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Chapter 4
Business and Organizational Structure

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Introduction

An important part of succession planning is selecting an organizational structure for the farm business. The choice of an appropriate organization structure is important not only for succession planning but also for governing how the operation conducts business. For example, organizational structure can impact the taxation of the farm's profits and mitigate overall liability exposure of the owner(s) of the business. The focus of this chapter will be on the importance of organizational structure to successful succession planning.

A first step in discussing this choice is to consider exactly what comprises the organizational structure of a farm or family business. We can think of organizational structure as including the following three components:

- **Management Structure.** The management structure determines how decisions are made and responsibilities allocated among the individuals in the business. A clearly defined management structure lets all involved know not only what their roles are and what is expected of them but also how decisions concerning the farm will be made and who will make them. While a hierarchical, top-down management structure (where decision-making authority is retained at the top) remains popular, there is evidence that successful family businesses often rely on shared decision-making. While it may be difficult for older or more experienced managers to accommodate the ideas of younger, less experienced operators, this difficulty can be even greater when the younger, less experienced operators are also the offspring of the older, more experienced operators.

- **Owners Versus Managers.** In today's farming operations, owners of the operation may be somewhat removed from the day-to-day operations of the business. As the modern farm has become larger, owners and employees can specialize in their own business role(s). This has allowed some farming operations to be owned by individuals while being managed by others. Organizational structure becomes even more relevant to ensure that the goals of the owners and managers directly align with one another. Communication between the two parties is crucial to ensure the success of the business. To be sure that the goals of both groups align, the management team may become part owner of the farming operation as part of the succession plan.

- **Financial Structure.** The financial structure of the business defines how ongoing business operations are financed and how the income from the business is distributed among those who have contributed, leased or loaned capital to the business. Capital contributions can be human, physical or financial capital. Two aspects of a business' financial structure are worthy of particular attention within the context of a succession plan: the opportunity for investment and the sharing of business income. The transition from the current owners — who have often accumulated significant business assets over a lifetime of work — and new owners — who are often just starting out and thus may have limited assets and borrowing capacity — may require a change in financial structure. This change could involve the new owners borrowing extensively from lending institutions or the current owners purchasing assets at a single point in time. Or it could involve the new owners purchasing assets gradually by plowing profits back into the business and building equity over time. Given that the accumulation of business assets by the current owners has often occurred at the expense of investment in more traditional retirement accounts, it can be difficult to achieve a division of farm income that supports both the old and new owners and allows the new owners to invest in the business. The current owners of the farm's assets must look to the future and begin the succession plan many years before the actual transition. By doing so, you can provide sufficient time to plan for the potential financing of the younger generation's taking over the operation and/or provide enough income to support the elder generation in retirement.

- **Legal Structure.** The legal structure defines the legal relationships between and among the current and future owners, as well as the relationships between the current and future owners and third parties, such as lenders, vendors and buyers. These legal relationships are defined by the (i) legal entity under which the current owners operate the business; (ii) nature of the transfer of ownership, management and control of the farm business from the current to the future owners; and (iii) legal entity under which the future owners will operate the business. This chapter includes an overview of the different legal entities from which a farm or family business is likely to choose, along with a discussion of the factors that should be considered when choosing a particular legal entity. How ownership, management and control can be transferred from current to future owners are discussed both in this chapter and in *Chapter 5: Estate Planning Tools*. It is highly advised that farm families consult with a qualified accountant and attorney before electing the organizational structure for their farm.

Succession planning implies that, in choosing an organizational structure, business owners should consider not only how management and control will be structured but also how they will be transferred from one generation or owner to the next. In many instances, this transfer may be gradual, with the existing owner relinquishing management and control to the new owner over time. While a gradual transfer may benefit both parties, the temporary sharing of management and control can be difficult. The success of multigenerational businesses can depend upon the ability of family members and others to work together effectively. The likelihood of a successful farm transition hinges upon both the senior generation and the up-and-coming generation being on the same page. In this sense, a successful farm transition includes the transfer of not only the physical assets of the operation but also the knowledge and skills the senior generation has acquired over time.

The way in which the business is transferred from one generation or owner to another is likely to be affected by financial or credit constraints. These constraints may also affect the choice of organizational structure. It is important to note that financial misfortunes cannot be resolved by organizational structure, but can alleviate some of the headaches of transitioning assets of the farm from one generation to the next.

The remainder of this chapter discusses particular aspects of these three components of organizational structure and how they relate to succession planning in more detail. However, the focus of the chapter is on the second component, i.e., the legal structure, because it involves several technical terms and concepts with which many people may not be familiar. Much of what follows in this chapter assumes the succession plan does not include the termination of the farm or family business. That said, the general concepts and principles discussed in this chapter are relevant for those instances in which the succession plan includes the sale of the land and/or termination of the farm business.

What follows is a brief overview of the three general ways in which the ownership, management and control of the farm or family business may be transferred from one generation or owner to another and a more detailed discussion on the use of legal agreements and entities in this process. The chapter is meant to equip readers with a general understanding of the legal processes and tools involved in farm business succession.

General Forms of Succession Plans

The different ways in which the ownership, management and control of the farm business are transferred from one party to another can be grouped into four broad categories:

- **Legacy (or Dynasty).** In a legacy arrangement, the existing farming operation is passed along to the next generation, which is usually the senior generation's children, grandchildren or other family members, including in-laws. In this type of succession, the farming operation continues with little change in the day-to-day operations with gradual changes taking effect further down the road. Ownership of assets can be passed along upon the passing of the senior generation (i.e., inheritance) or purchased by the up-and-coming successor(s). Generally speaking, this requires some type of financing of the "buyout" of the senior generation. The financial component of the transition can be simple or extremely complicated. Each situation is different, but one rule of thumb needs to be followed: plan for sufficient time to allow the successor(s) to be financially able to make the transition, while supplying the senior generation sufficient income to maintain their proper standard of living. This takes proper planning and serious consideration by all parties involved.

- **Spin-off.** In a spin-off arrangement, a new farming enterprise is spun-off or created that is separate and independent from the existing enterprise. For these arrangements, the structure of the existing operation typically changes moderately. The parties often share labor and machinery, and, over time, the new enterprise builds equity and takes over an increasing part of the operation of the business. These arrangements are based on an implicit or explicit (oral or written) agreement as to how the business will be transferred over time. Thus, the relationship between the parties is contractual and often fairly short-lived. The success of spin-off arrangements depends upon the parties having similar expectations as to the transfer of the business. To this end, explicit written agreements between the parties can reduce conflict and promote the growth and development of the new enterprise. In a spin-off arrangement, it is not uncommon to hear of "things going south" when the successor takes the operation in a new direction in comparison to how the former owners operated. If land or equipment is retained by the previous owner, it is wise to have things in writing to prevent the loss of assets essential to continuing the farming operation.

