- Think carefully before guaranteeing any obligation of their business.

5). Generating additional financing and investors

All of these forms permit the business to go into debt to finance its operations. Subject to the applicable governing documents, all of the multi-ownership forms permit existing owners to solicit new co-owners.

Pragmatically, however, the fact that a business can use equity financing does not necessarily mean that it will be able to or even should:

- Who—aside from family members or friends—will be interested in investing in the farm or ranch?
- What do potential new owners want in order for them to invest?
- How will these investors be solicited?
- How might such investments dilute the current owners' authority or create new conflicts?

Different types of investors may prefer different legal forms. Producers should talk with their business advisors to determine which form is favored by their intended investors.

Seeking new outside investors may subject the business to state and federal securities laws. Small businesses may be exempt from registration requirements under specific federal exemptions. Nevertheless readers should alert their customers of this possibility if obtaining outside investors is a primary goal.

6). Fair distributions and compensation.
Partnerships, LLCs, and business trusts (and their hybrids) generally may allocate business profits and losses as they see fit through their applicable documents. Both partnerships and LLCs permit allocations to be made based upon services provided to the business. Profit allocation in statutory trusts is normally tied to each beneficial owner's proportionate share of total beneficial interests but remember—the creator of a statutory trust may distribute beneficial interests to individuals, even though they did not make any capital contributions.

Allocating profits in the corporate form is less flexible. It is typically tied to the type(s) and number of shares owned which in turn are based upon the capital contributions made when the stocks were issued. Shareholders have no rights to dividends until they are declared by the corporation's board of directors.

What happens if the relevant documents do not address the distribution of profits or compensation. The defaults under Wyoming law provide:

- Partners in general partnerships will receive an equal share of profits from general partnerships, regardless of their level of contributions. Partners have no right to remuneration for services performed, except in winding-up the business.

- Profits in limited partnerships are allocated based upon contributions. Managing partners have no right to remuneration for any services performed, other than in winding-up the business.

- Profits and losses in LLCs and their variations are to be allocated based upon the relative contributions of the owner-members. The statutes are silent regarding compensation for services provided to the company.

- Profits and losses from statutory trusts are to be allocated among beneficial owners of statutory trusts based upon the proportion of the entire undivided beneficial interest that they own.

7). Maximizing after-tax income.
Most producers want the legal form they adopt to assist them in taking advantage of peculiarities in the federal income tax code. These producers are interested in how business income will be taxed, what deductions may be available (either for themselves or their businesses), and what the tax consequences will be if the business is terminated or their interest bought-out.

Income from an agricultural enterprise is taxed as personal income for the sole proprietorship. Regarding partnerships, LLCs, business trusts, and their hybrids, co-owners can request that the IRS tax their business like a Subchapter C corporation or like a partnership. Solely-owned FLLCs and CLLCs will be treated like sole proprietorships unless their owners' indicate they want their businesses taxed like corporations.

Persons basing their choice of business form solely upon its federal income tax consequences must be aware that differences do exist:

- Allocations: Partners and owner-members of LLCs may allocate income and losses in any reasonable

manner, provided only that it has a substantial economic effect (i.e., its sole purpose may not be to simply minimize taxes).

- Self-employment taxes: Profits from the sole proprietorship and general partnership are subject to self-employment tax.

- Fringe benefits (e.g.,housing and meals, life or medical insurance):

    - Sole proprietorships and partnerships: Generally not deductible (proportion of medical insurance cost are).

    - Subchapter C corporations: Generally fully deductible.

    - Subchapter S corporations: Shareholder-employees, holding two percent or more of the stock of a Subchapter S corporation, will be treated like sole proprietors for purposes of fringe benefit deductions.

- Business Losses:
    - Sole Proprietors: Fully deductible.

    - Partnerships and Hybrids: General partners may deduct all such losses—even exceeding their basis and loans to the partnership—to the extent of their share of the partnership's liabilities.

