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Business Structures for Farmers and Food Entrepreneurs

As the owner of a business, you have the choice of how you want to operate your business. Businesses can be operated with or without a formal legal entity. Four common ways to operate a business are: a sole proprietorship, a general partnership, a limited liability company, and a corporation. If you are operating a business as an individual and you have not set up a legal entity, you are operating a sole proprietorship. If you are operating a business with other individuals and have not set up a legal entity, you are operating a general partnership. While forming a legal entity does require additional time, effort and cost, as well as additional ongoing obligations, structuring your business with a legal entity provides owners with some significant advantages that are not available to sole proprietorships and general partnerships.

I. Why form a legal entity for your business?

Forming a legal entity to operate your business helps protect you, as the business owner, from having personal liability for the obligations of the business. Personal liability means that creditors of the business can seek to recover what is owed to them by the business from the business owners' personal assets, such as money in personal bank accounts, a car, and possibly a home. If a business is properly organized and operated as a corporation or limited liability company, creditors can only look to the assets of the business to satisfy any outstanding obligations.

In order to eliminate owners' personal liability for business obligations using a limited liability company (called an LLC) or a corporation, owners must comply with laws governing those business entities, including maintaining a separate bank account for the business and keeping separate records specifically related to the business. As a matter of best practice, sole proprietorships and general partnerships should also segregate business bank accounts and records from personal bank accounts and records, although this is not required.

Although forming an LLC or a corporation involves some additional time, effort and cost, many farms and food businesses find that it is worth it in order to benefit from the liability protection that each provides.

II. What type of legal entity should a business owner have?

Key advantages and disadvantages of sole proprietorships, general partnerships, LLCs and corporations are discussed below.

a) Sole Proprietorships

General

A sole proprietorship is a business that is owned by one individual, the sole proprietor. As discussed above, a sole proprietorship is the default business organization when one person operates a business without setting up a legal entity. Sole proprietorships generally require less time, effort and cost to establish and operate. In a sole proprietorship, there is no requirement to file any organizational documents or annual reports with the Secretary of State's office. Additionally, sole proprietorships do not have to deal with corporate formalities, such as creating company bylaws, electing a board of directors and holding regular board and stockholder meetings. However, there are some disadvantages to operating a sole proprietorship. As the sole proprietor, you have personal liability for all obligations of the business. This means that your personal assets can, and will, if necessary, be used to pay business obligations that the business itself cannot pay. Additionally, a sole proprietorship cannot have more than one owner. Once a business has two or more owners (and has not formed a legal entity such as an LLC or corporation), it becomes a general partnership.

Income Tax Treatment

In a sole proprietorship, he or she reports the entirety of the business's income or losses on their personal income tax return. The sole proprietor pays taxes on any income, regardless of whether the sole proprietor distributes the income to himself or herself, reinvests the income into the business or merely keeps the money sitting in a bank account. There is no separate income tax return filed by the business.

Takeaway

A sole proprietorship is the default business structure for a business that is owned and operated by a single individual. In a sole proprietorship, the owner does not need to adhere to corporate formalities or make ongoing corporate filings with the state. As such, this structure can reduce time, effort and cost associated with organizing your business. However, sole proprietors are personally liable for satisfying business obligations.

b) General Partnerships

General

If a business has two or more owners, and the owners have not formed a legal entity, they are operating a general partnership. A general partnership operates like a sole proprietorship – the key difference being the number of owners. In a general partnership, there is no requirement to file any initial organizational documents or annual reports with the Secretary of State's office. General partnerships do not need to adhere to corporate formalities, such as creating company bylaws, electing a board of directors and holding regular board and stockholder meetings. However, it is advisable to have a partnership agreement. The partnership agreement outlines the economics of the business (such as what portion of business income each owner, called a partner, receives) as well as setting guidelines for how business and financial decisions are made. A general partnership may seek advice from lawyers and tax advisors in drafting this partnership agreement. Additionally, each partner in a general partnership is personally liable for the business obligations of the partnership. This means that creditors could seek payment from one of the partners (usually the one with the most assets) for the entire business debt.

Income Tax Treatment

For purposes of tax treatment, a general partnership is treated as a legal entity. A general partnership itself is not taxed on the income of the business. Rather, the business's income and losses "pass through" to the partners and the partners pay tax on their pro rata shares of that income on their personal income tax returns, regardless of whether the partnership distributes the income to the partners. The partnership must file federal and state income tax returns for information purposes and provide a Schedule K-1 to each partner. The K-1 informs the partner of his, her or its pro rata share of the partnership's income or loss that must be included on the partner's personal income tax return.

Takeaway

A business with two or more owners may be inclined to operate as a general partnership because of the reduced time, effort and cost in organizing and operating one as compared to an LLC or corporation (both discussed below). But, since the owners of a general partnership are each personally liable to satisfy the obligations of the business, we typically find that it is more beneficial in the long run for small businesses to organize as an LLC (or possibly a corporation).

c) Limited Liability Company

General

A limited liability company (LLC) can be thought of as a hybrid entity, combining aspects of both partnerships and corporations. The owner or owners of an LLC, called members, do not have personal liability for business obligations – an advantage that makes LLCs similar to corporations. LLCs incur some formation and maintenance costs, such as registering the entity with the state, making filings to maintain LLC status, and keeping the business's financial accounts and records separate from personal accounts and records.

