FARMERS' GUIDE TO

BUSINESS STRUCTURES

LLCs, CORPORATIONS, PARTNERSHIPS AND MORE

By Rachel Armstrong, Erin Hannum, Laura Fisher and Lisa Schlessinger

SARE Sustainable Agriculture Research & Education
HANDBOOK 14

Farmers' Guide to Business Structures

LLCs, Corporations, Partnerships and More

By Rachel Armstrong, Erin Hannum, Laura Fisher and Lisa Schlessinger

www.farmcommons.org

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Farm Commons believes that strong, resilient sustainable farm businesses are built on a solid legal foundation. Our mission is to provide the proactive legal resources that farmers need to become the stable, resilient foundation of a community-based food system. We look forward to the day when all sustainable farmers have access to the legal resources they need to become strong and resilient.

Farm Commons values the knowledge farmers and ranchers have to make solid decisions for their operations, their lives and their communities. We know that with accurate guidance from attorneys, accountants and tax preparers, farmers are eminently capable of managing their legal affairs. Through legal education resources that cultivate a community of learning, Farm Commons empowers the sustainable farming community. Our workshops, print resources and audio/visual materials help farmers move forward on many legal subjects, including business structures, farm employment law, land leasing, land purchasing, farm financing, insurance, liability and food safety.

Learn more at www.farmcommons.org.

About SARE

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Sustainable Agriculture Research and Education (SARE) is a grant-making and outreach program. Its mission is to advance—to the whole of American agriculture—innovations that improve profitability, stewardship and quality of life by investing in groundbreaking research and education. Since it began in 1988, SARE has funded more than 6,000 projects around the nation that explore innovations—from rotational grazing to direct marketing to cover crops—and many other best practices. Administering SARE grants are four regional councils composed of farmers, ranchers, researchers, educators and other local experts. SARE-funded Extension professionals in every state and island protectorate serve as sustainable agriculture coordinators who run education programs for agricultural professionals. SARE is funded by the National Institute of Food and Agriculture, U.S. Department of Agriculture.

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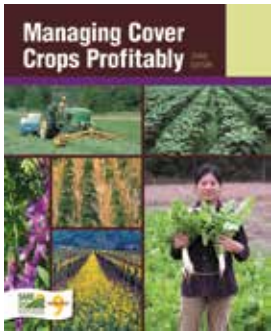

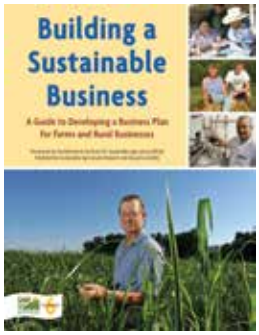

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Preface

Dear Reader,

Congratulations—you've started down the path of greater stability and resiliency through smart farm business structures! The process of choosing and maintaining a farm business structure can be a long journey as the farm grows, shifts and perhaps transfers to other operators. These resources are here to support farmers on their journey. We hope to put farmers in the driver's seat, as they set the best possible course for their future.

The length of this book might make readers worried about the complexity of this subject. Don't worry—finding the right farm business structure is a very approachable issue. The choice of an entity is usually a straightforward decision for most farmers. The complexity tends to emerge when farmers draft organizing documents to support their choice of entity. Fortunately, creating these organizing documents is one of the strongest risk management steps farmers can take. Our sample operating agreements, bylaws and other documents are meant to help farmers articulate their needs and wants for the farm operation. When we know where we are going, we can create legal resources to support our journey.

Any successful journey, farming or otherwise, depends on a solid team. By working with an attorney, accountant and tax preparer, farmers will take best advantage of the resources offered here. Clear communication with partners, heirs and peers will also ensure a smooth ride.

Let us know how your journey progresses. We love to hear your questions, thoughts and ideas. In fact, it's essential to Farm Commons! Your knowledge is the most powerful resource we have. Thank you for joining our community of farmers building and creating sustainable farm law together.

-Rachel Armstrong
Executive Director and Founder
Farm Commons

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Part 1:
Making the Choice

Chapter 1. Getting Started
Chapter 2. Understanding the Options

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Farmers' Guide to Business Structures:
LLCs, Corporations, Partnerships and More

Chapter 1: Getting Started

www.sare.org/guide-to-business-structures

DISCLAIMER: This Guide does not provide legal advice or establish an attorney-client relationship between the reader and author. Always consult an attorney regarding your specific situation.

Introduction

This Guide will help farm owners choose a smart business entity for their unique operation. A wise and thoughtful decision at the outset will help farmers build a strong and resilient farm business that can withstand the test of time. Selecting the right entity is like building the foundation of a house. Without the right foundation, the house will eventually falter. Fortunately, a strong foundation isn't difficult to build. Thought and attention are all that is required, and sustainable farmers have these qualities in spades. As when farmers turn thoughtful attention to their land and resources, thoughtful attention to legal issues will inspire the best solution for each unique sustainable farm.

> "Selecting the right business entity is like building the foundation of a house. Without the right foundation, the house will falter."

What is a business entity?

A business entity is the legal structure or form that outlines the legal parameters of a business operation. Many business entity options exist, including the C corporation, the LLC, the B corporation, the cooperative and the nonprofit. There's also an entity known as the S corporation, which actually is a federal tax status that can be applied to a C corporation, the LLC or the B corporation. We'll call all of these the "formal entities."

The "formal entities" include the C corporation, the LLC, the B corporation, the cooperative and the nonprofit. There's also the S corporation, which is a federal tax status.

In comparison, we have "default entities." These include the sole proprietorship, the general partnership and the unincorporated nonprofit association. Default entities are still subject to laws that define business operations that have not formally created an entity. For example, if a farmer is selling crops or livestock, they'll be considered a sole proprietorship if they haven't taken any other steps to define the business. If two friends come together to sell a product or service, they will be recognized by the law as a general partnership–even if they don't file any paperwork.

The "default entities" are the sole proprietorship if one owner, or the general partnership if multiple owners.

Every business entity, including the default sole proprietorship and general partnership, carries legal implications. These implications help define tax treatment and answer the questions of who has which rights and privileges, who has the authority to make decisions, when and how owners take a draw on profits, and who's liable for which decisions and actions. Taxation, rights and privileges, and liability are three driving forces for many farmers in choosing an entity. The purpose or objective of the farm operation may also come into play. Is the farm driven primarily by making profits, or do social or environmental causes play just as much of a guiding role? Succession planning is also key to consider when choosing an entity.

A formal business entity is considered a person in the eyes of the law

Before the corporation was created, people could only do business under their own personal name. At the same time, they took on the risk of personal liability for any acts or financial issues associated with the business. The ability for people to create corporations changed that. Fundamentally, corporate laws allow people to create an entity separate from themselves that can do business on its own, under its own name. The business entity in effect is classified as a "legal person" in the eyes of the law.

This means that, like people, the business entity has rights and duties. Its rights include the ability to enter contracts, possess property, and sue and defend itself—all in the name of the entity. Just like a person, the business entity can lose all its money and file for bankruptcy in its own name. The business entity can also be sued for wrongdoings and illegal action taken by the owners on behalf of the corporation.

The business entity effectively stands in for the people behind it. But, these benefits extend if, and only if, the courts agree that the owners were upholding certain standards. Otherwise, the corporate shield can be knocked down and the owners' mismanagement or wrongdoings will put them at risk personally. This is called "piercing the corporate veil" in corporate law speak. The takeaway is that a business entity is considered another person that can absorb and protect the owners from personal liability, unless the owners begin exploiting the rights of the entity. If this happens, the reality is that the entity is simply just a shell or a veil over the owners themselves.

"Like people, the business entity has rights and duties. Its rights include the ability to enter contracts, possess property, and sue and defend itself–all in the name of the entity."

How is a business entity governed?

State statutes control the way each business entity is created and governed, including the default sole proprietorship and general partnership. When it comes to business decisions and actions, the business entity itself can define its own rules through organizing documents such as the bylaws, a partnership agreement or an operating agreement. The business's own rules will prevail as long as the rules are in line with the baseline requirements of the state statute. Accordingly, each business entity may have a different baseline in terms of the rights, privileges or responsibilities for the business and its owners. Choosing the entity that matches the farm operation owners' goals can help bring everything into alignment.

Do I have to choose an entity?

Technically, a farm operation does not have to officially choose an entity. Farmers can certainly start selling their products without officially creating an entity. Of course, certain licenses and registrations may need to be obtained, but that can be done in the name of the owner(s) personally. If a farmer does nothing more, the farm operation will effectively be treated as a default entity–a sole proprietorship if one owner, a general partnership if multiple owners. (Although unlikely, an unincorporated nonprofit may be the default if the primary purpose of the farm operation is a nonprofit, social cause.)

Choosing not to form a formal entity is not necessarily a bad or wrong option. It takes time, money and willingness to follow certain formalities. Farmers unwilling to provide these resources might be better off managing risks in other ways.

Regardless of the ultimate decision, it can be helpful to go through a deliberate decision-making process of fully reviewing and understanding the pros, cons, benefits and risks of officially forming a formal entity or decisively electing to be a default entity. Occasionally, a bank, financial institutions or a regulatory agency may urge a farm operation to become one or another formal entity. It's good to get the facts up front and to make a conscious decision based on your unique farm operation.

> "If a farmer does nothing, the farm operation will effectively be treated as a sole proprietorship if one owner, or a general partnership if multiple owners."

What are the benefits of forming a formal entity?

While forming a formal entity, such as a C corporation, LLC, cooperative, or nonprofit, or electing S corporation tax status can take time and money and require certain formalities, these efforts come with privileges. The most significant benefit of a formal business entity is that the owners' personal assets are protected from the business's liabilities. This means that if the business incurs debt and is not able to pay its bills, or if it is sued for some wrongdoing, the owners' personal assets–such as vacation homes, land, boats, wages, individual bank accounts, etc.–cannot be touched by creditors or the courts to pay off the business's debts. Formal business entities offer business owners a sense of relief. Basically, their risk is limited to the amount that they invested in the company. No more, no less.

With that said, the business entity must abide by certain formalities to maintain this protection. This includes keeping the business's financial affairs separate from the owners' individual affairs, namely by keeping separate bank accounts and accounting

> "The most significant benefit of a formal entity is that the owners' personal assets are protected from the business's liabilities."

systems. In addition, the owners must ensure that the business is adequately capitalized, which means that the business can't recklessly spend money and live extravagantly outside its means in hopes that the owners will be protected. Such conduct undermines the integrity of the business entity and, in effect, the courts could use the owners' personal assets to cover the business's liabilities.

Another benefit of having a formal business entity is that the formalities themselves actually promote good business practices. For example, by having separate bank accounts, the business may maintain more accurate and diligent accounting, which may save money and identify opportunities for expansion. In addition, a well-thought-out organizing agreement will foster better communication and understanding as everyone will share similar expectations even through challenging times.

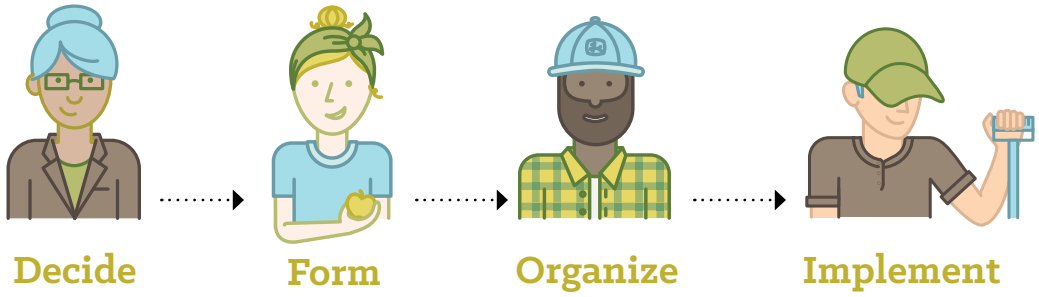
"Another benefit of having a formal business entity is that the formalities themselves actually promote good business practices."

A formal business entity can help a business raise funds from outside investors. This includes obtaining loans from banking institutions as well as seeking investments from wealthy individuals like venture capitalists and angel investors. Institutions and investors often prefer a stable entity that carries legal protections. In addition, the formal business structure assures them that the owners are operating the business with integrity, and thus their funding support will be taken seriously and is less likely to be frittered away. Farm owners who anticipate needing a significant amount of funding from the outside should consider this factor when deciding which business entity is right for their goals.

On the other hand, traditional farm lenders such as the USDA Farm Service Agency may occasionally raise concerns about farm businesses organized as LLCs or corporations. These concerns can usually be resolved by working with the lender to show the entity reflects the same fundamental organization as the sole proprietorship or general partnership with the additional benefits of a formal entity.

Finally, a formal business entity can ease the transition process of the farm operation. Succession planning is a huge issue that farmers face. Having a formal business entity provides the opportunity to set clear ground rules and processes for how the transition will take place. A formal entity creates a useful way to transfer the business as a whole rather than individual assets. It can also provide more favorable tax benefits. For example, if the farmland is placed in ownership of a formal business entity such as an LLC or a C corporation, it may be insulated from higher estate taxes if the heirs are properly named as owners of the entity itself.

How is a formal business entity created?



Decide

This can seem daunting at first; there are just too many entities to choose from. However, considering just a few factors will automatically narrow down your options. The following entity comparison chart reviews basic legal issues and implications associated with the various business entities. Turn to Chapter 2 for a user-friendly flowchart. Just answer a few questions and you will identify the best place to start. If you are lucky, the entity will choose you!

Decide: Turn to Chapter 2 for a user-friendly flowchart. Just answer a few questions and you will identify the best place to start.

Don't stop at the flowchart. The detailed chapters on each of the entities that follow provide incredibly important, detailed information on the structure and nature of the entity. Read the chapter corresponding to the entity that chooses you in the flowchart exercise. These chapters also contain supplemental materials including checklists and sample organizing documents to help walk you through the steps in forming that particular entity.

Before taking any action, be sure to read chapter 10 on anti-corporate farming laws. Certain Midwestern states have laws that affect a business's ability to own or control farmland and farm businesses. You'll need to confirm that your plan doesn't violate an anti-corporate farming statute if you live in one of these Midwestern states.

Certain Midwestern states have laws that affect a business's ability to own or control farmland. Review Chapter 10 on anti-corporate farming laws to confirm your plan doesn't violate an anti-corporate farming statute in your state.

We also strongly recommend working with an accountant or tax professional before taking any action. Businesses overall come with very specific tax and accounting issues with varying complexities. These financial issues should not be handled in isolation. While this Guide provides some information about tax issues to get a person started, this Guide does not serve in any way as tax advice. Tax matters are very specific to individual factors, including the farm's specific operations, the owners' financial situation and the entity chosen. This Guide does not address state tax issues at all. Obviously, state tax matters are still a vital consideration.

Need to know more about accounting and farm financial management? Check out *Fearless Farm Finances*, available from the Midwest Organic and Sustainable Education Service at mosesorganic.org.

An accountant's input early on is an investment in later efficiency. An accountant or tax professional can really help with the process of setting up the business, such as creating spreadsheets and financial tracking mechanisms. Good accounting practices and systems can provide insight into the business, help eliminate bad debt, manage cash flow issues, create favorable tax strategies and ease the processes of payroll and maintaining profit and loss statements, to name a few.

Once you've confirmed your business entity selection is right for your farm operation and is not counter to any anti-corporate farming statute, you'll next need to pull the rest of your team together to generate consensus. The team members may include your spouse, business partners and any potential investors.

An attorney can be another key team member. The attorney's role will be to confirm that your selection of business entity is most suitable for your farm operation based on your state's business entities laws. Again, each state has a specific statute for each type of entity. These statutes vary from state to state. Each one may have fewer or more restrictions on types of ownership and decision-making power and fewer or more requirements on upholding certain formalities, among other factors. Working with an attorney who is familiar with your state's business entities statutes provides assurance that your choice is wise and your business organization documents will be upheld.

Form: The next step is actually forming the entity in your state. This step involves preparing a formation document and filing it with the state agency responsible for business registration.

Form

Deciding on a business entity is just the first step. The next step is actually forming the entity in your state. (Or, if you've chosen a default entity, the next step is to do nothing!) This step involves preparing a formation document. The formation document is either called the "articles of incorporation" (C corporation, B corporation, cooperative or nonprofit corporation) or the "articles of organization" (LLC). This document is filed with the state agency responsible for business registration, which is usually the state's secretary of state office. It typically requires a fee that varies based on both the state and the specific entity. The fee can range anywhere from $40 to $1,000. The filing fee, as well as any required annual maintenance fees, can be a huge factor in which entity to choose. Be sure to look into this thoroughly before filing.

Once the articles are filed and approved, the business entity is recognized as official. The chapters on each of the business entities provide detailed explanations about the formation process.

Federal recognition of distinct business entities for tax purposes
Business entities are traditionally the responsibility of the states. The entity is created at the state level, and the state's statutes govern baseline operating rules. But, the Internal Revenue Service (IRS) still needs to tax the enterprise. The IRS' tax classifications may be slightly different than the state's entity classifications.

For example, an LLC or corporate entity may want to be classified as an S corporation with the IRS. Or, a nonprofit may want classification as a 501(c)(3) nonprofit organization. In addition, certain farmer cooperatives or consumer cooperatives selling agricultural products are eligible to receive special tax benefits if they meet specific IRS requirements outlined in the federal tax code. We provide enough information to help farmers get a sense of the IRS' expectations for each business entity. But again, farmers will need to work with an accountant or tax preparer for advice on tax matters.

Organize

Creating the organizing document

An organizing document defines how the business entity will operate. While the formation document is always required, the organizing document may be optional depending on your entity. In addition, while the formation document must be filed with the state, the organizing document does not. It is a private document that principally serves as a contract between and among the owners.

Organize: An organizing document defines how the business entity will operate. It may be optional depending on your entity.

What's in an organizing document

The organizing document prescribes the decision-making procedures, roles, responsibilities and other administrative matters for running high-level operations of the business. This includes: How is voting determined? Who has a say on big issues such as selling a significant amount of the business's assets or closing the business entirely? When are major meetings held? Can new owners be brought on and, if so, what is the process? What happens if a business owner wants to leave or dies suddenly? What happens if the business voluntarily or by force has to close? How is the business valued?

Day-to-day matters such as budgeting procedures, production standards and quality parameters are not usually included in an organizing document. Most businesses choose to write these issues into separate policy documents, which they write at the same time as the organizing document itself. Policy documents are kept separate, so they are a bit easier to modify as the business evolves. The organizing document is written to be modified rarely, if at all.

ORGANIZING DOCUMENT BY ENTITY

Entity	Organizing Document	Required?
Sole Proprietorship	None	Not required
General Partnership	Partnership Agreement	Not required
Non-Associated Nonprofit	Bylaws	Not required
LLC	Operating Agreement	Not required in most states*
C Corporation	Bylaws	Required
B Corporation	Bylaws	Required
Cooperative	Bylaws	Required
Nonprofit Corporation	Bylaws	Required

*LLC operating agreements are not required except in California, New York, Missouri, Maine and Delaware. New York is the only state that requires operating agreements to be in writing.

"Going through the process of creating an organizing document helps business owners kindly and judiciously address important matters that can, and indeed have, quickly ruined a farm business."

What are the benefits of an organizing document?

Most new business owners are optimistic and eager to build their farm business. Even thinking about worst-case scenarios like the death of a partner seems like a waste of valuable time. However, thinking through the worst cases is much better at preventing horror stories from developing than sticking one's head in the sand.

Going through the process of creating an organizing document helps business owners kindly and judiciously address important matters that can, and indeed have, quickly ruined a farm business. The process of deeply thinking through such matters can really help build trust and understanding between the owners and enhance a relationship built on respect and shared objectives. And, if a dispute were to arise, the organizing agreement can assure a quick resolution if it outlines responsibilities and resolutions. Mediation, arbitration and dispute resolution committees can all help businesses get back on track after a problem develops. But,

these mechanisms are much easier to put in place before a problem ever occurs.

Putting decisions in writing protects the memories and shared understanding of the founding owners and educates new owners about expectations. Writing it all down also helps to spot inconsistencies and conflicts.

How do you get an organizing document?

The ultimate goal is to get a thorough, affordable and understandable document that addresses your farm's situation specifically. How is this possible? One option is to pay an attorney to do all of it for you. Getting a standard organizing agreement drafted will likely cost around $1,000. Of course, the fees could be a lot higher depending on the complexity of the operation and the going legal rates in your region, especially if you are near an urban center. The base amount is for a pretty standard, boilerplate agreement. It may be great and serve many of the beneficial purposes outlined above. On the other hand, you may not really understand what it all means, and at a cost of $1,000, it still may not be affordable for many small farm operations.

You can start doing some of the legwork yourself by pulling together a draft organizing document. Checklists and samples of organizing documents are included in this Guide as tools to walk you through the process.

Another option would be to get a form from the library, through a quick internet search, or from a friend. This may seem appealing; all you have to do is swap out the names. While this may be the most affordable option, it will certainly not be catered for your specific farm operation. Also, there's no guarantee of the quality or thoroughness. Most likely, it will simply serve as a bare-bones skeleton and will not provide many of the benefits that a well-thought-out, written agreement can provide as listed above.

A third option, and the one for which this Guide advocates, is to educate yourself on the key aspects of an organizing document. This Guide can help you with that. Checklists and samples of organizing documents are included as tools. The checklists will walk you through a series of questions. Once you have your answers, one option is to start doing some of the legwork yourself by pulling together a draft organizing document. For this step, you can turn to the sample organizing documents included in the Guide, which contain provisions that you can draw from to develop an operating agreement that is best suited for your farm operation. The annotations include alternative provisions for a variety of scenarios. Keep in mind that these sample agreements are not boilerplates, as they were written with a particular farm operation in mind. Yours should be different.

Farm Commons strongly urges you to find an attorney who can help you draft,

finalize or review the organizing document. Interview the attorney and let them know you have done your homework. Ask them about their pricing and try to get a sense of their willingness to work with you to keep your costs down. Many attorneys out there are very sensitive to such requests.

"Farm Commons strongly urges you to find an attorney who can help you draft, finalize or review the organizing document."

Either way, it is very important to have an attorney review and finalize your work. This is primarily because organizing documents must comply with the baseline requirements set forth in the state statutes. The requirements vary from state to state. If your organizing document is in conflict with state law, it may be deemed void and unenforceable if an issue or dispute were to arise. In that case, all your effort would be futile.

Despite many farmers' inherent skills in problem-solving, it can be challenging to create a consistent organizing document where none of the provisions conflict with each other. If two provisions conflict, it only creates confusion. Which provision applies? All that effort and intention to set clear expectations among the owners goes out the window. An attorney can help assure you that your organizing document has no internal conflicts.

While doing some or all of the legwork yourself takes more time, it will be less expensive than paying an attorney to do it all. In addition, you'll reap the added benefit of gaining a lot of knowledge throughout the process. You'll know exactly how your business operates.

Implement: Keep the business's financial affairs separate from the owners' financial affairs; adequately capitalize the entity; file annual fees; obtain required licenses and registrations; keep up to date on tax filings; and so on.

Implement good business practices

All formal business entities have to uphold certain formalities and best practices to maintain the entity's integrity. Otherwise, all the benefits of having an entity, such as special tax treatment and protection of the owners' personal assets from the business's liabilities, could be taken away. Primarily, this includes keeping the business's financial affairs separate from the owners' financial affairs, including maintaining separate bank accounts, credit cards and accounting systems. In addition, the business entity must not recklessly spend money and incur a lot of debt, otherwise courts could determine that the entity is undercapitalized and use the members' personal assets to cover the business's liabilities. Implementing good business practices also includes filing annual fees, obtaining required licenses and registrations, keeping up to date on tax filings and so on. The default entities–the sole proprietorship, general partnership and the unincorporated nonprofit association–must also uphold such good business

practices. Each chapter on a specific entity has an *Implementing Good Business Practices* section that explains each of these requirements and practices in more detail.

How to use this Guide

The objective of this Guide is to help farmers decide which entity is best for their farm operation and to then take steps to actually form and uphold that entity. Ultimately, this Guide encourages farmers to be resourceful and do some of the legwork themselves. Not only will this save money in professional fees for attorneys and accountants, it will also equip the farmer with key knowledge on how to run a successful business. This Guide is organized to help you along the four-step path: Decide, Form, Organize and Implement.

Decide

The next chapter provides two tools to help farmers actually decide which business entity is best for their farm operation: *Entity Comparison Chart* and *Choose Your Entity Flowchart*. These charts will help farmers narrow down the options based on certain factors or characteristics of the business entity.

Decide: See the *Entity Comparison Chart* and *Choose Your Entity Flowchart* in Chapter 2 to help you narrow down the options and decide which business entity is best for your farm operation.

Part 2 of this Guide includes chapters on each of the main entities: sole proprietorship and general partnership, LLC, C corporation, S corporation, B corporation, cooperative and nonprofit (incorporated and unincorporated). Once you have narrowed down your choices by using these charts, the next step is to review the entity-specific chapter or chapters (if you're still narrowing it down from two or three options). These chapters can help you affirm your decision by giving you a more thorough understanding of the characteristics, benefits and drawbacks, and requirements for that particular entity.

Before finalizing a decision, farmers should consult the *Special Issues* section. Farmers in certain states, farmers with diversified operations and farmers forming a multi-farm venture should review these chapters for additional decision-making considerations.

Form

With an initial decision in hand, farmers need to know what it takes to form their chosen entity. How does a person set up the entity? What documents need to be filed and with whom? Many farmers choose the LLC or the corporation (generally

Form: See the *Going Deeeper* sections in the LLC and C corporation chapters, which include checklists to walk you through a step-by-step process for forming these business entities.

taxed as an S corporation with the IRS). The *Going Deeper* sections in the LLC and C corporation chapters include even more materials, such as a checklist on creating an LLC and a checklist for creating a C corporation. These checklists walk through a step-by-step process to help farmers form these particular business entities.

Organize: See the entity-specific chapters for steps required to organize the entity. See also the *Going Deeper* sections of the LLC and C corporation chapters for sample organizing documents.

Organize

The entity-specific chapters also outline the steps required to organize the entity. Primarily, this includes creating the organizing document–or the bylaws, partnership agreement or operating agreement. Again, the *Going Deeper* sections of the LLC chapter and the C corporation chapters include more extensive tools, including sample organizing documents and checklists for creating an organizing document. The organizing step also includes setting up the management structure, such as appointing a board of directors or managers, depending upon the entity. This step is discussed in the entity-specific chapters. For the LLC and the C corporation, these steps are further detailed in the Creating an LLC Checklist and the Creating a C Corporation Checklist.

Implement: Each entity-specific chapter includes an *Implementing Best Business Practices* section to help you maintain your entity.

Implement

Finally, each of the entity-specific chapters includes an *Implementing Best Business Practices* section, which highlights the requirements and best practices that are specific to that entity.

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Farmers' Guide to Business Structures:
LLCs, Corporations, Partnerships and More

Chapter 2: Understanding the Options

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DISCLAIMER: This Guide does not provide legal advice or establish an attorney-client relationship between the reader and author. Always consult an attorney regarding your specific situation.

Introduction

This section provides farmers with tools to help choose the best business entity for their farm operation: Entity Comparison Chart and Choose Your Entity Flowchart. Consciously choosing an entity is the first and probably most important step in running a successful farm operation.

These charts will help farmers narrow down the options based on certain factors or characteristics of the business entity.

Warning: Are you already a corporation?

If you are already a corporation, don't do anything until and unless you consult a tax professional. There can be serious tax implications when changing to another entity. While it can still be useful to go through the process of determining the best entity for you, if you decide on another entity, be sure you consult with your accountant or tax attorney before switching.

Entity Comparison Chart

		LLC	C Corp	B Corp	S Corp	Cooper-ative	Non-Profit	Sole Propri-etor	General Partner-ship
Formalities and Structure	Organizing document is required		✓	✓	✓	✓	✓		
	Annual meetings are required		✓	✓	✓	✓	✓		
	One owner is okay	✓	✓	✓	✓			✓	
Benefits	Can sell or transfer entity to others	✓	✓	✓	✓	✓			
	Personal liability is protected	✓	✓	✓	✓	✓	✓		
	Owners can make a profit	✓	✓	✓	✓	✓		✓	✓
	Can prioritize a social purpose over making profits	✓		✓	✓	✓	✓	✓	✓
Tax Implications	Entity does not have to pay taxes (pass-through)	✓			✓			✓	✓
	Potential self-employment tax savings				✓				
	Potential to be tax exempt						✓		
	Potential for donors to receive a tax deduction						✓		
	Potential for favorable tax deductions on business entity's earnings					✓			

Choose Your Entity Flowchart

So you are thinking about creating an entity? *Start here.*

Are you comfortable never being able to sell the farm business at a profit?

YES

Are you okay with having separate personal and business bank accounts and doing paperwork to protect your personal assets from liability and to gain some tax benefits?

NO

Proceed to next page

NO

Are at least two individuals involved?

YES

You may be recognized in your state as an **Unincorporated Nonprofit Association.** Note that some states require that at least three individuals are involved to get this status. So be sure to check your state's laws.*

NO

You might consider joining forces with an existing nonprofit that is aligned with your cause.

YES

Is your farm operation dedicated exclusively to a nonprofit cause that benefits the general public, such as education or scientific advancement?

NO

YES

You might consider forming a **Nonprofit Organization** in your state. However, to get the tax benefits of a 501(c)(3) nonprofit you'll have to file an application separately with the federal government, and you must meet certain tests. So let's start with a few questions:

Commerciality Test: Do the vast majority of activities you engage in serve your nonprofit cause (e.g., education, charity) without competing with for-profit companies? Even though selling fresh farm food to people may seem like a good cause, you're competing with businesses. If that's your cause, you won't meet this test.

Public Support Test: Do you expect that one-third of your revenue will come from public support such as donations from the general public and/or grants from government agencies or foundations (i.e., not from sales of products or services)?

YES

If you said YES to both tests, you'll most likely qualify as a **501(c)(3) nonprofit**. You'll have to file Form 1023 with the IRS and pay a processing fee of $400 or $800 depending on your anticipated annual gross revenues. The process can take up to six months. If this is too long to wait, you may need to consider another path. Also note that you'll still have to pay taxes on any profits you make that are unrelated to your stated public benefit.*

NO

If you answered NO to either test, then it's likely that you won't qualify for the 501(c)(3) tax exemption status. You can still be incorporated as a nonprofit organization in your state, which could be good for publicity, but you won't get any tax benefits and anyone that makes a donation won't get a tax write-off. You may want to consider another entity. **Proceed to next page.**

*Now that you have an idea about what entity might work for you, read more about it in our Guide. Don't forget to review Chapter 10 on anti-corporate farming laws as well.

Okay, so a nonprofit isn't right for you.

Many more entities are out there to choose from.
The following questions will help guide you to the best fit.

Are you okay with having separate personal and business bank accounts and doing paperwork to protect your personal assets from liability and to gain some tax benefits?

YES

Do you plan to seek funding from venture capitalists or to "go public" (meaning selling shares to the public)?

YES

Consider forming a corporation and following regular taxation (often called forming a **"C Corporation"**). Venture capitalists tend to prefer the C corporation structure, and it is required if you ever do a direct public offering.*

NO

Are you the only individual involved?

NO → **Proceed to next page.**

YES

Will you make more income than the average farmer in your situation? If so, you may be eligible to reduce your self-employment (SE) tax for business income above and beyond an average farmer's income. Would you like to take advantage of this?

YES

Consider forming an **LLC AND electing S Corporation status** with the IRS. An owner of an S corporation must designate a reasonable amount of income to wages and may designate the remainder to distributions, which are taxed at a lower dividend income tax rate.

NO

Consider forming an **LLC**, which will still allow you to protect your personal assets from liability. You'll simply file individual tax returns as if you were a sole proprietorship.

You'll be recognized in your state as a **Single Member LLC**.*
Skip the next page and proceed to Member-Managed or Manager-Managed.

NO

Then it's best not to officially form an entity. You'll be recognized as a **Sole Proprietorship** (if it's just you) or **General Partnership** (if it's more than you). Each individual involved will be subject to self-employment (SE) payroll tax on most of the net business income.*

*Now that you have an idea about what entity might work for you, read more about it in our Guide.
Don't forget to review Chapter 10 on anti-corporate farming laws as well.

Is your business inspired by a social purpose, such as increasing local food security or promoting health, more than by maximizing profits?

YES → Consider forming a **Benefit Corporation (B Corporation)** if it exists in your state. If not, you could form an LLC and follow steps to become a **Certified B ("Benefit") Corporation.***

NO ↓

Is one member, one vote important to you?

NO → Do you have multiple classes of members?

YES → Do you plan to offer certain benefits to your members, such as discounts, and to distribute profits or surplus revenues based on the usage rates of your members versus ownership interests?

NO ↓

Do you have multiple classes of members?

YES → Do you plan to offer certain benefits to your members, such as discounts, and to distribute profits or surplus revenues based on the usage rates of your members versus ownership interests?

NO ↓

Do you have more than 100 members?

YES → Do you plan to offer certain benefits to your members, such as discounts, and to distribute profits or surplus revenues based on the usage rates of your members versus ownership interests?

NO ↓

Are any of the members a for-profit business entity or an individual that is not a U.S. citizen?

YES → Do you plan to offer certain benefits to your members, such as discounts, and to distribute profits or surplus revenues based on the usage rates of your members versus ownership interests?

NO ↓

Are you willing to follow formalities, such as holding an annual meeting and filing an information form with the IRS each year?

NO → Consider forming an LLC, which will still allow you to assign one vote to each member and to protect your personal assets from liability. The members will pay taxes on the distribution of profits they receive from the LLC.* **Proceed to next page.**

YES ↓

Would you prefer not to be taxed at the high self-employment (SE) tax rate for all of your business income?

NO → Consider forming an LLC, which will still allow you to assign one vote to each member and to protect your personal assets from liability. The members will pay taxes on the distribution of profits they receive from the LLC.* **Proceed to next page.**

YES ↓

Consider forming either an **LLC AND electing S Corporation status** with the IRS or a **C Corporation AND electing S Corporation status** with the IRS (often called "forming an S corporation"), which allows non-wage income to be taxed at a lower rate.*

S Corporation: LLC or C Corporation? The IRS allows you to elect S corporation status if you are a C corporation or an LLC. Your decision here is based more on personal preference than a legal recommendation. The LLC offers more flexibility in management structure, and filing costs are often cheaper. But some farmers feel more comfortable with the traditional C corporation. It's entirely up to you!

If you go with an LLC, you'll next need to decide how to structure it. **Proceed to next page.**

YES → Consider forming a **Cooperative**. The members pay taxes on the surplus revenues they receive as income from the cooperative.*

*Now that you have an idea about what entity might work for you, read more about it in our Guide. Don't forget to review Chapter 10 on anti-corporate farming laws as well.

LLC: Member-Managed or Manager-Managed?

Now that you've decided on an LLC, you'll need to decide how to structure it. To do so, answer this: Will either you or other individual(s) of your choice make all the day-to-day decisions without having to check in with all the members of the LLC?

YES

Consider electing the **manager/management LLC structure**, which allows the appointed manager(s) to run the day-to-day operations of the business. The members will vote on "big" decisions, as determined by your operating agreement or state statute (if you choose not to create an operating agreement).

NO

Consider the **member/management LLC structure**, which allows all members of the LLC to make decisions about how to run the business. This is generally the default in most states.

Next Steps

The section that follows includes chapters on each of the main entities: sole proprietorship and general partnership, LLC, C corporation, S corporation, B corporation, cooperative, and nonprofit (incorporated and unincorporated). Once you have narrowed down your choice by using the above charts, the next step is to review the entity-specific chapter (or chapters if you're still narrowing it down from two or three options). These chapters can help you affirm your decision, as they will give you a more thorough understanding of the characteristics, benefits, drawbacks and requirements for that particular entity. These chapters also include detailed information and tools such as checklists and sample agreements to guide you through the process of forming, organizing and implementing your business entity of choice.

*Now that you have an idea about what entity might work for you, read more about it in our Guide. Don't forget to review Chapter 10 on anti-corporate farming laws as well.

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Farmers' Guide to Business Structures: LLCs, Corporations, Partnerships and More

Part 2: Getting Into the Details

Chapter 3. Sole Proprietorship and General Partnership Fundamentals
Chapter 4. Limited Liability Companies (LLCs)
- Section 1: LLC Fundamentals
- Section 2: Going Deeper Into LLCs

Chapter 5. C Corporations
- Section 1: C Corporation Fundamentals
- Section 2: Going Deeper Into C Corporations

Chapter 6. S Corporation Fundamentals
Chapter 7. B Corporation Fundamentals
Chapter 8. Nonprofit Fundamentals
Chapter 9. Cooperative Fundamentals

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Chapter 3: Sole Proprietorship and General Partnership Fundamentals

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AT-A-GLANCE CHART: SOLE PROPRIETORSHIP AND GENERAL PARTNERSHIP

General Concept	Sole Proprietorship	General Partnership
Name	"Your Name," unless register a different "DBA" (doing business as) name	"Your Name," unless register a different "DBA" (doing business as) name
Owners/investors are called	"Owner"	"Partners"
Persons who make management decisions are called	"Owner"	"Partners"
Creation document is called	None	None
Organizing document is called	None	"Partnership agreement" (optional)
An owner's investment in the company is called	"Contribution" or "investment"	"Contribution" or "investment"
An ownership share is called	Not relevant—sole owner owns all	"Ownership interest" or "equity"
A payment of the company's profits to the owners is called	Not relevant, as the personal assets and business assets are not separate. So all the profits that come in are one and the same.	"Distribution"
Is there personal liability?	Yes, there's no protection of personal assets from the business's liabilities.	Yes, there's no protection of personal assets from the business's liabilities.
How many participants can you have?	One	Two or more
Is an EIN necessary?	Not required	Not required
Who files the tax return?	Pass-through. Individual owner reports and pays taxes on the business's earnings when filing an individual tax return.	Pass-through. Partners each report and pay taxes on their share of the business's earnings when filing their individual tax returns.

Introduction

Sole proprietorships and general partnerships are the easiest business entities to set up and maintain. In fact, nothing is actually required to create them. You may already be operating one without even knowing it! For example, if you own your farm operation and you're not on an employer's regular payroll for the work you do, you are automatically a sole proprietor. If you and a friend or a group of friends are doing it together, you are automatically a general partnership. It may very well be that you want to maintain this simplicity and are not at all interested in officially forming a business entity. This chapter highlights some risks involved in keeping your farm operation as a sole proprietorship or general partnership, as well as what you can do to protect your interests along the way.

"The sole proprietorship and the general partnership are the default entities if you don't choose to officially form another entity."

Basic Characteristics of a Sole Proprietorship and General Partnership

Sole proprietorships and general partnerships are easy to create and manage

The sole proprietorship and the general partnership are the default entities if you don't choose to officially form another entity. If there's just one person involved, it's a sole proprietorship. If there is more than one person involved, it's a general partnership. You don't need to do anything to actively form it. For the most part, there are no filings and no paperwork.

If there's just one person involved, the default entity is a **sole proprietorship**. If there is more than one person involved, it's a **general partnership**.

However, some registrations, licenses and permits may be required. For example, if the farm operation wants to operate under a different name than the name of the owner(s), then it will need to file a name registration form with the county or state agency that manages what's called fictitious business names in your area. This is also called a "DBA" or "doing business as." In addition, most cities and many counties throughout the country require all businesses–even small farm-based sole proprietorships–to register and get a business license or a tax registration certificate. The local agency may also require the business to pay a minimum tax. Also, if the farm operation has employees, it must obtain an Employer Identification Number or "EIN" with the IRS. This is used for monitoring and paying required employment taxes. States may also require the farm business to get a seller's license before selling anything to the public, and the local planning board may require the farm business to have a zoning permit depending on the location of the farmland.

These are essentially simple forms that all businesses in a given area have to file. Other than that, the sole proprietorship or general partnership is ready to go.

The personal assets of the owners are NOT protected from the business's liabilities

Nothing good seems to come without a trade-off. This is the case here. Unlike with a C corporation or an LLC, the personal assets of the owner(s) of a sole proprietorship or general partnership are available to cover the debts and liabilities of the company. Basically, this means that if the farm business starts struggling and is not able to pay its debt, doesn't pay a supplier when the money is owed, or has to defend itself in a lawsuit brought by an employee, the creditor or court can legally come after the owners personally and grab hold of their assets. While bankruptcy laws for the most part protect primary homes, the creditors can most likely access personal bank accounts, cars, vacation homes, boats and other such things of value. Some folks think they don't have any assets, so it's fine. But, a court judgment–whether related to debt to a creditor or damages to a defendant–can extend to future owned assets, including wages. Basically, if the creditor has received a judgment from a court that you owe money, the creditor can file papers to have a portion of your paycheck garnished (taken or withheld) to pay off your debt. However, the creditor cannot take the part of your paycheck that you need to support yourself and your dependents.

> "Unlike with a C corporation or an LLC, the personal assets of the owner(s) of a sole proprietorship or general partnership are available to cover the debts and liabilities of the company."

The sole proprietorship provides no protection over personal assets

An example here will help illuminate this risk. Let's say that Judy runs a small dairy farm over the summer. The seasonal dairy farm has been mostly a hobby for her, as she loves taking care of the cows and loves making cheese. She's a school teacher, so the schedule is perfect for her. The farm itself is about two acres that she leases from her neighbor. It's located just down the road from her house that she bought just a year ago. She has another house in the city that she hasn't been able to sell yet. Judy mostly sells her cheese at the local farmers' market and to two local restaurants. She's been in business for about two years and has two Brown Swiss cows and two Jerseys. This summer Judy decided to hire a part-time volunteer to help her with the milking, as she wanted to focus her efforts on refining her cheese recipes. Her friend's daughter, Katie, was in town from college and was eager to help. Katie had some experience with milking cows, but it was years ago when she was a kid visiting her grandparents' farm. Judy encouraged

Katie to stick with the Brown Swiss until she got used to it, as the Jerseys were notorious kickers. One day, just two weeks into her volunteer gig, Katie got the guts to milk one of the Jerseys. Just as she finished and walked around back, the Jersey kicked her right in the chin. Ouch! Turns out she lost about five teeth and had to get reconstructive surgery of her jaw.

