



A.1. FORMING A FARM OR RANCH BUSINESS AND LIMITING PERSONAL LIABILITY

PURPOSE OF THIS FACT SHEET

If you have not formed a corporation for your farm or ranch business, then you are either the owner of a sole proprietorship, or a partner in a general partnership. An owner of a sole proprietorship or a partner in a general partnership is personally responsible for all of the debts and other liabilities of the business; this is called “unlimited liability.”

Unlimited liability means any of the debts or legal liabilities of the business can be enforced against any one of the individual owners, including against the personal property or wages of a spouse who does not own or work on the farm. Business debts includes accounts payable and loans payable. Business legal liabilities can include things like fines and penalties from failing to follow the law, and also legal judgments against you if you are found responsible for an accident.

Incorporation is a legal method for limiting personal liability. An individual or a group of individuals may incorporate as an entity by filing articles of incorporation in the state of choice. State statutes make the incorporated entity into a distinct legal “person” who may own property or conduct business, and who may sue and be sued. The separate legal status of the incorporated entity allows individuals to invest in ownership without subjecting themselves (or their spouses) to unlimited personal liability. The liability of the corporation is limited to the assets of the corporation. One of the best strategies for farmers and ranchers to limit liability and protect family wealth is to own land outside of the corporation and keep the farming and ranching activities inside of the corporation. The corporation’s officers must follow state law to ensure that the corporation is maintained, otherwise it will not serve its intended protective function. If the corporation is properly maintained, then in the event the farm or ranch is unable to pay its debts, or in the event of a farm or ranch-related injury resulting in a judgment ordering the farm or ranch to compensate the injured party, the total amount available to be paid out would be limited to the assets of the corporation, and the land and the future earnings of the corporation’s owners would not be available to pay the debt or legal liability.

CONCEPTS

Liability: is a legal term. You are personally liable for your debts, and for any number of mistakes you might make. If you are a sole proprietor you are personally liable for any debts of your business and any mistakes made by you or your employees, and possibly your contractors and customers.

Personally Liable: means that any of your personal assets, and any of the assets of your spouse may be used to pay the claim against you. This is also called “unlimited liability” because you – or your spouse – could have your wages garnished for life to settle a claim.

Forms of Ownership

- An individual may own property or farm without actively creating a separate business entity.
- When an individual owns their own business they are called a “sole proprietor.”

- Two or more individuals may own property together as tenants in common or as joint tenants without forming a separate business, or they may form a partnership or a corporation for the purpose of owning land.
- When two or more individuals farm together (meaning the activity of farming) they will be found under for federal tax purposes and under California (and most other states) law to have formed a partnership unless they are married. This will be true if the partners know it or not, and whether they have a written partnership agreement or not. This means that all partners share unlimited personal liability with each other. Each partner may be held personally responsible for the acts of the other partners.
- If you incorporate your business then the liability of the business is limited to the balance sheet of the business - you have limited your personal liability.
- There are a number of different types of incorporated entities. State statutes governing each of the different types of entities vary, but not greatly. The common types of incorporated entities are:
 - “C” corporations, which are usually large corporations and not usually the kind of corporation formed for a family-scale farm or ranch, because the tax treatment of profits is not favorable.
 - “S” corporations, which are the type of corporations usually formed for family-scale farming or ranching because it usually has the most favorable tax treatment of profits to owners.
 - A Limited Liability Corporation “LLC” is a hybrid with some aspects of a partnership and some aspects of a corporation. The owner of an LLC may elect to be taxed as a partnership or as a corporation. It differs from an “S” corporation in some important respects and it can be challenging to determine which entity, and S-corp or an LLC is the best entity to meet all of the owners’ goals.
 - Not-for-profit corporations, which are not owned by anyone and may not be used to create private wealth or profit for any individual other than the individuals being served as part of the organization’s tax exempt purpose.

REASONS NOT TO INCORPORATE

- Cost of attorney fees to incorporate
- Time and effort to create an agreement between multiple owners
- Additional cost and effort to file a corporation tax return
- You need to have a balance sheet and account for each owner’s contributions to the business
- The corporation must be maintained according to requirements of state law, in most states this requires things like annual meetings of shareholders, with written minutes, and a separate accounting which among other things clearly keeps owner’s payments and activities benefiting owners personally separate from the activities of the corporation.

WHAT GOES IN THE CORPORATION

The business is the activity of farming and ranching - this is what goes into the corporation. This includes equipment and machinery used in your operation and working capital.

Land should generally not go into a corporation for two reasons: 1) there are negative tax consequences - be sure to consult a tax expert before you form a corporation 2) for most farms and ranches the best way to protect the land is to have the operation inside the corporation and the land held outside of the corporation and to pay rent from the corporation to the land owners.