- **Landlord/Tenant.** In a landlord/tenant arrangement, the current owner of the business retains ownership of some or all of the farm or business assets and leases these assets to the new owner. This type of arrangement is often used to provide the current owners with income in their retirement years, while the new owner builds the financial or borrowing capacity needed to purchase the assets. The success of these types of arrangements depends upon the current owners being able to accept both a reduced role in farm or business management and a reduced income from farm or business operations.

- **Superfirm.** In a "superfirm" arrangement, one or more entities are created that survive the transfer of the farm or family business. These arrangements require the use of a separate legal entity, such as a partnership, corporation or limited liability company and imply at least a period of co-ownership of the farm or family business. Transfer of management and ownership of the entity can occur gradually over time through sales, gifts and bequests at death. An advantage of these types of arrangements is the flexibility they provide. For example, these arrangements may make it easier for parents to include off-farm heirs in the ownership (if not the management) of the farm than other arrangements. On the other hand, these arrangements may be more complex and more costly to create and maintain. For example, the creation of a corporation requires the creation of a board of directors, the designation of the management team, creation of an operating agreement, and filing of tax returns, in addition to simple individual returns.

Each of these types of arrangements has advantages and disadvantages. The type most appropriate for any particular set of circumstances depends upon many factors, including:

- The nature of the farm or family business;
- The current and future profitability of the farm or family business;
- The value of the assets associated with the farm or family business;
- The desires and preferences of both the current and future owners of the farm or family business;
- The financial position and income needs of the current owners; and
- The financial position, knowledge and experience of the future owners.

Regardless of which type of succession plan is used, the legal nuts and bolts of the plan will typically consist of one or more contractual arrangements between the parties (unless the transfer of management, ownership and control occurs exclusively at the death of the current owners) and one or more legal entities under which the farm business is operated. The following sections focus on these contractual arrangements and legal entities.

Contractual Agreements

A number of different contractual arrangements may be used during the transition from one farm owner to another. These agreements typically fit into one or more of the following four broad categories: employment, sale, lease and financing. It is possible for a single agreement to span more than one of these categories, as might be the case with a lease/purchase agreement, for example. In general, these agreements should be written and properly executed by both parties to avoid disagreements and confusion. The process of capturing the agreement in a written document may also promote a more complete specification of the relationship and a more careful consideration of the implications of the agreement.

Individuals entering into contracts such as those mentioned above may benefit from seeking legal counsel to ensure both parties mutually benefit from the contract. Both parties should be cautioned to not rely too heavily on one party's legal counsel to ensure contractual agreements are not one-sided.

Employment Agreements

A common relationship between a retiring farmer and a beginning farmer or family business owner is that of employer-employee. This relationship can allow the new owner to accumulate experience and assets while maintaining flexibility for the parties as they move forward. Legally, there are two different types of employment: at-will and contract. At-will employees can resign or be terminated by the employer at any time, without notice or justification. Contract employees are hired according to an oral or written contract specifying the terms of employment. Employment contracts typically set forth the conditions under which the employee can be terminated, as well as the process for doing so, and may also specify notice or other requirements for resignation by the employee. Thus, at-will employment retains maximum flexibility with a minimum of commitment, while an employment contract requires greater commitment but can provide the parties with some certainty regarding the nature and continuation of the employment.

Employees can be compensated in many different ways. The most basic form of compensation is the payment of wages, typically in terms of an hourly, weekly or monthly amount and paid weekly, biweekly or monthly. The wage rate paid depends upon the skill level of the employee and the demands of the employment. Sometimes, a portion of the wages is paid in the form of commodities instead of cash. Employers may also offer incentives that involve payment of prespecified amounts in exchange for the achievement of prespecified performance standards or goals. For an incentive plan to work, the reward offered must be in line with the value the employer obtains from the achievement of the goal or standard and the effort required by the employee. For example, a farm manager who can reduce costs by a certain percentage may receive compensation equivalent to a percentage of the cost savings achieved. Incentive payments differ from bonus payments in that bonuses are not designed to provide increased compensation for a specific achievement, and thus are not typically contingent upon anything other than continued employment. Thus, bonuses are typically designed to reward the employee for tenure in the job or to boost employee morale. Income sharing can be used to provide employees with a more general incentive. For example, under a wage and income-sharing plan, the employee is paid a combination of wages and a share of farm income or profit. This combination provides the employee with an incentive to contribute positively toward the enterprise while maintaining the employer-employee relationship instead of creating a partnership between the parties. Finally, employers often offer employees a variety of fringe benefits, such as meals, housing, health insurance, disability insurance and contributions to a retirement plan. Fringe benefits are often not taxable to the employee, making their after-tax value much higher than equivalent wage or other monetary payments. Health insurance is a crucial benefit that most farmers cannot offer their employees. A common reason for employees to quit working on the farm is to seek employment that offers health benefits. Operations that can afford to offer benefits could potentially increase employee retention.

Leases

A lease for real property (land and what is attached to or growing upon it) is a contractual arrangement by which the landowner (landlord) grants another party (tenant) an estate in land for a fixed period of time in exchange for the payment of rent. In Tennessee, real property leases for more than a year must be in writing to be enforceable. The payment of rent in leases for agricultural property can be structured in different ways, depending upon how the risks and rewards associated with yield and price variability are to be allocated between the landlord and tenant.

- **Fixed Cash Lease.** Under a fixed cash lease, the tenant pays rent that is either a fixed amount per acre or a fixed amount for the entire farm. The tenant bears all of the production and price risk.

- **Flexible Cash Lease.** Under a flexible cash lease, the amount of rent paid by the tenant fluctuates with production conditions (i.e., yield) and/or crop or livestock prices. Landlord and tenant share production and/or price risk. Flexible cash leases vary greatly from farm to farm. Some flexible cash leases set a floor for the rent paid to landowners or a set percent crop share, whichever is greater. For example, the floor may be a guarantee of $150 per acre that converts to a one-fourth crop share if one-fourth of gross revenues per acre exceed the $150 cash rent.

- **Crop Share Lease.** Under a crop share lease, the landlord receives a share of the crops or a share of the revenue generated by the sale of the crops as rent for the premises. Under some crop share leases, the landlord also shares in the cost of the production of the crop. A common example of crop share leases is one-fourth share and one-third share. In a traditional one-fourth rental agreement, it is quite common for the landlord to not pay any crop input expenses. In a one-third rental agreement, it is common practice for the landlord to pay a third of the fertilizer and lime. While the specific details of crop share leases vary greatly between regions and individual situations, they all result in landlord and tenant sharing in price and production risks.

- **Livestock Share Lease.** Under a livestock share lease, the landlord shares in the expenses of raising the livestock and receives a share of the livestock or a share of the revenue generated by the sale of the livestock as rent for the premises. Landlord and tenant share in price and production risks.