While Katie didn't make anything of it, when she was at the hospital filling out the paperwork, she reported that the incident occurred on Judy's farm while she was at work. Without her knowing, Katie's health insurance company did an investigation and filed a claim against Judy to recover the cost of the medical bills, which were $25,000! Judy didn't have that kind of cash, and she didn't have insurance to cover such a claim. Katie's insurance company was relentless and took her to court. After a long and drawn-out trial, the judge entered a judgment against Judy for the full amount of the medical bills. Meanwhile, the state department of labor started to investigate Judy's farm operation. It concluded that Judy failed to treat Katie as an employee, and it issued a fine and required her to pay back wages at the minimum wage rate and employment taxes.

"For general partnerships, not only are your personal assets available to cover the business liabilities related to your own actions, they also apply to commitments your partner(s) made."

In this circumstance, the court could put a lien on Judy's house in the city since it's no longer her primary residence. Also, the court could garnish a percentage of Judy's wages from her teaching job. If Judy had formed an LLC or a C corporation, these personal assets would have been protected from the business's liabilities. The reason this happened to Judy is because there's no distinction between the person and the business when it is a sole proprietorship. They are one and the same. On the plus side, the individual farmer is the business. Some farmers prefer the authenticity and integrity that comes with such a personal identity with the farm operation. However, this means that everything you have is vulnerable.

The problem is magnified for general partnerships

For general partnerships, not only are your personal assets available to cover the business liabilities related to your own actions, they also apply to commitments your partner(s) made. This means that individual partners have joint authority and joint liability. When it comes to authority, each individual can usually bind the whole farm business to a contract or other business deal. As for joint liability, each individual partner can be sued for—and required to pay—the full amount of any business debt. So if you have more personal assets than your partner, you are particularly at risk. Your only recourse may be to sue the other partners to recover their share of the debt. But if they have no money, doing so would be futile. Recall,

too, that a general partnership is the default entity and can be formed without you even knowing it. A court may decide, based on the fact that you have gone into business with another person, that you have a partnership over the farm operation's obligations.

Again, an example can be helpful here. Let's say that Joe and John are brothers and they've been operating an organic vegetable farm for the past decade on a 20-acre farm property that was handed down to them and their two sisters by their parents. They haven't been turning much of a profit, but they get by just fine. John is also a math professor at the local community college and makes a pretty good living on the side. He teaches mostly in the winter, so he's able to spend a significant amount of time on the farm during the growing season. John also has a mountain house and enjoys spending long winter weekends relaxing up there. Joe doesn't have a second job and just tries to live simply. Joe and John decide they should get a greenhouse so they can provide produce year-round. John puts Joe on the project and they agree that they have about $3,000 to spend on it. Joe goes online to do some research and gets a bit carried away. He chooses a 500-square-foot greenhouse that costs $30,000. The greenhouse company offers a three-year payment plan at a cost of $1,000 a month, including interest. The greenhouse arrives and Joe assembles it. John notices how amazing it is and thinks, wow, that's quite a greenhouse for $3,000. He doesn't think to ask Joe anything else about it.

Once the $3,000 budget is exceeded at month three, Joe stops making payments on the greenhouse. Six months go by, and after much warning, the greenhouse company files a claim in court. Ultimately, it gets a judgment against Joe and John, as the court concludes they were operating the farm business as a partnership. As such, Joe was authorized to purchase the greenhouse on behalf of the partnership, and John's assets are on the hook to cover the partnership's debts. The court puts a lien on the farm property. But, the farm property is also owned by their sisters, who are not part of the farm operation. The court finds out about John's mountain house and puts a lien on it to cover the debt. The court also garnishes a portion of John's wages from the community college. As you might imagine, John is quite upset with Joe. While he could sue Joe, it's not worth it because Joe doesn't have any personal assets. So, he must suck it up and pay for his partner's bad decision.

"A general partnership can be formed without you even kowing it. A court may decide, based on the fact that you have gone into business with another person, that you have a partnership over the farm's obligations."

Becoming a partnership without even trying

The example of Joe and John is quite the cautionary tale. Now, recall that a partnership is incredibly easy to form–so easy, in fact, you can accidentally form one. How can that happen? Read more about the risks of "accidental" partnerships in Chapter 12 (Joining Forces with Other Farmers–Legal Issues to Consider) to consider when a farm operation works with other farms.

There are ways to get around these concerns

While these concerns are real, and every farm operation that is operating as a sole proprietorship or general partnership should be made aware of them, they shouldn't be overstated. There are mechanisms to help protect the personal assets of owners that run sole proprietorships and general partnerships.

"Insurance should be the first line of defense, even if you have a business entity such as an LLC or corporation."

Insurance should be the first line of defense, even if you have a business entity such as an LLC or corporation. Second, many debts can be restructured or discharged through bankruptcy. This is not a solution; it's simply a fact. It's also worth noting that while other entities such as the LLC, C corporation and cooperative offer protection over the owners' personal assets, it's not absolute. If the owners do not uphold good business practices, such as properly capitalizing the entity, keeping personal assets separate from their business assets and keeping good accounting records, creditors can still go around the personal liability protection provided by the entity.

Preparing a Partnership Agreement for a General Partnership

Sole proprietorships do not have organizing documents. This would be rather futile–there's just one owner, so they get to make all the decisions for how to run the operation and don't need guidelines on voting and such. However, partnerships have the option to create a partnership agreement to outline the relationship. The partnership agreement allows the partners to establish the share of profits and losses that each partner will take, the responsibilities of each partner and what will happen to the business if a partner leaves. If a partnership agreement is not in place, or if it is not thorough, state partnership statutes will fill in the blanks and determine what rules govern in such scenarios. The benefit of having a partnership agreement is that you can decide what is best for your farm operation and your relationship, rather than relying on your state's fallback rules.

Key issues to consider and include in a partnership agreement

The following highlights some important topics that farmers should discuss with their business partners and ideally put into writing through a partnership agreement:

- **Contributions to the partnership.** It's essential that the partners decide and get in writing who's going to contribute what to the partnership, whether it's cash, property or services, as well as the ownership percentage each partner will have. So if John invested $60,000 and Joe invested $40,000, then John would have a 60 percent ownership interest.
- **Allocation of profits and losses.** The partners may have different financial needs and different ideas for how and when the company's profits are divvied up. Will profits and losses be allocated to partners in proportion to their ownership percentage in the farm operation? Who decides whether and how much of the profits are handed out to the partners as distributions versus being reinvested back into the farm operation? These financial issues are particularly important to resolve early on, as they have a tendency to cause a lot of internal dispute.
- **Partnership authority and decision-making.** Without an agreement, any partner can bind the partnership without the consent of the other partner(s). For example, if a partnership agreement was in place that required both partners to agree before entering a significant debt on behalf of the company, John would have further protection against Joe's poor decision to purchase the $30,000 greenhouse. There's no perfect formula for partnerships. You may, for example, want to require a unanimous vote for every decision. Or, if this seems too challenging, you can require a unanimous vote for major decisions and allow each partner to make minor decisions on their own. If this is the case, you'll need to set a parameter for what is a major and minor decision. For example, entering a debt for more than $10,000 dollars is a major decision.
- **Admitting new partners.** What if new partners want to come aboard? The initial partners should agree to a procedure that makes it easier when this issue arises.
- **Withdrawal or death of a partner.** For example, let's say that John wants to leave the partnership with Joe. This raises a lot of questions, including what the time frame is for him to receive a return on his investment in the

"The benefit of having a partnership agreement is that you can decide what is best for your farm operation and your relationship, rather than relying on your state's fallback rules."

farm operation or his share of the company. He likely won't want to just leave it all for Joe. So what assets might he expect to receive? How should the value of the business be determined in such a scenario? For example, if the farm operation was valued at $100,000 and John leaves, then he could expect to receive $60,000 in some form to reflect his 60 percent interest. If this is not all fleshed out in a partnership agreement, then the brothers may get snared in a serious argument.

- **Resolving disputes.** If you and your partner become deadlocked on an important issue, how is the issue resolved? Do you want to head straight to court? Oftentimes farm operations prefer an alternative dispute resolution, such as mediation or arbitration. The partnership agreement is the place to designate this.

While some of these issues are challenging, and most likely folks won't want to talk about them, it's best if partners take the time to work through them at the outset. Even if the state's default partnership laws would work fine, going through the process of creating a partnership agreement will help create shared expectations and clearer lines of communication as well as make things much easier should these challenging issues arise. Overall, a partnership agreement can help foster a stronger, more resilient farm business for the long haul.

Refer to the LLC chapter in this Guide for further guidance and resources

A model partnership agreement is not provided in this Guide, as most farm operations prefer the LLC structure if they're going to go through the trouble of creating an organizing document. The LLC is taxed the same way as the general partnership, and for all intents and purposes operates in a similar way. Also, the issues and contents of a partnership agreement and the LLC's operating agreement are very similar. If you decide to stick with a general partnership but decide to prepare a partnership agreement, refer to the chapter on LLCs (Chapter 4). Section 1 of the LLC chapter includes a thorough discussion on what issues should be included in an operating agreement, which is for the most part the same for a general partnership. Section 2 includes two sample LLC operating agreements–*Brief Operating Agreement for Married Couple Farm, LLC* and *Extensive Operating Agreement for Sun Sisters Farm, LLC*–as well as a checklist: *Preparing Your Farm's Operating Agreement*. These resources serve as helpful guides to preparing both an operating agreement and a partnership agreement.

"The issues and contents of a partnership agreement and the LLC's operating agreement are very similar."

Implementing Best Practices for Your Sole Proprietorship or General Partnership

Obtain required licenses and permits

As mentioned above, certain registrations, licenses and permits may be required for sole proprietorships and general partnerships. These include the DBA registration form with your state or county agency, should you choose to use a name other than the name of the owners. In addition, most cities and many counties require all businesses to register with them and get a business license or a tax registration certificate, which may also require the business to pay a minimum tax. Also, if the farm operation has employees, it must obtain an Employer Identification Number (EIN) with the IRS. This is used for monitoring and paying required employment taxes. States may also require the farm business to get a seller's license before selling anything to the public, and the local planning board may require the farm business to have a zoning permit depending on the location of the farmland. All these forms are pretty straightforward.

"Certain registrations, licenses and permits may be required for sole proprietorships and general partnerships."

File the proper tax forms with the IRS

Neither a sole proprietorship nor a general partnership is a separate tax entity. It is considered one and the same as its owners. This is what the IRS calls a "pass-through entity." In effect, the partnership itself does not pay any income taxes on the business's profits. Business income simply passes through the business to the owner(s). Each owner will report his or her share of the profits (or losses) on his or her individual income tax return. Basically, the farm operation's profits or losses are combined with the total tax situation of the individual owner(s). Partners may end up paying different tax rates depending on their overall financial situation or tax basis. While this is not a tax guide, the following provides a breakdown of the key tax forms that must be filed. This is not a comprehensive list of tax forms needed by a farm business, as other forms may be required depending upon employment and other issues. Be sure to talk with an accountant or tax attorney to confirm you are filing all the forms required based on your farm operation.

"The partnership itself does not pay any income taxes on the business's profits. Business income simply passes through the business to the owner(s)."

Sole proprietorship tax filings with the IRS

Individual owners must file Form 1040, "U.S. Individual Income Tax Return," along with any relevant schedules, which may include Schedule F, "Profit or Loss from Farming," and, if required, a separate Schedule SE, "Self-Employment Tax," to pay self-employment taxes.

"If the farm operation is run by spouses that meet the criteria of a qualified joint venture, or if they live in one of nine community property states, the spouses can choose to pay taxes as a sole proprietorship."

If the farm operation is run by spouses, there are other options. If the spouses meet the criteria of a qualified joint venture, or if they live in one of nine community property states, the spouses can choose to pay taxes on the farm business's income as a sole proprietorship. If this is the case, both spouses would need to elect the qualified joint venture status on Form 1040. The spouses would then need to file relevant schedules, most likely including Schedule F and, if required, a separate Schedule SE. Otherwise, the spouses would file as a partnership, which is explained below. It's best to consult with your tax accountant or tax attorney before making this determination and decision, as there are financial implications.

In addition, the individuals must make quarterly estimated tax payments to the IRS each year. Finally, you will need to be sure to comply with your state's income tax requirements.

Can a husband and wife operate a farm business as a sole proprietorship or do they need to be a partnership?

Note that if the other person is a spouse, it may still be considered a sole proprietorship. The IRS has a special test to help you answer this question, which is available online at the IRS website by searching for "Question: Can a husband and wife operate a business as a sole proprietorship or do they need to be a partnership?"

General partnership tax filings with the IRS

Tax filing requirements for general partnerships are similar to those for sole proprietorships. However, while the partnership does not have to pay taxes, it does have to file Form 1065, an informational return, with the IRS each year. This form sets out each partner's share of the partnership profits (or losses), which the IRS reviews to make sure the partners are reporting their income correctly. In addition, like the owner of a sole proprietorship, each owner of the general partnership must file their individual tax return, Form 1040, along with the required forms to report the business-related income, including, most likely, Schedule F and, if required, Schedule SE.

In addition, the individuals must make quarterly estimated tax payments to the IRS each year. Finally, you will need to be sure to comply with your state's income tax requirements.

"It's best to consult with your tax accountant or tax attorney to confirm that your tax and financial affairs are in order."

Again, this is not tax advice, and the tax forms listed here are not comprehensive for all farm operations. It's best to consult with your tax accountant or tax attorney to confirm that your tax and financial affairs are in order.

FARM COMMONS

SARE
Sustainable Agriculture Research & Education

Farmers' Guide to Business Structures: LLCs, Corporations, Partnerships and More

Chapter 4, Section 1: Limited Liability Company (LLC) Fundamentals

www.sare.org/guide-to-business-structures

DISCLAIMER: This Guide does not provide legal advice or establish an attorney-client relationship between the reader and author. Always consult an attorney regarding your specific situation.

AT-A-GLANCE CHART: LLC

	General Concept	Terminology
LLC-Specific Terminology	Name	"Farm Name, LLC"
	Owners/investors are called	"Members"
	Persons who make management decisions are called	"Managers" (if manager-managed); "Members" (if member-managed)
	Creation document is called	"Articles of organization"
	Organizing document is called	"Operating agreement"
	An owner's investment is called	"Capital contribution"
	An ownership share is called	"Percentage interest"
	A payment of the company's profits to the owners is called	Distribution
	Is there personal liability?	Limited to a member's capital contribution if LLC integrity is maintained.
	How many participants can you have?	One or more; can be other business entities or trusts unless elect S corporation tax status.
	Are annual meetings required?	Not required, unless elect S corporation tax status.
	Are different member classes allowed?	Allowed, unless elect S corporation tax status.
	Is an EIN necessary?	Required, unless you're a single-member LLC with no employees.
	Who files the tax return?	Pass-through is default (members file and report LLC's income on their tax returns); option to elect C corporation (entity files and reports LLC's income on Form 1120) or S corporation federal tax status.
LLC with S Corporation Federal Tax Status	How many participants can you have?	Maximum 100 people. Cannot be other business entities or trusts. All must be U.S. citizens.
	Are annual meetings required?	Required
	Are different member classes allowed?	Not allowed
	Is an EIN necessary?	Required
	Who files the tax return?	Pass-through; but, entity must file informational Form 1120S with the IRS, distribute Schedule K-1 to each member and file all Schedule K-1s with the IRS. Each member must report their share of business's income on their individual tax return.

Introduction

This section provides an overview of the limited liability company (LLC) entity. This section offers farmers a basic understanding of what it means to run a farm operation as an LLC. The following section, *Going Deeper into LLCs*, gives you some tools to help you navigate the process of creating and operating an LLC. It includes a checklist for creating an LLC, two sample operating agreements and a checklist for preparing an operating agreement. A fictitious story about three sisters who create Sun Sisters Farm, LLC is woven throughout this chapter to help explain some of the more complex legal scenarios and give you a better sense of some scenarios you should consider when forming and operating an LLC.

LLC Origins

An LLC is a separate and distinct legal entity. This means that unlike a sole proprietorship or general partnership, the law recognizes an LLC as separate from the individual(s) that run it.

> "The LLC has been gaining traction and is now one of the most popular entity choices for small businesses throughout the country."

Increasing popularity of the LLC

The LLC business entity has been gaining popularity over the past 35 years. Wyoming was the first state to create the LLC option way back in 1977. All 50 states and the District of Columbia have now authorized the organization of LLCs by enacting a state LLC statute. It took a while for the LLC to be generally accepted, mainly because it was not clear how the IRS would decide to tax the entity: As a corporation? As a sole proprietorship? Something else entirely? The IRS clarified its rules for LLCs in the late 1990s, allowing LLCs to elect the S corporation tax status. Ever since, the LLC has been gaining traction and is now one of the most popular entity choices for small businesses throughout the country.

The LLC was created to address a growing concern that individuals running sole proprietorships and general partnerships were personally exposed to liabilities related to their business. Before the LLC came about, becoming a corporation (either C corporation or S corporation) was the only option to protect the owner's personal liabilities. Yet the corporate structure, as we will get into later, is quite inflexible and can have unfavorable tax consequences for small business owners. The solution was to create the hybrid structure: the LLC. The LLC entity carries the

same flexibility and tax status as a sole proprietorship or general partnership while providing the same level of protection from personal liabilities as the corporation.

LLCs are now considered very stable business entities. Many of the same legal standards that apply to corporations in court are being applied to LLCs. For example, a concept like "fiduciary duty" (which involves determining whether an LLC owner acted in good faith and should therefore be protected from liability) is being applied to LLC owners the same way it is applied to a director or officer of a corporation. This continuity of legal principles between the comparatively new LLC and the time-tested corporation leaves most legal professionals comfortable recommending LLCs to their clients.

Basic Characteristics of the LLC

LLCs protect personal assets from business liabilities

One fundamental characteristic of the LLC entity is that it protects personal assets from business liabilities. For those who would like peace of mind in keeping the risks of their business separate from their personal assets, this is an advantage. The "members"–which is the LLC term for the business owners–are not at risk of losing personal assets if another person or business secures a court judgment against the member. The LLC members can, however, lose up to the amount they have invested in the company. The cash, property and other resources members give to the LLC is their investment, or in LLC lingo, their "capital contribution." Once a member transfers ownership of the cash or property, it is considered a contribution to the LLC. In effect, this capital contribution amount reflects each member's risk or stake in the business. No more, no less.

"The capital contribution amount reflects each member's risk or stake in the business. No more, no less."

We all know that, just like any small business, farm operations may not succeed. One season of unpredictable weather or out-of-control pests could lead to no profit or even a loss. If the farm doesn't turn a profit and uses up capital in the process, the members won't even get their capital contribution back. There's nothing left. Taking it a step further, let's say the business had taken out a loan to pay for some farm equipment and is no longer able to pay on its debt. It won't be long before the creditors come knocking on the farm business's door. However, given the LLC protects members from personal liability, the members do not have to worry so much that creditors will come knocking on their door and snatch up their lake house or their boat if the farm business starts going south. The creditor could still lay claim to any remaining farm LLC assets, but nothing more.

Capital contributions and percentage interest of the members

The capital contribution of each member can be cash, land, equipment, services, etc. However, be sure to see an accountant or your attorney if services are involved as that can lead to tax implications. If the LLC has one member, then that member will own 100 percent of the company. If there are multiple members, the company determines ownership shares or "percentage interest" of each member. The total value of all the capital contributions given by the members divided by the amount of each member's contribution reveals the individual member's shares. The percentage interest is significant, as depending on how you decided to structure your LLC, the percentage interest breakdown may determine voting rights and who ultimately has control over the company. See the LLC Operating Agreement Checklist for more details on making capital contributions. See the Story of Sun Sisters Farm, LLC for an example.

"The percentage interest is significant, as depending on how you decide to structure your LLC, the percentage interest breakdown may determine voting rights and who ultimately has control over the company."

Sun Sisters Farm, LLC story: capital contributions and percentage interest

Here at Farm Commons, we like to use stories to help illustrate confusing legal concepts. Throughout this section on LLCs, including the Extensive Farm Operating Agreement for Sun Sisters Farm, LLC, we'll often be referring to our story of the Sun Sisters Farm, LLC.

Jema, Ingrid and Marie are sisters who grew up with backyard gardens and an abundance of fresh fruits and vegetables. Each of them individually has always dreamed of starting a farm. Jema loves everything culinary and wants to cater to the local restaurants with fresh herbs and specialty items including heirloom vegetables, herbs and edible flowers. Ingrid is all about supporting the local community and wants to start a CSA. Marie has a keen business sense and currently runs a successful marketing company. She actually owns a beautiful 10-acre farm that she purchased 10 years ago with a dream of quitting her job and running a farm business. But it just hasn't happened and she can't do it herself. The property has a shed, a tiny two-bedroom farmhouse and about a half-acre fruit orchard. The rest of it is overgrown alfalfa.

The sisters meet up for Jema's birthday and get to talking about their shared dream of starting a farm business. They decide to go in on it together! They decide to form an LLC to provide liability protection. They file their

articles of organization and name their entity "Sun Sisters Farm, LLC." They then start drafting their operating agreement, first by discussing what their capital contributions will be. Marie decides she'll grant the LLC the title to her farmland as her capital contribution, valued at $45,000. Jema invests $30,000 in cash as her capital contribution. Ingrid offers one year of her farm labor as her capital contribution, which is valued at $25,000. Based on this, Sun Sisters Farm, LLC will have a total of $100,000 in capital. Marie has 45 percent, Jema has 30 percent and Ingrid has 25 percent percentage interest in the company.

With all that said, the LLC's protection from personal liability is not absolute. Hence the name *limited* liability company. If the farm business does not follow certain standards, then the courts can go around the LLC's personal liability shield and allow creditors to access the individual members' personal assets. Two essential ways to protect the members' personal assets are to adequately capitalize the LLC and to keep the LLC's financial affairs separate from the members' personal financial affairs. However, even if the LLC is properly maintained, some creditors may require members to personally guarantee farm debt. Also of note, the LLC's liability protection is not a substitute for insurance. We'll discuss each of these caveats on the LLC's liability protection in more detail now.

"Two essential ways to protect the LLC members' personal assets are to adequately capitalize the LLC and keep the LLC's financial affairs separate from the members' personal financial affairs."

Capitalize the farm operation LLC

Members may lose their personal liability protection if the company is undercapitalized. As a basic rule of thumb, a company is adequately capitalized if it can make due on its debts, or pay its monthly bills, so to speak. Anything less would be undercapitalized. In other words, if you start incurring more debt than you can reasonably pay off based on estimated revenue, your LLC will be considered undercapitalized. As a result, the members may be personally liable to cover the business's debt. The takeaway message is to be smart about how much debt you allow the LLC to take on. Good business planning and maintaining an accurate profit and loss statement are helpful ways to prevent undercapitalization of your company.

Sun Sisters Farm, LLC story: undercapitalization

For example, let's say that the members of Sun Sisters Farm, LLC decide they want to buy a brand new tractor with all the bells and whistles. They find one for $45,000. They've already blown all but $10,000 of the LLC's capital—$30,000 in cash—on various tools, a storage shed, seeds and soil

amendments. So, they decide to put all of their remaining $10,000 down and take out a three-year loan for $35,000 for the tractor using the farm property as collateral. The monthly payment plus interest works out to be $1,000 per month for the three years.

One month later, Jema and Ingrid decide they really need a greenhouse. They convince Marie to consider the idea. Jema calls up a contractor who is well known for building custom greenhouses. He draws up an elaborate plan. They all love it. He estimates it will cost $40,000 and offers them a flexible, interest-free payment plan for one year, after which he will charge 20 percent interest. They decide to go for it and sign a contract.

As you may have added up, the three sisters have created quite a bind for the LLC. The LLC now has no cash, and at best, they expect to make just $15,000 in annual profits in the first two years. There's really no way the company will be able to make due on these debts without incurring even more with hefty interest rates. The LLC is hugely undercapitalized as a direct result of the members' collective poor judgment. If the LLC fails to make its payments in time, the lender for the tractor loan and contractor for the greenhouse could sue to collect on the debt. A court would most likely conclude that Jema, Ingrid and Marie are each personally on the hook for the full amount. You can keep out of trouble by simply following good business judgment. In common sense terms, don't allow the LLC to bite off more than it can chew!

"Members must be sure not to commingle funds, such as draw on business assets to pay for personal expenses."

Astute farmers might realize they could avoid losing any investment in the farm by not investing anything in it. You can't lose capital if you don't contribute it, right? The reasoning is sound, but a farmer following that logic may expose his or her personal assets to the business's liabilities. If the farm needs capital to reasonably function, the members need to provide it to protect themselves.

Keep the LLC's financial affairs separate from the members' financial affairs

Courts are also able to access personal assets if the members fail to keep the business separate from their personal affairs. This includes commingling funds such as drawing on business assets to pay for personal expenses or not keeping separate business and individual bank accounts. Farmers accustomed to paying for household groceries and their feed bill with the same checkbook might find it awkward to keep two different payment methods at hand. On the other hand, many farmers benefit from two different bank accounts. The practice can make it

easier to assess the finances of the household separately from that of the business.

Of course, personal assets are available for personal liabilities. In other words, you cannot draw on business assets to pay your personal credit card debt, home mortgage or car payments. At the same time, business assets are available for business liabilities. The takeaway is to be sure to develop policies and systems for keeping your business and individual affairs separate, which include at a minimum having separate bank accounts, credit cards and accounting systems. Most importantly, be sure you follow the policies and systems you set in place.

Handling business and personal accounts

Just as business assets are available for business liabilities, personal assets are available for personal liabilities. Keep separate business and individual bank accounts, credit cards and accounting systems. Do not use the business's assets to pay your personal bills like credit card and rent payments.

LLC members might be required to personally guarantee farm debt

Let's not forget a few other factors that play out in the real world. First, creditors often require that individual owners of a business entity, in this case LLC members, personally guarantee obligations. Creditors know that if there's nothing left in the business there will be nothing left for them. This means that creditors may require the members to commit to loan payments as individuals, not just as LLC members. As a result, personal assets will be on the line even though the members took on the obligation to benefit the business. Members have to negotiate whether and to what extent a personal guarantee is required with creditors on a case-by-case basis.

"Forming an LLC is not a substitute for insurance."

LLCs do not substitute for insurance or reduce the likelihood of business liabilities

Finally, forming an LLC, or any business entity for that matter, is not a substitute for insurance. Some farmers mistakenly believe creating an LLC reduces the likelihood of liability. The name "limited liability" can be a little misleading. Creating an LLC does not change the landscape of a farm's potential liability. It only limits the assets available to satisfy a claim to business assets. All the farm's assets are entirely available to anyone with a successful claim against a farm LLC. Good liability insurance provides the farm with a defense in court and a source of funds to pay out on a successful court claim. Farm Commons strongly urges any farm business, no matter what business entity it adopts, to maintain adequate insurance coverage.

For more details on different farm insurance policies and the type of liability they cover, see Farm Commons' print resource, *Managing the Sustainable Farm's Risks with Insurance: Navigating Common Options*, which is available on our website.

"LLCs allow wide latitude in determining who has voting rights or control when big decisions are made."

LLCs are flexible

The second key characteristic of an LLC is that it allows for a lot of flexibility. Farmers and business owners in general take advantage of flexibility in three main areas: (1) determining voting rights and control, (2) allocating profits and losses, and (3) upholding formalities.

LLCs allow wide latitude in determining who has voting rights or control when big decisions are made. For example, you can establish multiple classes of members and say that some have voting rights and others don't. You could also determine that voting rights are based on percentage interest in the company, so that if one member has 55 percent percentage interest they will carry a majority in every vote. Or, you could say that every member has one vote regardless of the percentage interest breakdown.

LLC members have flexibility in deciding how to allocate profits and losses. Generally, farmers and business owners will allocate profits and losses in direct proportion to ownership, or "percentage interest" in LLC-speak. If two farmers have equal percentage interests, they split the profit (or loss) down the middle. When it comes to LLC law, you have freedom to set this up pretty much however you want. But when it comes to tax law, anyone looking to allocate losses out of proportion to percentage interest should understand the potential tax effects of the decision. So, if you want a creative arrangement, be sure you check with your accountant or tax attorney for more information.

For more on determining voting rights, see the *Checklist: Preparing for Your Farm's LLC Operating Agreement* and check out the *Extensive Farm Operating Agreement for Sun Sisters Farm, LLC* and the *Brief Operating Agreement for Happy Couple Farm, LLC* in section 2 of this chapter.

LLCs allow greater flexibility around formalities. Unlike corporations, state LLC statutes typically do not require LLCs to have elected members or hold annual meetings. Single-member LLCs are especially attracted to this flexibility. There's no need to hold a meeting and vote yourself in as the president, secretary, and treasurer! With that said, Farm Commons highly recommends that farm operations that form an LLC still follow some level of formality including holding annual meetings, assigning clear responsibilities, documenting decisions in writing, and establishing policies and procedures to ensure regular and clear communication. These procedures serve as evidence that you are, in fact, maintaining your business in a legitimate way, and will help prevent the court from reaching around the entity if allegations of improper play ever arise. In addition to these legal benefits, maintaining these formalities will help you maintain favorable relations with your members and make better business decisions, which will all help lead to a thriving farm business.

Ultimately, the flexibility that an LLC provides is often why farm operations prefer

this business entity structure over a corporation. As we'll see later, a corporation requires a more rigid structure and strict formalities.

For more details on when and how businesses allocate profits and losses, see the *Extensive Operating Agreement for Sun Sisters Farm, LLC* in section 2 of this chapter.

Forming an LLC

Now that we've provided some basic background and characteristics, we can dive into the process of creating an LLC. This includes filing the articles of organization and creating your operating agreement.

Choosing a name

Before you start the steps in creating an LLC, decide on a name for your farm operation. Choosing a name is a very important step. The name helps create an identity for your business, your product and your entire foodshed. But, it's also a legal consideration. Most states prohibit two businesses from registering the same business name in that state. In addition, if you choose the same name as another business already in operation, that business may demand that you stop using their name. Indeed, that business could have exclusive rights and protection to use the name under trademark law. If this problem comes up after your operation has been around a few years, changing your name will likely confuse customers. And it's sad to lose the name you've grown to love!

For more detailed information on each of the steps required for creating an LLC, see the *Checklist: Creating an LLC* in section 2 of this chapter.

Avoid potential legal problems by choosing a name that isn't already in use. First, check state and federal databases of trademarks and trade names. Generally, the state's secretary of state office will maintain a database of business names or "trade names," which will likely be searchable online. The United States Patent and Trademark Office (USPTO) has a searchable online database for registered federal trademarks. A basic internet search will point you in the direction of these databases. Although a farm should not automatically assume that federally registered names are unavailable, consider it a red flag. Be sure you get more information and even consult a trademark attorney before choosing a name already registered in the federal database. Finally, you may want to check if your preferred website address is available and even register that domain name. You can do a basic internet search for existing businesses with the same name. You can register your preferred domain name on websites like GoDaddy or DreamHost. Also of note, most state LLC statutes require that the name of an LLC include the words "limited liability company" or the abbreviation "LLC" and not have the terms "Corporation" or "Inc."

"Avoid potential legal problems by choosing a name that isn't already in use."

Who can create an LLC?

A basic question you may have is who can be a member of an LLC. Again, the LLC is quite flexible in this regard. An LLC can be created by a single person or multiple people. There are no restrictions on how many people may participate. Also of note, another business entity such as a nonprofit, another LLC, a trust or a corporation could be a member of an LLC.

What about married couples?

Married couples who live in specific states may choose to form their LLC with one member—the married couple as a single unit. This option is available to couples in states that adopt "community property" systems. The nature of community property is way beyond the scope of this Guide! To summarize, some married couples may want to form a single-member LLC for tax reasons. Married couples in community property states should talk with their accountant or tax preparer about the best option for their specific situation.

For more information on specific issues related to married couple LLCs, see the *Brief Operating Agreement for Happy Couple Farm, LLC* in section 2 of this chapter.

Preparing and filing articles of organization

The first step in formally creating an LLC is filing the "articles of organization." This is done at the state level, usually through the state's secretary of state office. Many states provide a form that can be easily downloaded or even filed online. Other states simply list the information required, in which case you can create your own document that includes this information. An internet search for "file an LLC and [your state's name]" should bring up a form and more information. Each state charges different fees, which vary from $25 to $1,000. Once your articles of organization and fee are filed and processed, you'll get a confirmation from the filing agency that your LLC is now recognized as an official business entity in your state.

Annual Fee: Note that most states also require an annual fee. It's a good idea to find out upfront whether your state charges an annual fee and, if so, how much. The amount of the fee may be a factor in your decision on whether to form an LLC.

Key terms for LLC articles of organization: registered agent and member-managed or manager-managed

Filing your articles of organization is typically a simple and non-technical process. However, there are a few terms you may not be familiar with. First is the "registered agent." This is basically the person who will receive "service of process," which is an official notice that the LLC is being sued. It does not in any way mean this individual is liable or responsible for the outcome. It simply means that the agent is required to pass on the notice to the other members

of the LLC so that the LLC is officially on notice. Some businesses select an LLC member to be the agent. Others choose to work with one of the many independent businesses that provide agent of process services for a fee. Second, the articles of organization will generally require you to specify whether your LLC will be "member-managed" or "manager-managed." Which one is your farm? It depends on who you determine has the authority to make day-to-day management decisions for the business (e.g., decisions related to managing employees, making small purchases, marketing and handling customer relations). If you want all members to make day-to-day decisions, you should designate member-managed. If you want only specific people to make those decisions, the farm must be manager-managed.

For more information on member-managed or manager-managed, see the *Checklist: Preparing for Your Farm's LLC Operating Agreement* in section 2 of this chapter.

Preparing an operating agreement

An operating agreement outlines how the LLC is to operate or run its business. The document usually is not filed with any government office–it is for the business's own use. As mentioned earlier, a lot of states do not require an LLC to create an operating agreement. However, even if it is not required in your state, Farm Commons strongly recommends that every LLC create an operating agreement. An operating agreement is a great choice for three reasons: (1) it helps safeguard the personal liability protection LLCs provide for individual members, (2) it lets your farm operation take advantage of the flexibility aspects of the LLC, and (3) it allows you to set more favorable ground rules in your relations with third parties. In addition, some lenders will require an operating agreement before making a loan to the farm.

"The operating agreement helps set the ground rules for how the members will manage and operate the company."

First, the operating agreement helps set the ground rules for how the members will manage and operate the company. When members operate the business in line with the written provisions of the operating agreement, a court is more likely to find that the members have earned the LLC's protection for personal assets. Also, when a written operating agreement is in place and it explicitly requires practices like maintaining separate bank accounts and accounting records, the members generally take these fundamental requirements of the business more seriously. This helps prevent the commingling of funds and other careless acts that could give a court grounds to go around the LLC and access the individual member's personal assets.

Second, if you don't have a thorough operating agreement, the detailed provisions in your state's LLC statute will step in as the default rules if a dispute arises between the members or with a third party. Your state's default rules may not be

preferable or suitable for your farm operation. In other words, creating a thorough operating agreement gives the farm operation the opportunity to write its own rules. By writing an operating agreement, farmers and business owners can take advantage of the flexibile aspects of the LLC entity that we discussed above.

Third, the operating agreement clarifies and governs relations with third parties. It may not seem to matter much if there are just a few members who all have a close working relationship. They could agree on how the LLC will operate in various conversations and that may seem good enough. However, if it's not written down in an operating agreement, it won't govern anyone else who wasn't a part of that discussion. For example, let's say one LLC member dies and bequeaths her membership to her daughter. If the prior agreements between the mother and other LLC members are written into an operating agreement, the daughter would have to follow the rules set forth in the operating agreement as well.

To reiterate, the LLC business entity provides business owners or members a lot of flexibility on how they want to structure their operation. When thinking about your operating agreement, use your imagination and really think about what would be ideal given the interests and objectives of your farm operation. One way of thinking about an operating agreement is to imagine all the contingencies or worst-case scenarios and then figure out how you'd want each scenario to be handled.

"One way of thinking about an operating agreement is to imagine all the contingencies or worst-case scenarios and then figure out how you'd want each scenario to be handled."

The *Checklist: Preparing for Your Farm's LLC Operating Agreement*, which is in the following section of this chapter, provides a helpful guide in walking you through some of these scenarios. Issues that you can address in your operating agreement include: How are big decisions handled, like whether to buy a major asset or sell the farm operation? How are profits and losses allocated, and who decides? What happens if a member dies? What happens if a member wants to leave? Can members be expelled from the business and, if so, how and under what condition? And so much more.

It can be an uncomfortable and challenging process to think about such bad scenarios. However, talking through these issues now will undoubtedly ease the process if and when such events happen. It helps all the members get on the same page and develop a sense of shared understanding and predictability. In this way, thinking through worst-case scenarios upfront actually helps prevent miscommunication and misunderstandings that may lead to such crises.

Step-by-step process for preparing an operating agreement

1. Review the questions in the *Checklist: Preparing for Your Farm's LLC Operating Agreement* and think through various contingencies or worst-case scenarios.
2. Openly discuss the questions and contingencies with your LLC members.
3. Agree on and outline an approach that's best for your farm operation.
4. Start drafting your operating agreement yourself using the *Extensive Operating Agreement for Sun Sisters Farm, LLC* or the *Brief Operating Agreement for Happy Couple Farms, LLC* as a guide, or give your outline to your attorney to draft most efficiently.
5. Have your attorney review your operating agreement before finalizing it.
6. Have all your members thoroughly review and sign your operating agreement to officially adopt it as the governing document.

The operating agreement examples provided in this LLC section include provisions with detailed explanations and stories to help guide you further along the process. Keep in mind that your operating agreement must comply with certain baseline requirements set forth in your state's LLC statute. Given these statutes vary from state to state, Farm Commons highly recommends that you work with an attorney to help you through the process. You can save costs by working through the step-by-step process above. If you decide to draft the operating agreement yourself, you should have an attorney review it. This will help ensure that all of the provisions are in line with your state's statute and that none of the provisions contradict each other, which is sometimes hard to spot. Internal contradictions result in confusion, which can lead to disputes. This would defeat the purpose of having an operating agreement.

For more detailed steps on how to create your own operating agreement, including various issues that can be addressed, see the *Checklist: Preparing for Your Farm's LLC Operating Agreement*. For sample provisions with detailed explanations and stories, see the *Extensive Operating Agreement for Sun Sisters Farm, LLC* in section 2 of this chapter. If you are a farm operation run by a married couple, see the *Brief Operating Agreement for Happy Couple Farms, LLC*, which provides sample provisions with detailed explanations and stories that are more applicable to this scenario.

Implementing Best Business Practices for Your LLC

Now that you've formed your LLC (by filing the articles of organization) and have established the governing rules (by finalizing and officially adopting your operating agreement), you must follow through by acting like you have a separate business. This means upholding best business practices by keeping your business affairs separate from your personal affairs, abiding by the provisions of your operating agreement, filing applicable annual maintenance fees with the state and filing your taxes.

"If the LLC upholds best business practices, each member's liability extends only to the value of his or her capital contribution."

Keep your business and personal financial affairs separate

It is essential that you maintain a clear and distinct level of separation between the LLC's business affairs and each member's personal affairs. Primarily, this means maintaining separate bank accounts and accounting records. This also includes not paying your personal debts or bills with the business assets. Of course, members can pay for legitimate expenses related to the LLC with their personal funds as long as they account for and properly record these expenses as business expenses. Be sure to keep all the receipts in case of an audit. The member can either write these "business expenses" off on their individual tax return, or they can request to be reimbursed directly by the LLC. If the LLC reimburses the expense, the member cannot also write it off. That would be a sure way of abusing the integrity and separation of the business entity!

Another key requirement for keeping the business affairs separate is to properly allocate assets to the LLC. Any land, equipment or other asset that is contributed to the LLC as a member's capital contribution needs to be formally transferred over. Officially allocating assets in this way helps make absolutely clear who owns what. It also clarifies the extent of each member's liability if the farm operation turns sour. Recall that if the LLC upholds best business practices, each member's liability extends only to the value of his or her capital contribution. If the lines aren't clear, the courts can go around the LLC and access personal assets.

Sun Sisters Farm, LLC story: allocation of assets

Let's go back to our Sun Sisters Farm, LLC story as an example. Recall that Marie offered her farmland as her capital contribution. To properly allocate this asset, she needs to transfer the title of the farm to the LLC so that the land is in the LLC's name. If a member prefers to keep the land in their personal ownership and instead decides to lease the land to the LLC, a written lease needs to be prepared that formalizes this arrangement between the member and the LLC.

Follow your operating agreement

Be sure to follow what your operating agreement says. Legally speaking, this is a contract that all the members are now bound by. You should make copies, or make it available in electronic form, so that every member has it and can refer to it as needed. Following the rules and procedures your operating agreement sets forth gives the business legitimacy in court. It also helps facilitate good relations among the members, as everyone will be on the same page.

