

**FARM LEGAL SERIES**

**June 2015**

# Choosing the Right Business Entity

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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 numerous factors to consider in determining what 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 work best to achieve your goals.

Some of 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 vital to also 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. This underscores the importance of understanding your own goals and seeking 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.

### 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. 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 Fred forms a business entity, and then secures a bank loan. Although the business entity will be liable to repay that debt, Farmer Fred will not be individually liable to the bank unless he signs a personal guaranty. Without a personal guaranty, the bank will be able to collect against assets of the business entity, but will not be able to reach Fred'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. 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.

### **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 that both the business and the owners pay tax on business income). Others – so-called pass through entities – are not taxed and the business income flows through to the owners, who report their share of business income on their personal tax returns.

### **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 that conducts business, not the individuals who own the business.

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

Certain business entities may also have specific 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 and/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 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.

The reason for this great amount of flexibility and freedom, however, is that a sole proprietor does not have any personal liability limitation. As such, the owner's personal assets are not protected from business creditors. Also, 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, though, that two or more people working together and representing themselves to the public as a partnership will likely create an informal 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 all partners have the 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 also transferring money or assets, or an existing partner may sell all or a portion of his or her 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.

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, subject to certain rules.

In summary, partnerships are generally easy to form, and they 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.

#### **Limited Liability Partnership**

A special kind of partnership is one referred to as a limited liability partnership. Although limited liability 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 liability 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. Every limited liability 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.

The limited partners, on the other hand, do have liability protection, but at the cost of not having any management authority or voice, or any 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 whenever 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**

Whenever the term corporation is used, it is likely that the type of corporation referred to is a C corporation (so called based on the fact that 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 record keeping and annual reporting requirements.

The owners 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. The only real risk that a shareholder has as an owner is the amount of investment 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 and 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, 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 on the basis that 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 also elect or appoint officers, such as a President, that may have the authority to run the day to day affairs of the corporation and have the power 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 only a small number of unrelated individuals.

### **S Corporation**

An alternative to the C Corporation is an S Corporation (so called based on the fact that 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. There are also restrictions as to ownership, as well 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 shareholders, all of whom must be US residents. Also, unlike C corporations, S corporations may have only one class of stock.

As to income allocations and distributions of profits, S corporations do not have the flexibility that partnerships do as to 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 organize a limited liability company. The owners of a limited liability company are referred to as members. 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 in a corporation).

Limited liability companies may be managed by the members, or the members may elect a board or managers 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

When selecting a business entity, the key is to understand your goals and seek professional advice to determine what form of entity will best achieve those goals. Although conversion from one entity to

another may be possible, there may be negative tax consequences associated with such a conversion. Thus, it is best to give careful consideration prior to making a choice to ensure that the entity you select will meet your needs.

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**For more information:**  
[extension.umn.edu/agriculture/business](http://extension.umn.edu/agriculture/business)