Each of these broad categories includes a wide range of possible arrangements. Also, there are important provisions that should be included in a lease and many important factors to consider before negotiating and entering into a lease — too many to be adequately covered in this workbook. An important factor to consider with long-term leases is what occurs upon the sale of real estate being leased. Contracts can include clauses addressing such sales to protect the individual leasing the farm. Fortunately, there are many publications and form lease agreements available to those who are interested in learning more about leases of agricultural lands.

The parties might also choose to lease personal property (essentially, any property that is not real property) such as farm machinery, equipment or livestock. Like leases for real property, personal property leases for a term longer than one year must be in writing to be enforceable in Tennessee.

Sales Contracts

Contracts for the sale of real property must also be in writing to be enforceable in Tennessee. Luckily, written contract forms for the sale of real property are readily available from real estate agents and other sources, and it is recommended to have an attorney or real estate agent prepare or at least review the contract. However, any contract for the sale of real property should contain, at a minimum, the following:

- Names of the buyer(s) and seller(s);
- Type of ownership interest to be passed from the seller to the buyer, the quality of title and the type of deed;
- An adequate description of the property to be transferred;
- Selling price and time of payment (buyers often try to include a contingency that allows them to cancel the contract if acceptable financing cannot be obtained);
- A description of how real property taxes for the year of the sale are to be apportioned between buyer and seller (for farms, property tax liability is often apportioned by crop year);
- A provision indicating which party bears the risk of loss from fire or other casualties;
- A detailed list of any personal property to be included in the sale; and
- Division of closing costs which will vary depending on financing.

Contracts for the sale of personal property will include many of the same provisions as contracts for the sale of real property.

A word of caution for individuals purchasing real estate "sight unseen." Online real estate purchases have grown in number in recent years. With that growth, there has been a rise in cases of individuals making purchases of real estate and discovering what they purchased was not what they had envisioned. For example, an individual buys a farm based upon an online description of the tillable acreage and photos of timber on the property. However, after purchasing the property, the new owner discovers that the previous owner has cut the timber on the farm, lowering the value of the property. In that example, the sales contract needs to have an avenue of recourse for the buyer to be compensated by the seller.

Financing Agreements

The transfer of the business or assets of the farm or family business from the current to new owners is often financed through loans. In these instances, the new owners typically borrow from either a bank or other lending institution or the current owners (or, often, some combination of the three). Thus, this section provides a brief overview of some of the legal principles and documents that are critical to financing arrangements where either real or personal property is used as collateral to secure the repayment of the loan.

The one element common to all loans is a promise, or I.O.U., by the borrower to pay the lender an amount or amounts of money or other items of value at some specified time in the future. When written, this promise is known as a promissory note. The function of a promissory note is to provide evidence of the debt owed by the borrower to the lender. If this debt is unsecured by any real or personal property, then the promissory note is all that is needed. However, if the borrower pledges property as collateral to secure the debt, then one or more additional agreements or documents are required. If the property pledged to secure the debt is personal property, then a security agreement is executed by both parties. The security agreement grants the lender a security interest in the collateral or the right to take and potentially sell the collateral if the borrower defaults on the promissory note or security agreement.

While the security agreement establishes the rights between the lender and borrower relative to the collateral, the filing of a financing statement is sometimes required for the lender to establish rights to the collateral relative to others. The financing statement is a brief document describing the collateral and providing the names and addresses of the borrower and lender. The financing statement is often referred to as a "UCC" since the actual form filed to secure the collateral is a UCC-1. If the property pledged to secure the loan is real property, then the borrower signs a mortgage or deed of trust granting the lender a security interest in the real property. Mortgages or deeds of trust are recorded in the county land records, while financing statements are filed with the Tennessee Secretary of State, the county or both, depending upon the nature of the personal property used to secure the debt.

Important Considerations in Choosing a Legal Entity

Each type of business form or entity has advantages and disadvantages. Thus, no single entity is generally superior to the other entities, and choosing a particular legal entity involves making trade-offs. The choice of a particular entity should depend upon how the entity performs on several different factors. These factors include the following:

- **Management and Control.** What are the implications of the business form for how the business is managed and controlled? Some entities allow the business to be run by a single individual, while other entities allow or require that other owners have a say in the management and control of the business.
- **Owner Liability.** Does the form of legal entity limit the personal liability of business owners for business debts and obligations to the amount of the owners' investment in the business? Or, are the owners personally liable for all of the debts and obligations of the business? Some lending institutions will require the owner(s) of an entity to sign a personal guarantee of the business's debt, which still leaves the owners of the entity liable for the debts of the business.
- **Tax Treatment.** How is the business entity taxed? Some entities are subject to "double taxation" in that the entity is taxed on the profits it earns, while its owners must also pay taxes on the share of these profits that are distributed to them. Other entities are "pass-through entities" in that the entity itself does not pay taxes on its profits. Instead, the tax obligation for these profits "passes through" to the owners.
- **Transferability of Ownership Interests.** How easy is it for business owners to transfer their interest in the business? In addition to being relevant for succession planning, the transferability of ownership interests can also determine how easy it is to raise additional financial capital for the business. Easy transferability makes it easier to attract investors and raise capital by selling ownership interests in the business. However, farm and family business owners may be reluctant to have easy transferability of ownership interests, as they may lose control over who else can become an owner and potentially have a say in the management and operation of the business.
- **Continuity of the Business Entity.** What happens to the business entity if an owner dies or otherwise withdraws from the entity? Does it continue in existence or must a new entity be formed for the business to continue? The answer varies from one entity to another. This can be addressed in the entity's operating agreement which is drafted upon the creation of a business entity.
- **Start-up Costs and Burden.** How much does it cost to create the entity? Some entities have little or no start-up costs, while others involve formal filings with the Secretary of State, along with the payment of filing fees and fees for professional services associated with the creation of the entity.
- **Administrative Costs and Burden.** How costly and time-consuming is it to comply with the requirements for operating the business entity? Some entities entail formal requirements such as annual meetings and fees for the business to continue to qualify as a particular type of entity. Failure to comply with these requirements can, among other things, lead to a dissolution of the legal entity. For example, entities structured as a corporation must have an elected board of directors and hold annual meetings where minutes must be kept. In most cases, closely held corporations involve family members, and meetings are rather informal. However, these extra measures have to be observed to maintain the integrity of such a legal entity.
- **Effect on Eligibility of Government Programs**. Eligibility of a farm business to qualify for government programs can be affected by the legal entity under which the business

operates. Thus, if the farm business participates in governmental programs or receives governmental subsidies or other incentive payments, the choice of entity should be made subject to an understanding of the eligibility rules for these programs.

The relative importance of each of these factors will vary from one set of circumstances to another. For example, the limitation of owner liability may be an important concern if a corn maze is being considered, while the start-up and administrative costs may be particularly important for a small operation. The next section provides an overview of the different types of legal entities appropriate for a farm or family business and considers them in light of the factors discussed above. **Table 4.1** summarizes entities in terms of these different factors.

