Agricultural Business Organizations
Risk Management Tools for Farm & Ranch Succession

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How to Think About a Business Entity

• Organizational Structure
  • How decisions are made
  • Who is responsible for what

• Financial Structure
  • Who or what owns the assets
  • Where does the income go

• Business Structure
  • Legal form of the entity
Financial Risks Associated with Business Entity Choice

- Formalities
- Continuity
- Liability
- Management/Control
- Taxation
- Profit/Loss
- Transferability
Sole Proprietorship

- **Definition**: Business operated by an individual engaged alone in a trade or business.
- **Formalities**: None. Simple to create and maintain
- **Continuity**: Terminates at will or on death.
- **Liability**: Unlimited personal liability.
- **Management/Control**: Owner has sole control
- **Taxation**: Personal income tax rates
- **Profit/Loss**: All to the proprietor
- **Transferability**: Transfer of specific assets required
General Partnership

• **Definition:**
  • Association of two or more persons to carry on as co-owners a business for profit.
  • An entity that may own partnership property.

• **Formalities:**
  • Agreement (written, oral, implied)
  • If none, “Kansas Revised Uniform Partnership Act”

• **Continuity:**
  • Death or withdrawal of a general partner
  • Occurrence of an event in the agreement.
General Partnership

• **Liability:**
  - Each partner fully and personally liable for all obligations of the partnership – Joint and Several.
  - Partnership assets must be exhausted first.

• **Management/Control:**
  - Each partner has equal say in management unless otherwise provided in the partnership agreement.
  - Each partner is an agent of the partnership.

• **Profit/Loss:**
  - Shared equally unless otherwise agreed
General Partnership

- **Tax Treatment:**
  - Partnership not a taxpaying entity.
  - Income, deductions, and credits “pass through.”

- **Transferability:**
  - Easier to transfer an interest in a partnership without having to transfer or liquidate specific assets.
  - The only transferable interest of a partner in the partnership is the partner's share of the profits and losses and the partner's right to receive distributions.
  - The interest of a partner is personal property.
Limited Partnership

• **Definition:**
  • Partnership with one or more general partners and one or more “limited” partners.
  • Limited partner has limited personal liability for debts and obligations of partnership.

• **Formalities:**
  • Agreement required
  • “Certificate of limited partnership” filing

• **Continuity:**
  • Dissolved by event in partnership agreement;
  • Consent of all partners;
  • Death or withdrawal of a general partner.
Limited Partnership

- **Liability:**
  - General partner is fully/personally liable.
  - Limited partner not personally liable, only to extent of her investment in the partnership.

- **Management/Control:**
  - Limited partner cannot “participate in the control of the business.”
  - General partner(s) have management & control.

- **Profit/Loss:**
  - Agreement of the parties.
Corporations

• **Definition:**
  - Separate legal entity created under state law.
  - Owned and operated by stockholders.
  - Guided by a board of directors.
  - Managed by officers and employees.

• **Formalities:**
  - Articles of Incorporation filed with KSOS.
  - Bylaws governing rights of stockholders, officers and employees.
  - Annual report (ag corporations farm 10 acres +).
Corporations

• **Continuity:**
  • Will continue in existence and not be dissolved by death of a stockholder, director, or officer.
  • Formalities must be maintained.

• **Liability:**
  • Stockholder not personally liable.
  • To maintain limited liability the corporation must be adequately capitalized & comply with formalities required by state law.
  • *Caution:* Stockholder may personally obligate themselves if they personally sign/cosign a note in their own name and not as an authorized representative.
Corporations

• **Management/Control:**
  • Stockholders have voting power.
  • Stockholders don’t own interest in specific assets.
  • Stockholders select board of directors who select officers who manage the business.
  • Stockholders, directors, and officers may all be same people or one person.

• **Profit/Loss:**
  • Income is distributed to stockholders as a dividend

• **Transferability:**
  • Stock can be freely transferred without affecting the underlying operation and assets.
Subchapter C & S Corporations

• “Subchapter C” – Regular corporation
  • Taxation:
    • Taxed as a separate legal entity with own tax rates.
    • Takes its own deductions and credits.
    • Dividends are not a deductible expense but are taxable income to the stockholder.
  • Profit:
    • To avoid paying a dividend the corporation may reinvest back into the corporation, or pay reasonable wages to a stockholder who is also an employee.
Subchapter C & S Corporations

- “Subchapter S” – Closely held corporation
  - **Taxation:**
    - Taxed like a partnership where income, deductions, losses and credits are passed through to stockholders.
    - The S-corporation does not pay taxes.
  - **Restrictions to qualify:**
    - One class of stock
    - Stockholders limited to 100
    - Stockholders must be individuals
Limited Liability Company (LLC)

- **Definition:**
  - A legal entity created under the laws of a particular state.
  - It is owned, operated and managed by it’s “members”.
  - It combines the tax and management traits of a GP with the limited liability of a corporation.