For example, if your operating agreement requires an annual meeting, then you need to have one. You should take minutes to record what happened. The minutes don't have to be elaborate, just enough for the members to recall what was discussed and decided. If you decide to make changes to your operating agreement, you'll need to follow the procedure it sets for making amendments. Your operating amendment could require unanimous consent, a supermajority (i.e., two-thirds of members), or just majority consent for an amendment, depending on how you set it up. If you properly agree to an amendment, get it in writing and have all the members sign it.

If the business starts turning a profit, the members can agree to take a draw on the profits–or "distribution." The distribution is generally associated with the member's ownership share–or "percentage interest" in the company. This reflects each of the member's potential gain.

You'll need to follow your operating agreement's rules about how distributions are made.

It's a good idea to keep your operating agreement, as well as all meeting minutes and any amendments in one binder so that they are readily available. This also helps prove the legitimacy of your LLC by showing you are taking the separate entity seriously. Whenever you have a doubt about what's required for making a decision, or how to deal with a specific scenario when it arises, refer to your operating agreement for guidance.

"Most states require an annual fee to continue to operate as an LLC. Be sure you pay this fee each year, on time."

Pay your state's annual LLC maintenance fees

This is simple, but it's amazing how many LLCs fail to follow up. Most states require an annual fee to continue to operate as an LLC. Be sure you pay this fee each year, on time. Otherwise, you could incur late fees. Or, at worse, your LLC could be administratively dissolved. You would then have to start the whole process over again, which no farmer has time to do.

Designate your tax status

Recall that the LLC entity arose through state-specific LLC statutes. When states started creating the LLC, the IRS decided not to designate a new LLC category for taxation. Instead, the IRS provides a lot of flexibility and lets the LLC entity chose from among existing business tax options. You can choose to be taxed as a sole proprietorship, a general partnership, a C corporation or an S corporation. While

this guide is not intended to provide tax advice, we will provide a brief overview to help with basic understanding as you work with your accountant or tax attorney to decide what designation is best for your LLC.

This Guide is not intended to be relied upon as tax advice. Farm Commons strongly advises any farm operation that decides to form an LLC to consult with an accountant or tax attorney before determining the preferred tax election.

"By default, the LLC has flow-through taxation. Each member will be required to report the LLC income on his or her personal tax returns."

By default, if an LLC has one member ("owner") it will be taxed as a sole proprietorship. Similarly, if it has two or more members it will be taxed as a partnership, unless you elect otherwise. When taxed as a sole proprietorship or partnership, income and deductions related to the business will flow through to the individual members of the LLC. Such flow-through taxation is often preferred over a corporation because there will be no federal income tax on the company itself. Each member will be required to report the LLC income on his or her personal tax returns.

For more on C corporations, see Chapter 5.

Does your LLC need an Employment Identification Number (EIN)?

An EIN is the identification number that the IRS uses to identify the tax accounts of employers and certain other business entities. Not all LLCs need an EIN. Again, this is because the IRS does not formally recognize LLCs as a separate entity for tax purposes, and instead allows LLCs to choose how they wish to be taxed. LLCs can select to be taxed as corporations (either as a C corporation or S corporation, both of which are discussed in upcoming chapters), general partnerships, or sole proprietorships. LLCs choosing to be taxed as corporations or general partnerships need an EIN. Single-member LLCs need an EIN only if they have employees or if they choose a corporation tax treatment. Otherwise, a single-member LLC will handle all of the LLC's tax issues by filing an individual tax return using the member's Social Security Number. So basically, you'll need an EIN unless you are a single-member LLC that has no employees. You can get an EIN immediately by applying online through the IRS website. If you prefer, you can download the Form SS-4 on the IRS website and fax your completed form to the service center for your state, and they will respond with a return fax in about one week. Some banks will refuse to issue bank accounts without an EIN, even if the IRS does not

require the business to have one. In those cases, it can be easier to simply get the EIN than to argue with the bank about the necessity of the EIN.

An LLC can be taxed as a corporation by filling out the IRS Form 8832, "Entity Classification Election," and electing corporation tax status. Once you do this, the default is that you will be taxed as a C corporation. Basically, the LLC will be taxed separately from the owners and profit remaining in the LLC at the end of its tax year will be taxed at corporate tax rates. This may be an option to consider if certain LLC members prefer privacy and do not want to report their business income on their individual tax returns. Also, with corporation tax status you can choose a fiscal year rather than a calendar year. For example, you can designate that your tax year ends on March 31 and begins on April 1. This might be preferable for farm operations that want to pay taxes more in tune with your particular farm operation season.

For more on S corporations, see Chapter 6.

Another option is to be taxed as an S corporation. After choosing the corporation election on Form 8832, the LLC would then need to file the IRS tax Form 2553, "Election by a Small Business Corporation." The S corporation handles self-employment taxes slightly differently. Basically, in addition to a "reasonable" salary that can be paid to the member(s) or owner(s) of the farm operation, the members can also receive income in the form of "distributions." Distributions are taxed at a lower rate and are free from self-employment taxes including Social Security and Medicare taxation. This can equate to about 15 percent savings in federal taxes. Distributions can of course only be made if there are sufficient profits in your farm operation. Otherwise, your company will be considered undercapitalized. Recall that if this happens, the members may be personally liable to cover the business's debt.

"An LLC can choose to be taxed as an S corporation, which handles self-employment taxes slightly differently."

Two more points of clarification. First, while you will be designated as an S corporation for federal tax purposes, your entity is still considered an LLC in the eyes of your state. Second, to be an S corporation, you must follow additional formalities including holding annual meetings and annually filing IRS Form 1120S. This informational tax document is used to report the income, losses and dividends of S corporation shareholders (i.e., members, if you are an LLC with S corporation tax status).

"If you designate the LLC as an S corporation for tax status, keep in mind that the IRS does not look fondly on artificially low salaries and can reclassify dividends as salary."

Deciding on salaries of members

Farmers may be motivated to keep their salary as low as possible so that the remainder is taxed at a lower rate. If you designate the LLC as an S corporation for tax status, keep in mind that the IRS does not look fondly on artificially low salaries and can reclassify dividends as salary. The IRS will look at many different factors in determining what a reasonable salary should be. Anything above that could be reclassified and taxed as dividends. Factors the IRS will consider include the following:

- training and experience
- duties and responsibilities
- time and effort devoted to the business
- dividend history
- payments to non-shareholder employees
- timing and manner of paying bonuses to key people
- what comparable businesses pay for similar services
- compensation agreements
- the use of a formula to determine compensation

This begs the question, what is a reasonable salary for a farmer? Where do we draw the line? According to the Bureau of Labor Statistics, in 2014, the average annual income for farm supervisors and farmworkers was $47,540. If you own and run your own farm operation, which includes supervisory duties, the IRS may consider this as the baseline. Let's say a member of an LLC with net annual income of $50,000 tried to claim that just $20,000 of that was a reasonable salary in hopes of getting a tax break on the remaining $30,000. You might have an uphill battle convincing the IRS that a farmer of similar skill and responsibilities could only reasonably expect $20,000.

Tax designation choices for an LLC

- Do nothing. The default will apply, which is a sole proprietorship (single-member LLC) or general partnership (two or more members).
- File IRS Form 8832, "Entity Classification Election," and elect corporation. You will be taxed as a C corporation.
- File IRS Form 8832, "Entity Classification Election," and elect

corporation, and then file IRS tax Form 2553, "Election by a Small Business Corporation." You will be taxed as an S corporation.

Note that this is simply for federal tax status. You will still be considered an LLC in the eyes of your state!

Fulfill your tax obligations

Once you decide on your tax designation and file the appropriate forms, you'll then need to be sure the entity and each of its members fulfill the annual tax obligations. This includes distributing forms, filing forms, and, of course, paying taxes when due. The following provides a basic breakdown of what's required based on the tax status you choose for your farm operation LLC. Again, Farm Commons strongly recommends that you seek guidance from your accountant or tax attorney come tax season. Tax law is very particular. Working with a tax expert will help guarantee you're doing everything properly; it could also end up saving you money by finding ways to minimize your tax burden.

> "Working with a tax expert will help guarantee you're doing everything properly; it could also end up saving you money by finding ways to minimize your tax burden."

If you choose the default status and are taxed as a sole proprietorship or general partnership, then the LLC itself does not have to file a separate annual income tax return. Rather, each member will report income from the LLC on their individual tax returns (i.e., Form 1040, Schedule C, E or F). If the LLC has more than one member and is thus taxed as a general partnership, it will need to distribute Form 1065 to each member. This is purely an informational form that provides each member the necessary profit and loss information of the LLC to report on his or her individual tax return. Each member must include Form 1065 when filing his or her tax return.

If you elect to be taxed as a C corporation, the LLC will have to file Form 1120, "U.S. Corporation Income Tax Return," and pay its own taxes. In addition, the members of the LLC will each have to individually report and pay taxes on any LLC income they receive (i.e., salary and distribution of profits).

Double taxation of LLC with C corporation tax status

In effect, the farm operation LLC members pay double taxes. First, the entity pays and then the individual members pay. This double taxation dilemma is why business owners often prefer the LLC structure, as it provides the option to be taxed as a pass-through entity (i.e., sole proprietorship, general partnership or S corporation). It would be a very unusual circumstance for

a farm operation LLC to choose to be taxed as a C corporation. Be sure to confirm with your tax attorney or accountant on whether this would be the ideal option for you.

If your LLC elects to be taxed as an S corporation, you'll have to file the annual Form 1120S with the IRS. This is an informational tax document used to report the income, losses and dividends of S corporation shareholders (i.e., members of an LLC with S corporation tax status). The entity itself will not have to pay taxes, as it passes through to the individual members. In addition, an LLC that elects S corporation status will have to provide each of the LLC's members with a Schedule K-1. The Schedule K-1 is similar to a W-2, the end-of-the-year wage statement that employees receive from their employers. The Schedule K-1 shows the self-employment income each of the members receives from the company. The LLC must also submit a copy of Schedule K-1 to the IRS for each member. This allows the IRS to be sure that each member is properly reporting any self-employment income he or she receives from an LLC that's being taxed as an S corporation.

"The business and all members need to keep good records of the business's financial affairs."

Tax forms that an LLC must file and distribute based on tax status

- **LLC with sole proprietorship tax status (default for single-member LLC):** None. The individual member reports LLC income and profit or loss allocations on his or her individual tax return (or Form 1040, Schedule C, E or F).
- **LLC with general partnership tax status (default for multi-member LLC)**: Distribute Form 1065 to each member. Each member reports LLC income and profit or loss allocations on his or her individual tax return and must include the Form 1065.
- **LLC with C corporation status**: File Form 1120, "U.S. Corporation Income Tax Return," with the IRS and pay taxes as a corporation. Each member will report and pay taxes on any income (e.g., salary and distribution of profits) he or she received from the entity on his or her individual income tax return.
- **LLC with S corporation tax status**: File Form 1120S with the IRS, which is purely informational. Distribute Schedule K-1 to each member and file Schedule K-1 for each member with the IRS. Each member reports LLC income and profit or loss allocations on his or her individual tax return.

Maintain accurate accounting records

Finally, the business and all members need to keep good records of the business's financial affairs, including all receipts of business expenses in case of an audit. It's also advisable that you use a reliable accounting system such as QuickBooks or hire an accountant to handle your accounting and taxes for you.

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Chapter 4, Section 2: Going Deeper Into LLCs

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DISCLAIMER: This Guide does not provide legal advice or establish an attorney-client relationship between the reader and author. Always consult an attorney regarding your specific situation.

Introduction and How to Use These Resources

With an initial decision in hand to form an LLC, farmers need to know exactly what it takes to form one. How does a person set up the LLC? What documents need to be filed and with whom? What should be included in the operating agreement? This section is filled with hands-on tools to help guide you through the process of creating and maintaining an LLC as well as preparing your farm LLC's operating agreement.

The *Checklist: Creating an LLC* sketches the basic process a farmer follows to form and organize an LLC; it's designed to help farmers understand the big picture as they comply with the laws and outfit their farm for success. It's best to start with the checklist to get a sense of what will be required.

The sample *Brief Operating Agreement for Happy Couple Farm, LLC* includes the foundational provisions that are particularly important for a married couple LLC. It presumes that the couple's communication and working relationship are relatively good. It also assumes that if the couple divorces, marital or family law may dictate the division of assets to a certain extent, aside from what an operating agreement might require. So the provisions are not as elaborate as some operating agreements. If you think that you will eventually take on new business partners outside your family, you may want to take a look at the sample *Extensive Operating Agreement for Sun Sisters Farm, LLC*. This extensive agreement provides more elaborate provisions to handle various scenarios that may arise in an LLC with members of diverse backgrounds and interests who may come and go. These sample operating agreements serve as examples of the ways a farm operation may want to handle certain situations should they arise. The annotations provide even more ideas.

> "Rather than simply adopting someone else's operating agreement, it's best to take the time to think through various issues and craft an agreement that is best for your particular farm operation."

Rather than simply adopting someone else's operating agreement, including any of the sample agreements in this section, it's best to take the time to think through the various issues and craft an agreement that is best for your particular farm operation. The *Checklist: Preparing Your Farm's LLC Operating Agreement* will guide you through that process. It's filled with questions to illicit the best result that is specific to your situation. You can either take your answers to an attorney, who will then be able to efficiently draft your operating agreement, or you can take a crack at drafting it yourself using the sample agreements as a guide. Either way, Farm Commons advises that you have an attorney familiar with the laws in your state look it over before it is finalized. This will ensure that it complies with your

state's corporation statute and that there are no conflicting provisions within the bylaws, which would only lead to confusion down the road.

Finally, while LLCs are generally not required to hold annual meetings, it is a good practice to do so anyway. Annual member meetings offer an opportunity for the members to get together and review the financials and strategize for the upcoming year. They help foster open communication and engagement from the membership. If you do hold annual member meetings, it's best to keep minutes to evidence what happened should a dispute or issue arise. In addition, if your LLC chooses to elect S corporation tax status, the IRS will require you to hold annual member meetings and take minutes. The sample *Annual Member Meeting Minutes with Annotations* included in this section illustrate how straightforward it is to take minutes. You can use these to guide you through the process should you decide or be required to hold annual member meetings.

Checklist: Creating a Farm Business as an LLC

With S Corporation Tax Status Option

"This checklist is designed to help farmers understand the big picture as they comply with their state's LLC laws and gear their farm for success."

Introduction

This checklist guides farmers who have made the careful decision to establish their farm operation as an LLC. Each state may have different requirements, since LLCs are a matter of state law. The LLC business entity can help farmers create clear decision-making procedures, outline responsibilities, plan an exit strategy and manage potential liability. Some of these benefits come from legal best practices such as writing an operating agreement, a step not required in every state. This checklist is designed to help famers understand the big picture as they comply with their state's LLC laws and gear their farm for success. Read beyond our summary checklist for more information on each step.

Summary Checklist

Establish the LLC

- Draft and file the articles of organization
- Get an Employer Identification Number (EIN) if you need one

Implement Best Practices

- Draft and sign an operating agreement
- Follow the operating agreement
- Allocate assets between personal and business ownership
- Document relationships for personal assets used for farm purposes
- Update websites, brochures, invoices, order forms and other materials with the "LLC" designation, if required
- Keep accurate and up-to-date accounting records for tax purposes
- Make note of and follow any annual obligations such as when, where and how to file your annual report or fee with the state

Optional: Elect S Corporation Federal Tax Status

- Elect S corporation tax status with the IRS
- Make note of and follow any annual obligations to maintain S corporation tax status

Checklist with Explanations

Establish the LLC

Draft and file the articles of organization

Each state requires that an LLC file a document titled "articles of organization." Legally speaking, the articles of organization are defined by state law, which specifies exactly what information must or may be included. To make it easier on business owners and the government agency processing the articles, many states provide fillable form articles of organization. Some states will require that the business use the form, while others will allow self-drafted articles. Some agencies don't provide forms at all, and in that case, farmers should simply create a document with the information requested in the statute. Filing is generally handled by the state's secretary of state office. An internet search should bring up a form and more information for your state.

The articles of organization will likely require you to list the business's "registered agent." A registered agent is appointed by the owners of the corporation to receive important legal and tax documents on behalf of the business before the business is officially incorporated, or recognized by the state. Most articles of organization also require listing the business's street address and may require a listing of "members" and their contact information. Finally, the form may ask whether the entity is "member-managed" or "manager-managed." Which one is your farm? It depends on who you determine has the authority to make day-to-day management decisions for the business (e.g., decisions related to managing employees, making small purchases, marketing, handling customer relations and so forth). If you want all members to make day-to-day decisions, you should designate member-managed. If you want only specific people to make those decisions, the farm must be manager-managed.

An LLC does not exist until the date its articles of organization are filed and then approved by the state agency. Approval can take anywhere from one day to one week from the time of filing. The form can generally be submitted online, along with the required fee. Each state charges different fees, which vary from $25 to $1,000. In addition, most states require an annual fee to maintain the LLC, which is generally less than the fee to create an LLC. Note that the information on the articles of organization may be changed at any time by filing amended articles.

Get an Employer Identification Number (EIN) if you need one

An EIN is the number that the IRS uses to identify the tax accounts of employers and certain other business entities. Not all LLCs need an EIN. Again, this is because the IRS does not formally recognize LLCs as a separate entity for tax purposes and instead allows LLCs to choose how they wish to be taxed. LLCs can select to be taxed as corporations (C corporations or S corporations, as we'll discuss in the upcoming chapters), general partnerships or sole proprietorships if there is only one member. LLCs choosing to be taxed as corporations or general partnerships need an EIN. Single-member LLCs need an EIN only if they have employees or if they choose a corporation tax treatment. Otherwise, a single-member LLC will handle all of the LLC's tax issues by filing an individual tax return using his or her Social Security Number. So basically, you'll need an EIN unless you are a single-member LLC that has no employees.

> "You'll need an EIN unless you are a single-member LLC that has no employees."

You can get an EIN immediately by applying online through the IRS website. If you prefer, you can download the Form SS-4 on the IRS website and fax your completed form to the service center for your state, and they will respond with a return fax in about one week. Some banks will refuse to issue bank accounts without an EIN, even if the IRS does not require the business to have one. In those cases, it can be easier to simply get the EIN than to argue with the bank about the necessity of the EIN.

Implement Best Practices

Draft and sign an operating agreement

Although not required by most state laws, an operating agreement is highly recommended. The operating agreement lays out exactly who makes decisions for the farm. It outlines how members can enter the business, leave the business and receive distributions of profits. The agreement also allocates business profits and losses for tax purposes. If a farm does not have its own operating agreement, state law provides default rules. However, those rules may not be best for your particular farm business. The operating agreement is your chance to establish rules and procedures that work best for the farm operation's individual situation.

For more information on operating agreements and guidance on developing your own, review our *Checklist: Preparing for Your Farm's LLC Operating Agreement* and check out our operating agreements in this resource.

Writing an operating agreement can be a very valuable process for farm operation owners, even if the state's default rules will work perfectly well. The operating agreement is a chance to think through some very important

contingencies. What happens if a farm partner dies? What if one partner wants to leave the business? What if you want to bring another partner on? These problems can cause massive disruption if people haven't thought them through. The discussion process puts everyone on the same page and can serve to prevent disputes that often lead to crises.

Don't forget to have all members sign the operating agreement and keep the signed copy in a safe place for your records.

Follow the operating agreement

If you go through the work of outlining how the business should handle important matters like decisions, taxes and the departure of a member, it's very important to follow the document. This gives the business legitimacy in court. And if you went to all that effort you should make it work for you.

Allocate assets between personal and business ownership

As discussed above, a farm business needs to follow through on creating an LLC by making the division between business and personal. If the farm doesn't already have a separate bank account, set one up. Farm expenses and payments should move through the farm account, only. Of course, if you forget the farm checkbook and use your personal bank card instead, you may pay yourself back.

Next, determine which assets are farm and which are personal. If there are multiple members and each has promised to make a capital contribution or investment in the LLC, each member needs to follow through with his or her promise. For example, if one member promised to invest $35,000 in cash, then that money needs to be deposited into the LLC's bank account. If a member promised to invest his or her farm property, then the title of the property needs to be transferred to the LLC.

Overall, a common-sense allocation is probably the best route. This process can be quite simple–there's no need to detail every feed scoop, hand weeder or trash bin. Making your best guess as to the value of the farm's various assets and placing them on the farm's balance sheet is a simple way to document the transfer. There is no need to get creative. If a farm tried to keep all assets personal and leave the farm with nothing, a court would likely not respect the LLC at all. The allocation must be based in reality and the farm must have enough assets to capitalize the operation.

Document relationships for personal assets used for farm purposes

If you choose to hold ownership of the land with yourself personally, you should document the new relationship with the LLC. If the farm business uses your property, the farm business has a lease with you, whether one is written or not. Written documents are generally the better choice, and it can be a very simple one-page outline of basic terms such as rental rate, lease term and renewal procedures. Many individuals choose to lease the farmland for a rate equal to the value of the annual property taxes, but each farm has unique needs.

For more information on drafting leases, see Farm Commons' print resource *Drafting a Lease: Questions for Farmers and Landowners to Ask*, available on our website.

Now is a good time to discuss our objectives in allocating assets and writing leases. At any point in time, a court should be able to determine which assets are the farm's and which are personal. This is because the farm's creditors can go after business assets. Thus, we need to know what they are. The court should also be able to determine exactly how and why assets are used for both personal and business reasons. Your documentation can go a long way towards creating an efficient process. If records are a mess and there is no documentation, a court may decide for itself which assets are personal or business, in which case the farm loses an opportunity to influence the process.

Update websites, brochures, invoices, order forms with the LLC designation

State statutes require that a limited liability company use the LLC designation in the name of the business. This signals to potential creditors that only business assets are available to satisfy potential judgments against the business. If you don't like the look of the words or you've already invested in marketing materials, check with your secretary of state's office about registering a trade name without the letters. In some states, the county register of deeds handles registration of trade names, so you may need to make a couple phone calls. For invoices and other official business, it's best to include the letters after your name.

Keep accurate and up-to-date accounting records for tax purposes

This includes maintaining an accurate profit and loss statement. While the LLC does not have to pay income taxes itself (unless it elects to be taxed as a C corporation or S corporation), each member will need to report his or her share of profits and losses on their individual tax returns. Keeping good accounting records throughout the year will help streamline this process for everyone and help the LLC manage its finances overall.

Make note of and follow any annual obligations such as when, where and how to file your annual report or fee with the state

Your state will likely require you to file an annual report and pay an annual fee to maintain your LLC. If you neglect these duties, the state may dissolve your LLC. The IRS will also expect additional filings, even if you do not need to file a separate income tax return for the LLC. The actual filings will depend on whether you are a single-member LLC, have employees and have elected to be taxed as either a C corporation or S corporation. Talk with your accountant or tax preparer, or your secretary of state's office and the IRS for more information on filing LLC taxes.

Optional: Elect S Corporation Federal Tax Status

Elect S corporation tax status with the federal government

Review Chapter 6 on the S corporation for more on the benefits as well as the eligibility criteria and requirements to obtain and maintain the S corporation tax status.

Electing S corporation tax status for an LLC is quite simple. You'll first need to fill out and file IRS Form 8832, "Entity Classification Election." Here, you'll elect your preference to be taxed as a corporation. Once you do this, you will be taxed as a C corporation and unless you follow the next step, you'll face the double taxation dilemma. Next, you will need to fill out and file with the IRS tax Form 2553, "Election by a Small Business Corporation." The form should be completed up to two months and 15 days after the beginning of the tax year the election is going to take effect, or at any time during the tax year preceding the tax year it is to take effect. This sounds complicated but the IRS provides examples of how the timing works in the instruction sheet for Form 2553.

Make note of and follow any annual obligations to maintain the S corporation tax status

These include filing annual tax documents with the IRS and holding annual meetings. As an S corporation, you'll have to file the annual Form 1120S with the IRS. This is an informational tax document used to report the LLC's income and losses and any profits given to its members (i.e., distributions). In addition, you will have to provide each of the LLC's members with a Schedule K-1. The Schedule K-1 is similar to a W-2, the end-of-year wage statement that employees receive from their employers. The Schedule K-1 shows the self-employment income each of the owners receives from the company. The LLC must also submit a copy of Schedule K-1 to the IRS for each LLC member.

While many states don't require LLCs to do so, the IRS requires that an S corporation hold an annual meeting. You'll need to follow the parameters for holding the annual meeting as set forth in your operating agreement (i.e., holding it during the month or season stated and providing the required notice to members). Be sure to also take minutes to record what happens at the meetings.

Sample Brief LLC Operating Agreement with Annotations

THE STORY OF HAPPY COUPLE FARM, LLC

Throughout this Brief Operating Agreement for Happy Couple Farm, LLC we will use the fictitious story of Happy Couple Farm, LLC to help explain some of the more complex legal concepts and to illustrate how certain provisions of the operating agreement actually work. Jackie and Pat Farmer have been married for 20 years. They have an 18-year-old son, Chris, and a 19-year-old daughter, Sonja. Pat's father passed away two years ago. In his last will and testament he granted the family's third-generation, 40-acre farm property and all his farm tools and equipment to Jackie and Pat. He noted his gratitude for their loving care for him in his last years. Jackie and Pat had been living on the property and taking care of him for two years before he passed. During that time, they began cultivating about five acres of the farm and running a small CSA. When Pat's father died, Pat's sister Jan came onto the scene to contest the will. She felt she deserved at least half of the property even though she hadn't visited in over three years. Jan ended up losing in court. The whole process took two years! Jackie and Pat learned a lot through the whole ordeal. They realized they wanted to protect their interests in the farm property and their budding farm operation. They also wanted to establish a more streamlined way to pass on the farm to their children. They spoke to their attorney, and she suggested they form an LLC in Wisconsin, their state of residence. So they did.

DISCLAIMER: This operating agreement is provided to illustrate how a married couple might draft a brief operating agreement for their farm LLC. This operating agreement does not and is not intended to provide any information relative to marital law or division of assets in a divorce. Farmers seeking advice on issues related to marital separation or divorce must seek the advice of a qualified attorney licensed to practice in their state.

Happy Couple Farm, LLC | Operating Agreement[1]

This Operating Agreement (the "Agreement") of Happy Couple Farm, LLC (the "Company") is entered into as of the date on the signature page by Jackie Farmer and Pat Farmer (collectively, the "Members,"[2] and individually, a "Member")[3] for the purpose of making the acknowledgment at the end of this Agreement.

[1] No matter how well you and your spouse get along, it's a good idea to create an operating agreement upon forming an LLC for your farm business. The operating agreement outlines how the LLC is to operate. This is important because operating in accordance with an operating agreement proves that you both are earning the LLC's liability protection. Plus, if you don't have an agreement, state law will fill in the blanks as necessary. The default provisions provided by state law may not be suitable for your farm operation. The operating agreement gives you and your spouse the opportunity to write your own rules. Moreover, it allows you to set more favorable ground rules in your relations with third parties. The operating agreement may not seem to matter much for a couple that has a close working relationship. They could agree on each of the issues addressed here in a casual conversation and that may be good enough. However, if it's not written down in an operating agreement, it won't govern anyone else who was not a part of that conversation. For example, let's say a creditor comes after one of the spouses and takes control of their LLC interest. The creditor must follow the operating agreement, which could say that such a creditor would have no voting rights. This Brief Operating Agreement for Happy Couple Farm, LLC includes the foundational provisions that are particularly important for a married couple LLC. It presumes that the couple's communication and working relationship are relatively good. This Brief Operating Agreement assumes that if the couple divorces, marital or family law may dictate the division of assets to a certain extent, aside from what an operating agreement might require. So the provisions are not as elaborate as some operating agreements. If you think that you will eventually take on new business partners outside your family, you may want to take a look at Farm Commons' Extensive Operating Agreement for Sun Sisters Farm, LLC. This operating agreement is for a Wisconsin business. If you use it as a starting point, be sure to make necessary changes to reflect your state.

[2] "Members" means the same thing as "owners." Because LLC law uses members, we do too.

[3] Married couples that live in specific states may choose to form their LLC with one member–the married couple as a single unit. This option is available to couples in states that adopt "community property" systems. The nature of community property is way beyond our scope here! To summarize, some married couples may want to form a single-member LLC for tax reasons. Married couples in community property states should talk with their accountant or tax preparer about their options. If you were to form a single-member LLC as a married couple, you should still consider creating an operating agreement. As explained above, the operating agreement helps address matters with third parties and also provides the procedure for shutting down the business. Note that in our story, Jackie and Pat have decided to form a multi-member LLC even though they live in a community property state. Again, check with your attorney to find out what's best for you.

The Members have formed the Company by filing with the Wisconsin Department of Financial Institutions the Company's Articles of Organization,[4] a copy of which is attached to this Agreement as Exhibit A and incorporated by this reference.

The Members wish to enter into this Agreement for the purposes of providing the rights, obligations and restrictions contained in this Agreement and otherwise to govern the operations and management of the Company, and the Members agree as follows[5]:

[4] This section creates the official link between the state-filed articles of organization and this operating agreement. It's not necessary, just recommended.

[5] These aren't the only terms and conditions for running the LLC. In running everyday matters, owners set all sorts of rules or policies for how to conduct business or make decisions. The operating agreement is the place for baseline foundational rules, such as who owns the business, how members make decisions, how disputes are resolved and how to get out of the business. Day-to-day operational matters are generally not included in an operating agreement.

ARTICLE 1: Business Purpose and Term of Company

Section 1.1: Purpose[6]

The purpose of the Company shall be to operate a farm business and to do any and all things necessary, convenient, or incidental to that purpose and to conduct any other lawful business.

Section 1.2: Term

Unless dissolved earlier under the terms of this Agreement, the term of the Company shall be perpetual.

[6] This section is not legally necessary. It's an opportunity for owners to incorporate the business purpose into the legal structure of the farm. The purpose can be binding in that an action taken by a member in opposition to the business purpose could be invalid. But, the phrase "… and to conduct any other lawful business" takes any teeth out of the purpose. Many farmers like incorporating a purpose into the operating agreement because it feels good to remind owners why they farm in the first place.

Section 1.3: Additional Members

Additional Members may be added upon the unanimous consent of the existing Members, except as permitted by Section 5.2.[7]

[7] This provision basically allows you to bring on new members if both you and your spouse agree. However, one exception applies here. Section 5.2 provides that one spouse can transfer some or all of his or her interest to a child or grandchild without the consent of the other. This simplifies matters in times of death of one spouse or, potentially, divorce. Basically, each spouse can determine how to divvy up his or her interest in the company to the children or grandchildren. This is just one way of doing it. You could require unanimous consent for all transfers.

ARTICLE 2: Capital Contributions

Section 2.1: Initial Capital Contribution and Percentage Interest[8]

The Members shall contribute the amounts set forth on Exhibit B, attached to this Agreement and incorporated herein, as their initial capital contributions.[9] The initial capital contributions shall initially entitle them to the Percentage Interests set forth on Exhibit B. The "Percentage Interests" is determined by dividing the Member's contribution by all contributions to the Company.[10] The Members agree to the amount and value of the Capital Contributions. "Capital Contributions" as subsequently used is defined to include any subsequent Capital Contributions added to the initial capital contributions.

[8] "Capital Contributions" are the assets each member contributes to the LLC. Assets contributed can be cash, equipment, services and other things of value. (Note that we strongly urge you to see an attorney or accountant before you contribute services because there are tax implications). The section on Capital Contributions is important for several reasons. First, although an LLC provides protection for personal assets, assets contributed to the LLC are no longer personal. In effect, members are liable for the LLC's debts to the extent that each has contributed to the LLC. That's why it's important to get the exact contribution in writing now and into the future. In addition, an LLC needs to

be adequately capitalized to be legally legitimate. How much capital do you need? Common sense suggests that you need enough to pay bills as they come due. If you can do that with cash flow from revenue, you may not need much capital.

Of note, we need to make a distinction between a capital contribution and a loan, lease or sale. You can loan your LLC cash, or sell or lease your LLC land or equipment. None of these situations is considered a capital contribution. For example, a member could loan the LLC a total of $1,000 for the opening bank account balance. This could cover the business until cash flow is sufficient to pay the member back. Unlike a capital contribution, the member has a right to be paid back for the loan. Of course, if the business folds, the business may need to pay off other creditors first and the member could end up losing that money in the end. Also, a member can sell or lease the LLC physical assets such as land or equipment rather than give the physical assets as a capital contribution. Loans, sales and leases should all be separately documented.

So now you must ask yourself: Exactly what capitalization and contribution arrangement is best for your farm operation? It will depend on several factors: costs of starting up the farm, expected cash flow, expected expenses, expected revenue and more. Contributions, expenses and revenue all determine income at the end of the year, which determines the members' tax obligations. This subject can be quite detailed. Bringing the farm business plan to an accountant is the quickest way to get answers to these questions. Also, bear in mind that farmers can make additional capital contributions, which may change the percentage interest breakdown, so the initial decision isn't necessarily set in stone.

[9] Each member must officially transfer whatever capital contribution they have promised. If they agree to contribute cash, they will need to deposit the cash in the LLC's bank account. If they agree to contribute land, they will need to transfer the title of the land to the LLC.

For example, let's say that Jackie and Pat don't transfer the farm property, tools and equipment to the LLC. Jackie decides to buy hundreds of dollars worth of seeds payable by check. She knows that the LLC's bank account is zero and that the farm has no other assets. She also does not expect revenue to flow in for another two months. She writes the check anyway. When the check bounces, the seed company could pursue the personal assets of both Jackie and Pat. This is because the company is not adequately capitalized.

[10] The "Percentage Interest" is the LLC way of saying "percentage of ownership." Basically this section boils down to if you contribute half the capital to the entity, you get half ownership. The percentage interest of all the members together will always equal 100

percent. It is possible for LLC members to allocate ownership in percentages that are not equal to capital contributions, but that subjects everyone to more complicated tax rules. Don't do that without consulting an attorney and accountant. As this agreement is written, the percentage interest breakdown in the company determines the weight of each member's vote. If one member has 60 percent percentage interest, then his or her vote will count 60 percent, or an automatic majority. Another option would be to make it one person, one vote so that each member's vote carries the same weight despite the percentage interest breakdown. Yet another option would be to tier the membership interests, which could include voting members and non-voting members. Incidentally, this agreement usually requires unanimous consent, so it wouldn't really matter.

Here, let's say that Jackie and Pat decide to use the farm property, equipment and tools Pat's father gave them as their capital contribution. They hire an appraiser who values the property at $100,000. They transfer title to the property to the LLC. They also make a list of all the equipment and tools that are now the LLC's property. They estimate the additional value of the equipment and tools is another $10,000. So the total capital is $110,000. Because Jackie and Pat own all of these assets equally they now each have 50 percent percentage interest. They fill out Exhibit B accordingly. (See Exhibit B at the end of this agreement for a sample of how this would look.) Next, they decide to loan the company $1,000 cash to pay for seeds and other supplies before more revenue starts to kick in. They draw up a simple promissory note with no interest for the first year and 4 percent thereafter. Note that they don't add the $1,000 loan to Exhibit B because it is not a capital contribution. But they do account for it on their profit and loss statement. Sure enough, the farm makes $2,000 in the first year and the LLC is able to pay off the loan from Jackie and Pat in full.

Keep in mind that a married couple could decide to set the LLC up so that one spouse is a dominant member. For example, Jackie could decide that she personally wants to invest another $10,000 of her own money that she received from her mother before she married Pat. If this were the case, Jackie's capital contribution would total $65,000 and the company's overall capital would total $120,000. Thus, she would have 54 percent and Pat would have 46 percent percentage interest. Jackie's vote would count as an automatic majority.

Section 2.2: Future Capital Contributions by Members[11]

The Members shall not be required to make any additional Capital Contributions or loans to the Company. Any future Capital Contributions by Members shall be approved in amount and in valuation method by unanimous consent of the Members and recorded on Exhibit B.[12]

[11] Because a capital contribution is the member's exposure to liability, as explained in footnote 8, this section specifically states that members are not required to contribute additional resources. Generally, a member wants to limit the total contributions to the LLC. As long as the LLC has positive cash flow and can reasonably be expected to pay all of its bills, members might consider making loans to the LLC for ongoing needs. This is illustrated in our example above with the $1,000 cash loan to the LLC from Jackie and Pat. However, some LLCs may want to require future or ongoing capital contributions. This could happen if the members expect that the farm operation will undergo a significant expansion and bank loans would not be an option or desired. If members require ongoing or future capital contributions, the members should have more complex rules including penalties or policies for default if a member fails to make the required contribution.

[12] Exhibit B needs to be actively maintained if you add any more capital in the future. This is because Section 3.1 states that profits and losses are distributed according to Exhibit B. The modification of Exhibit B is an amendment to the operating agreement, so the approval of all members and recording of the change are required. You should update Exhibit B as soon as you give the business money. However, it can also be done at tax time, when you have the whole picture at hand. Either way, it's a good idea to have your accountant or tax attorney review any changes you make and go over any tax implications. Again, as mentioned in the footnotes above and illustrated in the example, a person can loan personal money to an LLC. However, loans do not go on Exhibit B, because they are not a capital contribution.

Section 2.3: Future Capital Contributions by Additional Members

Any future Capital Contributions by Additional Members shall be approved in amount and in valuation method by unanimous consent of the existing Members and recorded on Exhibit B.[13]

[13] If new members are added, they may be required to invest or make a capital contribution to entitle them to a percentage interest or ownership share in the company. Another option for adding new members would be to transfer interests from existing members. This is addressed in Section 5. Either way, the percentage interest will always equal 100 percent and must always be recorded on Exhibit B.

Section 2.4: Capital Accounts

A capital account[14] shall be maintained for each Member, which shall be credited with: (1) the Member's Capital Contributions, (2) the Member's allocable share of profits, and (3) the amount of any debt of the Company that is assumed by the Member or that is secured by any property distributed to the Member. The capital account shall be debited with: (1) the amount of cash and the asset value of any property distributed to the Member, (2) the Member's allocable share of losses, and (3) the amount of any debt of the Member that is assumed by the Company or secured by any property contributed by the Member to the Company.[15]

[14] The capital account is a line item account. It exists on a spreadsheet or in a QuickBooks file, for example. It's not a bank account. The capital account is maintained for tax purposes. This section outlines the basic procedures, which are also outlined in federal tax law. Very detailed capital account regulations are at Treasury Regulations 1.704-1(b)(2)(ii)(b)(1), (b)(2)(iv). If you file your own taxes, you will need to know these basics. If you work with an accountant or tax preparer, they should know these procedures.

[15] To summarize, a member's "stake" in the LLC is the total of what the person puts in, the member's share of the profits and the value of any debt the member personally takes over from the LLC. A member's stake is reduced by any property the LLC gives to the member personally, the losses it gives the member and any debt the LLC takes over for the member. Here, Jackie and Pat's stake in the company is the farm property. If the business goes south, they could lose the farm property. However, so long as they keep their personal affairs separate from their business affairs and do their best to reasonably capitalize the company, they will not be at risk of losing their personal assets.

Section 2.5: Return of Captial

No Member is entitled to withdraw from the Company, to receive a return of any part of the Member's Capital Contribution or to receive a repayment of any balance in the Member's capital account, except as expressly provided in this Agreement.[16] No Member will be paid interest on any Capital Contribution or on the Member's capital account.[17]

[16] Overall, this provision states that members are not entitled to simply ask for their investment in the company to be returned. Without a provision like this, state laws might allow a member to withdraw from the LLC upon giving notice to the members. The problem is that a withdrawing member gets the return of their contribution to the LLC. The farm may not have the cash to pay back the capital contributed. So, this section states that a member doesn't have a guaranteed right to withdraw. Instead, the LLC can allow a member to withdraw only if the parties unanimously agree. Here, the members have to agree on the terms of the withdrawal, including when and how a withdrawing person is to be paid out for their percentage interest.

[17] A capital contribution is not a loan. The members are not entitled to any interest on the amount they contribute.

ARTICLE 3: Allocation of Profits and Losses; Distributions

Section 3.1: Allocation of Profits and Losses[18]

All profits and losses of the Company shall be allocated to the Members in accordance with their Percentage Interests[19] as detailed on Exhibit B.

[18] Allocating profits and losses is done to calculate taxes—it doesn't necessarily mean you hand out money. Members may not actually see any cash from the profit because the business is probably putting profit back into the business—not paying it out. That doesn't matter to the IRS, however. This is because an LLC does not pay taxes on its profit. Instead, the individual members report the LLC's profits and losses on their individual tax returns. The members will each pay income tax on their share of the profits whether or not they actually receive the money. If members get cash or property from the LLC, then the LLC is making a distribution. That's addressed in the next section.

[19] Oftentimes, married couples contribute marital property that they own in equal halves, so all profits and losses are allocated equally. This is the case in our example, where Jackie and Pat own the farm property, tools and equipment equally. However, if one member makes additional contributions and the percentage changes, the profit and loss allocation changes as well.

This would be the case if Jackie decided to invest an additional $10,000 of her own cash that she's kept in a separate account throughout her marriage (i.e., so it is not community property). Jackie would then have 54 percent percentage interest in the LLC. If this were the case, 54 percent of the profits and losses would be allocated to Jackie and 46 percent would be allocated to Pat.

[19 cont.] Profits and losses can be allocated in a way that is separate from percentage interests. LLCs are popular because of this flexibility that is not permitted in a corporation. However, there are detailed tax regulations as to how losses can be assigned. By assigning profits and losses according to your percentage interest, you can be comfortable that you are complying with those regulations. If a member wants to make changes to loss allocations (which may be desirable if one member has a unique tax situation such as an inheritance or large salary), check with an accountant or attorney before taking action.