Table 4.1. Comparison of Legal Entities

	Sole Proprietorship	General Partnership	Limited Partnership	Corporation	Limited Liability Company
Ownership	Single individual	Two or more general partners	One or more general partners and one or more limited partners	One or more shareholders	One or more members
Direction	Single individual	All partners	One or more general partners and one or more limited partners	One or more direc- tors	One or more members
Management	Single individual	Managing partner or all partners	One or more general partners	One or more officers	One or more members
Liability	Owner has unlimited personal liability	Partners have unlimit- ed personal liability	Limited for limited partners, unlimited personal liability for general partner	Limited	Limited or unlimited
Transferability	Not applicable	May be assigned, but assignee not a partner	May be assigned, but assignee not a partner	Corporate stock freely transferable; "S" corporation restrictions must be met	May be assigned, but assignee may or may not be a member
Continuity of Life	Terminates upon owner's death	Dissolves upon death or withdrawal, unless continued by partners	Generally dissolves upon death, withdrawal	Perpetual existence	Generally dissolves upon death, withdrawal
Federal Taxation	Individual taxed	Pass-through entity – partners taxed	Pass-through entity – partners taxed	"C" - corporation **and** shareholders taxed "S" - pass-through entity, shareholders taxed	Pass-through entity – members taxed
Franchise and Excise Taxes	No	No	Yes, unless 66.7 percent of activity is farming	Yes	Yes, unless 66.7 percent of activity is farming
Legal and Administrative Costs	No initial or annual filings or fees or legal costs	No initial or annual filings or fees but may need legal service to draft partnership agreement	Initial and annual filings and fees, legal fees for drafting limited partnership agreement	Initial and annual filings and fees, legal fees for drafting documents, annual meetings	Initial and annual filings and fees, legal fees for structuring entity

Business Insurance

Business owners can manage their exposure to risks associated with the operation of a business through the purchase of insurance. Insurance coverage is a standard cost of doing business. Sometimes, insurance coverage for a small business may be included as part of a personal policy or homeowner's policy. However, adequate coverage may require a separate commercial policy specifically for the business. Insurance companies offer a variety of different types of insurance coverage for businesses, including:

- **Product Liability Coverage:** protects you if your product causes injury to a consumer;
- **Auto Liability and "Non-owned" Auto Liability Insurance:** protects the business in the event of an accident involving an automobile that is used to support the business;
- **General Liability Coverage:** provides coverage for legal defense and financial compensation and is designed to protect the business from claims filed by third parties;
- **Property Insurance:** protects the business in the event of physical damage or loss to property from such incidents as fire and theft;
- **Medical Payments Insurance:** protects the business in the event someone is injured;
- **Worker's Compensation:** protects the business if employees are hurt on the job;
- **Business Interruption Insurance or Earnings Insurance:** compensates the business for lost income if the business has to vacate due to a disaster that causes a total or partial suspension of business operations;
- **Disability Income Protection:** a form of health insurance in case a business owner or employee becomes disabled;
- **Business Life Insurance:** provides funds for the transition of the business to a new owner in the event of the death of the business owner; and
- **Vandalism and Malicious Mischief Coverage:** protects the business in the event of vandalism and related crimes.

All insurance policies and business records should be kept in a safe location, and more than one person should know where the policies and records are stored. However, having insurance can provide a false sense of security, so it is important not only to have coverage but to have the right coverage. Business owners should read and understand the fine print in all policies and periodically reevaluate their insurance needs.
(Adapted from: Holland, Rob, 1998. Business Insurance Considerations. Agricultural Development Center, University of Tennessee Extension. Available online at: http://cpa.utk.edu/pdffiles/adc14.pdf.)

Additional Types of Insurance to Consider

Life Insurance — The most common types of life insurance policies include whole life and term life coverage. Farming operations will often have some life insurance coverage in place to assist in the transition of the farm from one generation to the next. The proceeds from a life insurance policy can serve many purposes. However, regarding transition planning, the proceeds from a life insurance policy are generally used for two main purposes: covering the debts of the farming operation and/or providing funds to nonfarming family members. Life insurance proceeds are often used to provide cash for nonfarming family members to ensure that farm assets remain unsold and the operation can continue to function. Most farm succession plans involving nonfarming family members attempt to be as "fair and equitable" as possible to all parties involved. Life insurance can be a great estate planning tool to help address this part of farm transitioning.

Crop Insurance — There are many different types of crop insurance policies offered to producers through the Risk Management Agency, which is a division of the USDA. For this chapter, we will only focus on the utilization of crop insurance proceeds to pay operating expenses or debts of the farm. When a policy is initiated by an *Approved Insurance Provider*, or AIP, the applicant must provide the insured information such as the name of policyholder, SSN/EIN, person type and authorized representative signature. Anyone with a 10 percent or more interest in the operation must be listed as having *Substantial Beneficial Interest*, or SBI. If there is a loss payee, a specific *Assignment of Indemnity* form must be filed with the AIP prior to a crop year initiation. In the event of a claim during a crop year, claim benefits would be issued jointly to the policyholder/insured and the loss payee/lienholder. If there was a loss of life of the policyholder during the policy period, any claims would be paid to the estate, or depending on the type of policy, the remaining indemnity would be paid to the spouse, partner or members, if a corporation.

If the operation is a partnership, an AIP may have producers sign a partnership agreement that lists all members of the partnership. If there was a death of a partner, then the proceeds go to the remaining partners in the operation in the event of a claim.

For operations that change organizational structure, crop insurance can be transferred from the previous policy owners to the new entity. A change in business after the *Sales Closing Date* (i.e., policy deadline) allows for a transfer of coverage and the right to any indemnity from one insured individual to another person when a portion of all of the ownership of the crop is transferred during the insurance period. If the new entity's ownership includes the previous owners and farms the same land as the previous operation, then the new entity uses the APH yields and production history of the previous owner(s).

Please refer to the Product Management Bulletin: PM-18-017 from RMA for additional details: https://www.rma.usda.gov/en/Policy-and-Procedure/Bulletins-and-Memos/2018/PM-18-017

Whole-Farm Revenue Insurance — Whole-farm revenue insurance is an alternative for farming operations with specialty or organic commodities (both crops and livestock), or those marketing to local, regional, farm-identity preserved, specialty or direct markets. As the name implies, this type of policy insures against loss of farm revenue for the entire operation. Farming operations that are looking for business insurance that provides protection against income loss for the farm may need to contact a certified crop insurance agent regarding this type of coverage.

Legal Entities

Sole Proprietorship

A sole proprietorship is a form of business organization that makes no legal distinction between the business and the individual owner; they are, in fact, the same. Thus, a sole proprietorship is owned by a single individual (often referred to as the sole proprietor) who has full control of the business and is solely responsible for all of the debts and obligations of the business. Any employees are hired by the owner and any contracts entered into are entered into personally by the owner. As a result, the business owner enjoys no limitation of liability and is just as liable for debts and obligations related to the business as the owner is for his or her personal debts or obligations. However, a sole proprietorship can operate under a trade or business name that is different from the sole proprietor's name, which is often described with the phrase "doing business as," as in John Smith doing business as Pleasant Valley Farms.