Laws governing LLCs typically provide more flexibility in how to structure the entity compared to laws governing corporations. For example, an LLC simply chooses who it wants making the decisions of the LLC and specifies the individual or individuals in its governing document, typically called an operating agreement. In contrast, corporations require a board of directors to make the decisions of the corporation. However, this flexibility can lead some people to create more complicated businesses, which in turn, can lead to greater time, effort and expense in operating the LLC.

LLCs require more time, effort and cost to form and maintain than sole proprietorships or general partnerships because LLCs need to register and make filings with the state. However, LLCs can be more advantageous than sole proprietorships and general partnerships because of the elimination of personal liability. Additionally, if the LLC uses an operating agreement, it becomes easier to understand and manage the expectations of both the business and members as compared to the often informal arrangements of a sole proprietorship and general partnership.

Income Tax Treatment

By default, LLCs are treated as pass-through tax entities. The business's income and losses "pass through" to the members and the members pay tax on their pro rata shares of that income on their personal income tax returns, regardless of whether the LLC distributes the income to the members. An LLC with more than one owner must file federal and state income tax returns for information purposes and provide a Schedule K-1 to each member to inform the member of his, her or its pro rata share of the LLC's income or loss that must be included on the member's personal income tax return. There is generally no additional tax to the member if LLC income is subsequently distributed to the member.

Takeaway

LLCs can provide business owners with greater flexibility in organizing and operating their businesses compared to corporations. More importantly, like corporations, LLCs eliminate personal liability of business owners for the obligations of the business – a feature that is not available in sole proprietorships and general partnerships.

d) Corporations

General

A corporation is a legal entity that allows business owners, called stockholders or shareholders, to eliminate their personal liability for the obligations of the business. Unlike a sole proprietorship or general partnership where owners are subject to personal liability, only the assets of the corporation can be used to satisfy the corporate obligations.

Owners must take the steps required to properly form a corporation, which involves preparing and filing with a Secretary of State's office the necessary paperwork and paying filing fees. After a corporation has been formed, the owners must continue to make ongoing filings, pay ongoing fees, and comply with laws governing corporations, such as creating bylaws, holding regular board and stockholder meetings and maintaining minutes of the meetings. Maintaining a separate bank account for the corporation and keeping separate records specifically related to the business are two other important steps for owners to take in order to properly operate a corporation.

Income Tax Treatment

A corporation is either a C-Corporation (C-Corp) or an S-Corporation (S-Corp) for tax purposes – each taking its name from the relevant section of the Internal Revenue Code. Unless electing to be an S-Corp, a corporation will be a C-Corp. In a C-Corp, there are two levels of taxation – (1) corporate tax and (2) stockholder tax. The C-Corp itself is taxed on the income of the business and must file federal and state income tax returns to report the income or losses of the business and pay any related taxes. In addition, any distributions of cash or property from the C-Corp to its stockholders are separately taxed at the stockholder level, and stockholders must pay any resulting taxes from the distribution on their personal income tax returns.

An S-Corp benefits from pass-through taxation. A corporation can only elect to be an S-Corp for tax purposes if it satisfies and continues to meet certain requirements of the Internal Revenue Service (IRS). For example, to qualify as an S-Corp, the corporation can only have one class of stock, and generally, all stockholders must be individuals who are US citizens or residents.

An S-Corp election must be made with the IRS within two months and 15 days of forming the corporation if the corporation wishes to be an S-Corp as of formation. The S-Corp must also file federal and state income tax returns for information purposes and must provide a Schedule K-1 to each stockholder to inform the stockholder of his or her pro rata share of the S-Corp's income or loss that must be included on the stockholder's personal income tax return. There is generally no additional tax at the stockholder level if that income is subsequently distributed from the S-Corp to the stockholder, making this a potential benefit of being an S-Corp as compared to a C-Corp where there are two levels of taxation.

Takeaway

Corporations can be advantageous for business owners due to the elimination of owners' personal liability to satisfy the corporation's obligations. Compared to C-Corps, forming an S-

Corp may be advantageous to the business owners because S-Corps generally only have one level of income tax, but qualifying and operating as an S-Corp involves greater complexity from a tax perspective. If you desire pass-through taxation benefits, you may consider forming an LLC, which does not have the same strict qualification requirements as an S-Corp and does not require filing an election with the IRS.

III. Conclusion

The following table summarizes the different features of sole proprietorships, general partnerships, LLCs, and corporations discussed throughout this guide.

	Business Form			
	Sole Proprietorship	General Partnership	Limited Liability Company	Corporation
Personal liability for business obligations?	Yes	Yes	No	No
Any formation requirements?	No	No	Yes	Yes
Ongoing corporate filings/business formalities to adhere to?	No	No	Yes	Yes
Tax treatment	Sole proprietor reports income or loss of business on personal tax return	Pass-through taxation	Pass-through taxation	Two levels of taxation unless S-Corp election

We would generally expect small farms and food entrepreneurs to form an LLC for their business. However, we realize that one size does <u>not</u> fit all when it comes to organizing a business. Therefore, you should consider factors such as your desire to eliminate personal liability of business owners for business obligations, your desired structure, your comfort with complying with laws and formalities, and your personal tax circumstances when deciding whether to form an entity and if so, what type of entity to form. Obtaining advice from lawyers, accountants and tax advisors is also recommended when making these business formation decisions.

Looking for legal help?
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