



Choosing the Right Business Entity

Farm Legal Series – June 2025

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Introduction

There are many types of business entities to choose from through which one or more individuals can conduct a farming operation. There are also many factors to consider in determining which type of entity to select. Note that there is no “one-size-fits-all” or “best choice” of business entity for farming operations. The purpose of this fact sheet is to introduce the most common business entities used to conduct farming operations and present various factors that should be considered when choosing which entity will best meet your needs.

The most common types of business entities used in farming operations include:

- Sole proprietorships
- Partnerships (general partnerships, limited liability partnerships, family limited partnerships)
- Corporations (C corporations and S corporations)
- Limited liability companies

Selecting the right business entity for a particular farming operation is a decision that should be made only after considerable thought and analysis. Although this fact sheet will provide general information as to the types of entities and factors to consider, it is important to seek professional advice when choosing and forming a business entity. Professional advisors, such as attorneys and accountants, can help determine what business structure will best achieve the goals of the business owners based on the particular facts and circumstances.

Keep in mind that there are often significant challenges to selecting one business entity and changing to another form at a later time. Often there are significant taxes that may be triggered upon a change in form. Therefore, it is important to understand your goals and seek professional advice to determine which type of business entity would be the best fit for you.

Factors to Consider

Before examining characteristics of the various business entities, it is important to consider certain factors that are relevant to the question of which entity to choose.

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LIMITATION OF LIABILITY

Liability protection is one of the most important benefits of operating a business through an entity. The level of protection may vary, but certain entities afford business owners the opportunity to limit their personal liability for debts of the business entity. In other words, although the business entity will be liable for any debt it incurs, operating a business through an entity can help owners protect their personal assets from the debts of the business.

For example, assume Farmer Y forms a business entity, and then secures a bank loan. Although the business entity will be liable to repay that debt, Farmer Y will not be personally liable to the bank unless he or she signs a personal guaranty of that debt. Without a personal guaranty, the bank will be able to collect against assets of the business entity, but will not be able to reach Farmer Y's personal assets.

It is important to note, however, that this type of liability protection does not protect the business itself from liability. Creditors will generally be able to reach business assets when collecting the business debt. Also, the entity will generally be liable for any other liability that may arise in the conduct of the business, such as liability for accidents and injuries. Thus, business insurance is always an important item to have in place, regardless of the type of business entity, to help protect the business assets from such claims.

TAXATION

The nature and extent of taxes is another key consideration in choosing a business entity. Some entities are taxed, and may even give rise to double taxation (meaning the business pays a tax on income received and the owners pay a separate tax on income they later receive from the business entity). Other entities - so-called pass through entities - are not taxed at the business level, and the business income flows through to the owners, who report business income on their personal tax returns and pay a tax on that amount.

OWNERSHIP AND MANAGEMENT

Each type of business entity will have a distinct manner of ownership and management issues to consider. Some entities provide great flexibility as to who can be an owner of the business, while others have very rigid ownership rules. For example, entities may or may not permit different classes of ownership. Also, some entities have very specific rules as to how the business must allocate income to the owners, while others generally permit the owners to share income as they see fit.

There are similar distinctions as to the structure of and manner in which the business may be managed and the level of control that an owner may have. The business owners may, in some cases, vest decision making authority in other individuals. In some cases, a certain type or class of ownership may not have voting rights.

AUTHORITY AND BUSINESS FORMALITIES

When an entity is formed to operate a business, the individual owners must adhere to certain rules regarding business authority, identity and operation. Owners must understand that it is the entity as a distinct legal actor that conducts business, not the individuals who own the business.

For example, when Farmer Y's business enters into a contract, it is the business entity rather than Farmer Y who enters into and performs under the contract. It may be that Farmer Y is the person who actually signs the contract, but Farmer Y must do so in his or her official business capacity, such as president or manager of the entity. When the business earns income, it must go into a business bank account rather than directly into Farmer Y's personal account. When Farmer Y would like to buy or sell a business asset or transfer ownership to a friend or relative, Farmer Y must ensure that he or she has the business authority to do so under applicable law and the entity's governing documents.

Certain business entities may also be subject to rules that either permit or restrict the rights of owners and management. In addition, there may be specific record keeping requirements. Even if an entity structure does not inherently provide such rights or include such limitations, any business entity with more than one owner should have a written agreement in place between the entity and the owners that sets forth the duties, rights and obligations of the company, owners and management. States have different rules and types of agreements that may apply depending on the type of entity.

CAPITALIZATION

It is important to consider how money and assets will be put into the entity, whether at formation or during operation. Owners may contribute money or assets, or the entity may borrow money necessary to acquire assets and operate. Various entities have different rules that apply to capitalization issues, particularly with respect to personal contributions and loans from owners or third-party lenders.