Because a sole proprietorship is not a separate legal entity, no agreements or filings are necessary to operate a business as a sole proprietorship (although a business license or permit may be required, depending upon the location and nature of the business). If a business is operated without taking the steps necessary to create another business form, it is a sole proprietorship by default. Similarly, with a sole proprietorship, there is no requirement to keep business and personal assets separate or maintain separate accounts. Thus, a sole proprietorship is the simplest and easiest form of business to start, which probably helps to explain why sole proprietorships are the most common form of business organization in the U.S. and why most farms and ranches are operated as sole proprietorships.

Any income earned by a sole proprietorship is treated as income earned by the owner, and the owner reports all profits and losses of the business on his or her individual tax return. In addition to being subject to income taxes, the profits from a sole proprietorship are generally also subject to self-employment taxes (contributions to Social Security and Medicare — equivalent to payroll taxes for employees). The income and expenses of the business are reported on a separate schedule — Schedule F for farms and ranches and Schedule C or C-EZ for most other forms of businesses.

The transfer of a business operated as a sole proprietorship is accomplished by transferring the individual assets (and possibly liabilities) associated with the business. While the business form imposes no limitations on the owner's ability to transfer these assets, liens or other encumbrances may limit such transfers. No formal documentation or procedure is required to terminate a sole proprietorship. Finally, a sole proprietorship, by definition, terminates upon the death of the sole proprietor.

General Partnership

A general partnership is a voluntary association of two or more individuals, partnerships, corporations or other associations for the purpose of carrying on, as co-owners, a business for profit. General partnerships are typically formed by either an oral or written agreement between the partners, but they can also be implied from the conduct of the partners. In Tennessee, there are no filing requirements associated with the formation of a general partnership. Thus, general partnerships are the easiest co-owned business entities to create. However, written partnership agreements are recommended to adequately set forth the terms of the partnership. More generally, the discussion, negotiation and preparation of an explicit partnership agreement seem to improve the chances that the partnership will avoid problems and satisfactorily resolve problems that do arise. The benefits of committing a partnership agreement to writing likely increase as the complexity, extent and length of the relationship between the partners increase.

Although partnerships are easy to create, they should not be entered into lightly for several reasons. First, all partners in a general partnership are personally liable for the debts and obligations of the partnership. More specifically, partners in a general partnership are jointly and severally liable for partnership debts and obligations, i.e., every partner in a general partnership is liable for all of the debts and obligations of the partnership. Thus, if a partnership were to default on a loan, the lender could conceivably collect the entire amount due from any one of the partners. However, any partner who is made to pay more than his or her share of a partnership obligation can seek compensation from those partners who have not been made to pay their share.

Second, any partner in a general partnership can legally obligate the partnership. Thus, if one partner enters into a contract on behalf of the partnership, all partners may be held liable if the partnership fails to fulfill the terms of the contract, regardless of whether the other partners approved of or were even aware of the contract. The extent to which individual partners can bind the partnership can be limited by the partnership agreement, but this limitation is not effective if the party with whom the partnership is entering into the contract is not aware of the limitation. Finally, partners owe certain legal duties or obligations to both the partnership and to one another, including, for example, the duty not to deal with the partnership as an adverse party nor enter into competition with the partnership.

Unless specified otherwise in the partnership agreement, partners are presumed to share equally in partnership profits and losses. However, partnerships can share profits and losses in any number of different ways through appropriate provisions in the partnership agreement. A common approach is for profits to be shared in proportion to capital contributions, or the value of the money and/or property contributed by the partners to the partnership.

Absent an agreement to the contrary, each partner has equal rights in the management of the partnership business. So, unless the partnership agreement specifies otherwise, each partner is entitled to one vote regardless of the relative size of the partner's capital contributions or right to partnership profits. However, partners have considerable flexibility to specify different arrangements for the management and control of the partnership in the partnership agreement.

For income tax purposes, a partnership is a pass-through entity that does not pay taxes. Instead, profits or losses "pass-through" the partnership and are reported on the individual tax returns of the partners in accordance with their share of profits or losses. Partnerships are, however, required to file an informational federal tax return (Form 1065) and provide an accounting of each partner's share of profits or losses (Schedule K-1).

A partner can assign his or her interest in the partnership to a third party, who gets the partner's right and obligation to share in profits and losses but not the right to participate in the management of the partnership. In general, the withdrawal, bankruptcy or death of any partner dissolves the partnership. In some instances, the partnership agreement may provide for a continuation of the partnership after such an event, but, in effect, a new partnership is formed among the remaining partners. A partnership agreement can provide for a partner's rights to purchase the partnership interest of a deceased or disabled partner's interest. Thus, partnerships can be a desirable entity for the operation of the farm or family business in a succession plan because they allow for co-ownership of the business but are still simple and relatively inexpensive to form and operate. Partners also have a great deal of flexibility in how they structure the partnership, but exercising this flexibility typically requires more extensive and complex partnership agreements. On the other hand, general partnerships do not limit the liability of the business owners, as all partners are personally liable for the debts and obligations of the partnership. Also, each general partner, typically, can legally bind the partnership. Thus, owners should be cautious about entering into general partnerships with individuals whom they do not know and trust.

Limited Partnership

A limited partnership is quite similar to a general partnership. However, there are a few key distinctions. All partners in a general partnership are general partners who have a right to participate in the management of the partnership business and who have unlimited personal liability for the partnership's debts and obligations. Limited partnerships, on the other hand, not only have one or more general partners, but they also have one or more limited partners. A limited partner invests capital in the partnership but does not have the right to participate in the management of the partnership business and does not have unlimited personal liability for partnership debts and obligations. Instead, the liability of a limited partner is limited to the amount of his or her capital contributions to the limited partnership. Thus, if the limited partnership's debts exceed its assets, a limited partner cannot be compelled to make up the difference, while a general partner can. However, a limited partner who participates in the management of the partnership business (i.e., acts as if he or she is a general and not a limited partner) can lose his or her limited partnership status and become personally liable for partnership debts and obligations.

Also, unlike a general partnership, a limited partnership in Tennessee must file a *Certificate of Limited Partnership* with the Tennessee Department of State and pay a filing fee that is currently (2020) $100. Changes in the limited partnership (change in partner's capital contribution, admission of a new partner, withdrawal of a partner, etc.) require the filing of an *Amendment to the Certificate of Limited Partnership*. In addition to the *Certificate of Limited Partnership*, the partners in a limited partnership often draft and execute a *Limited Partnership Agreement* that more fully specifies how the partnership is to be structured and operated. A written agreement is not legally required but is strongly encouraged.