WHAT COMES OUT OF THE CORPORATION

The corporation pays rent on land used in farming. In some cases the rent paid is paid to the same people who own the corporation. It is important to actually make the payments in order to maintain the separate ownership status of the land and protect it from any claims against the business.

A corporation pays salary to corporate officers. This is different from a sole proprietorship or a partnership which do not pay salaries to owners.

HOW TO FORM A CORPORATION

A corporation is formed by filing appropriate paper work with the state where the corporation is housed. This paper work includes articles of incorporation and bylaws. These documents together specify the choices the owners have made with respect to critical events in the life of a business: formation, management, sharing profit or loss among owners, taxation, additional capital contributions, and exiting or dissolving. Each individual business may also make individual decisions about the terms and conditions under which each owner invests in the original capitalization of the business, participates in business management, is compensated, participates in sharing profit or loss, the circumstances under which owners may or must contribute additional capital, and the circumstances and methods under which an owner may exit by selling to the other owners or to a new owner. When these issues are not addressed state law fills in the gaps.

There are different options for types of corporations, and how the corporation will be taxed, so before deciding what type of corporation to form it is important to consult a Certified Public Accountant or other tax expert.

Usually an attorney licensed to practice law in the state where the business is located prepares the articles of incorporation and bylaws. The owners can keep their bill down by researching the basic requirements of the articles and bylaws and making preliminary decisions about how they want to structure their business.

WHERE TO GET HELP

A Certified Public Accountant (CPA) is someone who is licensed by the state where they practice. The license authorizes the CPA to issue an opinion attesting that the financial statements of a company have (or have not) been prepared according to generally accepted accounting principles. The requirement for licensing in most states is a four-year degree with a certain number of units in taxation, business law, and

accounting, a passing score on a difficult multi-day examination, and a certain number hours of worked under the supervision of someone already licensed as a CPA. Many CPAs specialize in taxation and advise their clients about short term and long term tax planning strategies. Most CPAs work closely with licensed attorneys, particularly on business formation issues.

A licensed attorney is someone who is licensed by the state where they practice law. The license authorizes the attorney to represent clients in a court of law, or in an administrative appeal with a state or federal agency, including a state taxing authority or the IRS. The requirement for licensing in most states is a four-year degree, an additional degree from an accredited law school, a passing score on a difficult multi-day examination, and a background check. Some attorneys specialize in business issues including entity formation, contracts and taxation.

ADDITIONAL RESOURCES

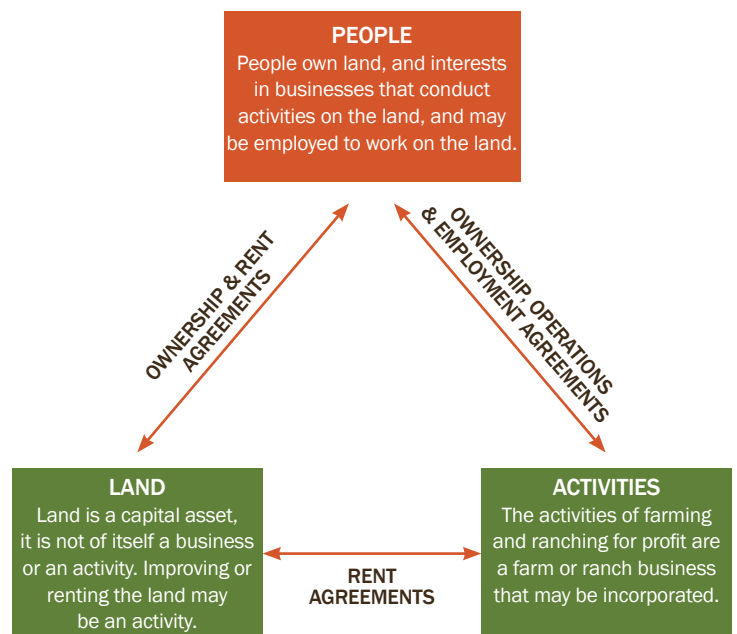
There are many resources to help you understand the rights and obligations of business entities. Keep in mind that while you might prefer the information resources of one state over another, business entity formation and state taxation is determined by the law of the state or tribal nation where you operate.

Small Business Administration and affiliated local Small Business Development Centers.

National AgLaw Center's "Business Organizations: An Overview"

Farm Commons <https://www.farmcommons.org/business-structures>

Keep your understanding of these things separate!



FARM AND RANCH BUSINESS HEALTH ASSESSMENT

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The Business Health Assessment and all related fact sheets are available on the Resources section of the California FarmLink website www.CaliforniaFarmLink.org

