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Using a Business Organization Structure to Limit Your Farm's Liability

PHOTO: EDWIN REMSBERG

Business structures can help limit your liability and set your farming operation up to continue through generations.

In Maryland, 82.7 percent of agricultural operations conduct business as sole proprietorships (Census of Agriculture, 2012). As agriculture continues to evolve, however, producers should consider investigating all types of business organization structure for their operations to limit liability and provide additional forms of capital.

Organization structures offer a variety of advantages and disadvantages, with each fitting a different need and purpose. The common thread, however, is that business structures can help limit your liability and set your operation up to continue through generations. Choosing an appropriate business structure can protect your personal assets such as your home, vehicle, and retirement accounts from business creditors and others who may seek compensation from your operation. Not only can a business structure limit liability but it can also help in estate planning if your goal is to pass on the operation to another generation (Musser, Lynch, and Goeringer, 2014). Even though each producer may seek a different structure for his or her personal operation, the benefits of business organizations can outweigh having no business structure in place.

Deciding on a particular business organization structure is not an easy task. Business owners should take their time and analyze how each organization structure could impact their current business. While this publication

provides a basic overview of the structures commonly used by farms, it is vital that you work with your farm's attorney and tax preparer to gain a better understanding of how these organizational structures could impact your situation. The decision to form a business entity should be well-calculated and planned based on the uniqueness of your situation and operation.

A big disadvantage of a sole proprietorship is that it does not offer the opportunities that other business structures do to shield personal assets from liabilities incurred by the business, and vice versa.

Sole Proprietorship Is Simplest Business Organization Structure and the One Most Often Used by Maryland Farmers

There is one advantage to using a sole proprietorship--no filing is required by the state. Creating a sole proprietorship is simple: you just declare yourself a business. The operator of a sole proprietorship has full managerial control over the business.

But what are the disadvantages? First, the business of a sole proprietorship ends upon the death of the owner. This is potentially a disadvantage if the owner's goal is to continue the business into the next generation. Second, a sole proprietorship is limited to two sources of business funds: 1) personal assets or 2) borrowed capital. Other business organization structures allow for the possibility of other sources of funds, such as investments. Next, all income earned in a sole proprietorship is taxed as personal income, with the owner paying self-employment taxes.

Another big disadvantage of a sole proprietorship is that it does not offer the opportunities that other business structures do to shield personal assets from liabilities incurred by the business, and vice versa. For example, Mike operates his farm as a sole proprietorship and one day is driving his tractor home from the field. As Mike comes over a hill, he accidentally runs an oncoming car off the road into the ditch. The driver is okay but his car is totaled. If the driver sues, both Mike's personal and business assets could potentially be used to pay any judgment against him. Other business organization structures would help shield personal assets from liabilities incurred by the business.

Partnerships are Separate Legal Entities Created by Two or More Individuals Who Each Contribute Capital, Equipment, and Skills and Share in Profits and Losses

Partnerships come in two forms: 1) general partnership and 2) limited partnership. Each form of partnership offers its own advantages and disadvantages.

General Partnerships

General partnerships are the simplest form of two-partnership types, and can be created with no legal agreement or filing with the state. A general partnership is a separate legal entity which can contract, title assets in its own name, and be sued. Similar to a sole proprietorship, the liability in a general partnership is not limited to just the business assets; your personal assets are potentially liable for legal claims against the business and other partners. If asset protection is your key goal, then a general partnership may not be for you.

Ease of formation is why many farming operations use general partnerships. In many cases, profit sharing is the only motivation for forming a partnership. For example, Bob and his son Charlie farm together. They share in management and labor decisions and split the profits each year. Even though there is no formal written agreement between Bob and Charlie, they have effectively created a general partnership. But an agreement between the parties formalizing the partnership should always be considered.

PHOTO: EDWIN REMSBERG

General partnerships are the simplest form of two-partnership types, and can be created with no legal agreement or filing with the state, and are as easy to dissolve as they are to create.

With a general partnership, each partner is a co-owner in the business, and each partner is jointly and severally liable for the business actions of the other partners. Looking back at Bob and Charlie, if Bob goes to the local tractor dealership and purchases a new tractor for the partnership without consulting Charlie, both parties would be liable for the tractor since this was a business action.