Finally, Tennessee limited partnerships are required to pay franchise and excise taxes (as are corporations, limited liability companies and business trusts, but not sole proprietorships or general partnerships). The excise tax is equal to 6.5 percent of the net earnings from business done in Tennessee for the tax year. The franchise tax is equal to 0.25 percent of the greater of net worth or the book value of real or tangible personal property owned or used, with a minimum tax of $100 per year. However, those limited partnerships, limited liability companies and limited liability partnerships for which at least 66.67 percent of their activities are devoted to either farming or holding personal residences where one or more of the entity's partners or members reside are exempt from franchise and excise taxes. To qualify for this exemption, an application must be made with the Tennessee Department of Revenue.

Thus, a limited partnership offers one important advantage over a general partnership — the opportunity for some of the business owners to enjoy limited liability, a useful characteristic for attracting investors who are not to be involved in the operation of the business. Limited partnerships might also be useful in the succession planning context where there are on-farm heirs who are going to take over the operation of the farm business and off-farm heirs who are to share in the profits of the business but not the management or operation of the business. In this case, the parents and on-farm heirs might serve as general partners who can be paid for managing the limited partnership, while the off-farm heirs or off-farm parents are limited partners. The tradeoff for this limited liability is that limited partnerships are required to file organizational documents with, and pay filing fees to, the

Tennessee Secretary of State. In most other ways, limited partnerships are similar to general partnerships.

Limited Liability Partnership

A limited liability partnership (LLP) is a relatively new type of partnership in which all partners enjoy a reduced form of liability in that they are not normally personally liable for the negligence of another partner. This reduced form of limited liability primarily benefits associations of professionals, such as doctors, lawyers or accountants, to protect each other from being personally liable for malpractice claims against one of their partners.

Corporation

A corporation is a legal entity separate and distinct from its owners. As a result, corporations can sue or be sued, enter into and enforce contracts, and hold title to and transfer property. In this way, a corporation is different from a partnership, which is a joint relationship between two or more parties, and actions by the partnership are, in effect, joint actions of the partners. The formation, operation and dissolution of a corporation are governed by the laws of the state in which the corporation is incorporated. A corporation incorporated in one state can conduct business in other states, although it has to qualify as a foreign corporation by filing papers with those states to do so.

A Tennessee corporation is incorporated or formed by filing a charter with the Tennessee Department of State and paying the $100 filing fee. Corporate charters can either be simple documents that provide only basic information about the corporation or more involved documents that describe how the corporation will be organized and operated. Other steps involved in forming a corporation include:

- Choosing a name for the corporation;
- Electing or appointing the initial board of directors;
- Issuing stock to the corporation’s owners or shareholders; and
- Drafting and approving the corporation’s bylaws, which will govern the operation of the corporation.

Many of these steps are typically taken by an individual or group of individuals acting as the corporation’s incorporator(s). The role of the incorporator(s) is limited to getting the corporation up and running, after which the corporation is governed by a three-tiered management and control structure. Shareholders elect a board of directors who are responsible for making policy decisions concerning the operation of the corporation and for hiring officers to oversee the corporation’s day-to-day activities. Corporate officers typically include, at a minimum, a president or chief executive officer, a secretary and a treasurer. Shareholders can also vote to amend the corporate charter and bylaws and approve major decisions, such as the sale of substantially all of the corporate assets; merger with, or acquisition of, another business; and dissolution of the corporation. Shareholder votes operate based on one vote per share of voting stock. Corporate profits are distributed to shareholders through dividends declared by the board of directors.

Corporations range from small closely held corporations with few shareholders to large, publicly held corporations with many shareholders and shares that trade in organized securities markets such as the New York Stock Exchange. For many small, closely held corporations, the shareholders are often involved in the management and operation of the corporation, often serving as incorporators, members of the board of directors and corporate officers.

Corporations can issue two different kinds of stock — common stock and preferred stock — although most corporations only issue common stock. Common stock represents ownership of the residual value of the corporation or the difference between the corporation's assets and liabilities. Each share of common stock gives its holder the right to one vote in shareholder elections. Preferred stock is given certain preferences or rights over common stock. These preferences typically involve the right to receive a fixed dividend (as opposed to a dividend determined each year by the board of directors) or a greater right to corporate assets upon the liquidation of the corporation. Preferred stock often has either no or reduced voting rights. The preferences and voting rights of preferred stock must be outlined in the corporate charter. As a separate entity, corporations are liable for their own debts and obligations, and corporate shareholders enjoy limited liability, i.e., their liability is limited to the extent of their investment in the corporation. They are not personally liable for the corporation's debts and other obligations. However, shareholder limited liability can be set aside by a court if the shareholders fail to observe the legal requirements for properly organizing and operating a corporation. These requirements (or "corporate formalities" as they are often called) include adequately capitalizing or funding the corporation; formally issuing stock to the shareholders; filing an annual report and paying annual fees (currently $20) to the state; holding annual shareholder and board of directors meetings, and maintaining adequate records and accounts for the corporation that are separate and distinct from those of the shareholders.

Corporations exist in perpetuity unless voluntarily terminated by their shareholders or involuntarily terminated in a bankruptcy proceeding. In general, shares of stock in a corporation are freely transferable by the shareholders and subsequent owners of the shares have all of the rights prior shareholders had. The ease with which corporate shares can be transferred gives corporations an advantage in raising capital through the sale of stock. However, a corporate charter or stock restriction agreement may impose restrictions on the transfer of shares, as is often the case with closely held corporations.

Corporations differ from the other types of business entities in that corporations must pay income taxes on their profits, unless the corporation chooses to be treated as an S or Subchapter S corporation (the S or subchapter S refers to a provision in the federal tax code). Corporations that do not elect to be treated as an S corporation are called C corporations. C corporations are subject to what is called “double taxation.” Corporate profits are taxed to the corporation when earned by the corporation and also taxed to shareholders as income if distributed to the shareholders as dividends. Many closely held corporations are largely able to avoid the adverse effects of double taxation by paying salaries to shareholders who serve as officers or employees of the corporation, interest to shareholders who lend the corporation money, and/or rental payments to shareholders who lease land or equipment to the corporation (all of which would typically be an expense or tax deduction for the corporation).

S corporations, on the other hand, are pass-through entities where the corporation does not pay income taxes on profits. Instead, S corporation profits and losses “pass through” to the shareholders as they do in other types of business entities. Also, like partnerships, profits pass through to shareholders regardless of whether any dividends are distributed. However, unlike partnerships and sole proprietorships, the shareholder’s share of profits from an S corporation is not subject to self-employment taxes. There are some restrictions on S corporations that are not placed on C corporations, including S corporation shareholders must be U.S. citizens or residents; S corporations can have no more than 100 shareholders and only one class of stock, although there can be differences in voting rights; and corporations and partnerships cannot own stock in an S corporation. Typically, these restrictions do not pose too much of a problem for farms or other small businesses. It can be complicated to transfer assets out of corporations, unlike general partnerships, LLCs and sole proprietorships. If the owners of a corporation want to distribute an asset owned by the corporation, the transfer can trigger a taxable gain for the corporation if the value of the asset has increased over time. This is a great example of why farm families need to work with a qualified professional to determine the tax implications of their chosen entity structure.

