Missouri *Ag Law Brief*

Introduction to Choosing a Business Structure

The type of entity in which a business is organized determines the ownership rights, responsibilities, and risks of each of the "owners" of the business. Historically, farm businesses have been organized under several common types of business entities, or structures, including sole proprietorship, partnerships, limited liability companies, or various types of corporations. As the business grows over time, either in terms of the size of the operation or the number of family members the business supports, or both, a reevaluation of the business structure is useful to reassure all parties relying on the business for their income as well as their lifestyle.

As the business grows so too does the attention required to monitor and forecast the impact of more complicated ownership issues such as potential legal liabilities, financial risk and returns, employee management, retirement income, and minimizing and allocating tax obligations. This reevaluation of whether the type of business structure under which the business currently operates needs to transition to a different type of structure is a decision-making process which might be looked at as a positive sign of the farm businesses stability and growth over time.

The evaluation of alternative business structures to which a farm business might transition requires an understanding of the positive and negative implications of each potential choice on the farm business. This process, in turn, requires thoughtful consideration and writing down of the objectives which the business and the active participant/owners wish to accomplish in the short and long-term. These objectives should include a desired role for each member of the family or management team as well as their associated equity and income expectations now and in the future.

Business structure decisions have commonly been made by the senior members of the farm family, typically those who own most if not all of the assets, and therefore have the greatest interest in the success of the business. Many of the business structure choices available today are commonly accompanied by financial and investment mechanisms which may impact several generations of the farm family and inclusion of this longer term perspective may influence the choice of the business structure. Some of the factors impacted by the choice of a business structure include such things as ownership transition, income, liability, taxes, and managerial control. It is important that each of the people impacted by the business structure be considered in terms of the decisions which impact their future.

The decision regarding any transition to a new business structure might be influenced by other unique factors to the business or family structure. For example, it may initially be the best choice for a business to choose a sole proprietorship because of the longer term characteristics of ownership, taxes and management control mentioned above, but there may be other more controlling reasons why a sole proprietorship is not the optimal solution.

For example, perhaps protecting personal assets for some family members might lead to consideration of a Limited Liability Company (LLC) over a Sole Proprietorship because of the LLC's protection of personal assets. In this case, however, there is a trade-off which needs to be considered between the personal asset protections created with a Limited Liability Company and the potential reduction in access to credit if the LLC is set up with limited assets which could be leveraged as collateral in financing the operation. This is just one aspect of one example demonstrating the complexity involved in making a business structure transition decision. It also serves as a suggestion that the process be very deliberate including not only all affected family and management parties but, perhaps, outside experts which can help evaluate the pros and cons of alternative business structures.

This deliberate decision process may be just as important for start-up businesses as it is for established farm businesses transitioning through the business life-cycle. The farm owner considers all of the characteristics of ownership, management control, taxes, risks etc., and their relative importance and flexibility in considering how to structure the business. In addition, the relative weight of each of the factors mentioned above may change for the business over time for many reasons including the change in the assets and liabilities of the business itself, the success of the business, as well as possible new partners/family members which have or want to enter or exit the business.

Factors which have been mentioned as important when considering the type of business structure best suited for a particular farm can be grouped into several categories to assist the decision-makers. These categories include: Management characteristics such as who should own what assets? Who should control the decision-making process? Who should benefit from the success of the business? Who should carry the various risks inherent in the business? Of course, the answer to each of these questions may involve a number of people, but the decision then becomes how to allocate, for example, the business risk, and how that allocation might change over time based on established milestones.

Estate and business transfer planning are another category of issues involved in considering the best choice for a business structure. However, the best structure to use when considering estate planning goals alone may be different than if the choice were based only on the management aspects discussed above and vice versa. Estate planning and management decisions are inextricably intertwined and therefore it is best to consider all the categories of issues at the same time or risk developing a plan with inherent conflicting goals. More importantly, a business structure which does not consider all of the issues important to the people who will be impacted by those decisions may result in a conflict among those people which becomes a built-in impediment to the long-term viability of the business.

Finally, the impact of taxes and the distribution of the tax liability among business partners and family members should be considered. It is important to understand that the ownership of assets is a separate determination from deciding the best type of business entity for the entire farm business. Real estate and personal property may be held in separate business entities for tax purposes, for income purposes, as well as for personal family and business management reasons. However, avoid particular structures selected solely for the purpose of minimizing taxes without a strong business reason for choosing that structure. The IRS may impose taxes on your business as if the business structure you chose doesn't exist if they believe that choice was only to avoid paying taxes.

Common Farm Business Structures in Missouri

A. Sole Proprietorship

B. Partnership
   1. General Partnership
   2. Limited Liability Partnership

C. Limited Liability Company (LLC)

D. Corporation
   1. Sub Chapter S
   2. Sub Chapter C

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