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Risk Management

Business Entity Planning

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Most farm or ranch businesses are owned by family members. Income and estate taxes and the sharing of income often create questions about the "best" business organization to use. Owners may also be concerned with how decision-making issues, management of liability, and access to non-traditional sources of investment capital may shape the business entity decision.

When choosing the form of a business entity consider:

Life/stage of business
Sources of capital
Inter/intra family issues
Taxes
Risk management
Estate planning implications
Management or control
Termination of business
Texas franchise tax
Multiple entities

Life/stage of business. The life cycle of the business is tied to that of the owner. Younger farmers may have little equity, debt capacity or management ability, but possibly excess labor. Older producers may become less willing to maintain the level of commitment necessary to continue the operation at peak efficiency. Younger producers may be willing to take on partners or investors in order to gain access to additional capital or other resources. Older business managers may view their choice of business entity as an opportunity to transfer management and ownership of the business and maintain greater efficiency.

Estate planning. The personal objectives of the people involved are critical. These objectives could include lowering estate taxes, providing for a surviving spouse, allocating assets among children, or continuing the business.

Sources of capital. All agricultural producers strive to lower their costs. The high cost of equity capital may lead them to seek non-traditional, lower cost sources of capital. A single producer may not have the resources to adequately finance the business. Many producers also are no longer willing to expose their equity to the same level of risk they have had in the past. This is leading producers to seek outside investors who are willing to assume some financial risk, and may mean adopting a business structure not typically associated with production agriculture (e.g., partnership, corporation, limited liability company or real estate investment trust).

Management/control of business. If the objective of maintaining independence and control dominates organizational and financial decisions, as it does in many small businesses, this may very well dictate the way the business is structured.

Risk Management Education

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Inter/intra family issues. Family issues include differences in labor or management inputs from family members, the employment of spouses, or the hiring of children. Certain business entity choices may eliminate certain tax incentives for hiring children. Bylaws or operating agreements can spell out what activities family members can participate in. Contingencies for as many of these issues as possible should be considered when choosing an operating entity.

Termination. Because of the low rate at which new businesses succeed and existing businesses are transferred successfully to the next generation, specific attention should be given to the methods by which an owner can withdraw from a business or the way a business will be terminated. Withdrawal or termination may become necessary if any of the partners, members or stockholders divorce, retire or die. It is best to address termination issues when the business is created, so the discussion does not become emotional. The tax aspects of business termination should be carefully considered.

Taxes. The full effects of a particular business structure on income taxes may not be known for years. Certain tax ramifications may not be experienced until the dissolution of a business entity. Entities that are registered with the Texas Secretary of State, limited partnerships, corporations, and limited liability companies are subject to a **Texas State Franchise Tax**. There should be considerable analysis and input from tax and legal professionals before owners commit to a particular structure for the business. Other publications in this series address the tax attributes of various business structures.

Liability issues. No business structure can protect you from your own wrongful acts, negligence or misconduct, or from tort liability. Partners in limited partnerships (LPs), members of limited liability companies (LLCs), and shareholders in corporations who are not directors, officers or employees have limited financial liability. Theoretically, their liability is limited to their investment in the entity. Unfortunately, in closely held farm businesses it is difficult to differentiate non-participatory owners from owners/managers. All business owners should assess the liability risks to which they are exposed, take steps to isolate those risks, and deal practically and realistically with them.

Multiple entities. Organizing a farm or ranch into more than one entity has become a common practice. Often real estate resources are separated from the operating portion of the business, or risky or "dangerous" enterprises are separated from the more stable or safe enterprises, for risk management purposes. Income tax management, estate planning and retirement planning are also common reasons for using multiple entities. For example, if the real estate were separated from the operating portion of the farm or ranch, rent could be paid by the operating entity to the landowner personally. This money could become retirement income for a retiring operator or a surviving spouse and might not be subject to self-employment taxes. From an estate tax planning perspective, the on-farm heirs could receive the operating assets, while the non-farm heirs could receive the real estate assets. This would limit the disruption of the operating portion of the business, requiring only that payment of rent be made to a different landlord(s).