- Subchapter C Corporations: Not deductible by shareholders.

- Subchapter S Corporations: Shareholders may deduct their share of the business's losses only up to their basis in the stock they own—generally the value of the cash and other property they contributed to obtain their interest—and loans they have made to the corporation.

- LLCs (and Hybrids): Owner-members may also deduct their share of the business's losses, beyond their initial basis, by their share of the company's debts and obligations.

Federal tax laws impose special rules for deducting losses when co-owners do not materially participate in the business. These passive loss rules permit taxpayers to deduct such losses only from income earned by another passive source. Similarly, federal income tax law imposes special limitations on income allocations in family partnerships to ensure that income is taxed to the person whose labor or capital earned it. In particular, these rules will not recognize minor children as co-owners of a family partnership unless they are shown to be competent or a fiduciary exercises control on their behalf, solely for their benefit, and under the supervision of a court.[4]

[4]**Treas. Reg. § 1.704-1(e)(2)(viii) ( ).**

8. A right to withdraw or transfer the ownership interest.

- Sole proprietor may withdraw or terminate their interest in the business at any time. Shareholders in general business corporations are also free to sell their interests in the business at any time. Regarding the remaining forms, the right to exit and reimbursement depends upon the form and type of owner involved:
- General partners: May withdraw from general partnerships, limited partnerships, and RLLP at any time, even if such withdrawals constitute a breach of contract.
    - They have no right to reimbursement unless the relevant agreement so specifies or the business is wound up.
    - Their investment will earn interest in the interim, less any damages caused by a wrongful withdrawal.
- Limited partners: May withdraw and receive back their contributions) only in accordance with the partnership agreement.
- Close corporations: Subject to governing documents.
    - Close corporations may restrict transfers by establishing: a) a right-of-first-refusal (allowing the corporation to match any offer received by a shareholder); b) mandatory re-purchase by the corporation of a decedent's or his/her

co-owner's shares; and c) buy-sell agreements, providing for shareholder purchases of an exiting owner's interest.

- Close corporation stock may only be transferred to "qualified" shareholders—those who otherwise qualify to own stock under the corporation's tax status (C versus S corporation) and whose ownership would not impose personal holding company or other penalties.

- LLCs: Member-owners may withdraw and seek return of their contributions at any time, following six months written notice to the other members-owners. The right to reimbursement is governed by the Operating Agreement. If the Operating Agreement is silent, withdrawing owner-members have only a right to return of their contributions; they have no right to receive a share of the company's value as a going concern.[5]

- CLLC: The statutes for CLLCs make no provisions for transferring member-owners' interests.

Perhaps a more interesting question in looking at the multi-owner forms is the nature of the interest that can be transferred. Under the corporate form, all rights, including the right to engage in management (i.e., vote

[5] ***Lieberman v. Wyoming.com LLC*, 11 P.3d 353 (Wyo. 2000).**

the shares), are transferred. With respect to the other multi-ownership forms, only the economic interests (rights to any distributions from the business) are readily transferable, subject to the terms of the applicable agreements. The right to participate in management is typically not transferred (other than possibly for the FLLCs), unless the remaining co-owners agree.

9. The business's duration.
A legal form's duration is generally tied to the governing documents, the willingness of co-owners to stay with the business, and the ability of exiting co-owners or third parties (e.g., creditors or transferees) to force the business to be terminated. All of these forms may be terminated voluntarily by their co-owners or upon the happening of an event specified in the relevant documents, unless the co-owners agree to keep the business going. Business forms with a limited duration or specific purpose are also normally terminated when this occurs, unless the co-owners agree otherwise.

Corporations theoretically have a perpetual existence. The duration of the other multi-owner legal forms differ in terms of when an exiting co-owner or third party (e.g., creditor, transferee of the co-owner's interest, etc.) can force the business to wind-up its affairs and reimburse the co-owners:

- Sole Proprietorships: May be terminated and its business required to be wound-up at any time through court action by a third party.

