BUSINESS STRUCTURE FOR SMALL FARMS: A QUICK GUIDE

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The business structure a small farm chooses has long-term implications worth careful consideration. The potential impacts of business structures include differences in federal taxation, vulnerability of the owner and family in lawsuits or debts, and operational considerations for current or future family members or partners.

Key questions to ask those sharing ownership and operation of the farm include:

- Will a partner or family member share farm ownership? If so, how much?
- What does each partner provide to the business?
- Do family members have an interest in taking over the business, and what is their current participation?
- Will friends or family invest in the farm? Will they want a say in operations?
- How will personal assets be protected from farm liabilities?
- Will there be off-farm income that affects tax liability?

Depending on the answers to these questions, there are advantages and disadvantages to each business structure. There is no one-size-fits-all situation. Because of this, legal counsel is strongly recommended when setting up the initial paperwork and filing necessary documents with the Secretary of State. A lawyer can ensure that operating documents are tailored to protect the farm and its specific situation. For many lawyers, this kind of work is routine and can be done quickly and relatively inexpensively.

Following is a brief description of each business structure and its implications for a small farm.

Sole Proprietorship

A sole proprietorship is a business structure with one owner, and the owner and the business are legally considered one and the same. This makes for relatively simple tax filing and very few steps in initial setup with the state and IRS. The owner is not required to submit articles of incorporation with the Secretary of State. As with all businesses, the owner needs to apply for a business license with the State Department of Licensing, and if hiring employees, follow the necessary steps with Labor and Industries and Employment Security.

Taxes: When filing with the IRS, the owner's social security number can also be the federal tax identification number for the business. The owner should apply for an Employer Identification Number (EIN) with the IRS if employees will be hired. All business income and losses are filed as part of the owner's individual tax return, with the addition of a Schedule F form to show farm income and loss. This can be an advantage in years when there is farm loss to offset off-farm income on the owner's tax return.

Liability: Liability is a significant concern for a sole proprietorship. Because the owner and the business are considered one and the same, the owner is personally liable for all business debts, judgments, or lawsuits. This can put the owner's non-exempt personal property at risk.

Decision-making/Ownership: Another concern for sole proprietorship is that only one person owns it. If both spouses or partners want co-ownership of a farm or ranch business beyond their title ownership on land or assets, they may be better off with one of the other business structures described below.

Table 1. Summary of sole proprietorship advantages and disadvantages (U.S. Small Business Administration 2014).

Sole Proprietorship Advantages	Sole Proprietorship Disadvantages
+ Simple and inexpensive to form.	– Personal liability.
+ Owner has sole control over decisions.	– Lack of investors, money.
+ Easier tax preparation.	– Solely responsible for success and failure.

Partnership

A partnership is when two or more people own a business together. Each partner contributes money, property, or skills to the business and shares in the profits and losses of the business. Partnerships do not require filing articles of incorporation or formation with the Secretary of State. Initial setup is relatively simple and similar to sole proprietorships.

Taxes: Partnerships have their own EIN, but they are not considered taxable entities. Partnerships are "pass-through" entities, meaning partners pay taxes on their share of the partnership's profit and loss on their individual returns.

A partner is taxed on his or her share of partnership profit regardless of whether the money comes to the partner. If a partnership decides to leave profit in the partnership, partners are still liable for the taxes on their share of the profit.

Liability: Partners are personally liable for all business debts, lawsuits, and judgments. Each partner is liable for all of the partnership's obligations. If one partner defrauds a customer or lender, all of the partners are responsible for the consequences.

Decision-making/Ownership: Partners may be active or silent. Participating as a silent partner allows friends and family members who don't want to take an active role in farm management to invest. Family members interested in transitioning farm property assets or land to future generations may consider forming family partnerships to aid in estate planning. In all cases, strong written partnership agreements are essential. Partnership agreements include the name and purpose of the business and the clearly defined expectations, contributions, and decision-making capabilities and responsibilities of each partner. Specific percentages of profit sharing and decision-making power should also be determined in the partnership agreement. Consider employing an estate planner to allow for younger family members to transition into the partnership.

Table 2. Summary of partnership advantages and disadvantages (U.S. Small Business Administration 2014).

Partnership Advantages	Partnership Disadvantages
+ Simple and inexpensive to form.	– Individual and joint liability with partners.
+ Partners' pooled resources means better access to money and credit.	– Disagreements among partners.
+ Partners' complimentary skills and knowledge.	– Shared profits.
+ Employees who are partners are motivated to succeed.	