General partnerships have some similarities with a sole proprietorship. Partners are taxed on profits and the partnership is not taxed, similar to a sole proprietorship. Also, the general partnership would dissolve when one partner dies or becomes incapacitated. This is similar to a sole proprietorship dissolving upon death of the owner. Finally, capital for the business is limited to what can be borrowed or personal assets of the partners, much like it was for a sole proprietorship. New partners can be added, but this effectively creates a new partnership every time partners are added.

General partnerships also are as easy to dissolve as they are to create: the partners can just decide to walk away and split up partnership assets. Another reason partners should consider a written partnership agreement is to spell out how assets will be distributed when the partnership is dissolved.

As you are beginning to see, not all business organization structures are created equally. Some offer little or no protection to shield personal assets from business liabilities. Sole proprietorships and general partnerships are two of the very basic structures offering limited protections. The next business structures become more complex and require filings with the appropriate state agencies.

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Limited partnerships allow for investments by limited partners who can invest in the business and will only be liable for that investment--not full liability.

Limited Partnerships

Limited partnerships are made up of at least one general partner and one or more limited partners. With limited partnerships, sources of available capital can expand beyond personal contributions and borrowed capital. Limited partnerships allow for investments by limited partners who can invest in the business and will only be liable for that investment--not full liability. General partners manage the business and take all the business risks. The limited partner(s) also will be taxed similar to a general partnership.

For example, you invest $1,000 in your friend's new company as a limited partner. The company sells faulty products and is now facing lawsuits from injured consumers potentially totaling $1 million. If the company is found liable, then the most you would be out is your original $1,000 investment since you are a limited partner. General partners, on the other hand, would be at risk for the full liability.

To form a limited partnership, all the general partners need to file a certificate of limited partnership with the Maryland Department of Assessments and Taxation. That certificate must have the name of the limited partnership, address of the principal office, name and address of resident agent (the person responsible for receiving service of process, or documents used to notify you of a legal action being filed), whether the limited partnership is perpetual or terminates on a certain date, and anything else the general partners decide to include.

The name of the limited partnership must contain either LP or L.P. in the name. Family Farms LP, for example, would be a valid name for a limited partnership in Maryland. The business name cannot contain the name of a limited partner with two exceptions: 1) if the name is also a general partner's name and;

Corporations enjoy most of the rights and responsibilities that individuals possess: the right to enter into contracts, loan and borrow money, sue and be sued, hire employees, own assets, and pay taxes.

2) if the limited partnership conducted business under that name before including the limited partner with the same name.

One special type of limited partnership is the family limited partnership. Here the partnership is limited to family members. Some family members will be general partners, typically those taking active roles in the management of the family business. Others will be limited partners who are not actively involved. This form would allow those family members actively running the business to continue to do so and enable other family members to receive income from the family business. Family limited partnerships are potentially useful as estate planning and business transition tools. Check with your tax advisor and attorney to determine if a family limited partnership is a good fit for you and your goals.

A Corporation Is a Legal Entity Separate and Distinct From Owners

A corporation is owned by its shareholders who are individuals, other business organizations, or both. Even though corporations are distinct and separate, they enjoy most of the rights and responsibilities that individuals possess. For example, corporations have the right to enter into contracts, loan and borrow money, sue and be sued, hire employees, own assets, and pay taxes.

To become a corporation, you must establish your business name and register your legal name with your state government. In Maryland, you are required to use one of the following words, or an abbreviation of one, in your corporate name: “incorporated,” “corporation,” “company,” or “limited.” Then you will be required to prepare and file articles of incorporation with the Maryland Department of Assessment and Taxation. From there, you will need to appoint a registered agent who is either an individual or a corporation that agrees to accept legal papers on the corporation’s behalf in the event it is sued.

You will also need to set up a corporate records book to document all important information, prepare corporate bylaws, appoint initial corporate directors, hold your first board of directors meeting, comply with Maryland Annual Report Requirements, and continue to comply with all other tax and regulatory requirements. Please consult your attorney or tax representative before and during setting up of a corporation to ensure your particular needs and requirements are fulfilled.