- **Formalities:**
  - Articles of Organization must be filed with the KSOS.
  - An “operating agreement” (similar to by-laws of a corporation) may be adopted.
  - In Kansas an LLC must have at least one member.
  - Annual report.
Limited Liability Company (LLC)

• **Continuity:**
  • Perpetual existence unless otherwise provided in the operating agreement.
  • Unless otherwise provided in the operating agreement, such things as death, retirement, expulsion, or bankruptcy of a member will generally **not** cause dissolution of LLC.

• **Management/Control:**
  • Members manage the LLC unless they provide in the Articles of Organization that management shall be vested in a “manager”, who then has authority to act as an agent to bind the LLC to any transaction in the “usual way of business or affairs”.
Limited Liability Company (LLC)

• **Liability:**
  - Neither “members” nor “managers” are personally liable for the debts of the LLC, unless they co-sign or guarantee a note personally and not as a representative of the LLC.

• **Taxation:**
  - Two or more members - taxed as a regular partnership.
  - May elect to be taxed as a corporation.

• **Transferability:**
  - Shares may be transferred w/o affecting assets.
  - Transferee cannot become a member unless otherwise provided in the operating agreement.
Sole Proprietorship – Adv/Disadv

- Advantages
  - Simple to create, maintain and terminate
  - SP makes all decisions
  - No sharing of profits
  - SP allowed to claim certain exempt assets

- Disadvantages
  - Unlimited personal liability
  - Limited transferability of assets—parceling out assets could hurt productivity of operation
  - Limited capital—only what he can borrow
General Partnership – Adv/Disadv

• **Advantages**
  - Simple– no special formalities required.
  - Easier to transfer an interest in GP than specific assets in a SP.
  - Not a separate taxpaying entity– no double tax.

• **Disadvantages**
  - Unlimited personal liability.
  - Management more difficult– partners must be consulted and decisions made jointly.
Limited Partnerships – Adv/Disadv

• **Advantages**
  - Provides new source of capital / limits liability of investor.
  - Transfer of an interest in the LP without losing control of the business or having to transfer specific assets.

• **Disadvantages**
  - More complex than a SP – written agreement needed and formalities required by state law.
  - Limited partner can’t control day-to-day operation but could pull the investment.
  - Unlimited personal liability of the general partner.
  - Lack of continuity if a general partner withdraws.
Corporations – Adv/Disadv

- **Advantages**
  - Limited liability of stockholders.
  - Continuity not affected by death or transfer of stock.
  - Convenient for transfer of interest in business through stocks without having to transfer specific assets.
  - Economic efficiency– more sources for capital and structure for expansion of the business.

- **Disadvantages**
  - Complexity to create, use and maintain.
  - Double taxation of dividends and on liquidation/transfer of land out of the corporation.
  - Possible to lose limited liability under certain facts.
LLC– Adv/Disadv

**Advantages**
- Limited liability of members & managers– compare to LP.
- Partnership treatment for tax purposes.
- Less restrictions on ownership than S corp.
- Avoids double taxation of a corporation.
- Transfer interest through units.

**Disadvantages**
- LLC does not have automatic continuity unless the articles of organization so provide.
- Complexity to create, use and maintain vs. SP or GP.
- Transferability of an interest in the LLC requires approval of all members.
Payment Limitations

• There are statutory limits on the amount of government payments individuals may receive that must be considered in selecting a business entity.

• This must especially be considered when multiple entities are involved and complex ownership of those entities.

• http://www.fsa.usda.gov/FSA/webapp?area=home&subject=pml&topic=pml - Direct Attribution

• http://www.calt.iastate.edu/article/farm-service-agency-adjusted-gross-income-calculation-could-influence-choice-entity - Calculation of adjusted gross income different across entity types.
How do you choose?

- Formalities – Complexities, costs, management; can you handle them or hire a professional to help?
- Continuity – Do you want the business to continue on after death or withdrawal of an owner?
- Liability – SP or Partnership v. Corporation or LLC
- Taxation –
  - Double taxation vs. pass through - Distributions of income and entity assets;
  - Tax rates – Corporate v. Individual;
  - Deductions from income – Corporation v. Partnership;
  - Reduced IRS value for farm assets - LLC
How do you choose?

- Management/Control –
  - Control over voting interests
  - Management structure for family members
  - Termination / buy - sell provisions
- Transferability - Transfer interest in business over time
- Sources of Capital – Alternative - Corporation / LP / LLC
- Life/stage of business – Older vs. younger
- Multiple entities – Separate risky enterprises; tax savings
- Government program benefits and limitations
- Estate planning tool - Protect on-farm heir; Fairness to off-farm
How do you choose?

• Research
• Reflect / Understand
• Communicate
• Seek Expert Advice
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