Section 3.2: Distributions

Members are not entitled to any distributions. Members may declare distributions by unanimous consent.[20] Distributions shall be allocated to Members in accordance with their Percentage Interests. No distribution may be declared that would result in the Company being unable to pay its debts as they become due in the usual course of business, or in the fair value of the Company's total assets to be less than the sum of its total liabilities.[21]

[20] A distribution is where the LLC actually gives members money or property, above and beyond any salary or wage members already receive for their duties. Distributions are essentially shares of the total profit, above and beyond expenses (including salary) of the business. Again, this is different than allocating profits and losses for the purposes of paying taxes on that amount. This provision requires unanimous consent before profits in the company are distributed to the members. It's good to state specifically that a member cannot demand that they receive the business's profit in cash. The company might wish to always put profit back into the business rather than pay it out. However, you are free to make distributions as you wish. You could, for example, only require majority consent. Or you could provide that any profit above a certain threshold at the end of your year must be distributed to the members.

Let's say that the Happy Couple Farm turns a $10,000 net profit in year two. Jackie's tired of farming and wants to go on a trip to Europe. She tries to convince Pat to make a distribution on the profits so they can have an extravagant holiday away. However, Pat has had an eye on a new greenhouse. He calculates that the farm's revenues could nearly double by extending the growing season with a greenhouse. He insists that the profits be reinvested back in the farm operation. Given this provision requires unanimous consent, Pat's refusal overrules and the profits stay in the company. If Jackie had 60 percent interest and this provision only required majority consent, she would have the final say.

[21] State LLC statutes usually prohibit distributions under certain circumstances, so this provision basically reinforces the law. For example, members can't give themselves the business's assets if doing so would jeopardize its ability to pay the bills. This would subvert the liability protection offered by an LLC.

ARTICLE 4: Management of the Company

Section 4.1: General Powers

The Company shall be managed by its Members.[22] The Members shall each have the right, power and authority to control all of the business and affairs of the Company, to transact business on behalf of the Company, to sign for the Company or on behalf of the Company, or otherwise to bind the Company.

Section 4.2: Manner of Acting[23]

Except as otherwise provided in this Agreement, the Members may act on majority consent at a meeting in which a quorum of the Members participate. Majority consent means the consent of holders of more than 50 percent of the Percentage Interests at the time of the consent, unless otherwise expressly provided in the Agreement. Members holding sufficient Percentage Interests to give majority consent to the action taken at any meeting shall constitute a quorum.[24] Alternatively, the Members may act by unanimous written consent without a meeting.

[22] This provision establishes the LLC as a "member-managed LLC." Basically, the day-to-day affairs are managed by the members themselves. Some LLCs choose to be managed by an appointed manager. This is called a "manager-managed LLC." For an example of this structure, see the *Extensive Operating Agreement for Sun Sisters Farm, LLC*.

[23] This is a somewhat confusing phrase. Basically, this section defines how the entity itself makes decisions. This should not be confused with how the members conduct the farm's day-to-day business affairs. Section 4.1 explains that the members each have the authority to perform the usual tasks required to run the farm, and no vote is needed. Under some circumstances the members might need to make "big" decisions together, and they do so by following this process. The default threshold for such big decisions in this agreement is majority consent. Incidentally, many of the provisions in this agreement specifically require unanimous consent. Any provision that requires unanimous consent will overrule the default of majority consent.

[24] This seems a bit silly with only two members. If each member has half the ownership, both members must attend to have a quorum and you both need to agree in order to get majority consent. This section is really only useful if another member is added. (In that case, you may want a more thorough operating agreement.)

Section 4.3: Actions Requiring Unanimous Member Approval[25]

Notwithstanding any other provision of this Agreement, the unanimous, written consent of the Members shall be required to approve the following matters:

a. Dissolution or winding up of the Company;

b. Merger or consolidation of the Company;

c. Sale, transfer, contribution, exchange, mortgage, pledge, encumbrance, lease or other disposition or transfer of all or substantially all of the assets of the Company;

d. Declaration of any distributions by the Company;

e. Amendments to this Agreement;

f. Issuance of any interest in the Company, including admission of new Members and additional Capital Contributions from a Member except as permitted by Section 5.1[26]; and

g. Conversion of the Company to a different entity.

[25] For a farm that has only two spouse members and each has 50 percent interest, if they have majority consent they also have unanimous consent. So, it could be silly to also list out things that require unanimous consent. But, if one person contributes additional capital, that person has more than 50 percent ownership and then holds majority consent. In that case, only these items that specifically require unanimous approval would need the consent of the minority member. By including these details, this operating agreement may be useful if an additional member, such as a child, is added in the future. If a member does something like sell the LLC without consent, that action is invalid and the member who didn't participate in the decision may have some recourse.

[26] Members generally want to unanimously approve any additional members or capital contributions because they can change the percentage interest breakdown. However, here, Section 5.2 allows each spouse to transfer his or her interest in the LLC to their children, to each other, or to a trust without the consent of the other.

ARTICLE 5: Transfer of Assignment of Interests[27]

Section 5.1: Definitions

a. "Transfer" means to sell, assign, give, bequeath, pledge, or otherwise encumber, divest, dispose of, or transfer ownership or control of all of, any part of, or any interest in a Percentage Interest to any person or entity, whether voluntarily or by operation of law, whether before or upon death.

b. "Permitted Transferee" means: (1) in the case of a Member that is an entity, the owners of the Member; (2) the spouse or the child of a Member or of any individual identified in subsection 1 above; (3) another Member; (4) a trust created for the benefit of a Member and/or any persons identified in subsections 1–3, above; (5) an entity controlled by, controlling or under common control with a Member or any persons identified in subsections 2, 3 and 4, above; or (6) the Company.[28]

c. "Involuntary Transfer" means any Transfer of a Percentage Interest by operation of law or in any proceeding, including a Transfer resulting from the dissociation of a Member, by or in which a Member would, but for the provisions of Section 5.3, be involuntarily deprived of any interest in or to the Member's Percentage Interest, including, without limitation, (a) a Transfer on bankruptcy, (b) any foreclosure of a security interest in the Percentage Interest, (c) any seizure under levy of attachment or execution, or (d) any Transfer to a state or to a public office or agency pursuant to any statute pertaining to escheat, abandoned property or forfeiture.

[27] Here's a plain-language summary of Article 5: A member can't sell or give away his or her interest in the LLC to anyone other than their children without approval of the other member. If the person does, the transfer is invalid. If someone takes over a member's interest in LLC (the most likely scenario being a creditor seizes it) then the new member receives distributions only—not voting rights. It is necessary that the more exacting, technical language of the section be accurate.

[28] This means members can transfer interests to each other, to children and to any trust members might create to manage property or assets, without first getting unanimous consent. This is most useful regarding wills: If members leave their interest to each other, their children or a trust, it may be easier to execute with this provision. Check with an attorney for more information on planning the estate.

Jackie is really upset with Pat. His refusal to distribute the farm's profits so they could take a holiday was the final straw. She thought that once the farm started making some money, things would get easier. She feels she's been stuck on this farm for more than five years now, with no break on the horizon. She now realizes that all Pat wants to do is grow the farm business, which will only further tie her to it. She insists on getting a divorce and files the paperwork. She couldn't care less about her interest in the farm business and would prefer not to deal with Pat or the farm any longer. She decides to gift her interest in the farm to their children, Sonja and Chris. Jackie doesn't need Pat's consent to do this. Now, Sonja and Chris each have 25 percent and Pat has 50 percent percentage interest in the farm business. Pat's vote carries a majority and Sonja and Chris are each minority members. Their vote matters for any provision that requires unanimous consent. Exhibit B would need to reflect this change in ownership. See the amendments to Exhibit B for an illustration of how this would look.

DISCLAIMER: This operating agreement is provided to illustrate how a married couple might draft a brief operating agreement for their farm LLC. This operating agreement does not and is not intended to provide any information relative to marital law or division of assets in a divorce. Farmers seeking advice on issues related to marital separation or divorce must seek the advice of a qualified attorney licensed to practice in their state.

Section 5.2: Transfers without Consent

A Member may Transfer all or part of the Member's Percentage Interest in the Company only with unanimous consent of all Members. Any attempt by a Member to Transfer all or part of his or her Percentage Interest in the Company without the prior approval of the Members shall be void.[29] However, a Member may Transfer all or any portion of the Member's Percentage Interest to a Permitted Transferee without unanimous consent.[30]

[29] A void transfer means it's as if it never happened. That means that even if Sonja sold her share of the company for cash to her best friend Erika without consent, the transfer is void. Sonja would still be a member and could still conduct business on behalf of the LLC. If Erika, not knowing that the transfer is void, votes or takes action on the LLC, those actions are void.

[30] The first part of this section makes it difficult to transfer membership—all members need to approve it. But, the second part adds an exception. Transfer is permissible without unanimous consent to certain people such as children, other members, the Company and other entities such as a trust.

Section 5.3: Involuntary Transfers

a. An Involuntary Transfer to anyone other than a Permitted Transferee will be effective only after the Members have complied with applicable provisions of this Section 5.3.[31] The creditor, receiver, trust or trustee, estate, beneficiary, or other person or entity to whom a Percentage Interest is Transferred by Involuntary Transfer (the "Involuntary Transferee") will have only the rights provided in this Section 5.3.

b. Notice to Company. The Transferor and the Involuntary Transferee shall each immediately give written notice to the Company describing the event giving rise to the Involuntary Transfer; the date on which the event occurred; the reason or reasons for the Involuntary Transfer; the name, address and capacity of the Involuntary Transferee; and the Percentage Interest involved (a "Notice of Involuntary Transfer").

c. Effect of Involuntary Transfer. Unless and until the Involuntary Transferee is admitted as a Member by majority consent[32] (determined by excluding the Transferor's Percentage Interest), the Percentage Interest held by the Involuntary Transferee shall have no voting rights. Unless and until the Involuntary Transferee is admitted as a member, the determination of majority consent for all purposes shall be made by excluding the Percentage Interest held by the Involuntary Transferee.

[31] This means that if one member never receives notice that a creditor has seized a member's interest (in subsection c) as required, then the member isn't responsible to find out themselves.

[32] Members can always admit an Involuntary Transferee as a member (i.e., give them voting rights, etc.), if wanted.

Section 5.4: Assignment

No Member may assign his or her interest in the Company.[33]

[33] Assignment is different than transfer of an interest. Assignment means that the person gets the profits/losses/distributions but cannot vote. Transfer means that the person gets profits/losses/distributions plus voting rights. Some state LLC statutes allow a member to assign his or her interest at any time, in whole or in part. This provision, instead, prohibits assignment. Many LLCs prohibit assignment because they don't want a member voting on LLC matters if the member does not have a financial interest in profits and distributions.

ARTICLE 6: Effect of Dissociation

The dissociation of a Member will not entitle a Member to a distribution in redemption of the Member's Percentage Interest. An event of dissociation will be treated as an Involuntary Transfer pursuant to Section 5.3 of this Agreement.[34]

[34] This section is basically restating Section 2.4: Members cannot withdraw and demand return of their capital contributions or capital account. It can be useful to repeat just to be sure it's clear.

ARTICLE 7: Dissolution

The Company shall be dissolved, and shall terminate and wind up its affairs, upon the first to occur of the following:

a. The determination by the Members to dissolve the Company;[35] or

b. The entry of a decree of judicial dissolution.

[35] Although no single member can withdraw without consent of the other members, both can vote to dissolve the entire company.

ARTICLE 8: Winding Up and Distribution of Assets

Section 8.1: Winding Up

If the Company is dissolved, the Members shall wind up the affairs of the Company.[36]

Section 8.2: Distribution of Assets

Upon the winding up of the Company, the liabilities of the Company, including all costs and expenses of the liquidation, shall be paid first. If there are insufficient assets, liabilities shall be paid according to their priority and, if of equal priority, ratably to the extent of assets available. Any remaining assets shall be distributed to the Members in proportion to their Percentage Interests.

[36] This means that if an LLC is dissolved, members won't ignore the dissolution by carrying on business as usual.

ARTICLE 9: Indemnification

a. To the maximum extent permitted by applicable law, the Members shall not be liable to the Company or any other third party (i) for mistakes of judgment, (ii) for any act or omission by such Member, or (iii) for losses due to any such mistakes, action or inaction.[37]

b. Except as may be restricted by applicable law, the Members shall not be liable for, and the Company shall indemnify the Members against, and the Company agrees to hold the Members harmless from, all liabilities and claims (including reasonable attorney's fees and expenses in defending against such liabilities and claims) against the Members, or any of them, arising from the Members' performance of duties in conformance with the terms of this Agreement.[38]

[37] This means that if members make an honest mistake or do something innocently dumb and cause the Company harm, the Company or a third party can't sue the member for it.

[38] An indemnification provision is simply a promise by another party to cover your losses if he or she does something that causes you harm or causes a third party to sue you. Indemnification provisions can vary quite a bit. Here, this indemnification provision means that if someone sues members for something they did on behalf of the LLC, the LLC has to pay to defend that lawsuit. An LLC should consider carrying insurance for this—without insurance, the business probably can't afford to follow through on this provision. Farm liability insurance may or may not provide this coverage. A commercial policy might be necessary.

ARTICLE 10: Miscellaneous

Section 10.1: Separability of Provisions

Each provision of this Agreement shall be considered separable. If any provision of this Agreement is determined to be invalid or contrary to any existing or future law, the invalidity shall not affect those portions of this Agreement that are valid.

Section 10.2: Governing Law and Jurisdiction

This Agreement and the rights of the Members shall be governed by the State of Wisconsin.

Section 10.3: Dispute Resolution[39]

If a dispute arises out of this Agreement, or a breach hereof, or otherwise develops between or among the Members, then the Members affected shall (before resorting to arbitration, litigation or any other dispute resolution procedure) each proceed to negotiate with each other in good faith, on a commercially reasonable basis. They must meet in person with one another at least three times in an effort to reach a resolution. If no resolution has been reached after such efforts, then they shall proceed to mediation administered by the American Arbitration Association under its Commercial Mediation Rules. If mediation is not successful in resolving the entire dispute, or is unavailable, any outstanding issues shall be submitted to final and binding arbitration in accordance with the laws of the State of Wisconsin. The arbitrator's award will be final and the judgment may be entered upon it by any court having jurisdiction within the State of Wisconsin.

[39] It is highly recommended that you include a dispute resolution clause. Keep in mind that a dispute may come into play with third parties, such as creditors. Here, mediation is preferred as it is generally the least expensive and most efficient way for resolving disputes. While many consider them effective for achieving just outcomes, both litigation and arbitration can be timely and expensive regardless of a "winning" outcome, the former more so than the latter. So as a safeguard, consider the worst-case scenario, a super-messy dispute involving facts and he said, she said opinions, and then determine how you'd want the dispute to be resolved so that you can get on with your farming operations.

THE MEMBERS HAVE EXECUTED THIS OPERATING AGREEMENT AS OF THE DAY AND YEAR WRITTEN ABOVE.

Jackie Farmer

Signature: _____

Pat Farmer

Signature: _____

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EXHIBIT A:

[The Articles of Organization]

EXHIBIT B:[40]
Member Contributions

Member Contributions

Member	Item	Value	Percentage Interest
Pat Farmer	Farm property located at [address and official parcel number]	$50,000	50%
	Farmall Super A	$900	
	Water wheel transplanter	$4,100	
	...and so forth...		
Jackie Farmer	Farm property located at [address and official parcel number]	$50,000	50%
	Irrigation equipment	$3,500	
	1998 Ford F150	$1,500	
	...and so forth...		
		$110,000	100%

[40] It is important to update this exhibit if the members contribute additional capital. However, the exhibit does not need to be updated as the value of the contributions change. The value of the contributions into the future is necessary for accounting and tax filings, but it's not relevant to whether and how an LLC is created.

Member Contributions

Amendment 1

Member	Item	Value	Percentage Interest
Pat Farmer	Farm property located at [address and official parcel number]	$50,000	50%
	Farmall Super A	$900	
	Water wheel transplanter	$4,100	
	...and so forth...		
Sonja Farmer	Farm property located at [address and official parcel number]	$25,000	25%
	Irrigation equipment	$1,750	
	1998 Ford F150	$750	
	...and so forth...		
Chris Farmer	Farm property located at [address and official parcel number]	$25,000	25%
	Irrigation equipment	$1,750	
	1998 Ford F150	$750	
	...and so forth...		
		$110,000	100%

Sample Extensive LLC Operating Agreement with Annotations

THE STORY OF SUN SISTERS FARM, LLC

Throughout this Extensive Operating Agreement for Sun Sisters Farm, LLC, we'll be using the fictitious story of Sun Sisters Farm, LLC to help guide you through various legal issues and scenarios that come up. We find that stories really help explain complex legal concepts. We first introduced Sun Sisters Farm, LLC in Chapter 4, Section 1. As you recall, the three sisters—Marie, Ingrid and Jema—have decided to start a farm business together. They each have always dreamt of starting a farm. Jema loves everything culinary and wants to cater to the local restaurants with fresh herbs and specialty items including heirloom vegetables, herbs and edible flowers. Ingrid is all about supporting the local community and wants to start a CSA. Marie has a keen business sense and currently runs a successful marketing company. In fact, Marie owns a beautiful 10-acre farm property that she purchased 10 years ago with a dream of leaving her marketing career and running a farm business. But she's torn, as she loves her work and she's nervous to run a farm all by herself. The property has a rundown shed, a tiny two-bedroom farmhouse and about a one-half-acre fruit orchard. The rest is overgrown alfalfa fields. The sisters meet up for Jema's 30th birthday and get to talking about their shared dream. They decide to go in on it together! They choose to form an LLC to protect them individually from liability. They come up with the name Sun Sisters Farm, LLC and file their articles of organization. They now start discussing how they want to manage the company and they put the details into this operating agreement. For demonstration purposes, Sun Sisters Farm, LLC is located and organized within Wisconsin. The educational material below is broadly applicable to farms in other states, as well.

DISCLAIMER: This operating agreement is a more thorough companion to Farm Commons' Brief Operating Agreement for Happy Couple Farm, LLC. This extensive version illustrates some of the deeper complexities non-married individuals might benefit from exploring before going into business together.

Sun Sisters Farm, LLC | LLC OPERATING AGREEMENT[1]

This Operating Agreement (the "Agreement") of Sun Sisters Farm, LLC (the "Company") is made by the signatory parties (the "Members"[2]) for the purpose of making the acknowledgment at the end of this Agreement and is entered into as of the date entered on the signature page. The Members have formed the Company by filing with the Wisconsin Department of Financial Institutions the Company's Articles of Organization, a copy of which is attached to this Agreement as Appendix A and incorporated by this reference.[3]

[1] An operating agreement outlines how the LLC entity is to operate or run its business. As discussed in the chapter on LLCs, it is important to create an operating agreement primarily for three reasons: (1) it helps safeguard the personal liability protection LLCs provide for individual members, (2) it lets your farm operation take advantage of the flexibility aspects of the LLC (otherwise your state's LLC statute will control how you must manage and operate your business), and (3) it allows you to set more favorable ground rules in your relations with third parties. The rules included in this sample operating agreement provide just one example of how an LLC could be managed and operated. The annotations point out various other ideas and ways for managing and operating an LLC. Again, the LLC structure is often preferred over a corporation because it provides far greater flexibility to adapt rules to best suit your unique business. So use your imagination and really think about what would be ideal given the interests and objectives of your particular farm operation. A lot of the "rules" in this model agreement may seem drastic and overly specific, but it's better to have them in place than to just hope for the best. One way of thinking about an operating agreement is to imagine all worst-case scenarios and then figure out how you'd want each scenario to be handled. Nevertheless, keep in mind that your operating agreement must comply with certain baseline requirements set forth in each state's LLC statute and regulations, which do vary from state to state. It is advisable to have an attorney draft or at least review your operating agreement before finalizing it. This operating agreement is for a Wisconsin business. If you use it as a starting point, be sure to make necessary changes to reflect your state.

[2] "Members" means the same thing as "owners." Because LLC law uses members, we do too.

[3] This creates the official link between the state-filed articles of organization and this operating agreement. It's not necessary, but it is recommended.

The Members wish to enter into this Agreement for the purposes of providing the rights, obligations and restrictions contained in this Agreement and otherwise to govern the operations and management of the Company, and the Members agree as follows:[4]

[4] The terms set forth in the operating agreement are not the only terms and conditions for operating the LLC. In running everyday matters, LLC members set all sorts of policies and procedures for how to manage the business or make routine decisions. These policies evolve with changing circumstances. The operating agreement is for more overarching rules: who owns the business, how are big decisions made, how and when are profits and losses allocated, how are disputes resolved, how can owners get out of the business, etc. While members can change these foundational rules by amending the operating agreement, they are typically more stable and long lasting. It's recommended not to include too many day-to-day operational matters in an operating agreement. Administrative issues can arise when frequently amending the operating agreement, which may involve getting every member to approve changes. If it's important to you that some of these day-to-day matters are included, you could make a reference to an appendix and add them there. We do this a few times in this model operating agreement as an example, including a reference to the roles, responsibilities and benefits of "manager-members." (See, for example, Article 4, Section 2.)

ARTICLE 1 : Organization and Purpose

Section 1.1: Name of the Company

The name of the Company shall be "Sun Sisters Farm, LLC."[5] The Company may do business under that name and under any other name or names that the Members approve. If the Company does business under a name other than that set forth in its Certificate of Formation, then the Company shall file assumed business name certificates as required by law.[6]

[5] Most state laws require that the name include the words "limited liability company" or the abbreviation "LLC."

[6] This basically provides that the Company could operate under another name through a "doing business as" (DBA), and wouldn't have to enter into another operating agreement.

Section 1.2: Purpose

The Company is organized to operate a farm business and to do any and all things necessary, convenient, or incidental to that purpose and to conduct any other lawful business.[7]

Section 1.3: Term

Unless dissolved earlier under the terms of this Agreement, the term of the Company shall be perpetual.[8]

Section 1.4: Principal Office

The principal office of the Company in the State of Wisconsin shall be located at 11 Get Along Ln., Madison, WI 53593 or at any other place within the State of Wisconsin approved by a Majority Vote of the Members.

Section 1.5: Registered Agent

The name and address of the Company's registered agent in the State of Wisconsin shall be Jema Member.[9]

[7] This section is not legally necessary. It's an opportunity for owners to incorporate the business purpose into the legal structure of the farm, if you want to. The purpose can be binding in that an action taken by a member in opposition to the business purpose could be invalid. But, the phrase "… and to conduct any other lawful business" takes any teeth out of the purpose. Many farmers like incorporating a purpose into the operating agreement because it feels good to do so and serves as a reminder of why they are in business.

[8] It's standard to make LLC's perpetual instead of setting a specific number of years, as it allows for the option to keep the business running as long as you want without having to jump through additional hurdles.

[9] The registered agent is the person that will be notified on behalf of the LLC if any lawsuit is filed against the company. All states require you to identify an official address and a registered agent, both of which must be included in the articles of organization. It's not necessary to include them again here, but it can help to have a direct reference for those just reading the operating agreement.

Section 1.6: Designation of Members

Section 1.6.1:

On Appendix B shall be set forth the name of each Member and the appropriate contact information for such Member (including, without limitation, such Member's mailing address, telephone number and email address as well as, in the case of a Member that is an entity, the name and title of an individual to whom notices and other correspondence should be directed).[10] Each Member shall promptly provide the Company with the information required to be set forth for such Member on Appendix B and shall thereafter promptly notify the Company of any change to such information.

[10] Appendix B is the way to track your members' contact information and percentage interests (or percent of ownership) in the company. It's important to keep Appendix B up to date if and when anything changes, including the addition of new members or additional capital investments, which we'll discuss soon.

Let's say that Marie decides she'll grant the LLC the title to her farmland valued at $45,000 as her capital contribution (again, we'll discuss capital contributions soon). Jema invests $30,000 in cash as her capital contribution. Ingrid offers one year of her services as farm labor as her capital contribution, which is valued at $25,000. Based on this, Marie has 45 percent, Jema has 30 percent and Ingrid has 25 percent percentage interest. See Appendix B at the end of this Model Agreement for a sample of how this would look in a table.

Section 1.6.2:

Additional Members may be admitted, from time to time, with the unanimous consent of all Members.[11] Upon (i) the prospective Additional Member's execution of this Agreement, as amended to reflect the terms of its membership, and (ii) the prospective Additional Member's paying in full the Initial Capital Contribution[12] (the amount of which shall be determined by the unanimous consent of all Members), such prospective Additional Member shall be admitted as a Member.

[11] Sometimes owners decide up front that they most likely will not want any additional members. This is often because they don't want their own percentage interest to be reduced or diluted, which could reduce their share in profits/losses as well as their voting power. However, it's still recommended that a provision is included for a process to add new members, as one never knows. What if the business needs more funds, and someone you like and trust wants to invest as a part owner? This Article requires that all members must agree to admit any additional members, which is an added safeguard. Another option would be to only require consent of a supermajority (typically defined as 75 percent) or even just the consent of a majority. Requiring less than unanimous consent may be advisable when the LLC has numerous and diverse members or you otherwise anticipate that it will be challenging to get everyone to agree.

Let's say that two years go by and the farm is beginning to really take off. They're selling consistently to about six local upscale restaurants and the local food co-op, and have grown from eight CSA members in the first year to 25 in the second. They're also selling at three local farmers' markets. The beets and cabbages are especially abundant and delicious! Margo, Ingrid's best friend, has a longstanding passion for canning and fermentations and has been experimenting with making sauerkraut and beet kvass with the beets and cabbages. She's shared her creations with some locals, and everyone loves them! She asks Ingrid whether she can start this business as part of Sun Sisters Farm. Ingrid runs it by her sister Jema, and after discussing it, they decide that if Margo wants to start her own segment of the business she needs to become a member and must come up with at least $10,000 as an initial capital investment so that she has some skin in the game. Ingrid presents this idea to Margo and Margo is excited about the opportunity. They review the operating agreement and realize they need unanimous consent to add an additional member. Now they just need to convince Marie, who has a bit of hesitation in letting Margo in as a member because that will dilute Marie's 45 percent. Jema and Ingrid convince Marie that having the additional fermentation products will really enhance the business, as they can be sold year-round. Marie finally agrees.

[12] Again, we discuss capital contributions more below. This just means that any additional members must make an investment of some asset, whether it be cash or in-kind (e.g., services, equipment), in the company before becoming a member.

Section 1.6.3:

A person shall not be admitted as a Member prior to the execution of this Agreement, as updated to reflect that person's Percentage Interest and the making of the full Initial Capital Contribution.[13]

Section 1.6.4:

The Capital Contributions of each Additional Member shall be set forth on Appendix B. The Percentage Interest of each Additional Member shall dilute the Percentage Interests of the previously admitted Members in proportion to their respective Percentage Interests.[14]

[13] This just means that any new member must sign and abide by this operating agreement.

[14] Appendix B must be updated with information related to any additional member, because Article 3.1 states that profits and losses are distributed according to Appendix B. With the addition of new members and their investment of capital, the percentage interest of existing members will be diluted or reduced, because at any given time, if you add up the percentage interests of all members it must equal 100 percent. This article explains that the dilution will be based on the most recent proportion of interest between the existing members, which may be different than the initial proportion (i.e., if one of the initial members had made an additional capital contribution the proportion of ownership will have changed).

Prior to bringing Margo on as a new member, none of the sisters have made an additional capital contribution. Once Margo invests her $10,000 cash as her capital contribution, the Appendix B would need to be revised. It will now include Margo's contact info, her initial capital contribution and adjustments to the percentage interest breakdown. Marie now has 40.9 percent, Jema has 27.3 percent, Ingrid has 22.7 percent, and Margo has 9.1 percent percentage interest. See Appendix B at the end of this operating agreement for an illustration of how this amendment would look.

ARTICLE 2: Capital Contributions

Section 2.1: Initial Capital Contributions[15]

Upon the execution of this Agreement, the Members shall contribute the amount set forth on Appendix B as such Member's initial Capital Contribution, which shall entitle them to the Percentage Interests[16] set forth on Appendix B. The "Percentage Interests" is determined by dividing the Member's contribution by all contributions to the Company. The Company shall record the amount of the initial Capital Contribution of each Member as a contribution to the capital of the Company. The Members agree to the amount and value of the Capital Contributions. "Capital Contributions" as hereafter used is defined to include any subsequent Capital Contributions added to the initial Capital Contributions.

[15] "Capital Contributions" are the assets each member contributes to the LLC. Assets contributed can be cash, equipment, services and other things of value.

As a special note, it's important to see an attorney or accountant before you contribute services because there are tax implications. In our example, Ingrid contributes $25,000 in farm labor as her capital contribution. She will have to pay taxes on this money as if she received it as a salary and then gave it back to the company, even though it doesn't tangibly reach her pockets. The tax implications are definitely something you need to consider before promising services as your capital contribution.

[15 cont.] The article on capital contributions is important for several reasons. First, although an LLC provides protection for personal assets, assets contributed to the LLC are no longer personal. In effect, members are liable for the LLC's debts to the extent that each has contributed to the LLC. That's why it's important to get the exact contribution in writing now and into the future. Second, an LLC needs to be adequately capitalized to be legally legitimate. How much capital do you need? Common sense suggests that you need enough to pay bills as they come due. If you can do that with cash flow from revenue, you may not need much capital.

Recall the example we provided in Section 1 of this chapter on how Sun Sisters Farm becomes undercapitalized. The sisters agree to take out a $35,000 loan for a tractor and then they enter an agreement with a contractor to build a greenhouse for $40,000. The LLC has blown through all its cash and there's no way it will be able to make due on these debts. It is severely undercapitalized, and it's likely a court would conclude that each member is individually on the hook for these debts.

15 cont. Of note, we need to make a distinction between a capital contribution and a loan, lease or sale. You can loan your LLC cash or sell or lease your LLC land or equipment. None of these situations is considered a capital contribution. For example, a member could loan the LLC a total of $1,000 for the opening bank account balance. This could cover the business until cash flow is sufficient to pay the member back. Unlike a capital contribution, the member has a right to be paid back for the loan. Of course, if the business folds, the business may need to pay off other creditors first and the member could end up losing that money in the end. Also, a member can sell or lease the LLC physical assets such as land or equipment rather than give the physical assets as a capital contribution. Loans, sales and leases should all be separately documented. So now you must ask yourself: Exactly what capitalization and contribution arrangement is best for your farm operation? It will depend on several factors: costs of starting up the farm, expected cash flow, expected expenses, expected revenue and more. Contributions, expenses and revenue all determine income at the end of the year, which determines the members' tax obligations. This subject can be quite detailed. Bringing the farm business plan to an accountant is the quickest way to get answers to these questions. Also, bear in mind that farmers can make additional capital contributions, which may change the percentage interest breakdown, so the initial decision isn't necessarily set in stone.

16 The "percentage interest" is the LLC way of saying "percentage of ownership." Basically, as this provision is written, if you contribute half the capital to the entity, you get half ownership. It is possible for LLC members to allocate ownership in percentages that are not equal to capital contributions. But, that subjects everyone to more complicated tax rules. Don't do that without consulting an attorney and accountant.

At the initial startup, Marie has 45 percent, Jema has 30 percent, and Ingrid has 25 percent percentage interest—together equaling 100 percent. This changes when Margo comes on. To make room for Margo and to account for her $10,000 capital contribution, Marie's percentage interest drops to 40.9 percent, Jema's drops to 27.3 percent and Ingrid's drops to 22.7 percent so that Margo has 9.1 percent—together equaling 100 percent. See how this works in Appendix B.

Section 2.2: Capital Accounts[17]

A separate Capital Account shall be maintained for each Member, which shall be credited with: (1) the Member's Capital Contributions, (2) the Member's allocable share of profits, and (3) the amount of any debt of the Company that is assumed by the Member or that is secured by any property distributed to the Member. The capital account shall be debited with: (1) the amount of cash and the asset value of the property distributed[18] to the Member, (2) the Member's allocable share of losses, and (3) the amount of any debt of the Member that is assumed by the Company or secured by any property contributed by the Member to the Company.[19]

[17] The capital account is a line item account. It exists on a spreadsheet or in a QuickBooks file, for example. It's not a bank account. The capital account is maintained for tax purposes. Requirements for capital accounts are outlined in federal tax law. This article outlines the basic procedures. It's helpful to include it to be sure that everyone understands that a capital account must be maintained. Very detailed capital account regulations are in Treasury Regulations 1.704-1(b)(2) (ii)(b)(1), (b)(2)(iv). If you file your own taxes, you will need to know these basics. If you work with an accountant or tax preparer, they will already know and follow these procedures.

[18] "Distributed" is a legal term that means you've transferred legal ownership of an item from the LLC to a member. It is the opposite of a capital contribution.

[19] To summarize, a member's "stake" in the LLC is the total of what the person puts in, the member's share of the profits and the value of any debt the member personally takes over from the LLC. A member's stake is reduced by any property the LLC gives to the member personally, the losses it gives the member and any debt the LLC takes over for the member.

Section 2.3: No Additional Capital Contributions.

No Member shall be required to contribute any additional capital or loans to the Company.[20] Any future Capital Contributions by Members shall be approved in amount and in valuation method by the Members and recorded on Appendix B.[21]

Section 2.4: No Interest on Capital Contributions

No Member shall be paid interest on their Capital Contributions.[22]

[20] This article specifically states that members are not required to contribute additional resources. Again, a capital contribution is the member's exposure to liability. Generally, a member wants to limit the total contributions to the LLC. As long as the LLC has positive cash flow and can reasonably be expected to pay all of its bills, including the loan payment, members shouldn't have to invest more money. Instead, they might consider making loans to the LLC for ongoing needs. Some LLCs want to require future or ongoing contributions (for example, if planning a significant expansion and bank loans can't be gotten or aren't wanted). If ongoing or future capital contributions are required, the operating agreement should have more complex rules such as what happens on default, etc.

[21] Again, Appendix B needs to be actively maintained if any member, new or existing, invests more capital. Also note that modifying Appendix B is an amendment to the operating agreement. Thus, you will have to follow the amendment process and record the change on Appendix B by basically updating the percentage interest for it to take effect. This agreement requires unanimous consent for any amendment. This means that Marie, Jema and Ingrid all have to agree on amendments to Appendix B. When Margo comes on, she too has to agree before any amendment can be made. It is advisable to consult with an attorney or your accountant before making changes to Appendix B as there may be tax implications. You should update Appendix B as soon as the capital is invested in the business. Again, as mentioned in the footnotes above, a person can loan personal money to an LLC, which is not considered a capital investment and would not have to be tracked on Appendix B. A loan represents a debt of the business to an individual; no ownership is established.

[22] A capital investment isn't a loan, so members don't get interest on capital investments.

Section 2.5: Return of Capital Contributions

Except as otherwise provided in this Agreement, no Member shall have the right to receive any return of any Capital Contribution or to receive a repayment of any balance in the Member's capital account.[23]

Section 2.6: Penalties for Failure to Make Required Contributions

If a Member fails to make a Capital Contribution when due, the Manager shall promptly notify such Member in writing that he/she/it is a "Defaulting Member." If within fourteen (14) days after actual receipt of such notice the Defaulting Member has not made the required Capital Contribution, such Defaulting Member shall be subject to any and all penalties and remedies available at law or equity, as selected by the Members. In addition, the Members may determine by a Majority Vote that a Defaulting Member shall withdraw as a Member.[24]

[23] Overall, this article states that members are not entitled to simply ask for their investment back. Without a provision like this, many state laws would allow a member to withdraw from the LLC upon giving notice to the members and require that the withdrawing member gets their capital contribution back. This becomes a problem if the farm operation does not have the cash flow to pay back the value of the capital contributed or would prefer to keep it invested in the company. This article addresses this issue by saying that a member doesn't have a guaranteed right to withdraw. Instead, the members have to agree on the terms of the withdrawal, including when and how a withdrawing person is to be paid out for their percentage interest.

[24] This article ensures that all members make their initial investment on time so that the company will be adequately capitalized. If a member doesn't follow through, he or she will be considered a defaulting member and the other members could file a lawsuit to get the promised initial investment or require that the defaulting member leave the company.

If for some reason one member can't afford to make the initial investment, there are other solutions. For example, let's say that when our three sisters got started, they wanted to have equal one-third interests in the LLC with an initial valuation of the farm operation set at $135,000, versus the $100,000 valuation being used in this Guide. Marie offers her farm property valued at $45,000 to cover her capital

contribution, so she's all set. But Jema and Ingrid don't have the full $45,000 to make a capital contribution in proportion to their equal interest. Jema only has $35,000 cash to offer, and Ingrid can only offer $25,000 in services. So to cover the difference, Jema could enter a promissory note for $10,000 and Ingrid could enter one for $20,000. This would operate somewhat like a loan to them from the company. They would be promising to pay this additonal capital contribution to the company by a certain time. This is fine, if the company doesn't need the money right away. Or, using an entirely different scenario, let's say there is no property or services involved and the three sisters want equal one-third interests with an initial valuation at $135,000. Say Marie has quite a bit of savings. She could loan the company $130,000, which the company would agree to pay back over time. Then, each of the sisters would invest $2,500 to get their one-third percentage interest. The company is now properly capitalized through the loan, and each sister has one-third interest in the company.

Section 2.7: Limitation of Liability

Except as otherwise required by applicable law or as provided in this Agreement, Members shall have no personal liability for the debts and obligations of the Company.[25]

[24 cont.] Bottom line, there are many creative ways to capitalize the company, but it's important to set some penalities in the operating agreement for failing to make a capital contribution to make sure everyone does what they say they're going to do.

[25] Members are personally liable only up to the amount of their capital investment, in the sense that you may not get that money back if, for example, the company is sued.

Here, Marie is only on the line for the $45,000 value of her farm property, Jema for $35,000 in cash, Ingrid for $25,000 worth of services and Margo for $10,000 in cash. This reflects each member's stake in the business.

Section 2.8: Contributed Property

With respect to any property contributed by a Member to the Company, such Member shall provide to the Company any information reasonably requested by the Company for purposes of determining the Company's tax basis in such property.[26]

[26] If a member gives property as the capital contribution, that member will need to provide a valuation of the property (i.e., through an appraisal or other legitimate process), which is considered the basis. Basis is used to figure depreciation, amortization, depletion, casualty losses and any gain or loss on the sale, exchange or other disposition of the property, all of which will be necessary for allocating profits and losses.

Here, Marie must give documentation to evidence that the farm property is in fact worth $45,000.

ARTICLE 3: Allocations and Distributions

Section 3.1: Allocation of Profit or Loss[27]

For financial accounting and tax purposes, the Company's net Profit or Loss shall be determined on an annual basis and shall be allocated to the Members in proportion to each Member's Percentage Interests[28] as set forth on Appendix B as amended from time to time in accordance with U.S. Department of the Treasury Regulations (hereafter "Regulations") Section 1.704-1.[29]

[27] Allocating profits and losses is done to calculate taxes—it doesn't necessarily mean you hand out money. Members may not actually see any cash from the profit because the business is probably putting profit back into the business—not paying it out. It doesn't matter to the IRS. Members are required to pay taxes on the profit whether or not they actually receive it. This is because an LLC does not pay taxes on its profit itself—members must account for the business's profits on their personal tax returns. If the LLC pays members cash or property, then the LLC is making a distribution, which is addressed in the next section.

[28] LLCs are popular because members can choose how to allocate profits and losses, which is not permitted in a corporation. However, there are detailed tax regulations as to how losses can be assigned. By assigning profits and losses according to your percentage interest, you can be comfortable that you are complying with those regulations. If members want to make changes to your loss allocations (which may be desirable if one member has a unique tax situation such as an inheritance or large salary), check with an accountant or attorney before taking action.

[29] It's advisable to check with a tax attorney or accountant when making any amendments to Appendix B, just to make sure the effect will be as intended. This reference to the regulations is a safeguard to make sure you stay in compliance.

Section 3.2: Distributions[30]

The Members may, but shall not be required to, distribute to the Members in proportion to their Percentage Interests any portion of available funds for each taxable year of the Company as the Members shall determine by Majority Vote.[31] The phrase "available funds" shall mean the net cash of the Company available after appropriate provision to pay current operating expenses and to pay or establish reasonable reserves for future expenses, debt payments, capital improvements and replacements as determined by the Managers. No distribution may be declared that would result in the Company being unable to pay its debts as they become due in the usual course of business or in the fair value of the Company's total assets to be less than the sum of its total liabilities.[32]

[30] A distribution is where the LLC actually gives members money or property based on profits, which is above and beyond any salary or wage members already receive for their duties. If you want to give out the equivalent of a "salary" to a member, you do that in a different way, and you have to make sure the company's revenue can sustain it if you write that into the operating agreement. Many folks who are more uncertain of their revenue/expenses or who are growing the business will simply use the procedures of this article: Vote on a distribution when you think your revenue is exceeding your expenses and the business can afford it. Please note that a distribution is different than allocating profits and losses for the purposes of paying taxes on that amount. A distribution means you put money in your pocket. When you allocate yourself profits/losses, you do so for tax purposes—you may or may not actually see the money counted as profit on your tax return, as you might choose to reinvest the profit in the business (rather than make a distribution).

[31] It's good to state specifically that a member cannot demand that they receive the business's profit in actual money. The company might wish to always put profit back into the business rather than pay it out. However, you are free to make distributions as you wish. This article provides that a distribution may be made upon majority vote. However, you could require unanimous consent of all members if you are concerned about cash flow.