Limited Liability Company (LLC)

An LLC is similar to a sole proprietorship and partnership in that it is a pass-through entity, with income and losses passed to members. LLCs are not taxable entities in themselves. They differ from sole proprietorships and partnerships in that they limit the liability of their members.

LLCs are established by filing Articles of Organization with the Secretary of State and paying a filing fee. Articles of Organization include the name of the organization, date of formation, whether it's managed by managers or members, duration of existence, business purpose, physical and mailing addresses, and names and addresses of the registered agent and executors.

Taxes: Taxes are filed and paid similarly as to a sole proprietorship or partnership, depending on whether the LLC is owned by an individual or two or more members. The IRS treats multiple-member LLCs like partnerships, and members pay taxes on their share of profit or loss. A member's share of the profit or loss is called a "distributive share." This share is based on their ownership interest in the company. Each member's share should be specified in an LLC Operating Agreement.

Liability: The LLC shields its members from personal liability for all business debts, lawsuits, and judgments. Only the assets of the LLC are at risk to claims; therefore, only members' investments into the company are at risk. Members can be personally liable if the business is used as an extension of the person or personal finances, making it very important to keep personal and business bookkeeping separate. For example, assets used in the business should have titles in the business name, such as vehicles, etc.

Decision-making/Ownership: Strong Operating Agreements are essential to the establishment and operation of LLCs. Operating Agreements govern how the business makes functional and financial decisions. The agreement is signed by the members and serves as a contract binding them to its terms. Operating Agreements help limit liability of members by clearly defining the operation and differentiating it from an unprotected partnership or sole proprietorship. An Operating Agreement also clarifies any verbal agreements made by members and is a good reference in case misunderstandings arise in the future.

Table 3. Summary of LLC advantages and disadvantages (U.S. Small Business Administration 2014).

LLC Advantages	LLC Disadvantages
+ Limited liability.	– Limited life; when a member leaves the LLC, it often must be dissolved*.
+ Less paperwork and start-up costs than corporations.	– Net income of LLC subject to self-employment tax toward Medicare and Social Security.
+ Flexible operations; members determine how profits are shared.	

*This may vary by state and operating agreement. Specific situations require legal counsel.

Corporation

A corporation is its own entity, separate from its owners. Owners are shareholders in the corporation. There are two types of corporations: S and C Corporations. The S and C stand for the subchapters where they are located in the Internal Revenue Code. In an S Corporation, the business profits and losses pass through to the shareholders who report them on their individual tax returns. There is no entity-level tax. The C Corporation is its own entity, and must pay its own income taxes on its net income. Then, shareholders also pay tax on dividends.

In Washington State, corporations may also elect to be "social purpose corporations," meaning they pursue social or environmental goals along with financial returns. They are required to have a report available to the public annually on their impacts to their defined social purposes.

With all types of corporations, more attention is required in the setup and ongoing operation than with other business structures. Formation steps include choosing a corporate name, naming directors, enacting bylaws, holding meetings of board of directors, issuing stock, filing articles of incorporation with the Secretary of State, and paying a filing fee. Ongoing management of a corporation requires shareholder and director meetings and maintaining written minutes and records of major decisions or transactions.

Articles of incorporation require the name of the corporation, number of authorized shares, effective date of incorporation, expected duration of existence, and names and addresses of the registered agent and incorporators (people who formed the corporation).

Taxes: S Corporations follow similar reporting requirements as partnerships. The C Corporation is the only type of business that must pay its own income taxes on profits. The profits do not "pass through" as they do with other business structures. Net income is taxable to the corporation, whether that income is kept in the company or distributed to shareholders as dividends. This can result in double taxation: the profit is taxed in the corporation, and dividends are taxed as personal income by shareholders. Corporations can avoid this with planning and advice from tax professionals. There are options to reduce double taxation, such as hiring shareholders as employees of the corporation or retaining earnings in the corporation.

One disadvantage to C Corporations is that corporate losses may not be passed through to shareholders.

Another disadvantage is that if an owner transferred land into the corporation and later wants to get the land out of the corporation, the gain on the land will be taxed twice: first to the corporation and then to the shareholder. Tax on the profit from sales of assets (capital gains tax) is usually taxed at a higher rate for corporations versus individuals.

