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. While choosing an organizational structure is important for reasons having nothing to do with succession planning, this chapter will focus on the importance of this choice 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 older or more experienced managers often have a difficult time accommodating the ideas of younger, less experienced operators, this difficulty is often magnified when the younger, less experienced operators are also the offspring of the older, more experienced operators.

- **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 physical, human or financial capital to the business. 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 – will often require a very different financial structure. At one extreme, the new owners may borrow extensively (either from lending institutions or the current
owners) to purchase assets, and at the other extreme the new owners may
purchase 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 often occurs at the expense of investment in more traditional retirement
accounts, a division of farm income that supports both the old and new owners
and allows the new owners to invest in the business can be difficult to achieve.

- **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 transfer of ownership,
management and control from the current to the future owners; and (iii) legal
entity under which the future owners 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. The ways in which
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.

Succession planning thus 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.
In fact, the success of multi-generational businesses can depend quite crucially upon the
ability of family members and others to work together effectively. Worksheet 4.1, The
Multi-Generational and Joint Business Operation Quiz, in the appendix can help you
evaluate the strengths and weaknesses of the individuals who are going to be involved
in the management and operation of the business. These difficulties can also be affected
by the choice of organizational structure. In addition, 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.

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 – legal structure – in
part, because it involves a number of technical terms and concepts with which many people may not be familiar. Much of what follows in this chapter assumes that 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 generally relevant for those instances in which the result of the succession planning process is that the land will no longer be used for farming or the business will be sold.

Following this introduction, the chapter moves to 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. This overview is followed by a more detailed focus on the use of legal agreements and entities in this process, including a discussion of critical problem areas and of the legal arrangements for transferring ownership, management and control of the farm business. The chapter then turns to a discussion of legal entities, discussing both the factors to be considered in choosing a particular entity and how the different legal entities perform. Finally, the chapter ends with a few concluding thoughts. Readers who are interested in more information on any of these topics are encouraged to consult those resources listed in the Additional Resources section of this workbook.

**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 three broad categories, described as follows:

- **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 very little. 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 in nature 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; explicit agreements between the parties put in writing to reduce conflict and the timely development of the new enterprise into a sufficiently profitable 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.

Each of these types of arrangements has advantages and disadvantages. The type most appropriate for any particular set of circumstances depends upon a number of 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 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, it is preferable that these agreements be written and properly executed by both parties to avoid disagreements over the terms of the arrangement. In addition to avoiding faulty or incomplete recollection of the specifics of the agreement, putting the agreement in writing may promote a more complete specification of the relationship and a more careful consideration of the implications of the agreement by the parties.

Employment Agreements

A common relationship between a retiring 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 considerable flexibility for the parties as they move forward. Legally, there are essentially 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 pursuant to an oral or written contract that provides the terms of the 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 assurance of certainty regarding the nature and continuation of the employment.

Employees can be compensated in a number of different ways. The most basic form of compensation is the payment of wages, typically stated 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 pre-specified amounts in exchange for the achievement of pre-specified 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. 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 firm income or profit. This provides the employee 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.

**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 a number of 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.

- **Crop Share Lease.** Under a crop share lease, the landlord shares in the expenses of growing the crops and receives a share of the crops or a share of the revenue generated by the sale of the crops as rent for the premises. Landlord and tenant share 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. In addition, there are a number of other important provisions that should be included in a lease and many important factors to consider before negotiating and entering into a lease – too many, in fact, to be adequately covered in this workbook. Fortunately, there
are a number of publications and form lease agreements available to those who are interested in learning more about leases of agricultural lands. References to these publications and form lease agreements are provided in the Additional Resources section of this workbook.

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. Also like real property leases, more detailed information on personal property leases can be found in the resources listed in the Additional Resources section.

Sales Contracts

Contracts for the sale of real property must also be in writing to be enforceable in Tennessee. Luckily, written form contracts 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 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 casualty;
- 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. More information on agreements for the sale of
personal property can be found in the resources listed in the Additional Resources section.

**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 evidence 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 (you will often hear financing statements referred to as a UCC-1, which is the name of the form). 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 tradeoffs. The choice of a particular entity should depend upon how
the entity performs on a number of different factors. These factors include the following:

- **Management and Control.** What are the implications of the business form for the way in which 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?

- **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.

- **Start-up Costs and Burden.** How extensive are the start-up costs? 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 in order 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.

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 a very important concern if a corn maze is being considered, while the start-up and administrative costs may be very 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. In addition, Table 4.1 on page 80 provides a comparison of the entities in terms of these different factors.
Business Insurance

Like the choice of legal entity, 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 from such incidents as fire & 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 death of the business owner; and
- **Vandalism & 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.