See https://egov.maryland.gov/easy for the steps and required documents needed for filing in Maryland.

Go to http://www.dat.state.md.us/sdatweb/checklist.html for a checklist when filing as a business organization in Maryland.

There are some disadvantages to creating a corporation. They are more complex than other business organizations and often have costly administrative fees and complex legal and tax requirements. Because of these characteristics, corporations are generally suggested for large, established companies with multiple employees.

Another disadvantage is that in some cases, corporations are actually taxed twice. This happens when the company makes a profit, and when they pay out dividends to their shareholders. Additionally, because corporations are heavily regulated by Federal, state, and sometimes local agencies, there are increased paperwork and recordkeeping burdens.

Corporations also offer many advantages, however, as a business organization. They can sell ownership shares in the business through stock offerings. The act of “going public” through an initial public offering (IPO) is a major selling point in receiving investment capital and attracting high-quality employees and companies.

It is also important to note that there is limited liability associated with corporations. Shareholders’ personal assets are protected from any debts stemming from actions taken by the company, and can only be held accountable up to their investment in the company (purchase of stock). On the other side of the tax coin, corporations file taxes separately from their owners. Owners of a corporation only pay taxes on the corporate profits paid to them in either salary or dividends while any other additional profits are taxed at a corporate tax rate, which is usually lower than the personal income tax rate.

A Limited Liability Company Is a Noncorporate Business Whose Owners Actively Participate in Management

A limited liability company (LLC) is a hybrid entity with the characteristics of a corporation and of a partnership. It provides owners corporate-like protection against personal liability; however, it is usually treated as a noncorporate business organization for tax purposes. This means that even though the LLC individual owner will not be held liable for any debts incurred by the LLC, the individual will be subject to self-employment taxes. The individual will be liable for the profits from the LLC because the LLC is not taxed as a corporate entity but rather, those profits incurred are passed to the individual and taxed on personal federal tax returns. This can be a disadvantage to the LLC and a great reason to speak with your legal and tax representative when considering this business structure.

When making the decision to form an LLC, you should consider many of the benefits this business organization offers. LLCs allow any entity, including individuals, partnerships, trusts, estates, corporations, or other LLCs to be owners. This can be beneficial if you already have part of your operation formed as a business entity and want that entity to benefit from a separate part of your operation. For example, you and your daughter who lives in another state actually own your farming operation in a partnership, but you also want the partnership to benefit from the dairy operation. You include your son, an individual, and the farm partnership as owners in the LLC which will include the dairy operation. This will allow the farm operation to own a portion of the dairy operation and benefit from its success as well as its own farm success. It is also a great way to involve other family members who may not be physically present but want to help manage the farm.

LLCs offer greater flexibility than corporations because they lack restrictions on number of members allowed but have the tax advantages (or disadvantages) of a partnership, such as pass-through of taxable income and losses. The IRS does not consider an LLC a distinct and separate entity for tax purposes. What this means is that the IRS does not tax the LLC directly; instead the members of the LLC decide how they want to be taxed. Typically, members of an LLC create an operating agreement outlining how they would like to be treated for tax purposes. Please see IRS.gov for further information regarding taxation of LLCs.

PHOTO: EDWIN REMSBERG

LLCs allow any entity, including individuals, partnerships, trusts, estates, corporations, or other LLCs to be owners.

LLCs require significantly less paperwork than its counterpart the corporation. The primary document you will want to have is an LLC Operating Agreement. Maryland requires that your LLC have either limited liability company, L.L.C, LLC, L.C., or LC in your name. After that, the rules and regulations are minimal as long as the LLC abides by tax and legal guidelines. Additionally, LLCs are not required, like corporations, to hold annual meetings or provide annual reports. LLCs also have the flexibility to distribute profits in any manner they wish without regard to each member's financial contribution.

A Cooperative is a Farm, Business, or Other Organization Owned and Run Jointly by Its Members, Who Share the Profits

A key factor of a cooperative is it involves a group of members (typically business owners) who have a common goal and objective in the marketplace. Cooperatives share a set of general principles such as:

Democratic Governance – Cooperatives generally have a one-vote-per-member rule. This is different from other business organizations which usually weigh each owner's vote based on their financial stake.

