



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 its “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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