Liability: A corporation shields its shareholders from personal liability for all business debts, lawsuits, and judgments. Only the assets of the corporation are at risk to claims; therefore, only owners' investments into the company are at risk. However, shareholders are always personally liable for anything personally guaranteed. If a shareholder personally guarantees a loan to the business, the shareholder is personally responsible for that debt. Shareholders can also be personally liable if the business is used as an extension of the person or personal finances, making it very important to keep personal and business bookkeeping separate.

Decision-making/Ownership: A corporation is owned by all its shareholders. It usually operates with a shareholder-elected board of directors that has decision-making authority for major transactions.

All corporation operations are governed by bylaws. These bylaws define when and where shareholder and board of director meetings are held, duties of officers and directors, how and when officers and directors are replaced, how corporate books are to be audited, when and how votes are held, how the corporation makes major transactions such as contracts and loans, and how shares will be sold or transferred and dividends distributed.

Table 4. Summary of corporation advantages and disadvantages (U.S. Small Business Administration 2014).

Corporation Advantages	Corporation Disadvantages
+ Limited liability.	– Stricter operation structure; requires shareholder meetings, etc.
+ Raise funds through sale of stock.	– Double taxing of C Corporations: profit taxed and dividends taxed.
+ Potential tax savings: only wages of shareholder as employee subject to employment tax. S Corporation distributions usually taxed at lower rate.	– Increased paperwork and bookkeeping.
+ Business has independent life. A shareholder can leave and business stays in operation.	– More costly to start and operate.

Cooperative

A cooperative is a business that is owned and operated by members using its services. For example, farms may join together for marketing or processing services. Cooperatives require careful setup to ensure all members agree on goals of the cooperative and strategies to achieve those goals. This usually requires several initial meetings, surveys, and feasibility analyses to ensure every member agrees with the business plan. Bylaws and membership applications must be created carefully, outlining requirements of members and the decision-making strategy members agree upon. Cooperatives are usually formed and managed similarly to corporations: filing articles of incorporation with the Secretary of State and electing a board of directors nominated by members.

Taxes: A cooperative operates as a corporation, but is a "pass-through" entity. Similar to partnerships, S Corporations, or LLCs, members report their share of the cooperative's profit or loss on their individual tax returns. There are specific tax codes for cooperatives; members file income tax returns using a specific 1099 form. Refer to the IRS website or a qualified accountant for more information.

Liability: Usually, cooperatives are operated as corporations thereby limiting liability to the members' investment.

Decision-making/Ownership: The ownership of the cooperative lies in its members. They also define how decisions are made via their bylaws. This can vary among cooperatives. Members usually elect a board of directors and officers who run the day-to-day operations of the cooperative, while regular members hold voting power and control the overall direction of the cooperative. The amount of a member's investment does not affect the weight of each vote, so no one person can dominate the decision-making process.

Table 5. Summary of cooperative advantages and disadvantages (U.S. Small Business Administration 2014).

Cooperative Advantages	Cooperative Disadvantages
+ Members of a cooperative only taxed once on their income from the cooperative and not on both the individual and the cooperative level.	– Slower cash flow; usually many small investors as members.
+ Government-sponsored grant programs to help start cooperatives, e.g., USDA Rural Development programs.	– Success depends on full member participation.
+ Cooperative members can routinely join or leave the business without causing dissolution.	
+ Democratic organization.	

Common Business Structures Among Farms

Sole proprietorships are the most common type of business structure among farms, while farms with higher sales tend to operate more often as Limited Liability Companies (LLCs) or Corporations. The 2012 Census of Agriculture shows smaller farms in Washington State often file as individuals or families rather than corporations. See Table 6. The Census of Agriculture doesn't break out LLCs in its compilation. A 2011 study by the U.S. Economic Research Service shows that U.S. farms with higher gross sales are more likely to operate as LLCs (O'Donoghue et al. 2011). See Figure 1.

Data compiled in 2015 from the Washington Employment Security Department show that more than a third of animal and crop farms choose sole proprietorships, and LLCs are as popular as sole proprietorships in animal farming.

Table 6. Summary of farm business structures for tax purposes by market value of products sold and government payments. The "other" category includes cooperatives, estates, and trusts.