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, one and 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.

Before using a trade or business name, the owner should make sure that it has not been reserved or registered by anyone else, by conducting a search through the Tennessee Department of State (http://www.tennesseeanytime.org/sosname/). More information on the registration or reservation of business names in Tennessee can be found at: http://www.state.tn.us/sos/forms/busname.pdf.

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). In fact, 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. More information on the tax treatment of sole proprietorships can be found in the publications listed in the Additional Resources section of this workbook.

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 entity 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 a number of different 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., each and 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 have the capacity to 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 itself 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). More information on the tax treatment of partnerships can be found in the materials listed in the Additional Resources section of this workbook.

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 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, has the ability to legally bind the partnership. Thus, owners should be cautious about entering into general partnerships with individuals who 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, 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 (2010) $100. Changes in the limited partnership (change in partner’s capital contribution, admission of 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, 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. This property is useful 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 by-laws, 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 by-laws 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 on the basis of 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 set forth 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 transferrable by the shareholders and subsequent owners of the
shares have all of the rights that 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 or not. 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 a number of 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.

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 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 corporation, with a minimum tax of $100 per year.

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. More information on the tax treatment of corporations can be found in the materials listed in the Additional Resources section of this workbook.

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, a 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.

Actually, 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 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 will focus 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. In fact, 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 a 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 currently (2010) $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 which 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 for 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 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, 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. In addition, 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, the director-managed LLC operates 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 actually 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.

**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 insure 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. Thus, readers interested in learning more about cooperatives are advised to consult the materials listed in the Additional Resources section of this workbook.

**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 over time 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.
Table 4.1 Comparison of Legal Entities.

<table>
<thead>
<tr>
<th></th>
<th>Sole Proprietorship</th>
<th>General Partnership</th>
<th>Limited Partnership</th>
<th>Corporation</th>
<th>Limited Liability Company</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ownership</strong></td>
<td>Single individual</td>
<td>2 or more general partners</td>
<td>1 or more general partners and 1 or more limited partners</td>
<td>1 or more shareholders</td>
<td>1 or more members</td>
</tr>
<tr>
<td><strong>Direction and Control</strong></td>
<td>Single individual</td>
<td>All partners</td>
<td>1 or more general partners and 1 or more limited partners</td>
<td>1 or more directors</td>
<td>1 or more members</td>
</tr>
<tr>
<td><strong>Management</strong></td>
<td>Single individual</td>
<td>Managing partner or all partners</td>
<td>1 or more general partners</td>
<td>1 or more officers</td>
<td>1 or more members</td>
</tr>
<tr>
<td><strong>Liability</strong></td>
<td>Owner has unlimited personal liability</td>
<td>Partners have unlimited personal liability</td>
<td>Limited for limited partners, unlimited personal liability for general partner</td>
<td>Limited</td>
<td>Limited or unlimited</td>
</tr>
<tr>
<td><strong>Transferability</strong></td>
<td>Not applicable</td>
<td>May be assigned, but assignee not a partner</td>
<td>May be assigned, but assignee not a partner</td>
<td>Corporate stock freely transferable, “S” corporation restrictions must be met</td>
<td>May be assigned, but assignee may or may not be a member</td>
</tr>
<tr>
<td><strong>Continuity of Life</strong></td>
<td>Terminates upon owner’s death</td>
<td>Dissolves upon death or withdrawal, unless continued by partners</td>
<td>Generally dissolves upon death, withdrawal</td>
<td>Perpetual existence</td>
<td>Generally dissolves upon death, withdrawal</td>
</tr>
<tr>
<td><strong>Federal Taxation</strong></td>
<td>Individual taxed</td>
<td>Pass-through entity – partners taxed</td>
<td>Pass-through entity – partners taxed</td>
<td>“C” - corporation and shareholders taxed “S” - pass-through entity, shareholders taxed</td>
<td>Pass-through entity – members taxed</td>
</tr>
<tr>
<td><strong>Franchise and Excise Taxes</strong></td>
<td>No</td>
<td>No</td>
<td>Yes, unless 66.7 percent of activity is farming</td>
<td>Yes</td>
<td>Yes, unless 66.7 percent of activity is farming</td>
</tr>
<tr>
<td><strong>Legal and Administrative Costs</strong></td>
<td>No initial or annual filings or fees or legal costs</td>
<td>No initial or annual filings or fees but may need legal service to draft partnership agreement</td>
<td>Initial and annual filings and fees, legal fees for drafting limited partnership agreement</td>
<td>Initial and annual filings and fees, legal fees for drafting documents, annual meetings</td>
<td>Initial and annual filings and fees, legal fees for structuring entity</td>
</tr>
</tbody>
</table>