- Partnerships-at-Will: May be terminated and its business required to be wound-up at any time by an exiting partner or third party.

- Durational Partnership: Not terminated automatically if an exiting partner or third party requests, provided the duration or purpose has not been accomplished. Remaining partner(s) may, however, request the business be terminated and its affairs be wound up.

- Limited Partnerships: Their affairs must be wound-up if the limited partners are unable to name a new general partner for the business after the last general partner leaves.

- LLCs: General LLCs must be dissolved and their businesses wound-up following the death, retirement, resignation, expulsion, bankruptcy, dissolution of an owner-member unless the remaining owner-members unanimously consent in writing to carrying on and the Articles of Organization give them such a right.

- CLLCs: Makes no provision for exiting member-owners or third parties to force the business to be wound up. Must be dissolved if; a) their duration expires; b) the owner-members unanimously agree; or c) an event specified in the Operating Agreement occurs.

- Statutory Trusts: Will only terminate—and the beneficial owner receive reimbursement for his or her proportional interest—in accordance with the Governing Instrument. Beneficial owners may also ask the courts to terminate their statutory trust based upon ordinary trust principles.

10). Estate planning considerations.
Many producers would like the legal forms they select to assist them in accomplishing their estate planning goals. A legal form can do this by permitting owners to transfer interests in the business to others and

- Take advantage of annual gift tax exclusions under federal estate and gift tax laws;

- Reduce federal income taxes by shifting income to family members who are in lower income tax brackets;

- Lessen their taxable estate for federal estate tax purposes when they die; and

- Still retain control of the income-producing assets themselves.

Other producers are not interested in retaining control. They may still want to accomplish the first three objectives and ensure a steady income for their retirement.

Sole proprietorships provide few estate planning benefits. Gifts of assets during the owner's lifetime may threaten the continued viability of the farm or ranch business. Transfers of the farm or ranch assets to family members at death create other problems, particularly when family squabbles or federal estate taxes remove resources necessary to keep the agricultural business from operating. Gifting income-producing assets, while attempting to retain control over them, can create the worst-of-all-possible-worlds for sole proprietors. The IRS may well conclude that the gift was not completed and include the income from and value of the supposedly

transferred asset in both the sole proprietor's federal income tax obligations during his or her lifetime and in his or her taxable estate, for estate tax purposes, upon his or her death.

The multi-ownership forms, discussed in this article, resolve these problems by permitting owners to transfer stock or other certificates of ownership to family members, rather than the assets themselves. Properly planned, a transfer of these interests will not threaten the viability of the operation and permit the parent-owners to accomplish their other estate planning objectives. Moreover, careful planned gifting may permit valuation discounts—for either the transferred interest or the parent's retained interests—when computing federal gift or estate taxes, based upon a claim that the transferred or retained minority interest is less valuable because of the holder's lack of control.

11. Protecting minority interests.
Many producers (and often their children) are concerned about what their rights might be if the majority owner is not playing fair. For example, a shareholder in a family-owned, Subchapter S corporation complained that the majority shareholder was taking most of the profits as compensation as its chief operating officer. She did not begrudge the salary but did object to the fact that the corporation had never declared a dividend, even though it had profits over the years. She was even less pleased when she discovered that she was legally responsible for her share of these retained profits and faced interest and penalties for not declaring them on her federal income form.

Conflicts are to be expected in a multi-owner, multi-manager business. Others have suggested such problems might be particularly troublesome in inter-generational agricultural operations because parents and children often times have very different goals for the business, earnings are not sufficient to permit every family member to stay on the farm or ranch, and parents are interested in providing for on-farm/ranch and off-farm/ranch heirs.[6]

In these fights, depending upon the terms of the governing documents, the majority owner normally wins. Theoretically, minority interests are protected by permitting them to transfer their interests to third parties. This protection is of limited utility, however, if:

- There is not a ready market for the ownership interest.
- Transfer rights themselves are restricted (as is the case for close corporations and CLLC).
- The rights being transferred are limited (e.g., the right of management will normally not transfer unless the majority partner, member-owner, or beneficial owner consents).