For example, let's say two years go by and the farm is beginning to gain traction. The three sisters finally make a profit, albeit small at $1,200. However, so far, they have decided not to make any distributions and rather keep all earnings in the business. A year later, after Margo is brought on as a member, the business really starts taking off. Her fermentation products are flying off the shelves! By the end of year three, the farm makes a net profit of $10,000. Ingrid and Margo are particularly excited because they've been working so hard. They decide they want to take a distribution on the year's profit. They turn to the operating agreement and realize that Article 3.2 requires approval by a majority of percentage interest. They present the idea to Jema and Marie. Jema thinks it sounds great, as she could use some extra cash. Marie feels like they should keep the money in the business, so she votes against it. However, Jema, Ingrid and Margo together have a majority of the percentage interest. So it's decided the $10,000 profits are distributed among the four members based on the percentage interest breakdown (i.e., Marie gets $4,090, Jema gets $2,730, Ingrid gets $2,270 and Margo gets $910). Of course, they each have to pay taxes on these profits when filing their individual tax returns!

[32] State laws usually prohibit distributions under some circumstances. Members can't give themselves the business's assets if doing so would jeopardize its ability to pay its bills. Doing so would subvert the liability protection offered by an LLC.

So, for example, if Sun Sisters Farm, LLC was undercapitalized and not able to make due on its debts, then the decision to distribute the $10,000 in profits could be subverted by the courts. Basically, the court could take that money back and give it to the creditors.

Section 3.2.1: Distributions in Liquidation

Distributions in liquidation of the Company or in liquidation of a Member's interest shall be made in accordance with the positive capital account balances pursuant to Section 1.704.1(b)(2)(ii)(b)(2) of the Regulations.[33]

Section 3.2.2: Negative Account Balances

To the extent a Member has a negative capital account balance, there shall be a qualified income offset, as set forth in Section 1.70.1(b)(2)(ii)(d) of the Regulations.[34]

[33] An operating agreement can establish certain tax designations, but they will be honored only if they have a substantial economic effect. This is quite a cumbersome area of tax law. The legal lingo in this article is included to ensure that you will meet this "substantial economic effect test" if and when the company's interests or a member's assets are liquidated or sold off upon dissolution of the company or termination of a member (i.e., the valuation and allocation of these interests passes muster). It's not necessary to include this legalese (which is complex-sounding legal language), but advisable.

[34] Again, you should include this legal lingo, as following it will permit the substantial economic effect test to be met.

ARTICLE 4: Administrative Provisions[35]

Section 4.1: Management of the Company Generally

Except as otherwise specifically provided in this Agreement:

Section 4.1.1: Manager Managed[36]

The business of the Company shall be managed by Manager(s). Ingrid Sister and Margo Friend, shall be the initial Managers. Except as otherwise set forth in this Agreement or applicable law, all decisions concerning the day-to-day management of the Company shall be made by the Managers, whereby each Manager will have one vote; if the Managers fail to reach a majority agreement on a management issue, the matter shall be determined by a Majority Vote of Members.[37]

[35] This article could also be titled "Management of the Company" and is an area of LLC law that provides a great deal of flexibility for determining how the day-to-day affairs of the company are managed and how more substantive decisions affecting the company are made. The provisions set forth in this model agreement provide just one example of how the day-to-day affairs and big decisions of an LLC could be managed. Most farm operations are unique, which is largely driven by the nature and diversity of farming as well as the diversity, interests and overall objectives of their founding members. You are encouraged to think creatively and devise a management protocol that best addresses the uniqueness of your business and your members' interests. However, it is advised that you consult with an attorney to ensure that the management provisions in particular, and your operating agreement as a whole, comply with your state's LLC statute and regulations.

[36] Most states have a default rule that the LLC is managed by its members unless otherwise provided for in the operating agreement. The provisions included in this model agreement designate this LLC as a "manager-managed" LLC. Basically one or more people are designated as managers and are responsible for managing the day-to-day activities of the company. Of note, the managers don't necessarily have to be members. If you want to require that the managers be members, you should clearly specify this in your operating agreement. Managers typically have the authority to act on behalf of the LLC and to contractually bind the LLC. A manager-managed structure is recommended for farm operations with many and/or diverse members, some of whom either are not in close proximity to the day-to-day affairs or have no interest in running the company per se but who want to have a say in issues that have a substantial effect on their interests in the company (e.g., adding additional members or allowing additional contributions that will dilute their percentage interest, dissolving the entity, declaring distributions, etc.). Another option would be to have a member-managed LLC in which the members manage the day-to-day operations. An alternative section for a member-managed LLC may include:

> **Member Managed**. The Company shall be managed by its Members. The Members shall each have the right, power and authority to control all of the business and affairs of the Company, to transact business on behalf of the Company, to sign for the Company or on behalf of the Company, or otherwise bind the Company.

[37] It is important to clearly set forth how the day-to-day decisions will be made for manager-managed LLCs; particularly if there is more than one manager. Here, the day-to-day decisions are decided by one vote per person and not their percentage interest in the company, because the managers may or may not be members. But voting by percentage interest would be an option if the operating agreement requires that the managers are also members, in which case the manager-member(s) with the most percentage interest would ultimately control the day-to-day operating decisions.

Let's take a step back to the beginning of the Sun Sisters Farm, LLC formation. The three sisters unanimously decide to designate Ingrid and her best friend from childhood, Margo, as the managing partners. (Note: This is before Margo comes on as a member.) They opt for this manager-managed structure because Jema and Marie don't have time to deal with the day-to-day operations and would rather assign Ingrid and Margo the tasks. As Ingrid's best friend, Margo has been like a sister to them all.

They get along great and are having no trouble deciding on day-to-day matters. However, when planning the initial year's crops, Ingrid and Margo have a blowout dispute on what variety of beets to plant. It becomes so contentious that they decide to take it to the members to decide by majority vote. They decide on the Krautman variety of cabbage and the Ruby Queen variety for beets.

Section 4.1.2: Member Action; Voting Rights[38]

When actions are to be taken by the Members, each Member shall vote in proportion to the Member's Percentage Interest as of the Record Date. Unless otherwise determined by the Majority of the Members, the Record Date shall be defined as 10 calendar days before the date of the meeting at which the vote is taken.[39] Manager Members shall not partake in any vote affecting his/her/their roles, responsibilities, benefits or dismissal.[40]

[38] This model agreement gives all members voting rights based on their percentage interest in the company. As outlined on Appendix B, at the beginning, Marie's vote counts for 45 percent, Jema's for 30 percent and Ingrid's for 25 percent. Once Margo joins as a voting member, this changes so that Marie's vote counts for 40.9 percent, Jema's for 27.3 percent, Ingrid's for 22.7 percent and Margo's for 9.1 percent. Another option would be to make it one person, one vote so that each member's vote carries equal weight despite their percentage interest. Yet another option would be to tier the membership interests (whether for a manager-managed or member-managed structure), which could include voting members and non-voting members. This could be of interest for farm operations with founding members driven by a distinct vision and mission but who have brought on additional investor members who trust the founding members to decide how the company should operate and just want a share in profits/losses. Or, you could designate certain committees where certain members have voting rights on certain issues. The possibilities are endless for LLCs. Just be sure to have an attorney review your agreement before finalizing to be sure it complies with your state's baseline LLC laws and regulations.

[39] The record date is basically the cut-off date for determining the percentage interest allocation that will control the voting rights for a scheduled meeting. This is important, because the percentage interest could change between the time the meeting is called and the time the meeting takes place. Here, the record date is set at 10 days before the meeting unless the majority of the members agree otherwise. You could set the record date to be shorter or longer, or even on the date of the meeting itself.

Here's an example of how the record date may matter. The three sisters schedule an annual meeting for April 15. The record date of this meeting is 10 days prior, or April 5. Let's say Margo is brought on as a member on April 10. Based on the record date, Margo's percentage interest vote won't count on any matter voted on unless a majority of the other members agree otherwise.

[40] This makes it clear that if managers are members, they cannot vote on anything that affects their roles and responsibilities as managers. This would present a "conflict" between their personal interests and the best interests of the company. For example, Ingrid can't vote on anything related to her salary, as she has a personal interest in the matter. This also serves to protect the managers themselves, as such conflicts of interest could subject them to liability if a dispute were to arise.

Section 4.1.3: Appointment of Managers

The Manager(s) shall serve until his/her/their resignation, a Majority of the Members vote to remove or replace the Manager(s), retirement, death or permanent incapacity. If such event results in the Company having no Manager, a Majority of the Members shall select one or more new Manager(s).

Section 4.2: The Manager(s) Will Carry on the Day-to-Day Affairs of the Company

The Manager(s) shall have the full authority to bind the Company with respect to matters in the ordinary course of business.[41] Except as otherwise specifically determined by unanimous resolution of the Members or required by law, checks, drafts, promissory notes, orders for the payment of money and other evidence of indebtedness of the Company must be signed by two authorized Members if over $1,000 and must be approved by a Majority Vote of the Members if over $4,500.[42] Except as authorized by this Section 4.2 or by a Majority Vote of the Members, the Manager(s)

shall not have the power or authority to bind the Company in any way, pledge its credit or render it liable for any purpose.[43] The Manager(s) shall be entitled to compensation commensurate with the value of such services rendered as determined by a Majority of the Members. The roles, responsibilities and benefits of the Manager(s) are further set forth on Appendix C, which may be amended from time to time by the consent of a Majority of the Members.[44]

[41] This section provides that the managers have the authority to perform the usual tasks required to run the farm, and a member vote is not needed.

[42] This is an example of how you could restrict the powers of the managers. It is common to require two authorized signatures on checks over a certain dollar amount, here $1,000. This ensures that at least one other person has visibility into the farm's spending, which helps prevent runaway spending. Also, here, the managers can only bind the company up to $4,500. These limitations could be set as more or less, or taken out altogether.

As managers, Ingrid and Margo want to purchase some basic farming tools and supplies at the local farm store that cost about $1,500. They review the operating agreement and realize they need to get two members to approve the transaction because it is over $1,000. Jema agrees to sign along with Ingrid, who are both members.

Ingrid and Margo then decide that they want to purchase a tractor that costs $45,000. They only have $10,000 cash and would need to enter a loan for the remaining $35,000. They realize they'll need to get a majority approval to enter such a transaction. Jema and Marie are both reluctant to buy a new tractor, as they're concerned about cash flow. They suggest renting a tractor on an as-needed basis instead. Ingrid and Margo persist and finally win Jema over. This gives them the majority approval they need. They purchase the tractor even though Marie is against it.

[43] This is another safeguard. Basically, here managers can bind the company on any matter that is in the ordinary course of business and equates to less than $4,500 of indebtedness.

[44] The specifics of roles, responsibilities and benefits of managers may be set forth in the operating agreement itself. However, it's often easier to incorporate them as a separate appendix that can provide more details and be more efficient for tracking changes. The specifics would include a clear description of roles and responsibilities, somewhat like a job description, as well as any special benefits such as salary, housing arrangements and health benefits, which are common for farm LLC managers. Here, this appendix may be amended by a majority vote of the members and thus does not require unanimous consent like other amendments to the operating agreement. This makes it easier to resolve such nuanced issues. However, you could require unanimous consent. Another option is to create an entirely separate employment agreement with your manager(s).

Here, let's say that Margo is willing to work on the farm and co-manage the LLC in exchange for living in the tiny farmhouse, fruit and vegetables, and a $25,000 annual salary. Recall that Ingrid's salary in the first year is her initial contribution in "services"—for co-managing the LLC and farm labor—which is valued at $25,000. Part of Ingrid's compensation package also includes living in the farmhouse and farm food. Instead of putting all these nuanced details in the operating agreement, they decide to include these terms and more detailed descriptions of the roles and responsibilities of Ingrid and Margo as managers as an appendix. This may include either an employment agreement for each or some other memorandum of understanding outlining the terms of their duties, housing arrangement and salary. If amendments ever need to be made to this appendix, all that's needed is a majority vote. Note, however, that Ingrid and Margo cannot vote on issues that relate to each of their arrangements, as that would be a conflict of interest.

Section 4.3: Reimbursement

The Company shall reimburse the Manager(s) and/or Members for all direct out-of-pocket expenses incurred in managing and supervising the Company.

Section 4.4: Member Action; Voting Process[45]

Section 4.4.1: Voting at Meetings

All Members shall be entitled to vote on any matter submitted to a vote. Members may vote either in person or by proxy at any meeting.[46] No proxy shall be valid after 11 months from the date of its execution, unless otherwise provided in the proxy.[47] Unless otherwise specifically provided herein, the Majority Vote of the Members shall be determinative. Majority Vote means the consent of holders of more than 50 percent of the Percentage Interests at the time of the vote.[48] A quorum shall be met when Members and proxies holding a majority of Percentage Interests are present.[49]

[45] Under some circumstances, the members might need to make a decision together, and they do so by following these processes.

[46] A proxy is a separate agreement in writing that one member has with another member that specifies that the other member can vote on his or her behalf. Proxies count toward a quorum (the minimum percentage interest that must be present at a meeting to make actions valid), so allowing for proxies can make it easier for the company to ensure that things get done, especially if there are a lot of members. By allowing votes by proxy, members are free to decide for themselves whether they want to delegate their voting privileges to another member and not necessarily have to attend meetings. If it is important to you that all of your members make critical decisions for themselves, and that they attend meetings, then you shouldn't allow proxy voting.

[47] State law generally establishes an 11-month default time limit on proxies, which protects the member initiating the proxy from potential abuse, and this simply reiterates the law.

[48] This article explains that the default threshold for making a decision is a majority vote of the members, which is based on the percentage interest allocation. You have many options here. First, you could set the threshold differently, such as a supermajority (or three-quarters consent) or unanimous consent. Also, you could base the voting rights on something different, such as one member, one vote. You could also specify that some members have voting rights and others don't. It's also important to note that this is the default voting threshold. Other places in the operating agreement specify a more stringent threshold, including a list of "big" decisions requiring unanimous consent set forth in Article 4.5.

[49] A quorum is a requirement that a certain number of people attend a meeting to even vote on a decision. Here, if less than a majority of members are present or accounted for through a proxy, then no vote can be held.

Section 4.4.2: Written Consent

Any action that may be taken at a meeting of the Members may be taken without a meeting if the Members consent in writing. Such consent shall set forth the action to be taken, and be signed and dated by Members holding the requisite Percentage Interests.[50]

Section 4.5: Actions Requiring Unanimous Member Approval[51]

Notwithstanding any other provision of this Agreement, the unanimous, written consent of the Members shall be required to approve the following matters:

a. Dissolution or winding up of the Company;
b. Merger or consolidation of the Company;
c. Sale, transfer, contribution, exchange, mortgage, pledge, encumbrance, lease or other disposition or transfer of all or substantially all of the assets of the Company;
d. Amendments to this Agreement;
e. Issuance of any interest in the Company, including admission of new Members and additional Capital Contributions from a Member; and
f. Conversion of the Company to a different entity.

[50] This provides another option for making decisions, which doesn't require holding a meeting.

[51] The actions set forth here have a substantial impact on the business and therefore LLC Agreements most often list them as requiring unanimous consent, which overrules the majority agreement default set forth in Article 4.4.1. If a member or set of members does something like sell the LLC without consent, that action is invalid and the member(s) who didn't make the decision has some protection. Of note, operating agreements sometimes require only that a supermajority, usually defined as members owning at least three-quarters of the company, approve these types of decisions, including an amendment to the operating agreement. This may be advisable if the LLC has numerous and diverse members and it's anticipated that it would be very challenging to get everyone to agree. For example, if 10 members of an LLC have equal ownership and nine of the 10 want to wind down the farm or sell it, they would not be able to proceed if unanimous consent were required. However, they would be able to choose their favored course of action if the threshold were set at 75 percent. Keep in mind, however, that requiring unanimous consent protects initial founding members and safeguards their vision for how the company operates. Indeed, if and when additional members are added, the percentage interest of the initial members will get diluted, and the additional members could eventually hold a supermajority! Again, it's up to you to decide and clearly outline in your operating agreement what is required for making various types of decisions—whether a majority, supermajority, unanimous consent or something else—so that it is most suited to the unique nature and makeup of your farm operation.

Section 4.6: Place of Meetings[52]

Meetings of the Members shall be held at such place within or without the State of Wisconsin as determined by a Majority Vote of the Members.

Section 4.7: Annual Meeting

The annual meeting of the Members of the Company shall be held during the month of April of each year on the date and at the time each year as determined by a Majority Vote of the Members. The failure to hold an annual meeting at the time stated herein does not affect the validity of any action taken by the Company.[53]

Section 4.8: Special Meetings

Meetings of the Members may be called for any proper purpose or purposes[54] by a Member or Members who hold at least 20 percent of the Percentage Interests.

[52] This clause sounds obvious—it simply says the meeting could be held in Wisconsin or it could be held anywhere else. This clause is followed by several more that detail when, how, why and where a meeting might be held. Why state these obvious details? This is because we write an operating agreement anticipating that difficulties might arise. If relationships between members sour, some members might try to hold covert meetings where they make decisions that affect the farm's sustainability or the rights of the members who aren't present. These meeting notice and time/place provisions help prevent that possibility by preventing covert meetings from occuring.

[53] Most state laws don't require members to have annual meetings. If you do decide to hold one, it's important to designate a time and place. It's also advisable to have an out clause so that if your annual meeting isn't in fact held in the specified month, your actions at the annual meeting aren't held invalid.

[54] Proper purpose is really anything that's legal and reasonably worth the time and effort to hold a meeting. This is in here as a safeguard to raise issue if some member is unreasonably asking to have a meeting for anything and everything, or some "illegal" purpose.

Section 4.9: Conference Telephone Meetings

Meetings of the Members may be held by means of conference telephone or similar communications equipment so long as all Persons participating in the meeting can hear each other. Participation in a meeting by means of conference telephone shall constitute presence in person at such meeting.[55]

Section 4.10: Notice of Meetings

A notice of all meetings, stating the place, day and hour of the meeting, and in the case of a special meeting, the purpose or purposes for which the meeting is called, shall be delivered not less than 10 nor more than 60 days before the meeting to each Member entitled to attend.[56]

Section 4.11: Waiver of Notice

Attendance of a Member at a meeting shall constitute a waiver of notice of the meeting, except where such Member attends for the express purpose of objecting to the transaction of any business on the ground that the meeting is not lawfully called or convened. A Member may also waive notification of a meeting in writing.[57]

[55] Allowing for teleconference meetings gives members leeway in logistically making decisions and is advisable if members are particularly busy or geographically dispersed, making physical attendance at meetings challenging.

[56] This article is important to ensure that your members actually know when your meetings are being held. See also Article 4.10, which specifies how notice must take place.

[57] This basically means that if a member didn't receive formal notice (the announcement that the meeting will be held) as specified in Article 4.10, and yet they attend the meeting, then they can't complain that they didn't receive notice. However, the member can raise objections at the meeting about how notice was given. This article protects members who may feel that somehow their interests are being subverted by the majority. It's not necessary, but is advisable if you expect to have a lot of members or a diversity of interests, or otherwise think it's likely that contentious issues may arise.

ARTICLE 5: Limitation of Liability; Independent Activities; Indemnification

Section 5.1: Limitation of Liability

To the maximum extent permitted by applicable law, the Members and Managers shall not be liable to the Company or any other third party (i) for mistakes of judgment, (ii) for any act or omission by such Member or Manager, or (iii) for losses due to any such mistakes, action or inaction.[58]

Section 5.2: Independent Activities

Any Member or Manager may engage in or possess an interest in other business ventures of every nature and description, independently or with others, including, without limitation, the ownership, financing, management, employment by, lending or otherwise participating in businesses that are similar to the business of the Company. This agreement does not create any rights for the Company or the other Member related to independent ventures, including any income or profits from such independent ventures.[59]

[58] This means that if members or managers make an honest mistake or do something innocently dumb and cause the company harm, the company or a third party can't sue the member or manager personally for it. Of course, the members and managers have responsibility to be conscientious and make good business decisions. The courts will decide whether a mistake is innocent or the result of really bad judgment on behalf of the member or manager.

[59] This article protects members and managers who may be involved in related ventures or businesses. It basically allows them to compete with the business. Most states frown on "non-compete provisions" in any operating agreements or employment agreements, so if you do decide to place any limitations on members or managers with respect to activities outside of the farm operations, they must be reasonable in both subject and geographic scope. It is advisable to consult an attorney before writing non-compete limitations into your operating agreement.

Section 5.3: Indemnification

Section 5.3.1: Indemnification

To the fullest extent permitted by applicable law, a Member, a Manager and each director, officer, partner, employee or agent thereof ("Covered Person") shall be entitled to indemnification from the Company for any loss, damage or claim (including attorney fees and costs) incurred by such Covered Person by reason or any act or omission performed or omitted by such Covered Person in good faith on behalf of the Company and in a manner reasonably believed to be within the scope of authority conferred on such Covered Person by this Agreement. Notwithstanding the prior sentence, no Covered Person shall be entitled to be indemnified in respect of any loss, damage or claim incurred by such Covered Person by reason of gross negligence, bad faith or willful misconduct with respect to such act or omissions. Any indemnity under this Section 5.3.1 shall be provided out of and to the extent of Company assets only, and no other Covered Person shall have any personal liability on account thereof.[60]

Section 5.3.2: Notice

In the event that any claim, demand, action, suit or proceeding shall be instituted or asserted or any loss, damage or claim shall arise in respect of which indemnity may be sought by a Covered Person pursuant to Section 5.3.1, such Covered Person shall promptly notify the Company thereof in writing. Failure to provide notice shall not affect the Company's obligations hereunder except to the extent the Company is actually prejudiced thereby.[61]

[60] An indemnification provision is simply a promise by the other party to cover your losses if he or she does something that causes you harm or causes a third party to sue you. Indemnification provisions can vary quite a bit. Here, this indemnification clause means that if someone sues members for something they did on behalf of the LLC, the LLC has to pay to defend that lawsuit. An LLC should consider carrying insurance for this—without insurance, the business probably can't afford to follow through on this provision. Farm liability insurance may or may not provide this coverage. A commercial policy might be necessary.

[61] This requires that any member sued for their work with the LLC tells the company that the suit was filed. That way the company can monitor the issue and have adequate opportunity to represent its interests. However, the company can't get out of its obligations to the person filing the suit simply because the member or manager failed to tell the company. Basically, this provision gives the company a right to go after members or managers who fail to give proper notice and yet protects any third party that has a valid claim against the company.

Section 5.3.3: Contest

The Company shall have the right, exercisable subject to the approval of the disinterested Covered Persons, to participate in and control the defense of any such claim, demand, action, suit or proceeding, and in connection therewith, to retain counsel reasonably satisfactory to each Covered Person, at the Company's expense, to represent each Covered Person and any others the Company may designate in such claim, demand, action, suit or proceeding.[62] The Company shall keep the Covered Person advised of the status of such claim, demand, action, suit or proceeding and the defense thereof and shall consider in good faith recommendations made by the Covered Person.[63]

[62] This ensures that the company has a say and can monitor the effectiveness of the outcome of any dispute that may arise involving its managers and/or members and requires the company to pay for legal counsel.

[63] Indemnification is easiest to understand through examples. Recall that Ingrid handles the production and community-supported agriculture program of Sun Sisters Farm, LLC. A couple of years into the CSA, Ingrid runs into a very disgruntled customer named Mildred. Mildred wasn't familiar with the CSA concept before she signed up for a Sun Sisters Farm share, and she was under the impression that she would receive a greater quantity and variety of vegetables. Mildred is also inclined to use the court system rather than raise her concerns with Ingrid. At the end of the season, Mildred files a lawsuit against Ingrid claming Ingrid's sale of the CSA share was fraudulent. Ingrid tells her co-members at Sun Sisters Farm, LLC about the suit immediately and asks for the farm business to defend her. At first, some of the other members are hesitant—they aren't sure if the farm can afford this process … and they might be wondering if Ingrid should be personally responsible, not the farm business as a whole. While trying not to offend Ingrid, they explore the issue of whether Ingrid made the sale in her capacity as a member of the LLC. Considering that Ingrid made the sale through the farm business and her sale was a perfectly reasonable exercise of her authority within the farm, the members realize that Article 5.3.1 requires the LLC to defend Ingrid. The business must "indemnify" Ingrid. The members contact their insurance company immediately to get the ball rolling on a defense.

ARTICLE 6: Transfers of Interest[64]

Section 6.1: Transfers

Except as permitted by this Agreement, a Member shall not Transfer any portion of the Member's Interest. "Transfer" means to sell, assign,[65] give, bequeath, pledge, or otherwise encumber, divest, dispose of, or transfer ownership or control of all of, any part of, or any interest in a Percentage Interest to any person or entity, whether voluntarily or by operation of law, whether before or upon death. The Transfer of all or a portion of an Interest does entitle the transferee to become a Member or to exercise any rights of a Member.[66] Unless provided otherwise by this Agreement, a transferee shall be entitled to receive only the distributions to which the transferor would be entitled. The transferee shall not be admitted as a Member unless approved by unanimous consent of the Members who are not transferring their Interests.[67] Unless and until the transferee is admitted as a member, the determination of majority consent for all purposes shall be made by excluding the Percentage Interest held by the transferee.[68]

[64] Here's a plain-language summary of Article 6: A member can't sell or give away his or her interest in the LLC without approval of the other members and without following the process set forth in the agreement, which includes a "right of first refusal" by the other members. If a member tries to transfer their interest without following the process, it is invalid. Such an elaborate process as the one included in this model agreement is certainly not required. Indeed, you could just simply require that all members unanimously—or a supermajority or a majority—agree to the transfer, otherwise it is not allowable. Or, you could openly allow any and all transfers (which is generally not advisable), but it's up to you.

[65] This definition of transfer includes an assignment, which basically means to transfer a right or set of rights. This prohibits assignment unless the provisions set forth in Article 6 are followed. Many LLCs prohibit assignment because they don't want a member voting on LLC matters if the member does not have a financial interest in profits and distributions.

[66] If someone takes over a member's interest in the company, then the new member receives distributions only—not voting rights. Here's what this means. Let's say a member goes on vacation to another state, causes a vehicle accident, and is sued by the injured person. Let's also say that the member doesn't have car insurance and the injured person goes after the member's personal assets for compensation. The member's interest in this LLC is a personal asset. If the injured person successfully sues the member, the court could

award the injured person the member's interest in this LLC. With this provision, that injured person gets a right to receive any distributions (remember, that's cash or property paid out to members) that would have been made to the member. But, the injured individual can't vote on issues—they don't become a "real" member, basically.

[67] Even if an interest is transferred, the transferee won't become an actual member with voting privileges, etc. unless a majority of the members agree to make them a full member.

[68] Given the transferee doesn't have voting rights, their percentage interest will be excluded from the mix when counting up votes to get a majority. For example, if the transferee has a 10 percent interest, then the total percentage interest of members will actually be 90 percent, and it will just take a consent of 46 percent to get a majority.

Section 6.2: Voluntary Withdrawal

No Member shall have the right or power to voluntarily withdraw from the Company, except as otherwise provided by this Agreement.[69]

Section 6.3: Member's Right of First Refusal[70]

In the event a Member wishes to Transfer such Member's Interest, such Member (the "Transferring Member") shall first be required to provide the Manager(s) and the other Members with a written offer ("Offer") that shall set forth the following: (a) the intention to Transfer; (b) the name and address of the prospective transferee; (c) the Interest being offered ("Offered Interest"); and (d) the terms and conditions of the Transfer, including the purchase price for the Offered Interest.

[69] This reiterates Article 2.5 (and explanation in footnote 23) that a member can't simply withdraw from the company and expect the return of their capital investment, which is generally the default rule of state LLC laws and regulations. It's important to include this provision to protect the company from cash flow and other issues resulting from a member's arbitrary decision to simply withdraw their interest.

[70] Requiring this right-of-first-refusal process gives the members the opportunity to keep all interests in the company within the existing members versus allowing any member to just transfer their interest to some stranger.

Here's an example of how the right-of-first-refusal transfer provisions in this operating agreement could play out. Let's say that Marie is increasingly frustrated with how the business is being run, as it's counter to her keen business sense. She's still upset about the "majority" decisions to buy an expensive tractor and distribute profits at year three, both of which she was against. She decides she wants to leave the company. Marie has a good friend, Juliet, who is interested in taking over her 40.9 percent interest. Marie and Juliet decide on a price of $60,000. This price takes into account the thriving business and the increased value in the farm property that Marie originally invested as her capital contribution. However, Marie reviews the operating agreement and realizes that she first needs to follow Article 6 and provide a "right of first refusal" to the other members—Jema, Ingrid and Margo. So Marie follows the provisions. She writes up an "offer" to the members for the amount of $60,000 that she negotiated with Juliet, an actual prospective buyer. Jema, Ingrid and Margo each consider whether to buy in at their pro rata (i.e., proportional) shares. Jema decides to. However, Ingrid and Margo aren't able to come up with the money to buy their shares. So, Ingrid and Margo then each write up an offer to Jema for their pro rata shares of Marie's interest based on this negotiated price of $60,000. Jema decides not to make such a huge investment—that means she would have to buy all of Marie's interest. Instead, Jema rejects the offers from Ingrid and Margo and takes the offer from Marie to just buy her pro rata share. Ingrid and Margo's pro rata shares are still on the table (Ingrid and Margot can't buy them and Jema chooses not to). This means Marie can sell that remaining interest to Juliet.

Now for the math! Jema's pro rata share vis a vis her, Ingrid and Margo is 46 percent. In other words, presuming Marie's out, Jema's original capital contribution of $30,000 equates to 46 percent of the remaining three's total capital contributions of $65,000. So for Jema to purchase her pro rata share of Marie's interest, based on the negotiated price of $60,000 for all, Jema must invest an additional $27,600 (46 percent of $60,000). Juliet must then invest the remaining $32,400. Now, Jema has 46 percent, Juliet has 26 percent, Ingrid has 20 percent and Margo has 8 percent. Marie has 0 percent and is out. Exhibit B will also need to be adjusted to remove Marie, add Juiliet, include Jema's additional contribution and adjust everyone's percentage interest accordingly. See Exhibit B

to illustrate how this would look.

Nevertheless, Jema, Ingrid and Margo decide not to let Juliet in as a member. So Juliet basically owns "equity interest" but has no voting rights. (This is called an equity interest because it's an interest primarily in the distributions the company may make, which come out of equity.) So now, Jema holds a majority of percentage interest for voting purposes (vis a vis the percentage interest of Jema, Ingrid and Margo—the three members).

Section 6.3.1: Acceptance Offer

Each of the remaining Members may elect within 45 days after receipt of the Offer to purchase his or her prorated portion of the Offered Interest by giving written notice within such 45 day period to the Transferring Member and to the Company.

Section 6.3.2: Pro Rata Portion

For purposes of this Section 6.3, each accepting Member's pro rata portion of the Offered Interest is that proportion of the Offered Interest as the Interest held by such accepting Member(s) bears to the Interests held by all other accepting Members. If any accepting Member elects not to accept all or any part of his or her pro rata portion of the Offered Interest, the Member(s) shall give written notice on or before the 35th day after receipt of the Offer of the Member's election to the other accepting Member(s). The Accepting Member(s) may accept his or her respective pro rata portion of that accepting Member's pro rata portion of the Offered Interest.[71]

[71] This article basically allows each member the opportunity to purchase a portion of the offered interest based on his/her percentage interest. If one or more choose not to purchase their share, then it is offered to the members (if any) who have chosen to purchase their portion. This way, everyone gets an equal chance to further buy into the company, and the members as a whole have the opportunity to keep the interest within their group instead of having it transferred to some outsider.

Section 6.3.3: Offer Not Accepted as to All Interests

If the accepting Member(s) has not elected to accept all the Offered Interest within the time periods specified above, the Transferring Member may Transfer the Offered Interest to the prospective transferee named in the Offer as provided in Section 6.3, such transfer to be made only in strict compliance with the terms set forth in such statement and to be completed within 90 days following the expiration of the time provided for the election by the Member to accept the Offered Interest, after which time any such Transfer shall again become subject to all the restrictions of this Agreement.

Section 6.4: Interests Not Subject to Restrictions

Notwithstanding any other provision of this Agreement to the contrary, the restrictions on Transfer of a Member's Interest set forth in this Agreement shall not apply, subject to Section 6.1, to the gift, by bequest or otherwise, of Membership Rights to the spouse of a Member, to a Member's lineal descendants, or to trusts for the benefit of a Member's spouse or lineal descendants, which Transfers may take place after the date of the execution of this Agreement and are hereby consented to by the Member.[72]

[72] This means members can transfer interests to their spouse, their children, and to any trust members might create to manage property or assets without first getting unanimous consent. This is most useful regarding wills: If members leave their interest to each other, their children or a trust, it may be easier to execute with this provision. Check with an attorney for more information on planning the estate. Oftentimes operating agreements also permit transfers to other members without first getting unanimous consent, which is something you may want to consider including in this list. Note that this is subject to Article 6.1, which means that the transferee doesn't automatically become a member with voting rights until and unless all members unanimously agree to admit them as a member.

Section 6.5: Effect of Transfer

In the event of any Transfer accomplished in accordance with this Agreement, including a Transfer permitted by Sections 6.3 or 6.4, the transferee and transferee's spouse, if any, shall receive and hold the Interest transferred subject to the terms and provisions of this Agreement. The transferee shall be subject to the obligations of the transferor set forth in this Agreement and shall, upon request by the Company or any Member, execute an endorsement to this Agreement.[73]

Section 6.6: Void Transfers

Any Transfer of any Interest by a Member shall be deemed void, and the Company shall not record or recognize any such Transfer, until there has been compliance with the provisions of this Agreement.[74] If no Offer is made as herein required, the Company and the Member may nevertheless exercise their rights hereunder as to the Interest being transferred, and they may do so at any time, even after the Transfer of the Interest.

Section 6.7: Involuntary Transfers

An Involuntary Transfer will be effective only after compliance with applicable provisions of this Section 6.7.[75] The creditor, receiver, trust or trustee, estate, beneficiary, or other person or entity to whom a Percentage Interest is Transferred by Involuntary Transfer (the "Involuntary Transferee") will have only the rights provided in this Section 6.7.

[73] This basically means that if a transfer is effective, the transferee (i.e., the one that now holds the interest) must sign and abide by the operating agreement.

[74] A void transfer means it's as if it never happened. That means that even if Member A sold their share of the company for cash to Member Z without consent, the transfer is void. Then Member A is still a member and can conduct business on behalf of the LLC. If Member Z, not knowing that the transfer is void, votes or takes action on the LLC, those actions are void.

[75] An involuntary transfer typically happens as a matter of law because of a default of some kind, whether through a creditor taking the interest, bankruptcy, foreclosure, etc. This article basically means that whoever receives the interest through such a scenario is obligated to immediately notify the members of the LLC that they have seized the interest. Otherwise, they have no legal rights to future distributions.

Section 6.7.1: Definition

"Involuntary Transfer" means any Transfer of a Percentage Interest by operation of law or in any proceeding, including a Transfer resulting from the dissociation of a Member, by or in which a Member would, but for the provisions of this Section 6.2, be involuntarily deprived of any interest in or to the Member's Percentage Interest. "Involuntary Transfer" includes, without limitation, (a) a Transfer from bankruptcy, (b) any foreclosure of a security interest in the Percentage Interest, (c) any seizure under levy of attachment or execution, or (d) any Transfer to a state or to a public office or agency pursuant to any statute pertaining to escheat (the reversion of property to the state upon its owner's death when an heir does not exist), abandoned property or forfeiture.

Section 6.7.2: Notice to the Company

The Transferor and the Involuntary Transferee shall each immediately give written notice to the Company describing the event giving rise to the Involuntary Transfer; the date on which the event occurred; the reason or reasons for the Involuntary Transfer; the name, address and capacity of the Involuntary Transferee; and the Percentage Interest involved (a "Notice of Involuntary Transfer").

Section 6.7.3: Effect of Involuntary Transfer

Upon the receipt of the Notice of Involuntary Transfer, the Involuntary Transferee shall have the rights of an assignee of the Transferor's Percentage Interest as set out in section 183.0704(1)(b) of the Wisconsin Limited Liability Company Law.[76] Unless and until the Involuntary Transferee is admitted as a member by unanimous consent, the Percentage Interest held by the Involuntary Transferee shall have no voting rights.[77]

[76] As discussed earlier, one reason to write an operating agreement is to outline when and how the LLC members want to deviate from the "default" rules provided by state law. That's the role of this reference to Wisconsin law—it helps the company clearly communicate how it relates to state law. It may not be strictly necessary at times, but it's always a best practice.

[77] Members can always admit the Involuntary Transferee as a member, if wanted. Recall that until and unless that's done, the percentage interest held by the transferee will be excluded from the majority vote.

Section 6.8: Effect of Dissociation

The dissociation of a Member will not entitle a Member to a distribution in redemption of the Member's Percentage Interest. An event of dissociation under section 183.0802(1)(d)–(k) of the Wisconsin Limited Liability Company Law will be treated as an Involuntary Transfer pursuant to Section 7.4 of this Agreement.[78]

[78] This article is basically restating Article 2.5 (and explanation in footnote 23): Members cannot withdraw and demand return of their capital contributions or capital account. It's helpful to repeat it here in the specific context of transfer and incorporate a state law citation just to be sure it's clear.

ARTICLE 7: Books, Records and Accounting

Section 7.1: Bank Accounts

All funds of the Company shall be deposited in a bank account or accounts opened in the Company's name. The Manager(s) shall determine the institution or institutions at which the accounts will be opened and maintained, the types of accounts and the Persons who will have authority with respect to the accounts and the funds therein.[79]

Section 7.2: Books and Records[80]

Section 7.2.1:

The Manager(s) shall cause to be kept complete and accurate books and records of the Company and supporting documentation of the transactions with respect to the conduct of the Company's business. The records shall include, but not be limited to, complete and accurate information regarding the state of the business and financial condition of the Company, a copy of the Certificate of Formation and this Agreement and all amendments thereto, a current list of the names and last known business, residence or mailing addresses of all Members, and the Company's federal, state and local tax returns.

[79] It's important that the LLC has a separate banking account to ensure that its funds are not inappropriately commingled with the funds of its members.

[80] This Article basically says that all members have access to the books and records of the company; however, they must pay for any costs the company incurs in inspection, including copying.

Section 7.2.2:

The books and records shall be maintained in accordance with sound accounting practices consistently applied and shall be available at the Company's principal place of business for examination by any Member or the Member's duly authorized representative at any and all reasonable times during normal business hours. The Company shall maintain reasonable internal controls to safeguard its assets and business.

Section 7.2.3:

Each Member shall reimburse the Company for all costs and expenses incurred by the Company in connection with the Member's inspection and copying of the Company's books and records.

Section 7.3: Annual Accounting Period

The annual accounting period of the Company shall be the calendar year. The Company's taxable year shall be the calendar year, subject to the requirements and limitations of the Internal Revenue Code of 1986 ("Code") and Regulations.[81]

[81] For tax purposes, some companies prefer to designate their accounting period to end on another date, such as March, June, September—mostly based on the predicted cycle of profits and losses. You should consult an attorney or your accountant to determine what would be best based on your specific farming operation.

Section 7.4: Reports to Member

Within 75 days after the end of each taxable year of the Company, the Manager shall cause to be sent to each Person who was a Member at any time during the taxable year then ended: (i) an annual report, prepared by the Company's independent accountants in accordance with generally accepted auditing standards and expressing an unqualified opinion on the financial statements presented therein; and (ii) a report summarizing the fees and other remuneration paid by the Company to any Member or any Affiliate in respect of the taxable year. In addition, within 75 days after the end of each taxable year of the Company, the Manager shall cause to be sent to each Person who was a Member at any time during the taxable year then ended that tax information concerning the Company necessary for preparing the Member's income tax returns for that year.[82]

[82] Some states require that annual reports are prepared and filed with the secretary of state or financial institutions agency. Regardless, it can be beneficial for the company to require that an annual report is prepared, which keeps all members informed of key issues related to the farm operations. It's also important to ensure that all requisite tax information is sent to each member each year, as the LLC entity does not itself pay taxes. Rather, each member is required to account for their respective profit/loss related to the company on their individual tax returns.

Section 7.5: Tax Matters Member

A Member shall serve as the Company's tax matters partner ("Tax Matters Member"). The Tax Matters Member shall have all powers and responsibilities of a "tax matters partner" as defined in Section 6231 of the Code. The Tax Matters Member shall keep all Members informed of all notices from government taxing authorities that may come to the attention of the Tax Matters Member. The Company shall pay and be responsible for all reasonable third-party costs and expenses incurred by the Tax Matters Member in performing those duties. A Member shall be responsible for any costs incurred by the Member with respect to any tax audit or tax-related administrative or judicial proceeding against any Member, even though it relates to the Company. The Tax Matters Member shall not interfere with any dispute with the Internal Revenue Service without the approval of the Member.[83]

Section 7.6: Tax Elections

The Company shall make those elections permitted under the Internal Revenue Code and Regulations, including, without limitation, elections of methods of depreciation and elections under Section 754 of the Code, as approved by a Majority Vote of the Members.[84]

[83] All states require that a tax matters member be designated, who will ultimately be responsible for keeping all members informed of tax-related issues. This provision explains that since the company itself doesn't pay taxes, each member is responsible for their own tax matters. In particular, the tax matters member must stay out of the way and cannot get involved in any dispute that a member has with the IRS unless that member approves.

[84] Tax laws offer some flexibility in how certain allocations and accounting for depreciation of company and/or member assets are made. This article basically allows the LLC members to decide these tax issues by a majority vote. However, members are advised to consult with an attorney or accountant when making such decisions.

Section 7.7: Title to Company Property

All real and personal property acquired by the Company shall be acquired and held by the Company in its name.[85]

Section 7.8: Valuation of Company Assets and Interests[86]

Section 7.8.1: General

In the event that the Fair Market Value of a Company asset or Interest must be determined, such value shall be determined by a Majority of the Members, each acting in good faith. Within 90 days after such determination, the determining party shall provide notice thereof to all the other Members (a "Valuation Notice").