Corporations are also required to pay franchise and excise taxes to the state of Tennessee. The Tennessee excise tax is currently equal to 6.5 percent of the net earnings from business conducted in Tennessee for the tax year, while the franchise tax is currently equal to 0.25 percent of the greater of net worth or the book value of real or tangible personal property owned or used by the corporation, with a minimum tax of $100 per year. Unlike limited partnerships and limited liability companies, there is no farming exemption from franchise and excise taxes for corporations.

Given that there are differences in corporate and individual income tax rates and which costs can be deducted from income earned, the effects of incorporation and/or election to be treated as an S corporation on income tax liability vary from one set of circumstances to the next. Thus, it is not necessarily true that an S corporation or other pass-through entity will result in a lower federal income tax liability than a C corporation.

Thus, the primary advantages of the corporate form are limited liability for all owners (so long as the corporate formalities are observed), perpetual existence, and the ease with which corporations can raise capital through the sale of shares of stock (which carry with them full voting rights). On the other hand, corporations are more costly to form and operate than sole proprietorships or general partnerships, as they require initial and annual filings and the payment of filing and annual fees, as well as franchise and excise taxes. In addition, corporations may face a heavier tax burden than pass-through entities, unless the Subchapter S election is taken. While Subchapter S corporations come with some restrictions, these restrictions are unlikely to pose much of a problem for most farm and family businesses. The combination of limited liability and pass-through taxation has made Subchapter S corporations a popular choice for small businesses. However, the popularity of S corporations has recently declined due to a new type of business entity — the limited liability company.

Limited Liability Company

An increasingly popular choice for farms and small businesses is the limited liability company (LLC). LLCs are something of a hybrid, combining some of the most favorable attributes of partnerships and corporations into a single entity. For example, an LLC can elect to be taxed as a partnership while the LLC's owners can still enjoy limited liability and the right to participate in the management of the business. Further, the Tennessee law authorizing LLCs is designed to allow a great deal of flexibility in how an LLC is organized and operated.

There are two different sets of statutes in Tennessee authorizing LLCs. The first was adopted in 1994 and the second in 2005. The first governs all LLCs formed before January 1, 2006, unless the LLC chooses to be governed under the new law. The second statute governs all LLCs formed after January 1, 2006, as well as those formed earlier that elect to be governed by the new law. While there are a lot of similarities in the two sets of statutes, there are also substantial differences. Where there are differences, the following discussion focuses exclusively on the provisions in the new law. If one were to attempt to sum up these differences in a single concept, it would be that the new law provides even greater flexibility in LLC organization and operation. Most of the provisions in the new statute for how LLCs are to be structured and operated can be waived by the LLC – thus they operate as default provisions for how the LLC operates absent agreement among the members to the contrary. This flexibility, while great for those wanting to custom design an LLC to fit their particular circumstances, makes it difficult to discuss LLCs as an option for farm and family businesses, since there are relatively few hard-and-fast rules.

In general though, LLCs, like corporations, are separate legal entities distinct from their owners. Unlike corporations, LLC owners are typically referred to as members instead of shareholders. Unlike the restrictions imposed on shareholders in S corporations, LLCs have no limits on the number of members or the type of entity that can be a member. LLCs are formed in Tennessee by filing articles of organization with the Tennessee Department of State. The filing fee for the articles of organization is $50 per member, with a minimum of $300 and a maximum of $3,000. The Articles of Organization set out some basic information about the LLC but provide little information on its structure. This information is left to an operating agreement — the functional equivalent of a corporation's bylaws but, unlike bylaws, can be either oral or written. A written operating agreement is recommended. LLCs are required to file annual reports and pay annual fees currently equal to $50 per member, with a minimum of $300 and a maximum of $3,000. As these fees, and all other fees described in this chapter, may change over time, one should check with the Tennessee Secretary of State for any changes and a more complete record of the filing fees associated with LLCs or other business entities.

LLCs are also required to pay franchise and excise taxes to the state of Tennessee. The Tennessee excise tax is currently equal to 6.5 percent of the net earnings from business done in Tennessee for the tax year, while the franchise tax is currently equal to 0.25 percent of the greater of net worth or the book value of real or tangible personal property owned or used by the LLC, with a minimum tax of $100 per year. However, LLCs that devote at least 66.67 percent of their activities to either farming or holding personal residences where one or more of its partners or members reside are exempt from franchise and excise taxes, provided an application for the exemption has been made and approved by the Tennessee Department of Revenue.

LLCs are allowed great latitude in defining how they will be managed and what rights members will have. However, the Tennessee statute sets forth three different management structures that serve as models or templates of how LLCs can be structured. In a member-managed LLC, each member has equal rights in the management and conduct of the LLC's business, and any matter relating to the business of the LLC is decided by a majority vote of the members. In a manager-managed LLC, each manager has equal rights in the management and conduct of the LLC's business, and any matter relating to the business of the LLC shall be exclusively decided by the manager or, if there is more than one manager, by a majority vote of the managers. Managers are appointed or elected by a majority vote of the members and need not be members of the LLC. In a director-managed LLC, all LLC powers are exercised under the authority of its board of directors, and the business and affairs of the LLC are managed under the direction of its board of directors. Any matter relating to the business of the LLC is exclusively decided by the director or, if there is more than one director, by a majority vote of the directors. Directors are appointed or elected by a majority vote of the members and need not be members of the LLC. Also, a director-managed LLC shall have a president who is appointed or elected by a majority vote of the directors and is authorized to act as an agent of the LLC. Thus, the member-managed LLC operates much like a general partnership and the manager-managed resembles a limited partnership, with the important difference that in both cases, all members enjoy limited liability. Finally, director-managed LLCs operate much like a corporation.

LLCs can elect to be treated as either a pass-through entity, where the tax consequences of profits and losses pass directly through the LLC to the members, or as a corporation, where the LLC pays taxes on its profits and members pay taxes when they receive a distribution of profits. To conduct business in a state other than the one in which they were formed, LLCs must obtain a certificate of authority from the secretary of state of such other state.

Although LLCs can be somewhat costly to start and operate, the benefits and flexibility they offer have made them a popular choice for small businesses. They can be structured to offer most of the advantages of both the corporate and partnership entities, with few of the drawbacks. Thus, for LLCs, the question is often whether these advantages are worth the costs of creating and maintaining an LLC.