Economic Class	Family or individual	Partnership	Corporation	Other
Less than $10,000	21069	937	801	527
$10,000 to $99,999	6134	618	698	237
$100,000 to $249,999	1348	280	412	70
$250,000 to $499,999	669	198	396	41
$500,000 to $999,999	473	217	476	28
$1,000,000 or more	474	435	680	31

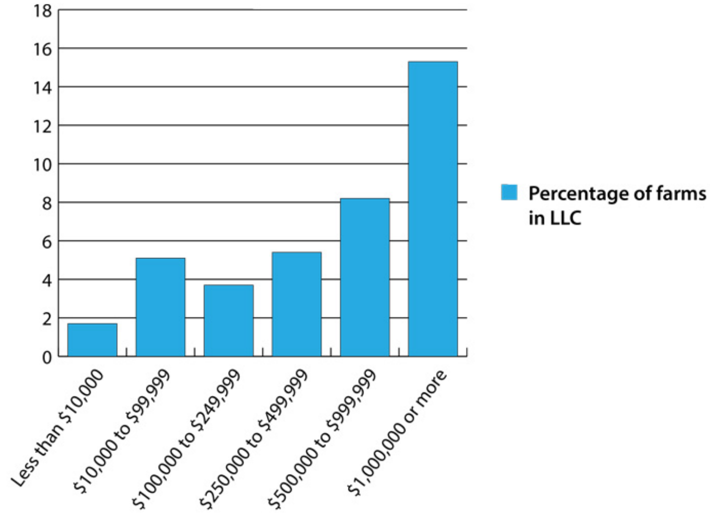

Figure 1. LLCs by sales class.

Corporations make up a majority of ownership of tree farms, as well as a nearly a third of crop farms and a quarter of animal farms. Similar to national data, sole proprietorship is the predominant business structure of farms in the state of Washington across farm types. See Figure 2.

Conclusion

Farmers have many options when establishing a business structure that works best for their specific situations. This guide is not intended to be exhaustive but to help start a conversation with farm partners and family members. Experienced legal and tax experts can help with specific questions in forming and choosing a business structure most suited to individual situations. Take time, assess needs, talk through questions with family and farm partners, and set the path for a rewarding farm business.

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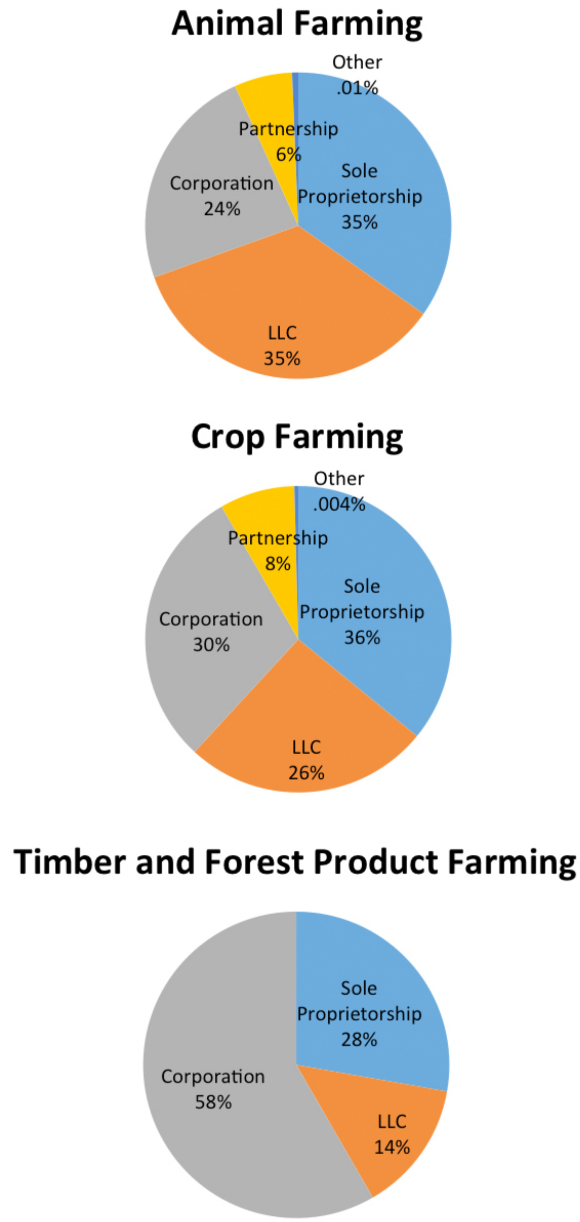

Figure 2. Business structures used by Washington farms.

For Further Reading

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