

## *Risk Management*

# Limited Liability Companies and Corporate Business Structures

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The economic environment in which today's farming and ranching operations must compete is becoming much more challenging because of the capital intensive nature of agricultural production, liability concerns, narrow operating margins, tax management, intergenerational issues and other concerns. The choice of operating structure for the farm or ranch business is also difficult. This publication describes limited liability companies and corporate forms of business organization.

## **Multiple Entities**

Three entities discussed here are frequently used in a multiple entity approach to business organization. Typically, the operating portion of an operation is separated from the real assets. Several objectives can be met with this strategy:

- Retirement planning/providing for a surviving spouse
- Tax management—income, self-employment and estate taxes
- Acquisition of the operating entity by on-farm heirs
- Estate planning—equitable treatment of on-farm and off-farm heirs
- Limiting liability—reducing or mitigating liability concerns

## **Limited Liability Company**

The Limited Liability Company (LLC) form of organization is relatively new in this country. The first state to authorize LLCs did so in 1977, though the use of LLCs did not become commonplace until the mid 1990s. The LLC is truly a hybrid business organization, combining certain characteristics of partnerships and S-corporations. An LLC is a means of combining the resources, skills or talents of two or more people.

Unlike general partnerships, which potentially expose personal assets to claims made against the partnership, owners of an LLC have some protection from financial liability. This feature is similar to the protection provided to corporate shareholders.

LLCs offer some flexibility in the manner of taxation. Most LLCs are taxed like partnerships; however, since 1997, Internal Revenue Service (IRS) "check the box regulations" appear to allow an LLC to be taxed as a corporation. The partnership tax treatment makes the LLC a pass-through tax entity so that income or loss is allocated by classification to members/owners and taxes are paid by the individuals. This pass-through aspect of taxation is similar to the tax treatment of S-corporations.

LLCs differ from S-corporations in that fewer ownership restrictions are placed on LLCs. Where S-corporations have limitations on the number of shareholders and the types of entities that may own stock, these restrictions do not apply to LLCs.



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The accounting requirements of LLCs, like partnerships, can be considerable. Members have their own tax equity in the LLC, called capital accounts. Contributions into and withdrawals out of the LLC, along with the allocated earnings (loss), are netted against these capital accounts. Under ordinary business practices, accounting can be very simple; but partial or total distribution of a membership interest can be complex. With the distribution of a membership interest, the disposition of certain classes of assets, and where withdrawals from the LLC have exceeded taxable income, the tax consequences are often unanticipated and may be severe.

The start-up costs associated with creating an LLC can be an issue. The complexity of organizing articles, operating agreements, buy/sell agreements and termination agreements will dictate the relative costs for establishing an LLC. Because public filing or disclosure is limited to the organizing articles, typical filings do not reveal much information about the LLC. Management control is assumed to be shared by all members unless otherwise directed in the organizing articles.

The sources of capital available to the LLC will be contributions from members and borrowings. The limited liability aspects of an LLC may allow producers to attract outside investors; however, borrowing may be limited by the amount of collateral owned by the LLC. Furthermore, the use of personal guarantees could jeopardize the limited liability protection provided for by the LLC and undermine the purpose of the business structure.

## *Corporate Structures*

Corporations are legal entities separate from the shareholders who own them. A corporation has most of the rights of an individual. A corporation can own real and personal property, enter into contracts, sue and be sued. The liability of stockholders who are not officers, employees or directors is generally limited to their investment in the corporation. However, farming and ranching operations tend to be family operations where family members are also owners, officers and employees.

Start-up costs can also be an issue in the creation of a corporation. Articles of incorporation, by-laws, the issuance of stock, buy/sell agreements on the issued stock, and lease arrangements are some of the details that add to the cost of incorporation. Annual maintenance costs include required annual meetings, minutes of these meetings, and separate bookkeeping and accounting; all of these are necessary to maintaining status as a separate entity.

Corporations have several options for raising capital. These include contributions of property or services in exchange for stock, the sale of stock, the issuance of bonds, and borrowings. Again, borrowing may be limited by the amount of collateral available to lenders. Most farming or ranching corporations are family owned, which limits the amount of capital that can be raised through the sale of stock. Farming corporations that do have unrelated shareholders still tend to be small and closely held.

The management of a corporation is defined by the corporate bylaws. A paid manager and any other employees will answer to the corporate president, who in turn is responsible to the board of directors. The directors are elected by the voting shareholders of the corporation. Involvement by family members in the operation of the business needs to be specifically addressed by the bylaws to avoid future real or perceived differences in labor or management inputs. Minority interests in closely held corporations are of uncertain value because input into daily management may not be possible, nor can minority interests demand a salary or dividends. Any kind of return on the value of a minority interest ownership may not be likely or even possible. Because of this uncertainty, the discounting of a minority interest is possible.

One of the distinct advantages of the corporate structure is the indefinite life span and the ease of transferring shares of stock. Rather than trying to allocate dollar equivalents of land, machinery or livestock in order to make a full or partial sale or distribution of assets to heirs, an owner of a corporation can simply divide shares of stock to suit his or her purposes.

### *S-Corporations*

The sub-chapter S corporation is created by making an IRS election. This election gives the S-corporation a pass-through tax treatment similar to what partnerships and LLCs enjoy. Net income (loss) is allocated (Form K-1) to shareholders based on ownership percentages and is not subject to self-employment taxes. However, reasonable wages must be paid to all employees, including shareholder employees. These wages are subject to various withholding taxes. Certain fringe benefits are not deductible for employees who own more than 2 percent of the corporation.

An advantage of the sub-chapter S election would be a reduction of the double taxation potential seen with C-corporations. Shareholders can build tax basis along with market value on their shares. Distributions or withdrawals from an S-corporation are possible, though reductions in the per-share tax basis will be necessary. Another possible advantage to selecting a sub-chapter S corporation is the savings in self-employment taxes. As a sole proprietor or partner in a partnership, all earnings up to an established threshold are subject to self-employment taxes. In an S-corporation, only the salary payments by the business are subject to social security and Medicare tax withholding. Income taxes are paid only on the other earnings that are retained by the corporation for corporate growth.

### *C-Corporations*

Many of the tax benefits of incorporating that existed in the 1970s have been phased out. This, and the arrival of the LLC form of business organization, has slowed the rate of farm and ranch incorporation. There are still many valid reasons for incorporating a family farming or ranching operation, but the perpetual life of a corporation makes long-term planning critical. After the corporation is created, the regular bookkeeping requirements may be simpler than maintaining varying inputs from several family members. Shareholder liability protection is also a key advantage of incorporating.

One disadvantage to incorporation is the potential for double taxation. Earnings that are taxed at the corporate level will be taxed a second time if disbursed as dividends or upon liquidation of the corporation.

### *Summary*

There are many factors to consider when choosing a business structure. Circumstances unique to a particular farm or ranch may dictate the choice of one form over another. The choice of business entity operating structure can have both long-term and short-term consequences. It is advisable to seek professional help from a certified public accountant or tax preparer, legal advisor, lender, and other people used as management resources for the business. These people can help both in the planning process and in the actual formation of the entity chosen.

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