Operating agreements for entities: Upon the creation of an LLC, an operating agreement is created and signed by all members. It is similar to the bylaws of a corporation, with the agreement providing the rules about the operation of the business and the relationship between the members. It creates the entity's method of management, dictates how profits and losses are distributed to members, places restrictions on the transfer of ownership interests, and outlines how to dissolve the entity. The operating agreement can detail who has a say in the management of the company. Some operating agreements allow all members an equal voice in management affairs, regardless of ownership percentage. The process to hire a manager for the entity that is not necessarily a member with ownership interest can be included in the agreement. The operating agreement also needs to address what happens should an owning member choose to exit the business. What happens to that member's interest in the LLC? The operating agreement can lay the groundwork for allowing in other members or purchasing the ownership interest of the member that desires to exit the entity. In regards to agriculture, the operating agreement should address the sale of assets by members of the LLC. The sale of farmland and essential equipment could spell the end of a farming operation. To prevent such sales, operating agreements can be used to address this potential issue. A clause can be added to operating agreements that include a Right of First Refusal. This allows the other members the first chance to purchase jointly owned assets should there be a forced sale.

LLCs are not allowed "perpetual life" like a corporation. The LLC can persist if there is a change in the relationship of members. This is dictated by state law; however, the LLC can continue with the consent of the remaining members. This is called the continuity-of-life factor, and the ability of the members to consent to the continuation of the entity needs to be addressed in the articles of organization. In some states, if the articles of organization do not address the "lifespan" of the LLC, then the entity is dissolved by statute 30 years after its formation.

Cooperative

A final type of business entity relevant to farm operations is the cooperative. Cooperatives have been around for a long time and played an important role in the agricultural industry. However, their use was traditionally somewhat limited by rules designed to ensure that they operated as a "cooperative venture" between individuals. However, the state of Tennessee recently authorized the creation of a new type of cooperative, designed to be more attractive for investors and more applicable to modern agricultural production. Thus, there are now two types of cooperatives: traditional and new generation. Traditional cooperatives are businesses owned and controlled by the people who use them. They differ from other businesses in that the intent is to benefit their users rather than earn profits for investors. New generation cooperatives differ from traditional cooperatives in that they recognize the need for investment by people other than the users to finance modern value-added agricultural enterprises and, thus, allow for the participation of outside investors. However, cooperatives are generally not a viable option for the farm or family business.

Qualified Business Income Deduction

The tax advantages of pass-through entities have recently been enhanced with a change in the federal tax laws allowing eligible sole proprietors and owners of partnerships, S corporations and LLCs to deduct up to 20 percent of their *qualified business income* (QBI) from their taxable income. This deduction, known as the *Qualified Business Income Deduction*, is designed to benefit small business owners and is, thus, not available to taxpayers with incomes above prescribed amounts or to income earned from C corporations, employee compensation, capital gains or losses, dividends, interest income or income earned outside of the U.S. For eligible taxpayers, the deduction creates an added incentive to utilize a pass-through entity (i.e., sole proprietorship, general or limited partnership, S corporation or LLC) rather than a C corporation.

Impact of Organizational Structure on Federal Program Payments

The selection of entity impacts the amount of agricultural program payments that an operation can receive through programs administered by the Farm Service Agency (FSA). The Agricultural Act of 2014 set the annual payment limitation at $125,000 per person or legal entity, including all payments and benefits from Agriculture Risk Coverage (ARC), Price Loss Coverage (PLC), Loan Deficiency Payments (LDPs) and Marketing Loan Gains (MLGs). The Agricultural Act of 2018 extended those program payment limitations with the same structure. A general partnership or joint venture is not considered to be a legal entity. However, corporations, LLPs and LLCs are designated as legal entities for the average AGI limitation provision for federal agricultural program payments. The FSA has established criteria that determine which members of a partnership or joint venture are eligible for program payments. Each partner and/or member with an ownership interest must contribute active personal labor and/or active management to the farming operation to be eligible. These contributions of labor and management have to be performed regularly throughout the year, must be identified and documented for each partner, and must be separate from the contributions of other partners to the operation. Entities are limited to $125,000 per entity regardless of the number of owners, whereas partnerships and joint ventures can receive $125,000 per eligible partner. Partners that contribute 1,000 hours of management and labor to the operation can receive program payments up to a maximum of $125,000. If the Adjusted Gross Income of the partnership, joint venture or individual exceeds $900,000, then the person or legal entity is ineligible for payments and benefits under most federal agricultural programs.

The following definitions come from the FSA Payment Eligibility, Payment Limitation, and Average Adjusted Gross Income (5-PL) Handbook. These definitions and other important information regarding how entity structure impacts federal agricultural program payments can be found at your local Farm Service Agency office.

Definition of General Partnership

General partnership means:

- Comprised of two or more persons or legal entities formed under State law.
- Subject to the terms of a formalized agreement.
- Identified with EIN.

In a general partnership:

- The members combine assets, or the partnership may acquire property and assets.
- Single or multiple business enterprises are conducted by the partnership that are separate and apart from any business enterprises of the individual members.
- All members are held jointly and severally liable for obligations incurred by the partnership.
- Each member shares in the profits and losses.

Definition of Joint Operation

Joint operation means a general partnership or joint venture, whose members are jointly and severally liable for the obligations of the organization, in which two or more individuals or entities pool their resources, such as land, labor, capital, management and equipment, to conduct the farming operation for a common purpose, sharing the profits and losses.

Definition of Joint Venture

Joint venture means a short-term association of persons or legal entities where the association exists without an actual partnership or corporate designation.

In a joint venture:

- The members combine their property, money, effects, skills and knowledge.
- A single business enterprise is conducted.
- Each member intends to derive a share or benefit.
- Each member sustains a mutual responsibility.

Please refer to the Federal Program Payment 5PL FSA Handbook for examples of program payments regarding entity structure and programmatic information.

Organizational Structure Choice for Liability: Farming operations looking to limit their overall liability structure often consider forming an entity. Producers need to take the information mentioned in the above section and consider how it impacts program payments for their farm. In most cases, a good umbrella insurance policy can protect against any potential liability issues. Farm families need to work with their attorneys and tax professionals to help determine what organizational structure best fits their operation.

Conclusion

This chapter considers the importance of choosing an organizational structure within the context of a succession plan. It focuses on the factors to consider when choosing a structure, paying particular attention to the different types of business or legal entities for farm and family businesses. The intent is to provide information on some of the basic, structural elements that go into a succession plan. An additional point to consider is that some succession plans or farm or family businesses might best include a combination of one or more of these legal entities or arrangements.

Regardless of which organizational structure is chosen, it is important to revisit the structure in the event of significant, unexpected changes in the operation of the business, the circumstances in which the business operates or the circumstances of the individuals involved. Successful organizational structures often evolve as experiences, expectations and conditions change.

Finally, it is nearly impossible to overstate the importance of getting sound, well-informed legal and other professional assistance when needed. The material presented in this chapter and workbook can never substitute for the depth of experience and knowledge of a competent professional who is familiar with the unique circumstances relevant to a particular farm or family business. Thus, it is worth remembering that the goal of this chapter and workbook is to enable readers to play a more active role in the formation and evolution of succession planning for their farm or family business and be more sophisticated consumers of the legal and other professional services needed for this plan.

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