Section 7.8.2: Dispute

In the event that, within 30 days after having been given a Valuation Notice, any Member (an "Objecting Member") provides notice to the Company asserting that the value set forth in such Valuation Notice is materially inaccurate due to manifest error (a "Dispute Notice"), the Company and the Objecting Member shall undertake reasonable efforts to resolve their differences regarding such valuation through consultation and negotiation. In the event that the Company and the Objecting Member agree upon a revised Fair Market Value, such revised value shall be set forth in a new Valuation Notice to all the Members. In the event that the Company and the Objecting Member do not reach agreement within 60 days after the date of the Dispute Notice, the Objecting Member may, by notice to the Company within 30 days after the end of such 60-day period, require that the matter be submitted to mediation pursuant to Section 9.8.

[85] Most companies prefer that property titles, including land and farm equipment, be held in the name of the company and not its members. This does not apply to leases, only things that are "owned" in whole or in part by the company. If your farm operation includes land or equipment that is co-owned or involved in some other unique ownership arrangement where the company does not have full title, then this provision would need to specify that.

[86] Determining the valuation, or projected overall worth, of a company can be a subjective process. There are many ways of doing it and everyone will have an opinion, particularly when they have a vested interest. It is an essential exercise, as among other things, it will help determine the value of each member's percentage interest in the company. Article 7.8 says the valuation is to be determined by the majority of the members, but also provides a process for disputes. Other options could include specifying precise calculations based on accounting principles. Regardless, it's recommended that you include a protocol for determining the valuation in the operating agreement, as this area is ripe for contention.

ARTICLE 8: Dissolution And Liquidation

Section 8.1: Events of Dissolution

The Company shall be dissolved, and shall terminate and wind up its affairs, upon the first to occur of the following: (a) the determination by the Members to dissolve the Company;[87] or (b) the entry of a decree of judicial dissolution pursuant to 183.0902 of the Wisconsin Limited Liability Company Law.[88] The death, retirement, resignation, expulsion or bankruptcy of a Member, or the occurrence of any other event which otherwise terminates the continued membership of a Member in the Company shall not result in the dissolution of the Company.

Section 8.2: Procedure for Winding Up and Dissolution

If the Company is dissolved, the Members shall be collectively responsible for winding up its affairs.[89] On winding up of the Company, the assets of the Company shall be distributed, first, to creditors of the Company, including Members who are creditors, in satisfaction of the liabilities of the Company. Then, amounts in excess of any reserves deemed reasonably necessary by the Members to pay all of the Company's claims and obligations shall be distributed to the Members in accordance with Section 4.5 of this Agreement.

Section 8.3: Termination

The Members shall comply with any requirements of applicable law pertaining to the winding up of the affairs of the Company and the final distribution of its assets. Upon completion of the winding up, liquidation and distribution of the assets, the Company shall be deemed terminated.

[87] Although no single member can withdraw without consent of the other members, the members together can unanimously agree to dissolve the entire company.

[88] A court can require an LLC to dissolve. This can happen if one member is "oppressing" other members, such as by threatening them, or, if the LLC isn't acting in accordance with the operating agreement or the members are doing something illegal. Those are very, very unlikely to ever happen. But, you can be administratively dissolved if you fail to file your annual report with the state (it's easy and they send you a reminder) for five years in a row or so. You then have a year or two to file for reinstatement—if you don't, your LLC is gone.

[89] This means that if an LLC is dissolved, members won't ignore the dissolution by carrying on business as usual.

ARTICLE 9:
Amendments; General Provisions; Investment Representations

Section 9.1: Assurances

Each Member shall execute all certificates and other documents and shall do all such filing, recording, publishing and other acts as the Members deem appropriate to comply with the requirements of law for the formation and operation of the Company. Each Member shall also comply with any laws, rules and regulations relating to the acquisition, operation or holding of the property of the Company.[90]

[90] This requires that all members do what's necessary to make sure that all documents are signed, amended and filed with state or federal agencies and others, including creditors, so that the company is legally sound at all times.

Section 9.2: Notifications

Any notice, demand, consent, election, offer, approval, request or other communication (collectively a "notice") required or permitted under this Agreement must be in writing and either (a) delivered personally, (b) sent by certified or registered mail, with postage prepaid and a tracking number, (c) sent by a nationally reputable private carrier, or (d) sent by email or text. A notice must be addressed to a Member at the Member's last known address or transmitted to the Member's last known email address or mobile number accepting texts on the records of the Company. A notice to the Company must be addressed to the Company's principal office or to the official email address provided on the records of the Company. A notice delivered personally will be deemed given only when acknowledged in writing by the person to whom it is delivered. A notice that is sent by mail will be deemed given three business days after it is mailed. A notice sent by reputable overnight carrier will be deemed given on the date of delivery indicated on the carrier's delivery slip (no recipient signature required). A notice sent by email or text will be deemed given when sent. Any party may designate, by notice to all of the others, substitute addresses or addressees for notices; thereafter, notices are to be directed to those substitute addresses or addressees.[91]

[91] It's important to clearly set forth how any "notice" required by the provisions of the operating agreement will be delivered. This all sounds quite formal, but the formalities protect the members by ensuring that they have been properly notified well in advance of any significant issues. It helps that it's in writing. Here, email and text is provided as an option for giving notice. It's entirely up to you to decide how you prefer notice to be given.

Section 9.3: Specific Performance

The parties recognize that irreparable injury will result from a breach of any provision of this Agreement, and that monetary damages will be inadequate to remedy the injury fully. Accordingly, in the event of a breach or threatened breach of one or more of the provisions of this Agreement, any party who may be injured (in addition to any other remedies which may be available to that party) shall be entitled to one or more preliminary or permanent orders (a) restraining and enjoining any act that would constitute a breach, or (b) compelling the performance of any obligation that, if not performed, would constitute a breach.[92]

[92] Specific performance is a type of remedy that is specified in contracts where paying monetary damages wouldn't make the parties whole if the agreement is breached. For example, if you spend 30 years farming your land with blood, sweat and tears, and one of the members somehow breaches the operating agreement and illegally takes title to the land, that member's payment of the market value of the land may not adequately remedy the situation. Instead, the member would have to transfer title back to the company.

Section 9.4: Complete Agreement

This Agreement constitutes the complete and exclusive statement of the agreement among the Members and the Company. It supersedes all prior written and oral statements, including any prior representation, statement, condition or warranty.[93]

[93] This is typical contract legalese to confirm that any drafts or side agreements entered into by members are superseded by this agreement if a conflict were to arise.

Section 9.5: Applicable Law

All questions concerning the construction, validity and interpretation of this Agreement and the performance of the obligations imposed by this Agreement shall be governed by the internal law, not the law of conflicts, of the State of Wisconsin.[94]

[94] This is a fancy way of saying that the laws of Wisconsin will apply to any disputes arising from this contract. When disputes involve parties or incidents from multiple states, courts apply a legal doctrine called the "law of conflicts" to determine which state's law applies. One benefit of a contract is that the parties can agree upfront which state's law applies, regardless of the "law of conflicts" doctrine. It's important to designate which state's laws will govern the agreement, even if all your operations and your members are in one state, as otherwise creditors or other interest holders could bring you to court elsewhere.

Section 9.6: Section Titles

The headings herein are inserted as a matter of convenience only and do not define, limit or describe the scope of this Agreement or the intent of the provisions hereof.[95]

[95] This is typical contract legalese to guide the courts in interpreting the agreement if a dispute arises.

Section 9.7: Binding Provisions

This Agreement is binding upon, and inures to the benefit of, the parties hereto and their respective heirs, executors, administrators, personal and legal representatives, successors and permitted assigns.[96]

[96] This basically means that this agreement is binding on anyone who gets a legitimate interest in the company, even if they don't sign the agreement.

Section 9.8: Dispute Resolution[97]

If a dispute arises out of this Agreement, or a breach hereof, or otherwise develops between or among the Members and/or Managers with respect to the Company and/or its operation, business or affairs, then the Members and the Managers affected shall (before resorting to arbitration, litigation or any other dispute-resolution procedure) each proceed to negotiate with each other in good faith, on a commercially reasonable basis. They must meet in person with one another at least three times in an effort to reach a resolution. If no resolution has been reached after such efforts, then they shall proceed to mediation administered by the American Arbitration Association under its Commercial Mediation Rules. If mediation is not successful in resolving the entire dispute, or is unavailable, any outstanding issues shall be submitted to final and binding arbitration in accordance with the laws of the State of Wisconsin. The arbitrator's award will be final and the judgment may be entered upon it by any court having jurisdiction within the State of Wisconsin.

[97] It is highly recommended that you include a dispute-resolution clause. Here, mediation is preferred as it is generally the least expensive and most efficient way for resolving disputes. While many consider them effective for achieving just outcomes, both litigation and arbitration can be timely and expensive regardless of a "winning" outcome, the former more so than the latter. The key is to have a clear and comprehensive operating agreement so that disputes do not arise, but you can never be entirely sure they won't. So as a safeguard, consider the worst-case scenario, a super-messy dispute involving facts and he said, she said opinions, and then determine how you'd want the dispute to be resolved so that you can get on with your farming operations.

Section 9.9: Terms

Common nouns and pronouns shall be deemed to refer to the masculine, feminine, neuter, singular and plural, as the identity of the Person may in the context require.[98]

[98] This ensures that all terms are interpreted to include all parties, even if a singular is used. It's more legal jargon.

Section 9.10: Separability of Provisions[99]

Each provision of this Agreement shall be considered separable. If, for any reason, any provision or provisions herein are determined to be invalid and contrary to any existing or future law, such invalidity shall not impair the operation of or affect those portions of this Agreement that are valid.

Section 9.11: Counterparts

This Agreement may be executed simultaneously in two or more counterparts, each of which shall be deemed an original and all of which, when taken together, constitute one and the same document. The signature of any party to any counterpart shall be deemed a signature to, and may be appended to, any other counterpart.[100]

Section 9.12: Investment Representations[101]

The Interests have not been registered under the Securities Act of 1933, as amended, or any state securities laws (collectively, the "Securities Acts"), because the Company is issuing the Interests in reliance upon the exemptions from the registration requirements of the Securities Acts, and the Company is relying upon the fact that the Interests are to be held by each Member for investment. Accordingly, each Member hereby confirms the following representations:

[99] This article basically provides that if a court were to interpret one article of this agreement as illegal or otherwise invalid, the other sections of the operating agreement will still stand.

[100] This is legal jargon that basically allows members to sign the agreement on separate pieces of paper.

[101] These articles offer some measure of protection to the company because by signing this agreement, the members are each effectively making certain representations regarding their qualifications and fitness to serve as a member. Also, each member is effectively making certain representations regarding their investment objectives, which are necessary representations to comply with state and federal securities laws. If these provisions are not included in the operating agreement, it is advisable that you have all members sign an investment representation letter upon making their initial capital investment, which will effectively do the same thing.

Section 9.12.1:

Interests have been acquired for such Member's own account for investment and not with a view to the resale or distribution thereof, and may not be offered or sold to anyone unless there is an effective registration or other qualification relating thereto under all applicable Securities Acts, or unless such Member delivers to the Company an opinion of counsel, satisfactory to the Company, that such registration or other qualification is not required;

Section 9.12.2:

The Member understands that the Company is under no obligation to register the Interests or to assist any Member in complying with any exemption from registration under the Securities Acts;

Section 9.12.3:

The Member is experienced in evaluating and investing in companies such as the Company.[102] The Member is aware of the Company's business affairs and financial condition, and has acquired sufficient information about the Company to reach an informed and knowledgeable decision to acquire the Interests;

Section 9.12.4:

The Member understands that: (i) the Company is a newly formed limited liability company with no prior operating history, revenues or earnings; (ii) there can be no assurance as to the amount, if any, of revenues or profits that the Company may generate; (iii) an investment in the Interest is highly speculative; (iv) investors must accept the risk of potentially losing their entire investment in the Company; (v) the Company has only very limited amounts of cash and may be required to obtain additional cash in order to finance its operations; and (vi) there can be no assurance that the Company will be able to obtain additional capital on acceptable terms or at all.

[102] Again, these provisions are provided to protect the Company. By signing this agreement, the members are representing that they have some level of savviness in understanding how businesses operate and the risks involved. It does not necessarily mean that a member is an expert or even has prior experience in an LLC. Ultimately, it means they are taking this seriously, have done the due diligence or research into the business affairs prior to signing on as a member and making their capital contribution, and realize that they have no right to get their money back.

Section 9.12.5:

The Member acknowledges that the Company has not made any representation or warranty, either express or implied, to Member regarding the Company, the Interest or the investment in the Interests.

THE MEMBERS HAVE EXECUTED THIS OPERATING AGREEMENT AS OF THE DAY AND YEAR WRITTEN ABOVE.

Marie Sister

Signature: _____

Jema Sister

Signature: _____

Ingrid Sister

Signature: _____

Others**

Signature: _____

*** Both Margo and Juliet need to sign the operating agreement when they come on.*

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EXHIBIT A:

[The Articles of Organization]

EXHIBIT B: Member Capital Contributions

Based on our story of Sun Sisters Farm, LLC, the following is what Appendix B would look like at the outset.

Name & Contact Info	Capital Contribution	Percentage Interest
Marie Sister 33 Appleview Ln Madison, WI marie@sunsister.com	$45,000 farm property	45%
Jema Sister 44 Creekside St Madison, WI jema@sunsister.com	$30,000 cash	30%
Ingrid Sister 55 Suncircle Rd Madison, WI ingrid@sunsister.com	$25,000 services	25%
Total	**$100,000**	**100%**

EXHIBIT B: Member Capital Contributions - Amendment 1

The following is what Appendix B would look like once Margo Friend is brought on as a member.

Name & Contact Info	Capital Contribution	Percentage Interest
Marie Sister 33 Appleview Ln Madison, WI marie@sunsister.com	$45,000 farm property	40.9%
Jema Sister 44 Creekside St Madison, WI jema@sunsister.com	$30,000 cash	27.3%
Ingrid Sister 55 Suncircle Rd Madison, WI ingrid@sunsister.com	$25,000 services	22.7%
Margo Friend 66 Crabtree St Madison, WI margo@sunsister.com	$10,000 cash	9.1%
Total	**$110,000**	**100%**

EXHIBIT B: Member Capital Contributions - Amendment 2

The following is what Appendix B would look like once Marie leaves, Jema buys her pro rata share of Marie's interest, and Juliet buys Marie's remaining interest but is not brought on as a member so has no voting rights.

Name & Contact Info	Capital Contribution	Percentage Interest
Jema Sister 44 Creekside St Madison, WI jema@sunsister.com	$30,000 cash (initial) $27,600 cash (additional)	46%
Ingrid Sister 55 Suncircle Rd Madison, WI ingrid@sunsister.com	$25,000 services	20%
Margo Friend 66 Crabtree St Madison, WI margo@sunsister.com	$10,000 cash	8%
Juliet Friend 33 Appleview Ln Madison, WI juliet@sunsister.com	$32,400 cash	26%*
Total	**$125,000**	**100%**

* A non-voting member.

APPENDIX C

This would include the following for Ingrid and Margo as the managers:

- **job description outlining the roles and responsibilities**
- **employment agreements**
- **details of compensation package**

Checklist: Preparing Your Farm's LLC Operating Agreement

Using This Checklist

Are you ready to start putting together your operating agreement? This checklist with explanations details basic issues that should be addressed in a thorough and well-considered operating agreement. Not all questions will be relevant in every situation. One way of thinking about all of the issues on this checklist is to imagine the worst-case scenario—no matter how far-fetched—and then figure out how you'd want each scenario to be handled.

> "One way of thinking about all the issues on this checklist is to imagine the worst-case scenario and then figure out how you'd want each scenario to be handled."

Once you have a basic understanding of the answers to these questions, you might be ready for the next step: drafting. However, drafting an operating agreement can be challenging and may not be the best use of a farmer's limited time. Bring your responses to these questions to a qualified attorney. Armed with this information, he or she should be able to assemble a terrific operating agreement that is consistent with the laws of your state.

Keep in mind that your operating agreement must comply with certain baseline requirements set forth in your state's LLC statute. Given these statutes vary from state to state, Farm Commons highly recommends that you work with an attorney to help you through the process. If you decide to draft the operating agreement yourself, you should have an attorney review it. This will help assure that all of the provisions are in line with your state's statute and that none of the provisions contradict each other, which is sometimes hard to spot. Internal contradictions result in confusion, which can lead to disputes. This would defeat the purpose of having an operating agreement.

This checklist is designed to be used with the other resources provided in the LLC section of this Guide, including the *Extensive Operating Agreement for Sun Sisters Farm, LLC* and the *Brief Operating Agreement for Happy Couple Farm, LLC*.

Summary Checklist

Financial Matters

- What is everyone contributing to the business, financially?
- How are profits and losses handled?
- When is the decision made, and who decides whether to hand out or "distribute" profits to the members?

Management Matters

- Who makes the day-to-day decisions? That is, will the LLC be manager-managed or member-managed?
- What is the protocol for making day-to-day decisions?
- Are there any particular roles, responsibilities or benefits of any members or managers you want to specify?

Meetings and Voting Matters

- Will you have an annual meeting and, if so, when?
- How are members informed about the time and place of meetings and how meetings can be conducted?
- Who has voting rights and upon what are they based?

"Big" Decisions

- Will you allow additional members and, if so, who decides?
- What happens if a member wants to leave, or if a member's interest in the company is somehow passed on to someone else?
- Who decides whether the company takes on debt?
- Who decides whether to close the company?
- Who decides whether existing members can make additional capital contributions?
- Who decides on amendments to the operating agreement?
- Who decides whether the company can change hands (i.e., be acquired or merged with another company)?
- How are all other "big" decisions (i.e., not day-to-day decisions) made?

Checklist with Explanations

Financial Matters

- What is everyone contributing to the business, financially?

Another way of saying this is, what is the form and value of each member's (the LLC term for "owners") initial "capital contribution"? The idea is that each member brings something to the table–whether it be cash, land, equipment, past or future

services, or other things that are valued as capital.

Be sure to see an attorney or accountant before offering services as a capital contribution–there are tax implications.

What each member offers is called a capital contribution. It is important to determine upfront and put in writing the form and value of each member's capital contribution for a number of reasons. First, the LLC needs to be adequately capitalized to be legally legitimate. What is considered adequate will depend on your business. A basic rule of thumb is that you need enough to pay the bills as they come due. Also, the value placed on the capital contribution of each member will coincide with his or her ownership share or "percentage interest" in the company. The percentage interest breakdown may have significant implications as we'll discuss throughout this checklist, such as how profits and losses are dealt with and what voting rights are based on.

Keep in mind that once capital is offered to the company, it is no longer considered a personal asset. It is now a company asset and the member has no right to get the capital back or to expect anything in exchange for it. This is what makes a capital contribution different than a loan, lease, or sale of land or equipment. In effect, members are liable for the LLC's debts only to the extent or amount that each has contributed to the LLC. It's each member's "stake" in the business.

"The allocation of profits and losses will affect the tax basis on each member's individual tax return."

How are profits and losses dealt with?

Unlike corporations, LLCs have flexibility in allocating and distributing profits and losses. Profits and losses are revenue minus expenses. If you have more coming in than going out, you have a profit. If you have less coming in than going out, you have a loss. The LLC is required to establish how profits and losses are allocated to the members for tax purposes. The allocation of profits and losses will affect the tax basis on each member's individual tax return.

Profit and loss allocation could be based on the percentage interest breakdown, equal distribution (i.e., if there are three members, each gets one-third allocation regardless of percentage interest), or some other determinant. A member may want to allocate losses in a unique way to lower their tax basis. Farm Commons strongly recommends that you seek the guidance of your accountant or tax attorney if you want to allocate profits and losses on something other than the percentage interest.

When is the decision made, and who decides whether to hand out or "distribute" profits to the members?

A distribution is when the LLC actually gives members money or property based on profits. This is more akin to a dividend to shareholders in a corporation and is

different than a salary or wage.

What is your preferred timing for making distributions?

Typically, the decision is made annually based on year-end accounting. However, you could choose to allow to decide more or less frequently (e.g., every six months or every two years).

How is the decision made?

You could require unanimous consent of all members, a supermajority or a simple majority vote. See more below on voting and decision-making options. Or, you could specify that profits will be distributed only if the company has cash reserves above a certain amount. Some LLCs choose to place a high threshold on the decision to distribute profits, particularly early on, as they feel it is important to reinvest profits back into the company. Believe it or not, the distribution of profits is the source of a lot of internal battles in companies.

> "Some LLCs choose to place a high thresold on the decision to distribute profits, particularly early on, as they feel it is important to reinvest profits back into the company."

Story of Sun Sisters Farm, LLC

Article 3 of the *Extensive Operating Agreement for Sun Sisters Farm, LLC* requires just a majority consent before making a distribution of profit. The story that accompanies this sample operating agreement illustrates how touchy of a topic this can be. One of the members, Marie, prefers to keep the profits in the business. However, she holds less than a majority percentage interest and gets out-voted by the other members.

It's best to determine upfront what is ideal for the timing and process of distribution of profits and to put it in writing. This way everyone will know what to expect. Also keep in mind that state statutes generally prohibit distributions if doing so would jeopardize the company's ability to pay its bills.

Management Matters

Who makes the day-to-day decisions?

Another way of saying this is, will the entity be "member-managed" or "manager-managed"? Most states have a default rule that the LLC is managed by its members unless otherwise provided for in the operating agreement. If you have just a few members, you'll want to keep the day-to-day decisions and operations of the company in the hands of the members.

"A manager-managed structure allows you to designate a certain person or group of people to run the day-to-day operations."

However, management issues can get rather cumbersome if you have many members, or just a few members with very diverse interests. A manager-managed structure addresses this by allowing you to designate a certain person or group of people as managers of the company. The manager(s) could be members or non-members–it's up to you to decide the parameters.

The *Extensive Operating Agreement for Sun Sisters Farm, LLC* included in this Guide provides one example of a manager-managed LLC. The annotations also include a provision for a member-managed designation. The *Brief Operating Agreement for Happy Couple Farm, LLC* provides an example of a family-owned, member-managed LLC.

What is the protocol for making day-to-day decisions?

Whether you decide to go the member-managed or manager-managed route, you still may want to include some basic guidelines on day-to-day operations in your operating agreement. Here are some questions to consider:

- Are day-to-day decisions made by a single person or a set of people?
- Who are the managers and how are they appointed or removed from this role?
- Will you have some sort of a voting process if multiple people are involved in the day-to-day decisions?
- If you have an even number of members or managers, what happens if there's a 50/50 split on a day-to-day decision?
- Are there restrictions on any day-to-day decisions, such as spending amounts?

Spending restrictions

It is common to require two signatures from authorized members and/or managers on checks over a certain dollar amount (e.g., $1,000). This ensures that at least one other person has visibility into the farm's spending and provides an additional safeguard against runaway spending. It's also common to set a threshold (e.g., $4,500) for when the decision becomes a "big" decision and requires a vote by all voting members.

It's helpful to put such key aspects of your management protocol in your operating agreement so that everyone is on the same page and to ensure accountability.

Keep in mind, the operating agreement is not the place to lay out nitty gritty details on day-to-day decisions, but is rather the overarching protocol or framework for how those decisions are made.

> "The operating agreement is not the place to lay out nitty gritty details on day-to-day decisions, but is rather the overarching protocol or frameork for how those decisions are made."

Are there any particular roles, responsibilities or benefits of any members or managers you want to specify?

You may want to set forth the details regarding expectations of certain members or managers in the operating agreement itself. The specifics could include a clear description of roles and responsibilities of key members or managers, somewhat like a job description. It could also include any special benefits such as salary, housing arrangements and health benefits that you may decide to offer any managers of the LLC (if you are a manager-managed LLC).

If you decide to include such details in your operating agreement, it's best to incorporate them as a separate appendix. This will make it far easier to make changes and updates to these nuanced issues. Otherwise, you would have to consistently amend your operating agreement for minor details. Also, you should consider the protocol and threshold (e.g., majority, supermajority or unanimous consent) for making changes to this appendix. Do you want to make it less than what's required for amending the operating agreement itself? For more on this, see the discussion on "big" decisions below.

Another option is to create an entirely separate employment agreement that will govern all your agreements with your manager(s). Or, you could have a separate member agreement that governs any special arrangements with particular members, such as roles and responsibilities, housing arrangements, health benefits, etc. Either way, you are encouraged to think through these details at the get go and put them in writing in some form.

Meetings and Voting Matters

Will you have an annual meeting and, if so, when?

While state law doesn't require it, it's a good idea to have annual meetings for members to bring legitimacy to your company and to foster good relations with your members. Annual meetings are a perfect time to vote on "big" decisions, engage in strategic planning, and set and evaluate goals that will help your farming operation succeed. If you decide to hold annual meetings and designate a month or season for the meeting to be held, it's important to stick to it.

How are members informed of meetings and how can meetings be conducted?

Operating agreements also typically include a provision saying that in addition to the annual meeting, special meetings can be called if any big decisions need to be made. If you decide to have annual meetings or allow for special meetings, you'll need to set clear ground rules for how your members are notified of the time and place of the meeting, as well as rules for how and where meetings are conducted.

- Can members be notified of a meeting via email?
- How far in advance must the notice or invitation to a meeting be given?
- Can meetings take place by phone or internet (e.g., Skype or Google Hangout), or must they be in person?

If a member with voting rights doesn't know that a meeting is taking place and a vote is held on an important issue, he or she could raise issue with the decision that was made. This could result in legal issues down the road.

Who has voting rights and upon what are they based?

Voting rights will come into play for significant company decisions (and could even play a role in certain day-to-day management decisions if you decide to make your LLC member-managed). The following are some questions you'll need to answer.

What is the basis of voting rights in your company?

"Voting rights will come into play for significant company decisions."

The default rule in most state LLC statutes is that voting rights are based on the percentage interest of the members.

Story of Sun Sisters Farm, LLC

Let's say that the LLC has three members: Marie has a 55 percent percentage interest, Jema has a 30 percent percentage interest and Ingrid has a 15 percent percentage interest. Based on this, Marie automatically carries a majority vote even though she's just one of three members. Together, Marie and Jema would carry a supermajority (i.e., three-quarters agreement).

You could choose to structure voting rights some other way, such as one-member, one-vote. Or perhaps you want to designate one person as having the final say on *everything* or on certain matters. It's entirely up to you.

Does every member have voting rights?

You could decide to tier your membership interests so that some members have voting rights while others don't. It may be that you have members who don't really

care how the business is run. Or, maybe you don't want them to have a say! On the other hand, you may have members who want a say in every aspect of the company. How you structure the voting rights is entirely up to you.

"Big" Decisions

"Big" decisions are typically addressed separately in the operating agreement, including specifying detailed protocols, establishing certain restrictions and setting a higher threshold for the decision-making process. A higher threshold would be unanimous consent or supermajority versus just a majority. What are the "big" decisions for your farm operation and how do you want to handle them?

The following are the typical "big" decisions that are addressed separately in operating agreements. You may have others that are unique to your farming operation. Again, one way of thinking about these issues is to imagine the worst-case scenario–no matter how far-fetched–and to then figure out how you'd want each scenario to be handled. Keep in mind that requiring unanimous consent protects initial founding members and safeguards their vision for how the company operates if additional members are added. However, it may be challenging to reach unanimous consent if you have many or even just a few diverse members. Operating agreements sometimes require only that a supermajority, usually defined as members owning at least three-quarters of the company, approve "big" decisions. This may be advisable if you anticipate it will be very challenging to get *everyone* to agree on anything.

It's up to you to decide and clearly outline in your operating agreement what is required for making various types of decisions–whether a unanimous consent, supermajority, majority or something else.

"It's up to you to decide and clearly outline in your operating agreement what is required for making various types of decisions–whether a unanimous consent, supermajority, majority or something else."

Will you allow additional members and, if so, who decides?

Sometimes owners decide upfront that they most likely will not want any additional members. This is often because they don't want their own percentage interest in the company to be reduced or diluted. Dilution could reduce their share in profits and their voting power. However, it's still recommended that a provision is included for a process to add new members. What if the business needs more funds? What if someone you like and trust wants to invest as a part owner? If you decide to include a provision for additional members, what is the threshold for the decision? Unanimous consent, majority, supermajority or something else?

What happens if a member wants to leave, or if a member's interest in the company is somehow passed on to someone else?

A member's desire to leave or to transfer his or her interest in the company to someone else (voluntarily or involuntarily) will inevitably raise several issues. Voluntary transfers refer to the scenario when a member wants to leave and sell their interest to someone else. Involuntary transfers include events like a member's death or default on a loan if the member listed their interest in the LLC as collateral. These scenarios are all considered "transfers" in LLC-speak. You should consider them all carefully and set forth detailed parameters in your operating agreement. Here are some guiding questions:

> "A member's desire to leave or to transfer his or her interest in the company will inevitably raise several issues."

- If a member voluntarily decides to leave, how and when will his or her ownership interest be bought out?
- Can the leaving member automatically transfer his or her interest to another member of his or her choice?
- Can a member transfer his or her interest to a non-member?
  - If so, what's the protocol?
- Will that non-member automatically become a member with voting rights once he or she becomes an interest holder?
- Does there need to be a vote on the decision to allow a voluntary transfer?
  - If so, what's the threshold for the decision?
- As for involuntary transfers, what if a member dies?
- Will the deceased member's interest transfer to his or her heirs?
  - If so, will these heirs be voting members or simply interest holders?
- Will the deceased member's interest somehow be allocated to existing members?
- What if a creditor acquires a member's interest? Will the creditor automatically have voting rights?

For some creative ideas on how to address decisions and issues related to transfers, read through Article 6 of the *Extensive Operating Agreement for Sun Sisters Farm, LLC* and the accompanying story. This sample operating agreement includes a right-of-first-refusal protocol that applies if a member wants to leave and transfer their interest to a non-member. The departing member has to first make an offer to existing members to give them the option to buy the departing member's interest. This is just one way to address this issue and it may or may not be the best option for your farming operation. Either way, carefully think through

the line of questions above to help you develop the right transfer provisions for your farm business.

Who decides whether the company takes on debt?

Taking on debt will obviously impact the company's financials. It will also ultimately affect the tax basis and overall interest of each member in the farm operation. Again, each member is liable up to their capital contribution. So, taking on debt puts them at risk. It's very important to set parameters for how decisions involving debt are made.

- Do you want to require a member vote before any debt is incurred?
- Or, do you want to set a ceiling and anything above it requires a member vote?
- Is the ceiling based on a dollar amount or a percentage of company assets?
- If a vote is involved, what is the threshold? Unanimous consent, supermajority, majority or something else?

Who decides whether to close the business?

Closing the business–or dissolution and winding up in LLC-speak–is obviously a big decision. Some members may be more optimistic than others and want to keep going if it no longer makes sense to keep the business running for whatever reason. Others may have a low tolerance for risk. Who decides whether and when to close the business? What is the threshold for making this decision? Unanimous consent, supermajority, majority or something else?

Who decides whether existing members can make additional capital contributions?

You may need additional capital to address cash flow issues or to purchase equipment or land that the business needs to grow. While you could take out loans, another option is to seek additional capital contributions from members. However, this may change the percentage interest breakdown of the company. What's the threshold for making this decision? Unanimous consent, supermajority majority or something else?

Who decides on amendments to the operating agreement?

The operating agreement controls how the business runs. Amending the operating agreement can, in effect, change everything. What is the threshold for making this

decision? Unanimous consent, supermajority majority or something else?

Who decides whether the company can change hands (i.e., be acquired or merged with another company)?

The possibility could arise that someone or another company presents an offer to buy the farming business. While to some members it may seem like an offer you can't refuse, to others it may be that the company has sentimental value to them and no amount of money would be enough to sell it. Even if you think it's far-fetched, it's important to set a threshold for decisions regarding a merger or acquisition in your operating agreement, as one never knows. What's the threshold for making this decision? Unanimous consent, supermajority, majority or something else?

How are all other decisions made?

"Typically operating agreements have a default clause for decisions that are not specifically addressed in the operating agreement."

Typically operating agreements have a default clause for decisions that are not specifically addressed in the operating agreement. Here are some questions to think about concerning other decisions not addressed in this checklist:

- What is your default threshold for any decision not specifically addressed in your operating agreement–unanimous consent, supermajority, majority or something else?
- Can you imagine any other "big decisions" that may arise that are unique to your farming operation? If so, what is the threshold for these decisions?
    - For example, does the farming operation have a special piece of equipment or asset that you want to require unanimous consent before the company sells it or makes it collateral for a debt?
    - Or, do you want to require unanimous consent on a decision to launch an additional line of business, such as a value-added product line?

The more you think through this now, the more your unique interests will be protected in the long run.

Next Steps

The intention of this checklist is to get you thinking about how you want to structure your LLC and to address certain potential scenarios. Once you've answered these questions, you'll be ready to seek an attorney who can streamline the process of drafting your operating agreement.

Once you have your operating agreement in hand, be sure to follow the document. Following the rules and procedures detailed in your operating agreement gives the business legitimacy in court. It also helps facilitate good relations with your members or partners.

You should make copies or make it available in electronic form so that every member has the agreement and can refer to it as needed. It's a good idea to keep your operating agreement in one binder along with all meeting minutes and any amendments so that they are all readily available. This also helps prove the legitimacy of your LLC by showing you are taking the separate entity seriously. Whenever you have a doubt about what's required for making a decision or how to deal with a specific scenario when it arises, refer to your operating agreement for guidance.

"Following the rules and procedures detailed in your operating agreement gives the business legitimacy in court. It also helps facilitate good relations with your members or partners."

Sample LLC Annual Member Meeting Minutes with Annotations

ANNUAL MEMBERS MEETING MINUTES FOR SUN SISTERS FARM, LLC[1]

The annual meeting of this limited liability company was held on February 11, 2018, at 2 PM at the Sun Sisters Farm, LLC office in Wisconsin.[2]

[1] Annual member meetings are not required by most state LLC statutes. However, if the LLC chooses to elect S corporation tax status, it must hold annual meetings. The IRS requires all S corporations, whether organized as an LLC or C corporation, to hold meetings to ensure a layer of accountability in the operation of the company. These meeting minutes are included as a sample should you choose to hold annual member meetings, regardless of whether you elect S corporation tax status for your farm operation LLC.

[2] The place, time and date information needs to be in line with whatever is specified, if anything, in the LLC's operating agreement for holding annual meetings. For Sun Sisters Farm, LLC, the operating agreement does not specify an exact time or place. Your operating agreement could be more precise, such as specifying an exact month or the third Thursday of February, for example. If so, be sure that you follow what your operating agreement says and report it in your minutes.

The following members and/or managers were present at this annual meeting with the represented percentage interest:

- Marie Sister, member: 40.9 percent
- Jema Sister, member: 27.3 percent
- Ingrid Sister, member/manager: 22.7 percent
- Margo Friend, member/manager: 9.1 percent

Marie was designated as chairperson, and Jema was designated as secretary for the purpose of the meeting.[3]

[3] It can be helpful to designate a chairperson and secretary of the meeting. The chairperson basically makes sure that the meeting agenda is followed and keeps the discussion on track. The secretary is responsible for taking minutes and keeping them in the LLC book for reference should an issue or dispute arise.

The chairperson announced that the meeting was called by the members of the limited liability company and that a quorum was present.[4]

The minutes from the previous meeting were distributed. The complete LLC book was made available to inspect the articles of organization and any amendments, the operating agreement, the members' capital contributions and percentage interest breakdown, all meeting minutes and a current print out of the articles of organization filed with the state agency, showing what the records currently look like in that state agency's database. All members who were present read the previous meeting's minutes and inspected any LLC records if they wanted to.[5]

[4] If you include provisions in your operating agreement requiring an annual meeting, they should specify what a quorum is, or how many members need to be present for a vote to take place. A quorum will depend on the voting basis set forth in your operating agreement. For example, if voting is based on the percentage interest breakdown, a quorum will typically be member(s) representing a majority of the percentage interest in the company. If the voting is instead based on the number of members (i.e., one member, one vote), the quorum would be a majority of the number of members. Either way, requiring a quorum at the annual member meeting ensures that if there's a vote on an issue that requires a "majority" (i.e., percentage interest or number of members), it can effectively take place.

[5] It's advisable to make the entire LLC book as described here available, as this shows the transparency of the company's official status and records. In other words, it helps guarantee that no member is wrongly being subverted or pushed out and it shows to all the members that the LLC is up to date, so to speak. Including a statement about it in the minutes is good practice.

The annual financial report from the previous ending year was presented that stated the LLC had a net profit of $10,000. Upon a motion made and carried, the annual financial report was approved, attached to the minutes of the LLC.[6]

Ingrid made a motion and Margo seconded the motion to vote on the distribution of the net profit.[7] Ingrid, Margo and Jema voted in favor of the motion, together carrying a majority in favor of a

distribution as required by the operating agreement.[8] It was decided that the net profit would be distributed in the following manner based on percentage interests:

Member name:	Distribution amount:
• Marie Sister	$4,090
• Jema Sister	$2,730
• Ingrid Sister	$2,270
• Margo Friend	$910

[6] If any reports are presented at the meeting, be sure to attach them to the minutes. Again, this serves to track what information was presented in case a dispute arises. Reviewing the financial performance annually can be a helpful exercise. Doing this at an annual meeting ensures that all members have the opportunity to review it together, ask for clarifications as need, discuss any issues and suggest tips for financial improvement.

[7] "Making a motion" and "seconding the motion" is a custom formality in corporate meetings. Surely you've seen it in the movies. Basically, any official action or vote that is to be taken at a meeting requires at least two people to agree. The first "moves" or "makes a motion" for the vote and the second person "seconds" the motion. Then the vote can take place. This helps assure that only relevant and significant matters go to a vote.

[8] This is certainly a matter that may come up in the annual meeting, as the decision whether to distribute the year's profits, if any, will come up annually. Here, Article 3.2 of the Sun Sisters Farm, LLC operating agreement requires approval by a majority of percentage interest before profits are distributed to members. Marie feels they should keep the money in the business, so she votes against it. However, Jema, Ingrid and Margo together have a majority of the percentage interest. So it's decided the $10,000 profits are distributed among the four members based on the percentage interest breakdown.

The following people were named as the managers of the LLC for the next year:[9]

Ingrid Sister

Margo Friend

Upon motion made and carried by the members, the managers' salaries were fixed at the following rates until another meeting:[10]

Ingrid Sister	$20,000
Margo Friend	$20,000

[9] Another issue that can be addressed at the annual meeting is the appointment of managers. Here, Ingrid and Margo, who both were already serving as managers, were again named to continue in their posts. However, if for whatever reason there needed to be a switch in who served as manager(s), the annual meeting would be a great time and place to discuss and vote on the matter.

[10] The salary of managers may go up or down each year. The annual meeting is a perfect place to discuss it, particularly because the financial matters were just reviewed by all members. Note that if the issue of raising or reducing salaries goes to vote, Ingrid may not vote on her own salary and Margo may not vote on her own salary. This would raise a conflict of interest and be highly suspect in the eyes of the IRS and the courts should an issue or dispute arise regarding financial matters of the company.

Upon motion made and carried, the members decide that the next annual meeting shall be held on February 12, 2019.

Since there was no further business to come before the meeting, upon a motion by Jema and carried, the meeting was adjourned.[11]

Jema Sister, Secretary

[11] If there is no further business discussed, the meeting can be adjourned. Again, customarily, this official action requires two people to agree by making a motion and seconding the motion.

FARM COMMONS

SARE
Sustainable Agriculture Research & Education

Farmers' Guide to Business Structures: LLCs, Corporations, Partnerships and More

Chapter 5, Section 1: C Corporation Fundamentals

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AT-A-GLANCE CHART: C CORPORATION

	General Concept	Terminology
C Corporation Terminology	Name	"Farm Name, Inc"
	Owners/investors are called	"Shareholders" or "Stockholders"
	Persons who make management decisions are called	The "Board of Directors" is responsible for making key decisions; the "Officers" are responsible for the day-to-day management.
	Creation document is called	"Articles of Incorporation"
	Organizing document is called	"Bylaws"
	An owner's investment in the company is called	"Equity Investment"
	An ownership share is called	"Shareholder Equity" or "Shares"
	A payment of the company's profits to the owners is called	"Dividend"
	Is there personal liability?	Limited to a shareholder's investment
	How many participants can you have?	One or more, unless elect S corporation tax status
	Are annual meeting required?	Required
	Are different shareholder classes allowed?	Allowed, unless elect S corporation tax status
	Is an EIN necessary?	Required
	Who files the tax return?	Entity files an income tax return and pays corporate taxes; individuals also pay taxes on any dividends they receive from the corporation. Option to elect S corporation federal tax status
C Corporation with S Corporation Federal Tax Status	How many participants can you have?	Maximum 100 persons; all must be U.S. citizens and all must be human beings, estates, tax exempt entities, or certain qualified trusts
	Are different shareholder classes allowed?	Not allowed
	Who files the tax return?	Pass-through, but entity must file informational Form 1120S with the IRS, distribute Schedule K-1 to each owner and file all Schedule K-1s with the IRS

Introduction

The C corporation is the ordinary, traditional corporation. Most know it as just "corporation." Nowadays the letter "C" is often included as a prefix to prevent confusion, as there's been a recent rise of new corporate forms such as the S corporation federal tax status (where the "S" stands for small) and the B corporation (where the "B" stands for benefit).

This section explores significant aspects of the C corporation, how the entity is formed and what needs to be done to maintain it. The following section, *Going Deeper into C Corporations*, gives you some tools to help you navigate the process of creating and operating a C corporation; it includes a checklist for creating a C corporation as well as sample bylaws and annual meeting minutes with explanations.