The typical structures used for farm and ranch businesses are the proprietorship, general and limited partnerships, sub-chapter S- and C-corporations, and, since 1995, limited liability companies. Though they are rarely formalized, producers working together may have a joint operating agreement. The general characteristics of these business entities are summarized in Table 1.

Table 1. Comparison of farm business entities.

	Sole proprietor	Joint operation	Partnership	Limited partnership	`pany	Corporation
Life of business	Terminates on death.	Terminates on death.	Agreed term, may terminate on death of partner.	Agreed term, may terminate on death of partner.	Most LLCs lack the corporate characteristic of continuity of life.	Perpetual.
Estate planning	Limited usefulness.	Limited usefulness.	Useful tool when used in conjunction with multiple entities.	Useful tool when used in conjunction with multiple entities and gifting program.	Useful tool when used in conjunction with multiple entities.	Very flexible estate planning tool.
Sources of capital	Personal resources and debt capital.	Personal resources or debt capital of each proprietor.	Capital contributed by each partner, debt capital.	Capital contributed by each partner, debt capital.	Capital contributed by each partner, debt capital.	Contributions of shareholders for stock, sale of stock, bonds, debt.
Management or control	Proprietor has ultimate control.	Proprietor has control subject to conditions of operating agreement.	Agreement of partners.	Agreement of general partners; limited partners have no control.	A managing member can be identified, otherwise agreement of members.	Shareholders elect directors who manage business along with officers elected by directors.
Inter/intra family	Proprietor's discretion.	Proprietor's discretion; other issues are subject to operating agreement.	Issues addressed in partnership agreement.	Issues addressed in partnership agreement.	Issues addressed in operating agreement.	Corporate bylaws and directors determine family involvement in business.
Termination	Free to terminate business at will, paying taxes only if assets are liquidated.	Termination subject to terms of operating agreement. No tax consequences.	May be terminated upon death or withdrawal of partner. Partnership or buy/sell agreement dictates withdrawal. Potential for tax consequences.	May be terminated upon death or withdrawal of partner. Partnership or buy/sell agreement dictates withdrawal. Potential for tax consequences.	Death or withdrawal of interest will not necessarily terminate LLC. Operating or buy/sell agreement dictates withdrawal. Potential for tax consequences.	Shareholders free to sell shares; buy/sell agreement may set conditions. Capital gains taxes may apply. Shares will pass through estate upon death of shareholder.
Taxes	Proprietor responsible for all income, self-employment and capital gains taxes.	Proprietors individually responsible for all income, self-employment and capital gains taxes.	Income allocated to partners by classification. Partners pay all income, self- employment and capital gains taxes.	Income allocated to partners by classification. Partners pay all income, self-employment and capital gains taxes.	Can elect for tax treatment of partnership or corporation.	S-Corp.- Income taxed at shareholder level. Income allocated to shareholders via K-1 not subject to self-employment tax. C-Corp.- Separate entity that pays its own income tax and capital gains tax.
Texas franchise tax	Not applicable.	Not applicable.	Not applicable if all partners are "natural persons."	Must file. May pay if total revenue is greater than $300,000.	Must file. May pay if total revenue is greater than $300,000.	Must file. May pay if total revenue is greater than $300,000.
Risk management	Bears all risk.	Bears all risk.	Jointly and severally liable for the business actions of all partners	General partners bear all the risk, to the extent that limited partners provide no management.	Members' financial liability limited to their investment.	Shareholders not liable for corporate obligations. Value of stocks likely lost.
Multiple entities	Not applicable.	Not applicable.	Potential application of multiple entities.	Potential application of multiple entities.	Potential application of multiple entities.	Potential application of multiple entities.

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