Good planning, well drafted documents, and continuing communications should address many of these fears. Producers also should be aware of the statutory default protections afforded minority owners under each of these legal forms:

[6] KENNETH H. THOMAS & MICHAEL D. BOEHLJE, FARM BUSINESS ARRANGEMENTS: WHICH ONE FOR YOU (North Central Regional Extension Publication 50, Rev. 1982).

- Partnerships: Managing general partners owe duties of loyalty, due care, good faith, and fair dealing in operating the business to both the partnership and the minority partners. All partners have a right of access to the partnership books and records.

- Statutory Trusts: Trustees owe a fiduciary duty to the beneficial owners, though no greater than the duty owed by directors to shareholders of Wyoming general business corporations.

- General Business Corporations: Directors and officers of general business corporations have a duty to act in good faith, with the care of an ordinary prudent person in a like position would exercise under similar circumstances, and in a manner they reasonably believe to be in or at least not opposed to the corporation's best interest. The statutes also regulate potential conflict-of-interest transactions between directors and the corporation.

- Close Corporations: Close corporation shareholders may seek relief from state district courts if they can show, among other reasons, that "[t]he directors or those in control have acted, are acting, or will act in a manner that is illegal, oppressive, fraudulent or unfairly prejudicial to the petitioner whether in his capacity as a shareholder, director or officer of the corporation."[7]

[7] **Wyo. Stat. Ann. § 17-17-140(a)(i) (LexisNexis 2001).**

Minority owners should carefully consider what they want an intervening court to do. A commentator has pointed out that the typical remedy in close corporation cases is an opportunity for minority shareholders to be bought out rather than a change in the offending party's actions.[8] This may or may not be satisfactory, given the desires of the minority shareholder(s).

4. Summary: choosing the right business form for an alternative agricultural enterprise

Changes in federal and state laws has significantly transformed earlier discussions of choice of a legal form to operate a business. Those discussions focused almost exclusively on the sole proprietorship, partnership, and corporate forms and based their analysis on duration, limited liability, and income tax concerns. Today all of the multi-owner, noncorporate forms or their hybrids can provide owners with some form of limited liability and a choice between being taxed like a partnership or a corporation. Additionally, producers can—through the governing documents—provide for central or decentralized management or variations in-between.

Thus there is no one criteria or one business form that is best for an agricultural enterprise. Sole proprietorships and general partnerships fare worst under almost all of the eleven objectives we have discussed, aside from ease of entry and exit. The remaining forms share many similar attributes. Which is best for particular producers will depend upon how much weight they give to each of the eleven objectives and the particular facts of their operations.

Persons considering whether to establish an alternative agricultural enterprise may decide to employ several business forms rather than

[8] Steven C. Bahl, *Judicial Approaches to Resolving Dissention Among Owners of the Family Farm*, 73 NEB. L. REV. 14 (1994).

one. Multiple legal forms allow producers to take advantage of the unique attributes of each to accomplish the multiple, sometimes conflicting goals of the co-owners.[9] For example, parents, interested in establishing a ranch recreation enterprise with one of their children, might establish the enterprise as a CLLC, separate and distinct from their ranch business. Doing so may:

- Protect the parents' ranch land from creditor claims and tort actions brought by injured customers against the ranch recreation enterprise.

- Allow the co-owners to allocate profits and management responsibilities, taking into account contributions in addition to capital and the co-owners' relative interests in participating in management.

- Prevent ownership from being transferred to nonfamily members.

- Permit producers to weigh the tax advantages of having the two separate business entities taxed like C corporations or partnerships.

- Satisfy estate planning objectives by transferring income potential to on-ranch family members (who might operate the separate ranch recreation enterprise) while distributing some or all of the income from the main ranch business to off-ranch heirs.