> "Most know the C corporation as just "corporation." Nowadays, the letter "C" is often included as a prefix to prevent confusion between the S corporation and the B corporation."

See Chapter 6 on S corporations and Chapter 7 on B corporations for more details on each.

Basic Characteristics of the C Corporation

C corporations protect personal assets from business liabilities

Forming a C corporation, or any business entity, is a fundamental way to help protect personal assets of the owners from the farm business's liabilities. The C corporation offers farm operation owners peace of mind in keeping the risks of their business separate from their personal assets. As long as corporate formalities are upheld, the shareholders–which is the C corporation term for the business owners–are not at risk of losing personal assets if another person or business secures a court judgment against the shareholder. The shareholders can, however, lose up to the amount they have invested in the company. Whatever cash, property or other resources a shareholder invests in the C corporation is considered their equity investment; it reflects their risk or stake in the business, so to speak. The potential gain is a return on the investment in the form of profits based on their ownership percentage or equity in the company. The potential loss is losing all that they invested, no more, no less. That's because once a shareholder transfers ownership of the cash or property invested, it is thereafter owned by the C corporation itself.

Running a farm operation is not easy, and there's no guarantee it will succeed. Equipment breakdown, crop failure, unpredictable weather or a number of other events could lead to no profit or even a loss in a given season. If the farm doesn't turn a profit and uses up all the company's money or capital in the process, the owners of the C corporation won't even get their equity investment back. There's nothing left. Taking it a step further, let's say the C corporation had taken out a

loan to pay for some farm equipment and is no longer able to pay on its debt. It won't be long before the creditors come knocking on the farm business's door. However, given the C corporation protects shareholders from personal liability, the shareholders do not have to worry so much that creditors will come knocking on their doors and snatch up their lake house or their boat if the farm business starts going south. The creditor could still lay claim to any remaining assets of the C corporation, but nothing more. This is one advantage of creating a business entity such as a C corporation.

The C corporation protection on personal assets requires adherence to certain principles

In return for this privilege, state corporation statutes require business owners to follow certain rules and procedures. Each state has its own corporation statute, which establishes what is required to form and maintain a C corporation in that state. The rules and procedures a C corporation must follow vary from state to state; however, they all require the business owners to follow some fundamental principles.

> "The rules and procedures a C corporation must follow vary from state to state; however, they all require the business owners to follow some fundamental principles."

C corporations require a strict governance structure: shareholders, directors and officers

All state C corporation statutes require a very strict governance structure, which includes having shareholders, a board of directors and officers. Each of these titles carries its own roles and responsibilities.

Shareholders are those who contribute assets–or an equity investment–to fund the farm operation. They are the owners. They generally have little say or right to run the day-to-day operations of the company. However, they get to elect the board of directors and have the right to remove directors as they wish. The board of directors is elected by the shareholders each year at the annual meeting. The directors may or may not be shareholders themselves. The directors have high-level responsibilities for running the business, including making certain big decisions such as whether the company should take on a major financial liability like a loan to buy farmland, start a new business segment like value-added products or sell off a significant part of the farm operation. Another key role of the board of directors is to appoint the corporation's officers. Like the directors, the officers may or may not be directors or shareholders. The officers of a corporation are the ones on the ground running the day-to-day operation of the business and making management decisions. The officers include the president or chief executive officer (CEO), vice president or chief

operations officer (COO), treasurer or chief financial officer (CFO), and secretary. One person can hold multiple positions, or even all of them. This might sound silly, but acting with these separate hats is an essential formality that must be upheld to maintain the integrity of a C corporation entity. We'll discuss each of these positions in a bit more detail later.

What if you have just one or a few business owners?

It is of note that one person can fill all the roles of the shareholder, board and officer(s). If this were the case, that person would make decisions in different capacities. For example, let's say a mother and daughter decide to form a business entity for an organic goat cheese operation they've gone in on together. They call it Mother Earth Farm, Inc. It's just the two of them, and they need to figure out how they will fill all of these roles. Let's say they both invest some cash as an equity investment, so they are both shareholders. As shareholders, they elect the board of directors. They elect each other! Then, as directors, they decide who will be the officers. Together they agree that mom will serve as president and treasurer and daughter will serve as vice president and secretary. As officers, they now get to decide day-to-day matters such as how many goats to have, what types of cheese to make and so on. Any big decisions such as getting a substantial loan to buy farmland would need to be made as directors. If they decide the company needs more money for a new milking parlor, they would act as shareholders when writing a personal check to the business as an equity investment.

Be sure the farm operation has enough money, and keep the C corporation's financial affairs separate from the shareholders' financial affairs

In addition, like the LLC, the owners of the farm operation must also abide by certain principles to maintain the C corporation's protection from personal liability. If the farm business does not follow certain standards, then the courts can go around the C corporation's personal liability shield and allow creditors to access the individual owners' personal assets. Just as for an LLC, the two essential ways to protect the shareholders' personal assets are to adequately capitalize the C corporation and to keep the C corporation's financial affairs separate from the owners' personal financial affairs.

"Two essential ways to protect the shareholders' personal assets are to adequately capitalize the C corporation and to keep the C corporation's financial affairs separate from the owners' personal financial affairs."

First, as a basic rule of thumb, a company is adequately capitalized if it can make due on its debts, or pay its monthly bills, so to speak. Anything less would be undercapitalized. In other words, if you start incurring more debt than you can reasonably pay off based on estimated revenue, the C corporation will be considered undercapitalized. As a result, the shareholders may be personally liable to cover the business's debt. The directors and officers need to be smart about how much debt they allow the C corporation to take on.

Courts are also able to access personal assets if the shareholders fail to keep the business separate from their personal affairs. This includes commingling funds such as drawing on business assets to pay for personal expenses or not keeping separate business and personal bank accounts. The takeaway here is that just as business assets are available for business liabilities, personal assets are available for personal liabilities—each needs to remain separate and not be commingled. Be sure to keep separate bank accounts, credit cards and accounting records for the business entity, and to keep these all distinct from the personal financial affairs of the shareholders. For example, do not use the business's assets to pay a shareholder's personal bills, including credit card bills and rent payments.

"Be sure to keep separate bank accounts, credit cards and accounting records for the business entity, and to keep these all distinct from the personal financial affairs of the shareholders."

Also keep in mind that even if the C corporation is properly maintained, some creditors may require shareholders to personally guarantee farm debt. Creditors know that if there's nothing left in the business entity there will be nothing left for them. What this means is that creditors may require the shareholders to commit to loan payments as individuals, not just as shareholders to the C corporation. Shareholders will have to negotiate whether and to what extent a personal guarantee is required with creditors on a case-by-case basis.

C corporations do not substitute for insurance or reduce the likelihood of liabilities

Forming a C corporation or any business entity is not a substitute for insurance. Some farmers mistakenly believe creating a C corporation reduces the likelihood of liability. Creating a C corporation does nothing to change the landscape of a farm's potential liability; it only limits the assets available to satisfy that liability, should it materialize, to business assets. All the farm's assets are entirely available to anyone with a successful claim against a C corporation. Good liability insurance provides the farm with a defense in court and a source of funds to pay out on a court claim if it is successful. Farm Commons strongly urges any farm business, no matter what business entity it adopts, to maintain adequate insurance coverage.

How the C Corporation Compares to the LLC and the S Corporation: Which to Choose?

This is a good question that many farmers ask. For all intents and purposes, the liability protection offered by an LLC and a corporation are the same. Comparing some of the key characteristics of the C corporation and LLC may help you decide which option better matches your needs.

Flexibility versus formality

In practice, the statutory flexibility of the LLC with respect to how the entity is governed may lead many to mismanage it, degrading the protection it is meant to offer. For example, LLC statutes do not require separate directors and officers with such defined roles and responsibilities, though an LLC can certainly appoint individuals with such authority. Also, most state LLC statutes do not require the owners to hold an annual meeting. State C corporation statutes require the owners to hold an annual shareholder meeting, which provides an opportunity for everyone to review the financials and elect next year's board of directors. The board of directors must also meet annually to appoint the officers. The formality of annual meetings helps keep the board and the officers in check. As stated above, liability protection can be lost through mismanagement, including undercapitalization or the commingling of business and personal financial affairs. The formalities of a C corporation, including its strict governance structure and required annual meetings, may make mismanagement less likely. However, to non-lawyers, the formalities involved with a C corporation can look like too much pageantry. To many, the formalized processes of decision-making and authority are unwelcome. To these folks, the statutory obligations of a C corporation are a detraction. They may prefer an LLC.

> "Unlike for LLCs, state C corporation statutes require the owners to hold annual shareholder meetings."

Newness versus tradition

On the other hand, while the LLC has been around for over 35 years and is a very stable entity in the eyes of the law, the reality is that C corporations have been around a lot longer. The courts' interpretation and application of laws governing corporations are very well detailed. Now, much of this case law or precedent on corporations is being applied to LLCs, which lends further credibility to the LLC entity. Nevertheless, some farmers feel more comfortable with the traditional C corporation. This is also why some folks set up their LLC exactly like a corporation–with a similar governance structure and required annual meetings–

even though it's not required. They want to rest assured that they will have the benefits of the stable, thorough body of law controlling corporate governance. Ultimately, the decision may come down to personal inclination and comfort with what they are used to seeing in their family, town or region.

Financing options

Some other factors to consider in the choice between an LLC or C corporation relate to financial issues. First, if a farm operation anticipates it will need to raise a large amount of capital that exceeds what they can or want to get a loan for and is more than what the initial farm operation owners can afford, it may be beneficial to form a C corporation. This will preserve the option to raise capital from venture capitalists and angel investors. These are individuals with a significant amount of money who invest in small businesses in hopes of making a profit. Venture capitalists and angel investors typically prefer the formal C corporation structure and may even require it before making an investment. Also, if you think that your company will go public by advertising and offering ownership shares to the public at large through what's called an initial public offering (IPO), then the law requires a C corporation structure. Conducting an IPO is a very costly and time-consuming process that involves very complex securities law. It is typically done by multi-million dollar companies like Google and Amazon, for example. But maybe your farm operation has the next big idea! Of note, both a C corporation and an LLC can advertise and offer ownership interests directly to members of the public with whom they have a connection–like customers or suppliers. This is called a DPO. However, the LLC's choices on what it can offer through a DPO are a bit more limited than the C corporation.

> "If you think your farm operation will go public by advertising and offering ownership shares to the public at large, then the law requires a C corporation structure."

These financing issues are beyond the scope of this chapter. The point here is that these types of considerations can certainly come into play in the decision of which entity to choose, especially if the farm operation is considering a creative financing option to raise additional capital at the outset or in the future.

Tax implications

Finally, there are significant tax differences between a C corporation and an LLC. The LLC is a pass-through entity, so the entity itself does not have to pay federal income taxes. Instead the individual members report their share of the LLC's income on their individual tax returns. The C corporation, on the other hand, is subject to double taxation. The entity first pays corporate tax on the business's

taxable income, and then the owners have to pay taxes on any earnings or profits they receive from the company. Granted, the individual owners are taxed at the dividend tax rate, which is currently less than the rate for ordinary income. But the total taxes paid on business income for some small business owners can be astronomically high. Many small farm operations see this as a huge pitfall of a C corporation and a reason to form an LLC.

Should I choose a C corporation or an S corporation?

If you decide you prefer the assurance of the formalities and stability of the C corporation, you still have an option to circumvent the double taxation dilemma. Unlike the LLC or the C corporation, the S corporation is actually not a separate entity created at the state level. The S corporation is simply a federal tax status issued by the IRS. In effect, either an LLC or a C corporation can become an S corporation for federal tax purposes. Basically, the S corporation tax status allows the entity to be taxed as a pass-through entity, just like an LLC. It also provides some potential tax benefits related to self-employment taxes that neither the C corporation nor LLC provide on their own right.

"If you decide you prefer the assurance of the formalities and stability of the C corporation, you still have an option to circumvent the double taxation dilemma by electing S corporation federal tax status."

With S corporation tax status, if the corporation has just a single shareholder, the entity would be taxed as if it was a sole proprietorship. If there are multiple shareholders, it would be taxed as if it were a general partnership. Each shareholder would report the company's earnings and pay applicable taxes through his or her own individual tax return. Accordingly, the farm operation owners will end up paying different tax rates depending on their overall financial situation. This could be very advantageous to certain farm business owners.

The IRS requires an entity to meet certain criteria to be eligible for the S corporation tax status and to complete annual tax documents to maintain the status. To be eligible, the entity must have fewer than 100 owners; all owners must be U.S. citizens; no owners can be for-profit entities such as an LLC or a C corporation (must be human beings, estates, tax-exempt entities or certain qualified trusts); and the entity can only have one class of owners. Review Chapter 6 on S corporations for more details on eligibility criteria, annual tax form requirements and how to elect S corporation tax status.

See Chapter 6 on S corporations for more details on the criteria and requirements for electing S corporation tax status.

Forming a C Corporation

Now that we've provided some basic background and characteristics of the C

corporation, we can dive into the process of creating one. This includes appointing the initial directors, filing the articles of incorporation, creating the bylaws, appointing the officers and issuing shares to the initial shareholders. This section should be read in conjunction with the *Creating a C Corporation Checklist* that is part of the "Dive Deeper" section of this chapter.

Who can form a C corporation?

Most state corporation statutes allow C corporations to be created by a single person or multiple people. There are no restrictions on how many people may participate. Another business entity, such as an LLC or a trust, could be a shareholder.

"One of the first steps a new C corporation will take is to appoint the members of its board of directors."

Appoint the initial directors, the deciders of big decisions

One of the first steps a new C corporation will take is to appoint the members of its board of directors. This is a bit tricky, as it needs to happen before the entity is actually formed. Usually, initial directors are identified in the "articles of incorporation," which is the formation document filed with the state. Often the initial directors are selected in the interim by the person who takes the initial step of incorporating the business (sometimes called the "incorporator"). Once the corporation is up and running, directors are typically elected by shareholders at annual meetings.

The directors do what their name says: they direct the corporation along its path and make big decisions that impact the financial affairs of the company. This includes approving contracts and agreements, making decisions about significant purchases such as land or expensive farm equipment, and approving overarching corporate policies including employee handbooks and such. The directors also decide when and whether to pay dividends to the shareholders. Dividends are payments made to the shareholders when the business makes a profit. Dividends reflect the shareholder's return on investment, or bang for their buck. The handing out of profit to the shareholders is not automatic; it's ultimately a significant business decision. That's why it's left for the directors to decide. The directors may very well decide that it's in the best interest of the farm operation to keep all or a part of the profits in the company. This way they can better grow the farm business, like investing in more equipment or capital, such as a greenhouse or a new parcel of farmland.

The board of directors is also fundamentally on the legal hook, so to speak, for the corporation's actions. First and foremost, the board of directors is accountable to the shareholders. They also have what's called a "fiduciary duty" to the corporation, which includes both a duty of care and a duty of loyalty. A duty of care is to diligently act on behalf of the best interests of the corporation. For example, if the farm operation wants to buy a piece of property, the directors need to really look into their options. Are there sufficient water rights? What is the going rate for a similar parcel? What's the quality of soil like? They need to take special care that the decision they make is not at all arbitrary and is in the best interest of the corporation. A duty of loyalty is to put the interest of the corporation above their own personal interest. So, for example, if a director owns a piece of land that they want to sell to the corporation, they need to realize that this presents a conflict of interest. As a landowner, they have an interest to sell the property at the highest price possible. As a director of the corporation that is a potential buyer, they need to get the best deal possible. In actuality, to fully abide by their duty of loyalty, they should really refrain from voting on the matter. The same goes for a director or officer making a decision on their own salary. It can be helpful to keep all of this in mind when appointing your directors.

How many directors should there be? You can have as many or as few as you want. The ideal number usually depends on the size of the farm operation. A small farm operation might have just one director, who also serves as the sole owner or shareholder and plays the roles of all the officers. A larger farm operation may have more directors. It's generally recommended to have an odd number, as that will ensure there are no deadlocks on voting. Many recommend having fewer than 10 directors, as it can be unwieldy to manage the opinions of a lot of directors. However, it's entirely up to you.

"You can have as many or as few directors as you want. The ideal number usually depends on the size of the farm operation."

Draft and file the articles of incorporation with your state

Once the initial board of directors is appointed, the next step in creating a C corporation is filing the "articles of incorporation." This is done at the state level, usually through the state's secretary of state office. Many states provide a form that can be easily downloaded or even filed online. Other states simply list the information required, in which case you can create your own document that includes this information. An internet search for "file a corporation and [your state's name]" should bring up a form and more information. Each state charges different fees, which vary from $25 to $1,000. Once your articles of incorporation and fee

are filed and processed, you'll get a confirmation from the filing agency that your C corporation is now recognized as an official business entity in your state.

A few key terms you'll need to know when filing the articles of incorporation are the "registered agent" and the "incorporator." The registered agent is basically the person who receives "service of process," which is an official notice that the C corporation is being sued. It does not in any way mean this individual is liable or responsible for the outcome. It simply means that the agent is required to pass on the notice to the other shareholders of the corporation so that the corporation is officially on notice. Some businesses select a shareholder to be the agent. Others choose to work with one of the many independent businesses that provide agent of process services for a small fee. An incorporator is an individual who organizes and arranges for the articles of incorporation to be filed with the secretary of state. The incorporator must verify that all the included information is true and correct, and must sign the articles of incorporation. This could be a shareholder; it's often the entity's attorney.

Annual Fee: Note that most states also require an annual fee. It's a good idea to find out upfront whether your state charges an annual fee and, if so, how much. The amount of the fee may be a factor in your decision on whether to form a C corporation.

"In addition to the articles of incorporation, state corporation statutes also require corporations to have bylaws."

Draft the bylaws

In addition to the articles of incorporation, state corporation statutes require corporations to have bylaws. The bylaws set the ground rules among the shareholders, directors and officers for how the corporation must be governed. They include baseline procedural guidelines for corporate governance. State corporation statutes often set specific parameters for certain governance matters that are to be included in bylaws, such as when and how shareholders must be informed about annual meetings, items that must be voted on at annual meetings, how voting must take place, and restrictions on who can decide what, etc. These details can vary from state to state. So, if you decide to draft your own bylaws, be sure to check your state's corporation statute or consult with an attorney who is familiar with your state's statute to ensure that your bylaws are fully in compliance with state law. The bylaws don't need to be filed with the state; however, they must be officially adopted by the board of directors. For more information about bylaws and examples of common language used with explanations, see the *Sample Bylaws for Mother Earth Farm, Inc.*

While many states do not require LLCs to create a governing document (the operating agreement), all states require C corporations to adopt a governing document (the bylaws).

included in the "Dive Deeper" section of this chapter.

Hold an organizational meeting

Adopt bylaws

After you have filed the articles of incorporation and drafted the bylaws, the board of directors should hold an organizational meeting. At this meeting, the directors should first officially adopt the bylaws. All directors should have read them and agreed to them by this point. It's important to document the board's approval of the bylaws in the minutes of the organizational meeting.

Elect officers

Next, the directors should elect officers, if they haven't already done so. The officers are responsible for the day-to-day management of the company. The board is responsible for appointing them and designating their salary. Officer positions include a president or chief executive officer (CEO), a vice president or chief operations officer (COO), a treasurer or chief financial officer (CFO), and a secretary. The president has ultimate responsibility for the corporation's activities. The president reports to the board of directors; however, he or she generally has the authority to sign contracts and other legally binding actions on behalf of the corporation. The vice president is optional, depending on the size of the farm operation. Typically, a vice president is charged with managing the corporation's day-to-day affairs. There can be multiple vice presidents if there are multiple segments of the business. Or, if the business is small and streamlined, this role is oftentimes filled by the president. The treasurer is responsible for the corporation's financial matters, including keeping the farm's accounting system up to date and in check. The secretary is in charge of maintaining the corporation's records, documents and "minutes" from shareholder and board meetings. Note that a director can serve as an officer and that one person can serve multiple offices. Like directors, the officers owe a fiduciary duty to the company (i.e., a duty of care and a duty of loyalty). Be sure to keep this in mind when deciding who the initial officers will be.

"The officers are responsible for the day-to-day management of the company."

Approve issuance of stock

The directors should also officially approve the issuance of shares or stock in the company. Let's say that the articles of incorporation specified that the corporation is authorized to issue 10 million shares. The board could decide to issue all the

shares to the founding shareholders. Or, they could decide to set some shares aside, say 1 million for future investors or stock option benefits for employees. These are decisions that have financial implications for the company and should be made in consultation with a corporate attorney or a tax accountant.

Decide whether to elect S corporation federal tax status

In addition, if the corporation will be an S corporation (i.e., elect S corporation federal tax status), the directors should approve the election at this time.

Be sure to follow the voting parameters set forth in your bylaws when voting on these matters. Also, written minutes must be kept for this organizational meeting and all meetings held by the board of directors and shareholders to evidence what happened, should a dispute or issue ever arise.

"Before engaging in any business activity as the corporation, the corporation needs to formally issue the shares authorized by the board to the founding shareholders."

Issue stock

Before engaging in any business activity as the corporation, the corporation needs to formally issue the shares authorized by the board to the founding shareholders. This is the formal process of dividing up the ownership in the company. It is also required by law if you are doing business as a corporation. Again, issuing stock can be complicated. Farm Commons strongly recommends that you have an attorney who is familiar with corporate and securities law handle the stock issuance for you.

First, both federal and state securities laws may apply. Unless you qualify for an exemption at both the federal and state level, you will have to file a securities registration. Fortunately, most small farm operations will qualify for an exemption. For example, the Securities Exchange Commission (SEC) rules and most state securities laws provide a "private offering" exemption. This basically means that you'll likely be exempt from securities filings if you don't advertise investment opportunities in your company to the general public and you only have a small number of people investing who are actively participating in running the business. Be sure to confirm with your attorney whether this or any other exemption applies. Security filings can be very time consuming and expensive. The stakes are high if you do not comply, as you could face fines and potentially be required to give investments back in full to the shareholders.

When you're ready to issue the actual shares to your founding shareholders, you'll need to put the following in writing: the initial shareholders' names and mailing addresses, the number of shares each shareholder will purchase and how each

shareholder will pay for their shares, which can be cash, property and services (also known as "sweat equity"). Keep in mind that most states have a minimum amount of stock that can be issued. Note also that if you plan on electing S corporation tax status, you can only issue one class of stock, which is generally common stock, meaning one vote per share. This information should be included in your bylaws.

Next, you can prepare and issue stock certificates. A stock certificate is a way to document stock ownership and is given to the shareholder. This step is not actually necessary, as most states no longer require corporations to issue actual stock certificates. However, shareholders have come to expect it, and it provides another layer of evidence of who owns how many shares. If you do issue a stock certificate, states generally require that you include the following information on the face of the certificate: the name of the corporation, the state where the corporation was formed, the name and number of shares issued to the shareholder, and a signature authenticating the document. Finally, some states require that you file a "notice of stock transaction" with your state's business agency or secretary of state. This is typically a simple form, but it's important that you file it if it's required. Otherwise you risk the state saying that the issuance of shares is invalid.

Create a shareholder agreement if the shareholders want one

While shareholder agreements are not required, they can be useful to set forth specific terms that all shareholders must abide by and follow among each other. A shareholder agreement provides even more detail than the bylaws on how the corporation will be run. Shareholder agreements can be particularly important in closely held corporations where the shares are held between a small group of people and are not offered to the general public. In addition, shareholder agreements can be a useful way to protect minority shareholders, who may fear that their voice will be overpowered on everything. For example, the shareholder agreement could require that certain decisions be agreed to by all the shareholders. Shareholder agreements also often include procedures for dispute resolution, which can help keep matters out of court, as well as restrictions to prevent unwanted parties or strangers from acquiring shares in the company.

"Shareholder agreements can be particularly important in closely held corporations where the shares are held between a small group of people."

Implementing Best Business Practices for Your C Corporation

Now that you've formed your C corporation (by filing the articles of organization) and have established the governing rules (by finalizing and officially adopting your bylaws), you now must follow through by acting like you have a separate business. This means upholding best business practices by keeping your business affairs separate from your personal affairs, abiding by the provisions of your bylaws, filing applicable annual maintenance fees with the state and filing your taxes.

"It is essential that you maintain a clear and distinct level of separation between the C corporation's business affairs and each of your shareholder's personal affairs."

Keep your business and personal financial affairs separate

It is essential that you maintain a clear and distinct level of separation between the C corporation's business affairs and each of your shareholder's personal affairs. Primarily, this means maintaining separate bank accounts and accounting records. This also includes not paying your personal debts or bills with the business assets. Of course, shareholders can pay for legitimate expenses related to the C corporation with their personal funds so long as they account for and properly record these expenses and record them as business expenses. Be sure to keep all the receipts in case of an audit. The shareholder can either write these "business expenses" off on their individual tax return or they can request to be reimbursed directly by the C corporation. If the company reimburses the expense, then they cannot also write it off. That would be a sure way of abusing the integrity and separation of the business entity!

Another key requirement for keeping the business affairs separate is to properly allocate assets to the C corporation. Any land, equipment or other asset that is contributed to the C corporation as shareholders' equity investment needs to be formally transferred over. Officially allocating assets in this way helps make absolutely clear who owns what; it also clarifies the extent of each shareholder's liability if the farm operation turns sour. Recall that if the C corporation upholds best business practices, each shareholder's liability extends only to the value of his or her equity investment. If the lines aren't clear, the courts can go around the business entity and access personal assets.

Follow your bylaws and hold annual meetings

Be sure to follow what the bylaws say, as well as any shareholder agreements should you decide to enter into them. Legally speaking, these are contracts

that all the shareholders are now bound by. You should make copies or make it available in electronic form so that every shareholder, director and officer has it and can refer to it as needed. Following the rules and procedures your bylaws set gives the business legitimacy in court.

For example, your bylaws should designate a general time and place for an annual shareholder meeting as well as specify particular requirements for how and when to let shareholders know about the details of the meeting. Be sure to follow these procedures, otherwise anything that's conducted at a meeting could be deemed invalid by a court. You should take minutes to record what happened. The minutes don't have to be elaborate, just enough for the shareholders present to recall what was discussed and decided, and for anyone not present to understand what happened. A sample of minutes from a shareholder's meeting is included in the "Dive Deeper" section of this chapter for a guide.

Also, if you decide to make changes to your bylaws, you'll need to follow the procedure it sets for making amendments. If the shareholders or board of directors properly agree to an amendment, be sure to document it in the minutes.

It's a good idea to keep your bylaws, any shareholder agreements, all meeting minutes and any amendments in one binder so that everything is readily available. This also helps prove the legitimacy of your C corporation by showing you are taking the separate entity seriously. Whenever you have a doubt about what's required for making a decision or how to deal with a specific scenario when it arises, refer to your bylaws or shareholder agreements for guidance.

"Most states require an annual fee to continue to operate as a C corporation. Be sure you pay this fee each year, on time."

Pay your state's annual maintenance fees

This is simple, but it's amazing how many business entities fail to follow up. Most states require an annual fee to continue to operate as a C corporation. Be sure you pay this fee each year, on time. Otherwise, you could incur late fees. Or, at worst, your C corporation could be administratively dissolved. You would then have to start the whole process over again, which no farmer has time to do.

Designate your tax status

As a C corporation, you can choose to be taxed as a C corporation or an S corporation. While this Guide is not intended to provide tax advice, we will provide a brief overview to help with basic understanding as you work with your accountant or tax attorney to decide what designation is best for your farm operation.

The default federal tax status for a C corporation is to pay corporate taxes. Basically, the farm operation will be taxed separately from the owners. Any profit remaining in the company at the end of its tax year will be taxed at corporate tax rates. If the corporation distributes profits to the shareholders, the shareholders will also have to report the dividends as income on their individual tax returns. Many say this is disadvantageous, as the owners end up paying double the taxes. First, they pay corporate taxes on the net earnings of the company and then they pay taxes on any profits they get from the corporation in the form of dividends.

"The S corporation tax status allows the C corporation to be taxed as a pass-through entity."

Another option is to elect the S corporation tax status with the IRS. It's simple to do: You just have to fill out and file IRS Form 2553, "Election by a Small Business Corporation." The S corporation tax status allows the C corporation to be taxed as a pass-through entity, just like the LLC. Instead of the entity paying corporate taxes, all earnings of the company are reported by the shareholders on their individual tax returns in accordance with their equity share in the company. The shareholders then pay taxes on the company's income based on their individual tax rate.

For more more on S corporations, see Chapter 6.

In addition, the S corporation tax status handles self-employment taxes slightly differently than any other entity. Basically, in addition to a "reasonable" salary that can be paid to the owners or shareholders of the farm operation, the owners can also receive income in the form of "distributions." Distributions are taxed at a lower rate and are free from self-employment taxes including Social Security and Medicare taxation. This can equate to about 15 percent savings in federal taxes. Distributions can of course only be made if there are sufficient profits in your farm operation. Otherwise, your company will be considered undercapitalized. Recall that if this happens, the shareholders may be personally liable to cover the business's debt.

To be eligible for S corporation tax status, the entity has to meet certain criteria. In addition, while the C corporation doesn't have to pay taxes, it does have to distribute tax forms to the shareholders each year and file certain forms with the IRS, including Form 1120S. This is the informational tax document used to report the income, losses and dividends of S corporation shareholders.

Deciding on salaries of owners

Farmers may be motivated to keep their salary as low as possible so that the remainder is taxed at a lower rate. If you elect S corporation tax status, keep in mind that the IRS does not look fondly on artificially low salaries

and can reclassify dividends as salary. The IRS will look at many different factors in determining what a reasonable salary should be. Anything above that could be reclassified and taxed as dividends. Factors the IRS will consider include the following:

- training and experience
- duties and responsibilities
- time and effort devoted to the business
- dividend history
- payments to non-shareholder employees
- timing and manner of paying bonuses to key people
- what comparable businesses pay for similar services
- compensation agreements
- the use of a formula to determine compensation

This begs the question, what is a reasonable salary for a farmer? Where do we draw the line? According to the Bureau of Labor Statistics, in 2014, the average annual income for supervisors of farms and farmworkers was $47,540. If you own and run your own farm operation, which includes supervisory duties, the IRS may consider this as the baseline. Let's say an owner of a C corporation with net annual income of $50,000 tried to claim that just $20,000 of that was a reasonable salary in hopes of getting a tax break on the remaining $30,000. You might have an uphill battle convincing the IRS that a farmer of similar skill and responsibilities could only reasonably expect $20,000.

Tax designation choices for the C corporation

- Do nothing. The default will apply. The entity will be required to file and pay its own corporate taxes. The shareholders will have to report and pay taxes on any dividends they receive from the company.
- File IRS Form 8832, "Entity Classification Election," and elect corporation, and then file IRS tax Form 2553, "Election by a Small Business Corporation." You will be taxed as an S corporation. The income of the corporation passes through to the shareholders, who each report and pay taxes based on their individual tax rate.

Note that this is simply for federal tax status. You will still need to pay any applicable corporate taxes in your state!

"Working with a tax expert will help guarantee you're doing everything properly; it could also end up saving you money by finding ways to minimize your tax burden."

Fulfill your tax obligations

Once you decide on your tax designation and file the appropriate forms, you'll then need to be sure the entity and each of its shareholders fulfill the annual tax obligations. This includes distributing forms, filing forms and, of course, paying taxes when due. The following provides a basic breakdown of what is required based on the tax status you choose for your farm operation. Again, Farm Commons strongly recommends that you seek guidance from your accountant or tax attorney come tax season. Tax law is very particular. Working with a tax expert will help guarantee you're doing everything properly; it could also end up saving you money by finding ways to minimize your tax burden.

If you go with the default tax status, the C corporation will have to file Form 1120, "U.S. Corporation Income Tax Return," and pay its own taxes. In addition, the shareholders will each have to individually report and pay taxes on any dividends they receive.

If you elect to be taxed as an S corporation, you'll have to file the annual Form 1120S with the IRS. This is an informational tax document used to report the income, losses and dividends of S corporation shareholders. The entity itself will not have to pay taxes, as it passes through to the individual shareholders. In addition, the company will have to provide each of the shareholders with a Schedule K-1. The Schedule K-1 is similar to a W-2, the end-of-year wage statement that employees receive from their employers. The Schedule K-1 shows the self-employment income each of the shareholders receives from the company. The company must also submit a copy of Schedule K-1 to the IRS for each shareholder. This allows the IRS to be sure that each shareholder is properly reporting any self-employment income he or she receives from the corporation.

Tax forms a C corporation must file and distribute based on tax status

- **C corporation status**: File Form 1120, "U.S. Corporation Income Tax Return," with the IRS and pay taxes as a corporation. Each shareholder will report and pay taxes on any income (i.e., salary and distribution of profits) he or she received from the entity on his or her individual income tax return.
- **C corporation with S corporation tax status**: File Form 1120S with the IRS, which is purely informational. Distribute Schedule K-1 to each shareholder and file Schedule K-1 for each shareholder with the IRS. Each shareholder reports and pays taxes on the individual tax return for his or her share of the corporation's income.

Maintain accurate accounting records

Finally, the business and all shareholders need to keep good records of the business's financial affairs, including all receipts of business expenses in case of an audit. It's also advisable that you use a reliable accounting system such as QuickBooks or hire an accountant to handle your accounting and taxes for you.

FARM COMMONS

SARE
Sustainable Agriculture Research & Education

Farmers' Guide to Business Structures: LLCs, Corporations, Partnerships and More

Chapter 5, Section 2: Going Deeper Into C Corporations

www.sare.org/guide-to-business-structures

DISCLAIMER: This Guide does not provide legal advice or establish an attorney-client relationship between the reader and author. Always consult an attorney regarding your specific situation.

Introduction and How to Use these Resources

With an initial decision in hand to form a C corporation, farmers need to know exactly what it takes to form one. How does a person set up the C corporation? What documents need to be filed and with whom? What should be included in the bylaws? This section is filled with hands-on tools to help guide you through the process of creating and maintaining a C corporation as well as preparing your bylaws.

The *Checklist: Creating a C Corporation* sketches the basic process a farmer follows to form and organize a C corporation. It is designed to help famers understand the big picture as they comply with the laws and gear their farm for success. Start with the checklist to get a sense of all that will be required.

The *Bylaws for Mother Earth Farm, Inc. with Annotations* includes the foundational provisions that are particularly important to include in a C corporation's bylaws. The sample provisions serve as examples of the ways a farm operation organized as a C corporation may want to handle certain situations should they arise. Note that rather than simply adopting someone else's bylaws, including those provided here, it's best to take the time to think through the various issues and craft provisions that are best for your particular farm operation. The annotations to the bylaws provide some alternative ideas as well as questions to illicit the best response and result that is specific to your situation. Upon reviewing these bylaws and the annotations, you can take a crack at drafting your own bylaws using the sample provisions as a guide. Or, you can jot down some key notes and take them to an attorney who will then be able to efficiently draft up your bylaws. Either way, Farm Commons advises that you have an attorney familiar with the laws in your state look over your bylaws before they are finalized. This will ensure that your bylaws comply with your state's corporation statute and that there are no conflicting provisions within them, which will only lead to confusion down the road.

> "Rather than simply adopting someone else's bylaws, it's best to take the time to think through various issues and craft provisions that are best for your particular farm operation."

Finally, C corporations are required by law to hold annual meetings and to keep minutes to provide evidence of what happens in case an issue or dispute arises. Annual meetings offer an opportunity for the shareholders to get together to elect the upcoming year's board of directors, review the financials and strategize. They also help foster open communication and engagement from the owners. The sample *Annual Shareholder Meeting Minutes with Annotations* included in this section illustrate how straightforward it is to take minutes. You can use these to guide you through the minute-taking process when you're holding your annual meetings.

Checklist: Creating a Farm Business as a C Corporation

With S Corporation Tax Status Option

Introduction

This checklist guides farmers who have made the careful decision to establish their farm operation as a C corporation. This checklist sketches the basic process a farmer follows to form and organize a C corporation at the state level. The C corporation entity can help farmers develop clear decision-making procedures, outline roles and responsibilities of the owners, plan an exit strategy and more. It also provides a layer of protection over the owners' personal assets from the business's liability. Note that state corporate statutes vary on the specifics of how a C corporation must be organized and operated. Be sure to review your state's statute carefully. Given that these statutes vary from state to state, Farm Commons highly recommends that you work with an attorney to help you through the process.

> "This checklist sketches the basic process a farmer follows to form and organize a C corporation at the state level."

Many farm owners who form a C corporation at the state level also want to take advantage of the federal S corporation tax status. So, this checklist also outlines the steps needed to obtain and maintain the S corporation tax status with the IRS. Note that this step is optional. If you do not make the S corporation election, the IRS will treat the entity as a C corporation and the entity itself will have to pay corporate taxes at the federal level. Conversely, with the S corporation tax status, the entity's income is passed through to the shareholders or business owners for federal tax purposes. Each shareholder reports the business income and pays his or her share of taxes when filing the individual tax return. The S corporation also provides tax advantages related to self-employment income. However, the tax benefits of the S corporation come with a cost. The entity must meet certain criteria to be eligible and must abide by certain formalities to maintain the S corporation tax status. If you choose to make the S corporation election, be sure you meet and maintain the S corporation criteria and abide by the formalities.

> "This checklist also outlines the steps needed to obtain and maintain the S corporation tax status."

This checklist is designed to be used with the other resources provided in the C corporation and S corporation chapters of this Guide (Chapters 5 and 6). It may be helpful to review those chapters first. This checklist and the accompanying explanations are intended to help famers understand the big picture as they comply with the laws and gear their farm for success.

Summary Checklist

Establish the C Corporation

- ☐ Choose the initial board of directors
- ☐ Select a registered agent
- ☐ Draft and file articles of incorporation
- ☐ Create bylaws
- ☐ Hold your first board of directors meeting
- ☐ Issue stock, create stock certificates and create shareholder agreement, if necessary
- ☐ Get an Employer Identification Number (EIN) from the IRS
- ☐ Obtain necessary licenses and permits from state and local agencies

Implement Best Practices

- ☐ Follow the bylaws
- ☐ Allocate assets between personal and business ownership accounts
- ☐ Document relationships for personal assets used for farm purposes
- ☐ Update websites, brochures, invoices, order forms and other materials with the "C corporation" (or "S corporation") designation, if required
- ☐ Hold annual shareholder and directors meetings
- ☐ Keep meeting minutes and maintain records of corporate decisions
- ☐ Keep accurate and up-to-date accounting records for tax purposes
- ☐ Make note of and follow any annual obligations such as when, where and how to file your annual report or fee with the state

Optional: Elect S Corporation Federal Tax Status

- ☐ Elect S corporation tax status with the federal government
- ☐ Make note of and follow any annual obligations to maintain the S corporation tax status

Checklist with Explanations

Establish the C Corporation

Choose the initial board of directors

The board of directors is a collection of one or more people that governs the corporation and makes major policy and financial decisions for the company. For example, the directors authorize the issuance of stock in the company, appoint officers, and approve loans and other significant financial matters. All states require corporations to have a board of directors. Many states permit just one director, which could be fine for a small farm operation. However, it can be beneficial for the business overall to have others offering advice and different perspectives. Many business experts recommend having an odd number of directors and some go further to recommend that five, seven and nine are magic numbers. The odd number prevents deadlock votes and the five through nine range provides a variety of perspectives, yet not too many opinions. Keep in mind that directors will need to abide by a fiduciary duty to the company (i.e., a duty of care and a duty of loyalty). This basically means that they can't whimsically make decisions; rather, they have to act with diligence and care. It also means they have to act primarily in the interest of the company and not their own interest. To help reinforce this, you should require directors to follow a strict conflict of interest policy that specifies that they cannot vote on a matter that affects their personal interests. For example, a director who is also the president or CEO should not be able to vote on the amount of their salary. Be sure to keep this in mind when deciding whom your initial directors will be.

> "The directors govern the corporation and make major policy and financial decisions. They have to act primarily in the interest of the company, and not their own interest."

Select and appoint a registered agent

A registered agent is the person on file for the public and the government to contact regarding the corporation. For example, the registered agent is the individual who is notified if the corporation becomes a party in a legal action. This is called service of process. A registered agent can be an officer or employee of the company, but is more often a third party such as the corporation's lawyer or a service provider who takes on this role for a small fee.

Draft and file the articles of incorporation

The corporation must draft and file articles of incorporation with the state agency that handles entity formation, which is usually the secretary of state office. The

articles of incorporation can be drafted either by the business owner with the help of an attorney or entirely by an attorney.

The articles of incorporation are publicly available documents and often include only the basic details about the corporation that are required, such as the corporation name, the name and address of a registered agent, a corporate purpose (the general objectives of the business), and the names and addresses of directors and officers. What is required can vary from state to state. A quick internet search should bring up the website of the state agency that handles this in your state, which will specify the information you need. Many state agencies have an articles of incorporation form on their website that a business can use and adapt for their needs.

Many states also require you to designate the number of authorized shares or stock to be issued. Deciding on the exact amount could be tricky, though many say it's actually quite arbitrary. The shares are the ownership interests in the company. Let's say the company authorizes 10 million shares. If there are two owners, each with 50 percent interest, they each get 5 million shares. It's advisable to consult with an attorney in your state to be sure the number you designate is proper and recommended for your particular farm operation. It could impact how you raise money or get financing in the future.

The articles will also need to include the name of the incorporator. An incorporator is an individual who organizes and arranges for the articles of incorporation to be filed with the secretary of state. The incorporator must verify that all the included information is true and correct, and must sign the articles of incorporation. The incorporator can be a shareholder, director or officer of the corporation. It is often the lawyer who is handling the formation of the corporation. While the incorporator is distinct from the registered agent, one person may serve as both.