TRANSFER OF OWNERSHIP AND ESTATE PLANNING

Business entities have different forms of ownership and rules that apply as to the transfer or sale of an ownership interest. These rules may impact how an owner sells an ownership interest to another owner or outsider. There are also certain rules that may apply with respect to estate planning and gifting ownership to the next generation.

GOVERNMENT AND AGRICULTURAL PROGRAMS

Although specific analysis of the various programs is beyond the scope of this fact sheet, there are certain government and agricultural programs that may factor into the business entity choice. The type of entity may impact eligibility or payment limits associated with such programs.

Business Entities

With the factors noted above in mind, it is now possible to examine various business entities and the specific characteristics, requirements, restrictions, and opportunities that apply to each.

SOLE PROPRIETOR

A sole proprietorship is the simplest form of business ownership. There are no organizational rules to follow, and there is virtually nothing that an owner needs to do or file to begin operating as a sole proprietor. The sole proprietor has total control and decision making authority, and all of the business income will flow through and be reported on the sole proprietor's personal tax return.

However, because no formal entity is created, a sole proprietor does not have any personal liability protection. As such, the owner's personal assets are subject and exposed to business creditors. Additionally, all business income will be subject to self-employment taxes.

PARTNERSHIP

A partnership is a legal entity in which two or more people operate a business jointly with the purpose of earning and sharing profit. States have specific rules as to forming and operating a partnership. It should be noted that two or more people working together and representing themselves to the public as a partnership will likely create a partnership even if they do not formally organize a partnership entity.

Unless otherwise stated in a partnership agreement, the partnership will be managed by the partners, and each partner has the unilateral authority to conduct business in the name of and bind the partnership. Given that a partnership requires at least two partners, it is imperative that all partnerships adopt a written partnership agreement that sets forth how the partners will interact with the partnership and one another.

Partners generally transfer money or assets to the partnership in exchange for a partnership interest. This is usually a tax-free exchange at the time of contribution. If the partners agree, new partners may enter the partnership by contributing money or assets, or an existing partner may sell all or a portion of their partnership interest to the incoming partner. Partners may also receive a partnership interest in exchange for services. Special rules apply, however, and partners who perform the normal functions of the partnership are not treated as partnership employees. Partners are liable for self-employment taxes.

For tax purposes, partnerships are pass through entities. Although the partnership will have a tax identification number and must file informational tax returns, all income or losses of the partnership flow through to the individual partners to be reported on their individual tax returns. Although partners generally are allocated profits and losses in accordance with their pro rata share (*i.e.*, two partners would generally share profits 50%-50%), partnerships are afforded great flexibility in that respect and may make special allocations of tax items among partners, subject to certain rules.

In summary, partnerships are generally easy to form and provide a great amount of economic and management flexibility. Income is taxed in the same manner as a sole proprietor, but partnerships also have the same disadvantage as a sole proprietor, namely that the partners do not enjoy liability protection and their personal assets may be reached by partnership creditors. This is likely true even if a partnership debt was incurred by only one partner's acts.

LIMITED PARTNERSHIP

A special kind of partnership is one referred to as a limited partnership and requires a specific filing with the secretary of state. Although limited partnerships are taxed the same as general partnerships, there are key distinctions as to management and liability protection. These distinctions are possible because a limited partnership has two classes of partners: limited partners and general partners.

The general partners have total control and management authority over the partnership. The trade-off, however, is that the general partners have no liability protection and will be personally liable for the partnership's debts. Every limited partnership must have at least one general partner. If there is more than one general partner, each of them are jointly and severally liable for any partnership obligations. This means a creditor can pursue the whole debt from any or all general partners.

On the other hand, the limited partners enjoy liability protection, but at the cost of having no management authority or power to bind the partnership.

FAMILY LIMITED PARTNERSHIP

Another type of partnership is a family limited partnership. As the name suggests, these partnerships are limited by the fact that all partners must be family members.

As such, these partnerships are sometimes used as an estate planning tool to pass a farming operation from one generation to the next. The elder generation may form a family limited partnership with the goal in mind of transferring an interest in the partnership to descendants. If structured properly, and depending on the facts and circumstances, such transfers may be tax-free. The transferring family members may retain management rights, but the transferees will receive the economic rights and resulting tax liabilities associated with the partnership interest.

The benefit of family ownership may turn into a burden, however, if a family member desires to sell his or her interest in the partnership given that only family members may be partners. Also, there will likely be significant tax consequences to the existing partners when the family limited partnership is ultimately dissolved and liquidated.

Family limited partnerships are generally not a common business entity. They are relevant, however, in the family farming business context. One should seek advice from an attorney and an accountant and carefully analyze specific goals to determine whether a family limited partnership is a viable option under the specific facts and circumstances.

