some state statutes require a written operating agreement. In other jurisdictions, an operating agreement is optional and only required if the members wish to vary the default rules provided for in the state statutes. Further, most state statutes permit the operating agreement to be oral.

Some state statutes presume that each member will have a vote equal to that of every other member but most statutes allocate voting power in accordance with the relative value of each member's contribution to the LLC, unless the members have agreed otherwise. The statutes in all states allow the members to change how voting power is allocated and such provisions are frequently included in operating agreements.

A limited liability company may be managed by the members or by a manager. This choice must be made when the LLC is formed. Member-managed means that all the members share responsibility for the day-to-day operations and have the power to bind the company by ordinary business contracts. This approach is more common in part because most LLCs are small businesses with limited resources and don't need a separate management level to operate. LLCs have a streamlined organizational structure, without officers or boards of directors, unlike corporations. As a result, the LLC form is often chosen by individuals who want to be directly involved in managing and operating their business.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Formation

An LLC is formed by filing an organizational document, often called "Articles of Organization," with the Secretary of State or other appropriate official. These articles perform a similar function and contain similar information to articles of incorporation or a certificate of limited partnership.

The articles of organization have certain requirements which depend on the statutes of the state in which the LLC is formed. One, the name of the LLC which may generally not be the same as or deceptively similar to the name of any other LLC, limited

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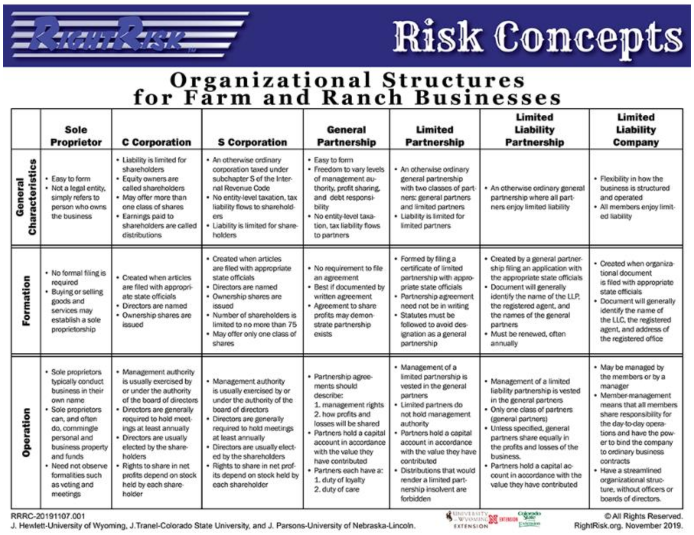
A manager-managed structure may be preferable in some situations. Manager-managed means the managers have both the actual power to manage and the apparent authority to bind the business by acts which appear to be carrying on the ordinary course of the LLC's business. This structure is preferred for situations in which (1) some members only want to be passive investors in the business, (2) when the business or ownership is too large, diverse, or complex to efficiently allow for sharing management among all members; or (3) when some members are not particularly skilled at management. The manager may be either a member or a nonmember.

Members of an LLC have no personal liability solely because of their status as a member under the default rules of every state. They will, however, be liable for the amount or value of any agreed-upon contributions, for any debt they have guaranteed or for which they have otherwise agreed to act as surety, and for any personal misconduct in which they engage. Members of an LLC are likely to have liability if the veil of limited liability is pierced.



Organizational Structures for Farm and Ranch Businesses

	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.

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Limited liability companies with two or more members are presumed to be taxed as partnerships, but an LLC may be authorized by the Internal Revenue Service to be taxed as a corporation. Some state statutes impose a specific tax status on LLCs, regardless of how they might be classified for federal income tax purposes. Limited liability companies are allowed to establish rules governing the allocation of profits and losses. The default allocative and distributional rights of the members can be modified by appropriate provisions in the operating agreement. In general, members may deduct losses only to the extent that they are at risk with respect to the entity, and a member's share of LLC income as self-employment income.

In most states, the transfer of an LLC membership interest operates only to transfer the economic rights, unless the remaining members unanimously agree to accept the transferee as a substitute member. They may provide in advance that a membership interest is freely transferable and that any transferees will automatically be accepted as members of the LLC by the simple expedient of a provision to that effect in the operating agreement. Alternatively, they may provide that a limited class of persons, such as immediate family members or employees, will be entitled to full membership upon the acquisition of any membership interest.

Succession planning is a critical part of owning a farm or ranch. It is important for members of both the retiring generation and successor generation to determine their risk preferences, set long and short term goals, and understand the basic terminology and tools used for a successful transition of the assets, business, and management from one generation to the next.

A retiring farm or ranch owner and the successor of that business should be familiar with the major characteristics of different business structures. Some business types are easier to form, some have strict guidelines for how the business is to be managed, some create different tax liabilities for the individual owner, and some allow for a smoother, more effective transition of the assets and business to the successor generation.

A series of fact sheets developed by RightRisk describes the major characteristics of the seven most common organizational structures for farm and ranch businesses. An accompanying 2-page chart highlights the general, formation, operational, liability, tax, ownership transfer, and dissolution characteristics of each of the structures. These resources can be downloaded, at no cost, at RightRisk.org/RiskConcepts. Many other resources pertaining to success and estate planning and management issues are also available at RightRisk.org.