Consensus Building – Cooperatives encourage members to work together if they want to take a certain action. Most, if not all, members must agree in order to make a business decision.

Community-Centric – Cooperatives are typically comprised of members from the same geographic area, i.e. town, city, county, state, or region. Since this means members live where they work, in most agriculture operations, they have less incentive to leave and are likely to invest locally.

Member Satisfaction Trumps Larger Profits – It goes without saying cooperatives must earn a profit in order to thrive. However, member well-being is valued above earning high profit margins. Generally, cooperatives have rules in place to help keep the work environment fair and preserve members' rights and safety.

Self-Motivation – Hand-in-hand with being community-centric, members are more likely to invest their time and energy in the cooperative because their hard work determines the cooperative's profitability. The decisions and work each member puts in relate directly to the increase in wealth of the cooperative, giving each member a stake in its future.

Training – Many cooperatives have a training program to prepare new members to participate in the business.

Open Membership – Most cooperatives generally allow any person to join regardless of gender, race, religion, or social status. However, to become a member, cooperatives typically require an entry-level training program, initial investment, and final approval by all members.

If after speaking with a legal representative and tax specialist, you decide to form a cooperative, it is important to know the steps you need to take and the decisions needed to be made moving forward. First, the group will need to decide under which legal structure it will formalize and register with government (i.e. organize or incorporate under a business organization such as an LLC or corporation). Not all cooperatives are incorporated but many choose to do so. Each state has different requirements for incorporating, just like any other business structure.

PHOTO: EDWIN REMSBERG

Cooperatives offer purchasing and marketing power to its members as well as tax advantages.

Please visit the Maryland Department of Assessments & Taxation website for details and forms for incorporation.

Forming a cooperative involves many steps and a common goal. It is important to make sure your operation and its uniqueness is a good fit. Visiting with specialists in tax, finance, and legal areas will help in setting up your cooperative. Many states, including Maryland, have rural development offices to help guide you and your members in forming a cooperative. Information from Maryland's Rural Development Corporation is available at: http://www.mrdc.net

As with the other business structures, cooperatives have advantages and disadvantages. The advantages involve sharing both expenses and risks with other members. For example, cooperatives offer purchasing and marketing power to its members. Purchasing power allows suppliers to offer discounts since they can balance lower profit margins with high sales volume. Additionally, cooperatives can purchase and pay for advertising at advantageous rates as well as market as a group, creating a brand across a geographic region. This can result in greater exposure for your individual operation which may be something you would not be able to afford alone or without the cooperative.

Cooperatives also offer tax advantages. Similar to an LLC, cooperatives are not usually taxed on dividends paid to its members. This means that members are only taxed once on their income from the cooperative and not both individually and as the cooperative.

Some of the disadvantages of cooperatives involve slower cash flow, generic branding, and lack of membership and participation. While the democratic operating environment may look good to small investors, larger investors may choose to invest their money elsewhere since large investments do not translate into greater decision making power.

On the other hand, members do not get their own branding image but rather a generic brand. This can be a disadvantage to members who seek to capitalize on their unique product and brand image. If members do not fully participate and perform their duties (for those who lack self-motivation), then the business cannot operate at full capacity and profits cannot reach their full potential. If this is an ongoing issue for the cooperative, it could risk losing members or gaining new members.

Always Consult Professionals Before Selecting a Business Structure

It is vital that you work with your farm's attorney and tax preparer to gain a better understanding of how these organizational structures could impact your situation. The decision to form a business entity is not one that should be taken lightly but rather a well calculated and planned out resolution to your uniqueness.

References

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In Partnership with

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http://www.mpowermaryland.com

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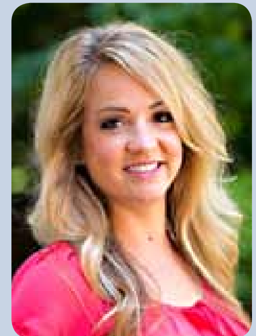

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