C CORPORATION

The term corporation often refers to a C corporation (so called because such corporations are subject to subchapter C of the Internal Revenue Code). Unlike partnerships, corporations may have only one owner and can only be formed by formally filing paperwork with the secretary of state. There are rules for filing and nominal filing fees, but corporations are not difficult to form. There are also specific recordkeeping and annual reporting requirements.

The owner(s) of a corporation own shares of stock and are usually referred to as shareholders or stockholders. One benefit of the corporate structure is that owners do not have personal liability for corporate obligations. Almost without exception the only risk that a shareholder has as owner of a corporation is the amount of capital that the shareholder invests in the corporation.

Contributions that shareholders make to a corporation in exchange for stock are generally tax free. If a shareholder contributes an asset, the asset becomes corporate property, and any appreciation in value accumulates inside the corporation. There is no tax consequence unless the asset is later distributed to a shareholder or the corporation is dissolved and liquidated.

Unlike sole proprietors and partnerships, C corporations are taxed as entities distinct from their owners. This means that the corporation pays taxes on corporate profits, and that the shareholders are also subject to tax when the corporation distributes money to them. This potential for tax at both the corporate and the shareholder level explains why the C corporation tax regime is referred to as double taxation.

As to management and authority, corporate shareholders do not inherently have a right to directly control or bind the corporation simply because they own stock. Generally, shareholders that have voting rights elect a board of directors (note that a corporation may also have different classes of stock, and that some stock may not come with voting rights). The board may run the corporation directly or may elect or appoint officers, such as a president, with authority to run the day-to-day affairs of the corporation and to enter into contracts or otherwise bind the corporation.

A corporation remains in existence until it is dissolved under state law. Both the corporation and shareholders will generally have tax consequences upon liquidation.

For most taxpayers, the double taxation is a negative factor and the key reason that many select an entity other than a C corporation. This is especially true in the case where the entity will be owned privately by family members or a small number of unrelated individuals.

S CORPORATION

An alternative to the C Corporation is an S Corporation (so called because such corporations are subject to subchapter S of the Internal Revenue Code). Although an S corporation has virtually all of the same characteristics of a C corporation, including liability protection, S corporations are distinct in that they are taxed in a manner similar to partnerships. This means the corporation does not pay taxes on corporate profit, but shareholders are subject to tax when the corporation distributes money to them. There are also strict restrictions as to ownership and limitations regarding the allocation of income and distribution of company profits.

As to ownership, except for a very few exceptions, only individuals can own stock in an S corporation. The number of shareholders is limited to 100, all of whom must be U.S. residents. Also, unlike C corporations, S corporations may have only one class of stock, but that single class may consist of both voting and non-voting stocks.

As to income allocations and distributions of profits, S corporations do not have the flexibility of partnerships to make special allocations or distributions. S corporation shareholders must be allocated income and receive distributions equal to their percentage ownership of the corporation. If, for example, shareholder A owns 75% of the corporation and shareholder B owns 25%, then shareholder A and B must be allocated 75% and 25% of corporate income, respectively.

To form an S corporation, it is necessary to follow the same procedure for starting a C corporation. The shareholders must then file documents with the IRS within certain time limits to elect S corporation status. There are certain requirements that apply to retain S corporation status, and there may be significant tax consequences for an S corporation that converts to a C corporation.

LIMITED LIABILITY COMPANY

The most recent type of business entity, and likely the most popular, is a limited liability company. Limited liability companies have the greatest amount of flexibility from an ownership and tax perspective, while affording its owners the personal liability protection of corporations.

Like corporations, one must file documents with the secretary of state to establish a limited liability company. The owners of a limited liability company are referred to as members rather than stockholders. Members own a membership interest in the company. Although it is not required, members often refer to such ownership in terms of units (similar to stock or shares in a corporation).

Limited liability companies may be managed by the members, or the members may elect managers or a board of governors to manage company business. The members have the power to bind the company unless the members determine that the company will be run by the board or managers. In all cases, however, members enjoy liability protection.

As to taxation, the limited liability company offers the greatest flexibility. The default rule is that the company will be taxed as a sole proprietor if there is only one member. The single member may elect to be treated as a corporation, however, and subsequently make an election to be taxed as an S corporation. If there are two or more members, the default rule is the company will be taxed as a partnership. Again, the members may elect to be taxed as a corporation. This flexibility is not unlimited, however, and it is important to realize that there may be significant tax consequences for initially electing one manner of taxation and subsequently making an election to be taxed in another manner.

Like corporations, limited liability companies remain in existence until dissolved under state law. There will be tax consequences at that time, but the nature and extent will depend on how the company elected to be taxed.

Conclusion

Before selecting a business entity, it is important to understand your current and future goals and seek professional advice to determine which form of entity will best achieve those goals. Although conversion from one entity to another may be possible, the conversion may result in negative tax consequences. Therefore, it is best to give careful consideration prior to making a choice to ensure that the entity you select will meet both your current and future needs.