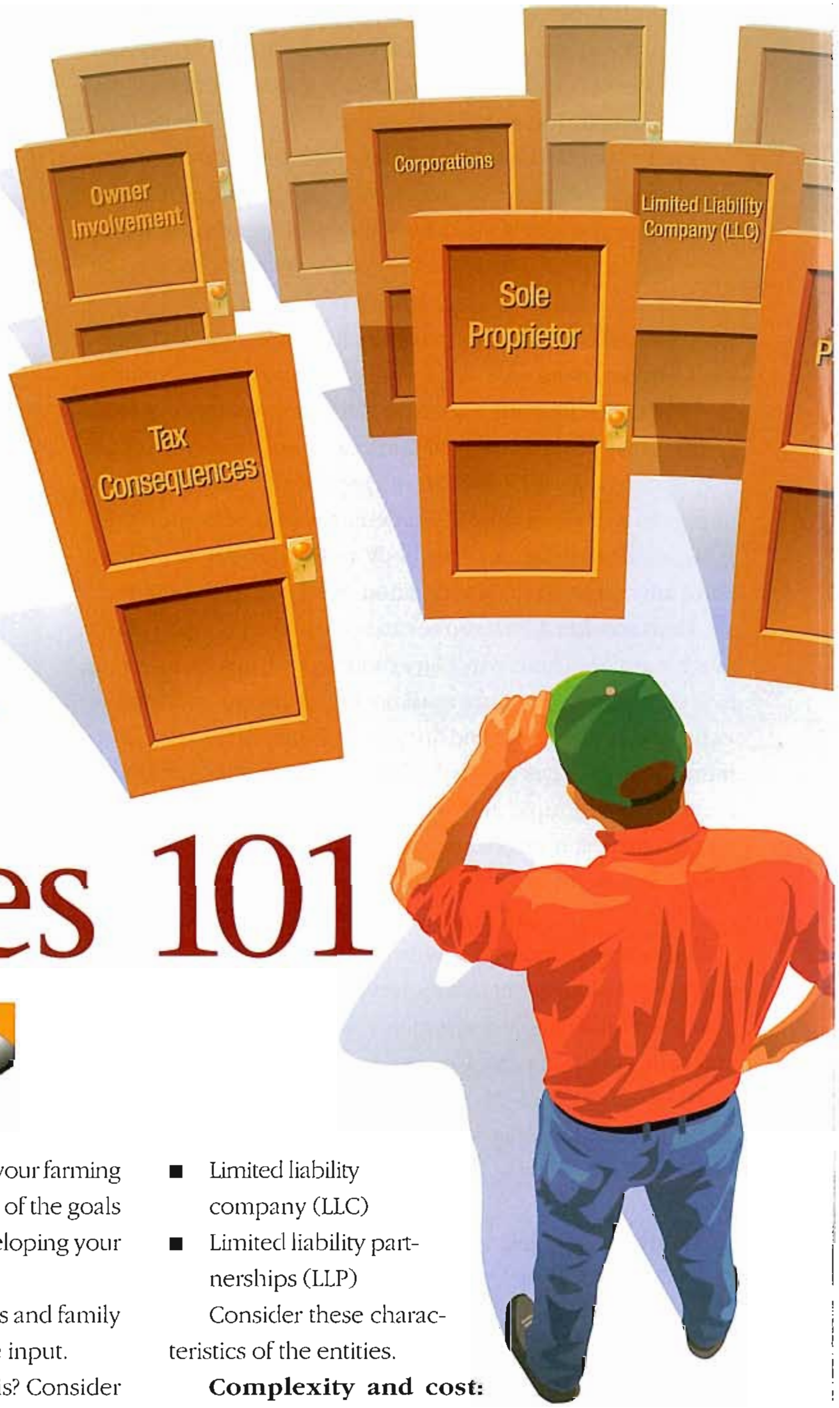

Organizational decisions should mirror the goals of your operation.

Entity choices 101

Learn more about farm entity alternatives. See Points of Internet Interest, page 17. Key code 7705

Editor's note: Kent Vickre and Chuck Cagley write a tax and finance column for each issue of Pioneer GrowingPoint® *magazine. Vickre is state coordinator of the Iowa Farm Business Association. Cagley is state coordinator of Illinois Farm Business Farm Management. They address issues that influence agribusiness success.*

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Your choice of legal entity options for your farming operation should start with a review of the goals you want to accomplish. When developing your business plan, consider these questions:

- Where are you going? Consider business and family goals. It's essential to let everyone have input.
- What do you have to do to achieve this? Consider the physical, financial and management skills available to your business.
- How do you get there? Be sure to analyze the different entities and business scenarios. Formulate and document a plan.