In contrast, a CLLC may be unacceptable if outside investors are to be involved. Such investors may like the fact that the CLLC permits them to participate in the management of the business (if the business

[9] **James R. Monroe, *The Restructuring of Agribusiness Operations from a Tax Perspective*, 4 DRAKE J. AGRIC. L. 407, 435-36 (1999).**

selects to be taxed like a partnership, outside investors who materially participate in the business can deduct any losses from other business income). However, they may:

- Dislike the limitations this form imposes on transferability.
- Be concerned whether the Articles of Organization might impose personal liability on the member-owners.
- Be somewhat worried regarding its limited track record in courts in Wyoming and other states.

5. Choosing a legal form for an alternative agricultural enterprise: assisting your customers

a. Some other questions to be addressed in selecting a legal form for an agricultural business

Figures 1 and 2 provide checklists that readers can give to customers to help them in preparing to work with their attorneys and accountants in making the final decision. The checklist in Figure 1 asks readers to consider several questions before selecting a legal form for their agricultural business. First, what will the operation look like over the next ten years? What is its purpose? What will it do and not do? A business form that is too big—permits too may enterprises—may be just as uncomfortable as one that is too small. The answer to these questions can be included in the operating agreements for many of the legal forms we have discussed.

Second, how important are the eleven objectives for their customer's operation? Do the customers have other goals they want to accomplish in making this choice? The article shows that several legal forms can satisfy many of the same

objectives. The reader's customers will have to determine whether other attributes—operating costs, legal uncertainties, added complexities, etc.—might tip the balance in favor of one form over another.

Third, is the current agricultural operation (or the operation being planned) profitable enough to support additional owners? What level of earnings would be necessary? What additional capital (debt or equity) and resources are necessary to support additional owners or the new enterprise(s)?

Fourth, can the current owner work with the proposed co-owner(s) on a day-to-day basis? What parts of the business would the current owner focus on; what parts of the business might the proposed co-owner(s) specialize in? If the co-owner is another family member, how might family interactions/conflicts complicate or smooth the business relationship? What conditions must be in place for this operation to work professionally and personally? Readers should encourage their customers to complete this questionnaire separately and share their answers. It may be eye-opening.

Figure 2 gives a checklist of documents potential co-owners should examine before entering into a multi-ownership arrangement. Many of these documents summarize the earning potential of the current operation. The parties should also prepare pro forma income and balance sheets to assess the viability of proposed new ventures. The remaining documents summarize basic ownership questions.

b. <u>Additional resources</u>

Producers should complete both checklists before meeting with their attorneys and accountants to make a final decision regarding the best legal form for their farm or ranch. For

additional general information regarding business forms and agriculture, readers might suggest their customers examine:

- Department of the Treasury, Internal Revenue Service, Publ. No. 225, Farmer's Tax Guide (2000).
- Farmers' Legal Action Group, Legal Issues for Minnesota Farmers Starting a Processing or Marketing Business (2000).
- Neil E. Harl, Farm Estate & Business Planning (14th ed., 1999).
- University of Minnesota Extension Service, Publ. No. PC-6317-GO, Transferring the Farm (nd).
- Wyoming Secretary of State, The Choice Is Yours (rev'd Nov. 2000).

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CHECKLIST 1:

EVALUATING THE FUTURE NATURE OF THE FARM OR RANCH BUSINESS

A. NATURE OF THE BUSINESS. OVER THE NEXT TEN YEARS (add additional pages if necessary)--

1. Briefly describe what the business form will be doing (business activities).

2. Are there some business activities it will not be doing (e.g. the business form will not raise the following alternative crops/livestock, engage in the following ranch recreation activities, and/or carry-out the following value-added enterprises)?

3. Assets:
   a. What assets will the business form control (e.g., land, structures, livestock, equipment, etc.)? How will these assets be controlled (e.g., the entity will own the property; the property will be rented to the form; the form will jointly own the property with another person or entity; etc.)?