Once the business goals are defined, evaluate the entity type that fits your goals. The most common legal entities agricultural producers choose are:

- Sole proprietor
- Partnership
- Corporation (S and C types)
- Limited liability company (LLC)
- Limited liability partnerships (LLP)

Consider these characteristics of the entities.

Complexity and cost: How easy is the entity to set up, and what are the initial costs, yearly costs and cost of dissolving the entity?

Resources and capital: The ability to raise capital depends on the entity's ability to issue stock or borrow funds.

Liability and risk: The owner's liability exposure also depends on the entity choice.

Owner involvement: Consider who wants to be involved in the day-to-day decisions.

Transfer of ownership: Understand the ability to transfer the entire business or specific assets.

Tax consequences: Be sure to consider federal, state and self-employment tax implications. Each entity has its strengths and weaknesses. You need to evaluate these. To help match your goals to an entity's characteristics, here's a general review, listed in order of simplicity.

Sole proprietor: An entity owned and operated by one individual.

Pros: Simplicity, full management control, no additional tax reports. This is the most common producer entity. You become a sole proprietor simply by "going into business." There's no requirement for additional paperwork such as a business ID number, tax return or payroll reports to file.

Cons: Unlimited liability, limited capital resources, few fringe benefits. The major disadvantage is the lack of fringe benefits. A typical example is that health insurance and out-of-pocket medical costs are **not** business expenses (deductible directly on the Schedule F or Schedule C).

Taxation: All profit or loss is reported on the personal 1040 tax return. The sole proprietor income is subject to federal, state and self-employment taxes.

Partnership: An association of two or more persons who become co-owners of the business. These partners can be classified as either general or limited, depending on how actively they're involved in management decisions.

Pros: Shared resources and management. A partnership increases resources to a business, such as capital and management skills. A typical example of shared capital would be partners purchasing larger equipment to share.

Cons: Unlimited liability, disagreement among partners, difficult to terminate. The most common issue with a partnership is the unlimited liability. Because of this, most producers favor the LLC or LLP (discussed later). Additionally, partnerships tend to be less formal, which can lead to issues when disagreements arise. To help address the less formal disadvantage, every partnership should have a written agreement that clarifies each partner's expectations. This agreement should address capital contribution, labor management, recordkeeping and dissolution.

Taxation: Partnerships are required to file Form 1065, "Partnership Income Tax Return," which specifies each partner's share of income. Each partner's income "flows through" to their personal 1040 tax return and is subject to federal, state and self-employment tax (if applicable).

Corporations: These entities are the most formal. They're owned by stockholders and operated by officers and employees. There are various types of corporations. The C and S corporations are the most common for agricultural producers.

Pros: Access to capital, limited liability, can easily transfer ownership, employee benefits. These entities offer the most options to raise capital and transfer business ownership through stock sales. Additionally, because the corporation hires "employees," future generations can be transitioned into the operation easily. The fringe benefits vary depending on the type of entity. The more complex C corporations can offer more tax-favorable fringe benefits to the stockholders and/or employees.

Cons: Complexity and cost, payroll reporting. Due to the complexity, stock, reporting requirements and numerous elections, corporations are the most costly and complicated to create and maintain.

Taxation: Although shareholder limits, stock classification and liability risk vary between the S and C corporations, the most noted difference is the structure and income tax treatment.

S corporation: These entities file a Form 1120S, S corporation Income Tax Return. The profit (after wages) "flows through" to the stockholder's individual 1040 return as unearned income.

C corporation: This is a separate tax entity, which files a corporate tax return Form 1120 and is subject to the corporation federal and state rates. In a typical agriculture situation, the corporation pays the producer wages, rent and/or dividends to shift income to his personal 1040 tax return. While the C corporation offers more tax planning opportunity, resulting from two entity tax brackets, this can quickly become a disadvantage when the C corporation stock is liquidated because of "double taxation."

Limited liability company (LLC) and Limited liability partnership (LLP): These entities are considered hybrids. The LLC and LLP are, in essence, "flow through" entities with some liability protection. The exact protection and classification depends on state laws governing these entities.

They follow the same "flow through" and tax-reporting rules as partnerships and S corporations. A unique characteristic is that some states allow a single-member LLC that provides a sole proprietor with limited liabilities. The single-member LLC also can opt to report the business on his or her 1040 tax return using Schedule C or Schedule F.

If you're considering creating a business entity, be sure to work closely with an attorney or your tax or financial adviser. This general overview should help start the discussion of which entity is the right choice for your operation. It's clear there's no magic bullet. Your choice depends on the situation and objectives of your farming operation.

The golden rule regarding legal entity choice is: "All entities are easier to create than to dissolve."