A corporation does not exist until the date its articles of incorporation are filed and then approved by the state agency. Approval can take anywhere from one day to one week from the time of filing. The articles of incorporation form can generally be submitted online, along with the required fee. If there is no form, the articles of incorporation will likely need to be mailed in. Each state charges different fees, which vary from $25 to $1,000. In addition, most states require an annual fee to maintain the corporation, which is generally less than the fee to create the corporation. The initial directors should review the articles together to be sure everything is accurate before filing. Note that the information on the articles of incorporation may be changed at any time by filing amended articles.

Draft bylaws

In addition to the articles of incorporation, state corporation statutes also require corporations to have bylaws. The bylaws are a private document, or in effect a contract, that sets the ground rules among the shareholders, directors and officers for how the corporation must be governed. They include procedural guidelines for corporate governance (e.g., shareholder meetings, board of directors meetings, etc.). There are two overarching principles for bylaws. First, like any legal document, they should be clear and precise to avoid challenges in interpretation down the road. Second, they should be consistent with all applicable state laws. In effect, any provision in the bylaws that runs counter to a state law will be deemed unenforceable. And, any action made pursuant to an unenforceable provision will be deemed invalid. Having unenforceable provisions and invalid actions is not good business practice for obvious reasons!

Like the articles of incorporation, the bylaws can be drafted by the business owner(s) with the help of an attorney or entirely by an attorney. Keep in mind that state corporation statutes often set specific parameters regarding certain corporate governance matters that are typically included in bylaws, such as when and how shareholders must be informed about annual meetings, items that must be voted on at annual meetings, how voting must take place, restrictions on who can decide what, etc. These details can vary from state to state. So, if you decide to draft your own bylaws, be sure to check your state's corporation statute or consult with an attorney who is familiar with your state's statute to ensure that your bylaws are fully in compliance with state law. The bylaws don't need to be filed with the state, but they must be officially adopted by the board of directors.

For more information on bylaws and guidance on developing your own, review our sample *Bylaws for Mother Earth Farm, Inc.* that follows this checklist.

Hold your first organizational meeting with the board of directors

Next, the board of directors should hold an organizational meeting. At this meeting, the directors should first officially adopt the bylaws. Then they should elect the initial officers. The officers are responsible for the day-to-day management of the company. Officer positions include a president or chief executive officer (CEO), a vice president or chief operations officer (COO), a treasurer or chief financial officer (CFO), and a secretary. A director can serve as an officer, and one person can serve multiple offices. Like directors, the officers owe a fiduciary duty to the company (i.e., a duty of care and a duty of loyalty). Be sure to keep this in mind when deciding who the initial officers will be. After the officers are elected, the directors should also officially approve the issuance of shares or

stock in the company. In addition, if the corporation will be an S corporation (i.e., elect S corporation federal tax status), the directors should approve the election at this time. Be sure to follow the voting parameters set forth in your bylaws when voting on these matters. Also, written minutes must be kept for this organizational meeting and all meetings held by the board of directors and shareholders to provide evidence of what happened should a dispute or issue ever arise.

Issue stock to the founding shareholders

Before engaging in any business activity as the corporation, you should issue shares of stock to the founding shareholders. This is the formal process of dividing up the ownership in the company. It is also required by law if you are doing business as a corporation. Issuing stock can be complicated; it could involve adherence with complex securities laws at both the state and federal level. Farm Commons strongly recommends that you have an attorney who is familiar with corporate and securities law handle the stock issuance for you. When you're ready to issue the actual shares to your founding shareholders, you'll need to put in writing the following: the initial shareholders' names and mailing addresses, the number of shares each shareholder will purchase and how each shareholder will pay for their shares (i.e., cash, property or services–also known as "sweat equity"). Keep in mind that most states have a minimum amount of stock that can be issued, so check your state's corporation statute. Some states require that you file a "notice of stock transaction" with your state's business agency or secretary of state. This is typically a simple form, but it's important that you file it if it's required. Otherwise you risk the state saying that the issuance of shares is invalid.

> "Issuing stock is the formal process of dividing up the ownership in the company."

You also have the option of issuing actual stock certificates. This is no longer required in most states, but shareholders have come to expect it, and it provides another layer of evidence of who owns how many shares. If you issue stock certificates, states generally require that you include on the face of the certificate: the name of the corporation, the state where the corporation was formed, the name and number of shares issued to the shareholder and a signature authenticating the document.

Note also that if you plan on electing S corporation tax status, you can only issue one class of stock, which is generally common stock, meaning one vote per share. This information should be included in your bylaws.

Create a shareholder agreement if shareholders want one

While shareholder agreements are not required, they can be useful to set forth specific terms that all shareholders must abide by and follow among each other, particularly with respect to the limitations and process for transferring or selling shares to others. Basically, shareholder agreements could set restrictions to prevent unwanted parties or strangers from acquiring shares in the company. In this way, shareholder agreements can be particularly important in closely held corporations where the shares are held by a small group of people and are not offered to the general public. In addition, shareholder agreements can be a useful way to protect minority shareholders who may fear that their voice will be overpowered. For example, the shareholder agreement could require that all shareholders agree on certain decisions. Shareholder agreements also often include procedures for dispute resolution, which can help keep matters out of court.

> "Shareholder agreements can be particularly important in closely held corporations where the shares are held by a small group of people."

Get an Employer Identification Number (EIN) from the IRS

An EIN is the number that the IRS uses to identify the tax accounts of employers and certain business entities like corporations. You can get an EIN immediately by applying online through the IRS website. If you prefer, you can download Form SS-4 on the IRS website and fax your completed form to the service center for your state. They will respond with a return fax in about one week. You will also likely need an EIN to get a bank account for the corporation.

Obtain necessary licenses and permits from state and local agencies

You're almost ready to open shop as a corporation. But first, you'll need to obtain any required licenses and permits for running your farm operation. Depending on your farm operation, this could include a business license with your city (i.e., a tax registration certificate), a seller's permit from your state or a zoning permit from the local planning board. It may be helpful to ask other local business owners what they did when starting their business, or contact the relevant state and city offices.

Implement Best Practices

Follow the bylaws

If you go through the work to outline how the business should handle important matters like decisions, taxes and the departure of a member, it's very important to follow the document. This gives the business legitimacy in court.

Allocate assets between personal and business ownership accounts

As discussed above, a farm business needs to follow through on creating a corporation by making the division between business and personal. If the farm doesn't already have a separate bank account, set one up. Farm expenses and payments should only move through the farm account. Of course, if you forget the farm checkbook and use your personal bank card instead, you may pay yourself back.

> "Making your best guess as to the value of the farm's various assets and placing them on the farm's balance sheet is a simple way to document the transfer of assets."

Next, determine which assets are farm and which are personal. If there are multiple members and each has promised to make an equity investment in the corporation in exchange for stock, each member needs to follow through with his or her promise by officially making the investment. For example, if one member promised to invest $35,000 in cash, then that money needs to be deposited into the corporation's bank account. If a member promised to invest his or her farm property, then the title of the property needs to be transferred to the corporation.

Overall, a common-sense allocation is probably the best route. This process can be quite simple–there's no need to detail every feed scoop, hand weeder or trash bin. Making your best guess as to the value of the farm's various assets and placing them on the farm's balance sheet is a simple way to document the transfer of assets. If a farm tried to keep all assets personal and leave the farm with nothing, a court would likely not respect the corporation. The allocation must be based in reality and the farm must have enough assets to capitalize the operation.

Document relationships for personal assets used for farm purposes

If you choose to hold ownership of the land with yourself personally, you should document the new relationship with the corporation. If the farm business uses your property, then the farm business has a lease with you, whether one is written or not. Written documents are generally the better choice, and it can be a very simple one-page outline of basic terms such as rental rate, lease term and renewal procedures. Many individuals choose to lease the farmland for a rate equal to the value of the annual property taxes, but each farm has unique needs.

For more information on drafting leases, see Farm Commons' print resource: *Drafting a Lease: Questions for Farmers and Landowners to Ask*, available on our website.

Now is a good time to discuss our objectives in allocating assets and writing leases. At any point in time, a court should be able to determine which assets are the farm's and which are personal. This is because the farm's creditors can go after business assets. Thus, we need to know what they are. The court should also be able to determine exactly how and why assets are used for both personal and

business reasons. Your documentation can go a long way towards creating an efficient process. If records are a mess and there is no documentation, a court may decide for itself which assets are personal or business and the farm would lose an opportunity to influence the process.

Update websites, brochures, invoices, order forms and other materials with the C corporation designation, if required

State statutes typically require that a corporation use the "Inc." designation in the name of the business. This signals to potential creditors that only business assets are available to satisfy potential judgments against the business. If you don't like the look of the abbreviation or you've already invested in marketing materials, check with your secretary of state's office about registering a trade name without the letters. In some states, the county register of deeds handles registration of trade names, so you may need to make a few phone calls. For invoices and other official business, it's best to include the letters after your name.

Hold your annual shareholder and annual board of directors meetings

State corporation statutes explicitly require that shareholder and board of directors meetings are each held annually. Some states may allow shareholders to approve actions through written consent instead of a meeting in person. This requires that all shareholders sign a document to evidence their agreement. Either way, it's important that you follow these formalities and either hold meetings or obtain written resolutions in their place. This helps establish the corporation's legitimacy and preserves the benefits of having an entity.

> "State corporation statutes explicitly require that shareholder and board of directors meetings are each held annually."

The board of directors must also meet annually. Board of directors meetings are often held immediately after the annual shareholder meeting where the board of directors is elected for the year. Like the shareholder meetings, board of directors meetings may also be done through consent resolution and written consent, so long as all the relevant details are in writing with signatures of all directors. It may seem silly to follow such formalities, particularly if the farm business has just a few individuals and they are wearing multiple hats, but these formalities are required by law and must be followed to protect the benefits of having an entity.

When holding meetings, be sure to follow the meeting requirements set forth in your bylaws, including having a quorum before voting (the minimum number of shares or people that must be represented for a vote to take place), providing proper notice within the specified time (the invitation to the meeting with precise details) and

administering the voting thresholds (e.g., one share, one vote for shareholders and one person, one vote for the board of directors, or whatever your bylaws specify).

Keep minutes at all meetings and keep records of significant business decisions

For an example of meeting minutes, see the *Sample Annual Meeting Minutes with Annotations* included in this section.

Many state corporation statutes require corporations to keep accurate minutes to record key decisions and resolutions of the shareholders and board of directors. While some states do not require this by law, courts in all states will look at the minutes if a dispute or legal mishap arises. The meeting minutes provide evidence that the corporation was acting properly in both how the decision was made and what was or was not decided. The minutes do not have to be elaborate; they just need to have enough detail to offer proof of what was decided and why. Not every routine business decision needs to be documented, but any decisions that require formal board or shareholder approval should be recorded. Types of decisions that should be recorded include any decision made at annual meetings, the issuance of new stock, purchases of real property, approval of long-term leases, authorizations for credit and decisions that involve federal or state tax implications.

Keep your corporate binder and stock register up to date

The corporation should maintain a binder that includes the articles of incorporation and any amendments, the bylaws and any amendments, the minutes for annual meetings and special meetings, any written resolutions made outside of a meeting (i.e., with unanimous consent) and any additional records of big decisions. Keeping all these documents in one place makes it easier to refer back to something if an issue arises. Again, it also records that the corporation is properly managing its affairs should a lawsuit arise and the court asks for such evidence. The corporation will also need to maintain a stock register. This register must include information like the names of all the shareholders, their addresses, the number of shares held, the date of certificates issued for the shares, any transfers of stock certificates and any cancellation of stock certificates (i.e., by a shareholder who transfers their stock to another). Generally, it's maintained by the corporation's secretary.

Keep accurate and up-to-date accounting records for tax purposes

This includes maintaining an accurate profit and loss statement. Keeping good accounting records throughout the year will help streamline the process of preparing an annual report (which is required in most states and includes financial information) and filing both state and federal taxes.

Fulfill annual obligations, including filing and paying corporate federal and state taxes, if applicable

Your state will likely require you to file an annual report and an annual fee to maintain your corporation. If you neglect these duties, the state may dissolve your corporation. You will also need to file and pay your corporate taxes. If you choose to be taxed as C corporation with the federal IRS (which is the default), the corporation will need to file IRS form 1120. The corporation will also need to distribute employment and dividend tax forms to employees and shareholders. Talk with your accountant or tax preparer or your secretary of state's office and the IRS for more information on filing corporate taxes.

Optional: Elect S Corporation Federal Tax Status

Elect S corporation tax status with the IRS

Electing S corporation tax status for your corporation is quite simple. You will need to fill out and file with the IRS tax Form 2553, "Election by a Small Business Corporation." The form should be completed up to two months and 15 days after the beginning of the tax year the election is going to take effect, or at any time during the tax year preceding the tax year it is to take effect. This sounds complicated but the IRS provides examples of how the timing works in the instruction sheet for Form 2553. Farm Commons highly recommends that farmers consult with a tax attorney or accountant *before* filing these tax forms to be sure the S corporation tax status is the best option.

Review Chapter 6 on the S corporation for more on the benefits as well as the eligibility criteria and requirements to obtain and maintain the S corporation tax status.

Make note of and follow any annual obligations to maintain the S corporation tax status

As an S corporation, you'll have to file the annual Form 1120S with the IRS. This is not a tax return, as the entity does not itself have to pay income taxes. Rather, this is an informational tax document used to report the corporation's income and losses as well as any disbursements of profits given to its shareholders (i.e., dividends to shareholders). Again, the entity itself will not have to pay taxes, as the business's income passes through to the individual shareholders.

In addition, you will have to provide each of the shareholders with a Schedule K-1. The Schedule K-1 is similar to a W-2, the end-of-year wage statement that

employees receive from their employers. The Schedule K-1 shows the self-employment income each of the shareholders receives from the company. The corporation must also submit a copy of Schedule K-1 to the IRS for each shareholder. This allows the IRS to be sure that each shareholder is properly reporting any self-employment income he or she receives from the entity that has S corporation tax status.

Farm Commons recommends that you seek expert tax guidance before filing any of the required S corporation tax forms. Be sure to also abide by all the state income tax requirements for your corporation. The S corporation tax status is only relevant for federal income taxes filed with the IRS.

C Corporation Sample Bylaws With Annotations

Mother Earth Farm, Inc. Bylaws[1] An Illinois Corporation

Article 1: Shareholders

Section 1: Place of Meetings

Shareholder meetings must be held at the principal office or place of business of the Corporation in the State of Illinois, or any location designated in the notice of meeting.[2]

1 Bylaws outline how the corporation is to operate or run its business, including procedural guidelines for corporate governance (e.g., shareholder meetings, board of directors meetings, etc.). There are two overarching principles for bylaws. First, like any legal document, they should be clear and precise to avoid interpretation challenges down the road. Second, they should be consistent with all applicable state laws. Any provision in the bylaws that runs counter to a state law will be deemed unenforceable. And, any action made pursuant to an unenforceable provision will be deemed invalid. Having unenforceable provisions and invalid actions is not good business practice for obvious reasons! So it's essential to follow your state laws. Each state has a corporation statute that requires all corporations to adopt bylaws and specifies what must be included. State corporation statutes often set specific parameters, such as when and how shareholders must be informed about annual meetings, items that must be voted on at annual meetings, how voting must take place and restrictions on who can decide what, etc. These details can vary from state to state. If you decide to draft your own bylaws, be sure to check your state's corporation statute or consult with an attorney who is familiar with your state's statute to ensure that your bylaws are fully in compliance with state law. That way, if you follow your bylaws you can rest assured that you are following the law. These bylaws for Mother Earth Farm, Inc. provide a sample of how bylaws look and illustrate the type of issues that are addressed. These bylaws are for an Illinois business. If you use this example as a starting point, be sure to make necessary changes to reflect your state.

2 Shareholder meetings don't necessarily have to be held inside the state where the corporation is based, nor do they have to take place at the farm or central place of business. While you could set a firm place for all meetings in your bylaws, it's often preferred to allow some flexibility in case circumstances change. The important thing is that the shareholders get an invitation to the meeting in advance, or receive "notice" as specified in the bylaws, including precisely when and where the meeting will be held. Here, Section 5 sets the notice or meeting invitation requirements.

Section 2: Annual Meetings

The Annual Meeting of Shareholders shall be held on the second Tuesday in February of each year at two o'clock P.M.[3]

3 Every state requires corporations to hold annual meetings. This is the opportunity for all the shareholders to get together and vote on important items, review the annual report and generally discuss the business affairs or any pressing issues. State corporation statutes often require that specific items are voted on during annual meetings, such as electing the next year's board of directors. Annual meetings are required by law, so be sure you actually hold them. And, hold it when your bylaws say you will. You don't necessarily need to specify an exact day or time in your bylaws. Setting a month is fine as long as you properly send out the invitation to your shareholders as specified in your bylaws, here Section 5. When holding annual meetings, be sure to take minutes of what happened, including any decisions or resolutions that were made. See the sample meeting minutes that follow for a guide.

Section 3: Special Meetings

Special meetings of the Shareholders may be called at any time by the Board of Directors of the Corporation, or by the President upon written request of one or more Shareholders holding at least 10 percent of the shares of stock of the Corporation.[4] The Shareholders may discuss any business at a special meeting.

4 Special meetings are typically called when urgent matters arise and a major decision needs to be made. This could include a decision to significantly expand, or conversely to sell, the farm operation. It could also involve a significant shift in ownership or a decision to amend the bylaws. The same "notice" requirements must be met to properly inform shareholders of the precise time and place of any special meeting as well as the purpose of calling the urgent meeting.

Section 4: Notice of Meetings

Notice of the time and place of a Shareholder meeting and the purpose for the meeting must be provided in writing no fewer than 10 days and no more than 50 days before the meeting to each Shareholder of record at their mailing address, as listed on the books of the Corporation.[5]

5 Giving "notice" is the legal speak for sending out an invitation. Basically, the notice or invitation to a meeting must let the shareholders or the board of directors know important details including when, where and the purpose of the meeting. Properly sending out the invitation to a meeting is essential. For example, if a shareholder doesn't receive the invitation as specified in the bylaws, they can contest what was discussed and all of the actions taken at the meeting can be deemed invalid. This would be a huge waste of time as it would have to be done all over again. The notice must be in writing. This provides a record of it. It's also a good idea to set a time range for sending out the invitation in your bylaws to allow some flexibility. Here, notice must be given between 10 and 50 days of the meeting, so the invitation can't be sent before or after this timeframe. The written notice can be mailed, handed out personally or electronically mailed if all individuals agree. Note that including the purpose in the notice or invitation is very important. Some state statutes say that if the purpose is not included in the invitation, the matter can't be voted or acted on.

Section 5: Waiver of Notice

A Shareholder may waive notice of a meeting by attending the meeting, either in person or by proxy, or by providing a written waiver before or after the meeting. Waiver of notice shall not be deemed if a Shareholder attends a meeting for the express purpose of contesting the notice or contending that the meeting was otherwise not lawfully called or convened.[6]

6 This provision basically says that the notice requirements can be waived. This gives the corporation some flexibility in urgent situations (i.e., if a meeting needs to be called in fewer than 10 days) or if the shareholders don't really care if they receive such an official invitation. Say all the shareholders are friends and they say, "Hey, I don't need an official notice mailed to me, just tell me when the meeting is and I'll be there." As long as they put this in writing, which can be a simple email, before or after the meeting, you can rest assured that there will be no issue. Also, if an individual shows up to a meeting and doesn't raise issue about whether or how they got the invitation, then that will be deemed a waiver. This makes sense, as the notice provision ensures that shareholders will learn when and where a meeting is to take place so they can attend. The person who shows up obviously found out about it, so the issue is waived. However, if the shareholder shows up to contest the notice, it is not waived. This gives shareholders the opportunity to lash out in person if they think their interests are being subverted or intentionally sabotaged, which does happen!

Section 6: Quorum

In order to transact business at a Shareholder meeting, there must be a quorum consisting of a majority of the issued and outstanding shares of stock of the Corporation either in person or by proxy.[7]

7 A quorum is the amount of represented shares that must be present for the meeting to happen. Note that a quorum is not based on a majority of the number of shareholders, but a majority of the shares of the company. Not all shareholders will necessarily hold the same amount of shares. Many state statutes specify a minimum for a quorum, such as a majority of the shares in the company. If this is the case, your bylaws can set the quorum higher (i.e., two-thirds of the shares) but not lower (i.e., one-third of the shares). Without a quorum, any decision made at the meeting is considered invalid as it could reflect the interest of just a small percentage of ownership interest in the company. Say only 10 percent of the company's shares are represented at a meeting. Allowing this 10 percent to take actions on behalf of the company wouldn't be in the best interest of the company.

Here, because Mother Earth Farm has just two shareholders who each have 50 percent of the shares, both mom and daughter need to be present for a quorum (i.e., majority of 51 percent).

Section 7: Number of Votes for Each Shareholder

Each Shareholder is entitled to one vote for each share of stock belonging in their name on the books of the Corporation.[8]

8 Most state statutes require a one share, one vote voting rule, so this restates the law. However, some states allow shareholders to receive fractional shares (e.g., 2.5 shares), which can then be matched with fractional voting power (2.5 votes). Small businesses do not usually deal in fractional shares, so the one share, one vote rule will work well for most farm operations.

Section 8: Proxies

At all Shareholder meetings, every person entitled to vote may authorize another person or persons to act by proxy with respect to their shares by filing a written proxy with the Secretary of the Corporation. A proxy may be revoked at any time before a vote, either by written notice to the Secretary or by oral notice given by the Shareholder at the meeting. The presence of a Shareholder at a meeting who filed a proxy does not constitute a revocation of the proxy. A proxy appointment is valid for 12 months from the filing, unless otherwise indicated in the written proxy form.[9]

9 A proxy is a written authorization signed by a shareholder (or a shareholder's power of attorney) giving someone else the power to represent and vote on behalf of the shareholder's shares. It basically allows someone to stand in for a shareholder at the meeting. The shareholder can specify parameters for how the other person, or proxy holder, should vote. Or, they could simply trust and allow the proxy holder to vote based on his or her own conscience. The proxy counts towards a quorum and represents the shareholder's votes.

In our example of Mother Earth Farm, if daughter gets sick and signs a written proxy allowing cousin to vote on behalf of her shares, cousin and mom can still make decisions and take a vote because cousin is standing in for daughter's 50 percent share.

Section 9: Voting

If a quorum is present, a majority vote of the shares entitled to vote and represented at the meeting shall be the act of the corporation.[10]

10 This basically says that a majority of the shares present at the meeting will have the final say on any matter that's taken to vote. This can be a bit tricky. Again, the quorum requires that at least a majority of the shares are present at the meeting.

Let's say for a moment that there are three shareholders: mom has 40 percent, daughter has 35 percent and aunt has 15 percent of the shares. Daughter and aunt attend the meeting as shareholders, but mom doesn't. There's a quorum, because daughter and aunt together have 60 percent of the shares. Now, let's say that daughter and aunt take up the matter of voting on next year's board of directors. Daughter now represents the majority of shares present at the meeting, as mom's shares don't count because mom's not present. So basically whatever daughter decides is the act of the company. This scenario shows how important it is to attend the meetings or to get a proxy (i.e., someone else to stand in for you).

Section 10: Order of Business

The following order of business shall be observed at all Annual and Special Meetings:

1. Roll call
2. Proof of notice of meeting

If a quorum is present, the meeting continues with the following order of business:

3. Approval of the minutes of previous meetings, unless waived by unanimous consent
4. Reports of Board of Directors, if any
5. Reports of Officers, if any
6. Reports of Committee, if any
7. Election of Directors, if necessary
8. Unfinished business, if any
9. New business, if any[11]

11 This provision isn't really necessary, but it can be helpful to have a sort of working agenda of items that must be handled at every meeting, and in what order. It can help ensure all important matters are covered in an efficient manner.

Section 11: List of Shareholders

A complete alphabetical list of the Shareholders of the Corporation entitled to vote at the meeting, including address of and number of shares owned by each Shareholder, must be prepared by the Secretary or other Officer of the Corporation in charge of the Stock Transfer Books. This list shall be kept on file for a period of at least 60 days prior to the meeting at the registered office of the Corporation and must be subject to inspection during usual business hours by any Shareholder. This list shall also be available at all Shareholder meetings and must be open to inspection by any Shareholder at any time during a meeting. Failure to comply with the requirements of this Section will not affect the validity of any action taken at any Shareholder meetings.[12]

12 Most states' statutes require the corporation to maintain an alphabetical list of shareholders and to have it readily available for inspection at shareholder meetings. This provides a level of accountability and transparency, which can help ensure that none of the shareholders are wrongly left out or being subverted.

Section 12: Adjournment of Annual Meeting

If a quorum is not present at the Annual Meeting, the Shareholders present, in person or by proxy, may adjourn for a future time agreed upon by a majority of the Shareholders present. Notice of such adjournment must be given to the Shareholders who are not present or represented at the meeting. If a quorum is present, they may adjourn when they see fit and return at a time and day that is agreed upon; no notice of such adjournment must be given.[13]

13 Adjournment means to suspend the meeting to another time or place. If the quorum is not met, there's really no point of meeting, as no official action can be taken. This adjournment provision allows the shareholders present to postpone the meeting to a time they agree will be more suitable for all. If this happens, they must send out an invitation to the shareholders who aren't present in accordance with the notice requirements in Section 5. When there is a quorum, the people who are present at the meeting can decide to adjourn the meeting and agree upon a date and time to meet again without notifying the people who are not present. This provision also allows the shareholders to end a meeting even if matters are not completed so long as they agree to a time and day to return. This is helpful if the meeting runs late, which often happens!

Article 2: Stock

Section 1: Certificates of Stock

The Corporation will issue certificates of stock when shares are fully paid.[14] Certificates of stock represent shares in the corporation and must include the following: (1) the name of the corporation and that it is organized under the laws of Illinois; (2) the name of the person who owns the shares (the Shareholder); and (3) the number of shares that the certificate represents. The certificates of stock must be signed by the president and by the secretary and must be attested by the corporate seal. All certificates must be consecutively numbered, and the name of the person owning the shares, the number of shares and the date of issue must be entered into the Corporation's books.

14 Most states no longer require corporations to issue certificates of stock. However, it is a custom that many corporations still observe. Many shareholders have come to expect paper stock certificates. Issuing them also provides another layer of proof of who has stock or equity ownership in the company. If your state requires certificates of stock, be sure to look up the section on share issuance in your state's corporation statute and follow the exact requirements.

Section 2: Transfer of Shares

Shareholders may transfer their stock in person or by their attorney upon surrender of the properly endorsed certificate of stock. It is the duty of the Secretary to issue a new certificate to the person entitled to it, to cancel the old certificates and to record the transaction on the share register of the Corporation.[15]

15 If the corporation issues stock certificates, this provision should be included to specify what happens when the stock is transferred to another person. Basically, the transferring shareholder needs to fill out the endorsement section (usually found on the back of the certificate of stock) and then give the certificate to the secretary of the corporation. It is the secretary's job to record the transfer in the corporation's stock transfer books and issue a new certificate to the new shareholder. Most farm operations will have a closely held corporation, which means that the shareholders can't just transfer the shares to a stranger. The shareholders of a closely held corporation typically enter a separate shareholder agreement that specifies some additional restrictions on how shares may be transferred. In addition, if the corporation elects the S corporation tax status, the transfer of shares is restricted in certain circumstances. If either is the case for your farm operation, be sure to follow the shareholder agreement and the S corporation restrictions. See Article 7 in these bylaws for an example of the type of provisions that should be included if you elect S corporation tax status.

Section 3: Lost, Destroyed or Stolen Shares[16]

If a Shareholder claims that their certificates of stock have been lost, destroyed or stolen, a new certificate will be issued in the place of the original if the owner: (1) requests a replacement certificate before the corporation has notice that the missing shares have been acquired by a bona fide purchaser; (2) files with the corporation an indemnity bond (no more than twice the value of the shares represented by the certificate) if required by the Board of Directors; and (3) satisfies other reasonable requirements provided under the authority of the Board of Directors.

16 This section discusses how lost, destroyed or stolen certificates of stock can be replaced. Following these procedures helps assure that there will be no double selling of the stock if the lost or stolen stock finds its way into the hands of an innocent purchaser who purchases the stock without any knowledge of its lost or stolen status. Basically, the original shareholder must give the corporation notice before the innocent purchaser records their stock with the secretary, otherwise the shareholder may have to cover any damages incurred to the corporation if stock ownership is contested. This is very unlikely to become an issue in a closely held corporation with only a few shareholders such as Mother Earth Farm, but it is important to include in case something happens to the certificates of stock.

Article 3: Directors[17]

Section 1: Number, Election and Term of Office

The Corporation is managed by a Board of Directors consisting of two people.[18] The number of Directors may be increased or decreased by an amendment to the Bylaws. However, the number of Directors shall never be fewer than two individuals. The Directors shall be elected at the annual Shareholder meeting and shall hold office until the next annual meeting and until their successors have been elected and trained.

17 Most state statutes require a corporation to have a board of directors. The board makes major management decisions for the company. The shareholders elect the members of the board to play this role. The shareholders can always remove directors if they're not happy with how decisions are being made.

18 Some states require a minimum of three board members while others require just one. Additionally, most states require that directors have a one-year term and require elections at the annual shareholder meeting. The same directors may be reelected each year, but the election formality needs to take place. Be sure to check your state statute to see what is specifically required here.

Section 2: Vacancies

Vacancies in the Board of Directors may be filled by a vote of the remaining Directors.[19] The Director fulfilling the vacancy shall serve until the next annual Shareholder meeting.

19 Allowing the remaining directors to fill a vacancy is consistent with the law in most states; however, some states require director vacancies to be filled by a shareholder vote. Again, be sure to check your state statute.

Section 3: Director Meetings and Quorum

An annual meeting of the Board of Directors shall be held immediately after and at the same location as the annual Shareholder meeting. Additionally, special meetings may be called by any Director by giving five days written notice of such meeting to each Director. Notice is not required for any Director who attends the meeting in person or who waives such notice in a writing filed with the Secretary of the Corporation. At all meetings of the Board a majority of the Directors shall constitute a quorum for the transaction of business.[20] The act of a majority of the Directors present at any meeting at which there is a quorum shall be the act of the Board of Directors, except as may be otherwise specifically provided by these Bylaws. If all Directors are present, a meeting may be held at any time without notice. In the event that the Corporation has only one Director at any time, a single Director shall constitute a quorum.

20 Most state statutes also require the board of directors to have an annual meeting. This provision sets the parameters for notice and a quorum, which is similar to the requirements for shareholder meetings. Note that the quorum for directors is a majority of the number of directors and has nothing to do with the share or stock percentage. This section also allows the board to meet as many times as necessary to deal with corporation issues.

For Mother Earth Farm, it is unlikely that mom and daughter will need to call a formal meeting whenever they want to meet, but to maintain corporate formalities and to ensure liability protection, mom and daughter should be sure to have a formal annual directors meeting.

Section 4: Powers

The business and affairs of the Corporation must be managed by the Directors who may exercise all the powers necessary to run the business.[21]

21 Again, the board plays the role of making major management decisions for the company. If the shareholders aren't happy, they can go through the process of removing directors.

Section 5: Removal

At any Shareholder meeting, any Director (or Directors) may be removed from office, without reason or cause,[22] by a majority vote of the present Shareholders. Vacancies will be filled according to Section 2.

22 Most state statutes specify that a director cannot be removed unless there's a cause, such as illegal activity, unless the bylaws specify otherwise. So if you want to give shareholders the right to remove directors without cause, you need to include this in your bylaws. This gives the shareholders the absolute ability to act if they feel the company is not being run well. After all, the shareholders are the ones who have a financial stake in the company.

Section 6: Compensation[23]

Directors and members of any committee of the Board of Directors are entitled to a reasonable compensation for their services as determined by resolution of the Board of Directors. A Director may also serve the corporation in any other capacity and receive compensation for that position. Directors must also be provided with reasonable pensions, disability or death benefits, and other benefits or payments to Directors and to their estates, families, dependents or beneficiaries for services rendered to the Corporation by the Directors.[24]

23 This section includes the generally accepted practice of not paying salaries to directors, but instead paying them for their services (such as the costs for traveling to and attending a meeting). Since mom and daughter will likely be compensated through their roles as officers, and meetings will be held on the farm, they may decide by resolution that directors will not be compensated for their services.

24 Including compensation and benefits for directors is optional. If you include it, it needs to be customized to the benefits that are being offered to the board.

Section 7: Committees[25]

The Board of Directors may designate one or more committees to report to the Board on any area of corporate operation and performance. Each committee shall consist of at least one member of the Board of Directors. Each committee may exercise any and all powers that are conferred or authorized by the Board of Directors. Matters will be decided by a majority vote of the committee members. The Board of Directors shall have the power to fill vacancies, to change the size of membership and to discharge any

committee. Each committee must keep a written record of its acts and proceedings and must submit that record to the Board of Directors at each regular meeting and at any other time as requested by the Board of Directors.

25 Committees are a way for the board to delegate decision-making to smaller groups rather than requiring all members of the board to vote on a matter. This is particularly useful for larger boards that want to divvy up the tasks based on interest or expertise (such as a committee for finances or personnel). State statutes specify that some issues may not be delegated to a committee, such as amendments to the bylaws. For a small corporation like Mother Earth Farm, it is unlikely any committees will be set up. However, including this clause sets up the infrastructure in case more directors come on or if there's a particular issue that the board decides only one board member needs to be present to make decisions on.

Section 8: Dividends

The Board of Directors has full power to determine whether any, and, if so, what part, of the funds legally available for the payment of dividends will be declared and paid to the Shareholders of the Corporation.[26]

26 A dividend is when the company hands out or distributes the company's earnings to shareholders. Dividends are not required and can only be made if the company turns a profit. It's often preferred to keep the money in the farm operation to spur growth. In these bylaws, it's up to the directors to decide whether, when and how much of the earnings should be given to the shareholders in the form of dividends. All state corporation statutes require that dividends be distributed based on shares of stock in the corporation.

Here, mom and daughter each have 50 percent stock, so they would split any dividends. If mom had 60 percent stock, she would get 60 percent of the dividend amount.

Article 4: Officers

Section 1: Titles, Election, and Duties

The Board of Directors shall appoint a President, a Vice President, a Treasurer and a Secretary.[27] The Directors may also appoint other Officers with titles and duties as determined by the Board of Directors. The duties of the Officers are described in the following sections of this article, by these Bylaws and from time to time as prescribed by the Board of Directors.

27 Most state statutes require corporations to have at least a president and a secretary. This section creates positions for a president, vice president, treasurer and secretary. It is good business practice to divvy up the roles. If your corporation prefers to call the president the chief executive officer (CEO), you can replace the term in the section. The same goes with chief financial officer (CFO) in place of treasurer. This section also gives the board of directors the flexibility to create other officer positions should the need arise.

Section 2: President

The President shall preside at all meetings of the Directors and Shareholders, and shall have general supervision, direction and control of the day-to-day business of the Corporation subject to the control of the Board of Directors.[28]

28 This clause describes the president's duties, which include presiding over all meetings of both shareholders and directors, as well as running the day-to-day business of the corporation. There is no state-required definition of what a president does, and wording the clause generally gives the corporation flexibility with regards to what the president can and can't do. As it's laid out here, Mom (the corporation's president) has flexibility to do what needs to be done for the company to succeed day to day. This makes sense for a small farm operation like Mother Earth Farm. It's important to craft the roles and responsibilities of the officers in a way that's most suitable for your farm operation.

Section 3: Vice President

The Vice President shall exercise the functions of the President during the President's absence or inability to fulfill their actions. In addition, the Vice President will have any other duties that are assigned to them by the Board of Directors.[29]

29 This clause also is designed to allow the vice president's role to be as flexible as possible.

Section 4: Treasurer

The Treasurer will keep and maintain the financial accounts of the Corporation, including an account of all monies received or disbursed. They will keep adequate and correct books and records of accounts of the properties and business transactions of the Corporation. The Treasurer may endorse on behalf of the Corporation for collection only, checks, notes and other obligations. They must deposit the same and all monies and valuables in the name of, and to the credit of, the Corporation in such banks and depositories as the Board of Directors shall designate.[30]

30 Generally, the treasurer, or chief financial officer if you prefer, is in charge of all the money flowing in and out of the corporate accounts. This provision provides a level of accountability by requiring that whatever the treasurer receives must be put into the proper corporate account. In addition, the treasurer must keep accurate books and records of all the corporate accounts.

Section 5: Secretary

The Secretary shall keep the minutes of the meetings of Shareholders and Directors, and shall give notice of all such meetings as required in these Bylaws. If the Secretary is not present at a meeting, the Shareholders at the Shareholder meetings or Directors at a Directors meeting shall appoint someone to take the meeting's minutes. The Secretary shall have custody of the seal of the Corporation and all books, records and papers of the Corporation, except those in the custody of the Treasurer or some other person authorized to have custody and possession thereof by a resolution of the Board of Directors. The Secretary shall also perform any duties that are incidental to her office or are properly required by the Board of Directors.[31]

31 The secretary is generally in charge of making sure that the notice or invitation to meetings is proper, that the meetings are held in accordance with the bylaws and state law, and that minutes are taken and kept in the corporate binder along with the articles, bylaws and any amendments. Here, the secretary is also in charge of keeping non-financial books, including the stock register. This register must include information like the names of all the shareholders, their addresses, the number of shares held, the date of certificates issued for the shares, any transfers of stock certificates and any cancellation of stock certificates (i.e., by a shareholder who transfers their stock to another). The secretary's job can be very detail oriented, including being sure that deadlines for sending meeting invitations are not missed. Some of the secretary's responsibilities can be delegated to other directors or employees by resolution of the board of directors.

Section 6: Compensation

The salaries of all Officers shall be fixed by the Board of Directors. If an individual serves as a Director and an Officer, she may receive compensation for both positions. No director or officer may vote on his or her own salary.[32]

32 Both directors and officers may receive compensation for their service in the role. Here, the board of directors has the authority to determine whether and how much compensation to pay the officers and directors. Note that all states require directors and officers to abide by a "fiduciary duty." This

is a legal term that says that the director or officer must act solely in another party's interest, which here is the corporation's interest. A director has a "conflict of interest" if they can vote on their own salary. They may personally have an interest in a huge bonus, but that would not be in the interest of the corporation. It's good practice to have a clear conflict of interest policy that all directors and officers abide by. Adding a voting restriction in the compensation provision of the bylaws serves as a reminder of the director's fiduciary duty to act first and foremost in the interest of the corporation.

Section 7: Appointment, Removal and Vacancies

Each Officer must serve for the term of one year[33] and until their successor is appointed and trained. However, an Officer may be removed by the Board of Directors at any time with or without cause and with or without hearing or notice of hearing.[34] Vacancies of an Officer by reason of death, resignation or other cause shall be filled by the Board of Directors.

33 It's up to you to decide how long you want officers to serve in their role. Here, it's one year.

34 The bylaws should specify who has the authority to appoint and dismiss officers and how this process takes place. Here, the authority is in the hands of the board of directors. Of note, even though dismissal can be "without cause," the board of directors must still be careful to abide by state and federal employment law. For example, dismissal of an officer cannot be based on discriminatory reasons.

Article 5: Indemnification

Section 1: Indemnification and Reimbursement

The Corporation must indemnify each of its Directors, Officers and employees (and any executor, administrator and heir of a Director, Officer or employee) whether or not currently in service against all reasonable expenses incurred by them in connection with the defense of any litigation they are a party to because they are or were a Director, Officer or employee of the Corporation. The individual will not have a right to reimbursement if the matter involves negligence or misconduct in the performance of their duties, or the individual was faulty in the performance of their duty as Director, Officer or employee by reason of willful misconduct, bad faith, gross negligence or reckless disregard for the duties of their position. The right to indemnity also applies to court-approved settlements and compromises.[35]

35 An indemnification provision is simply a promise by the other party to cover your losses if he or she does something that causes you harm or causes a third party to sue you. Indemnification provisions can vary quite a bit. Here, this indemnification clause means that if someone sues a director, officer

or employee of the company for something they did on behalf of the corporation, the corporation has to pay to defend that lawsuit. The caveat is that if the action is attributed to the negligence or intentional bad acts of the director, officer or employee, the corporation does not have to pay to defend the lawsuit. In general, if the individual was acting in good faith and with the corporation's best interests in mind, the corporation will need to indemnify or pay them for any legal costs incurred. A corporation should consider carrying insurance for this–without insurance, the business probably can't afford to follow through on this provision. Farm liability insurance may or may not provide this coverage. A commercial policy might be necessary.

Article 6: Amendments[36]

Section 1: By Shareholders

New Bylaws may be adopted and any Bylaws may be amended, altered or repealed by the Shareholders at any Shareholder meeting, provided written notice of such proposed action shall have been given in the call for such meeting.

Section 2: By Directors

Except as otherwise provided by law, the Directors may adopt, amend or repeal these Bylaws.

36 It's important to include explicit provisions for how the bylaws can be amended. Many state statutes speak to these as well, so be sure to check any specific requirements in your state's statute. In these bylaws, either the shareholders or the directors can amend the bylaws by a majority vote at a meeting (i.e., one share, one vote for shareholders and one person, one vote for directors). You could require a different voting threshold such as a supermajority (three-quarter approval) or unanimous consent to amend the bylaws or any other "big" decision that needs to be made, such as selling the company or closing the business. It's up to you. Just be sure to check your state's statute to ensure whatever you decide is in line with the laws of your state.

Certificate

This certifies that the foregoing is a true and correct copy of the Bylaws of Mother Earth Farm, Inc., and that these Bylaws were duly adopted by the Board of Directors of the Corporation on the date set forth below.

Dated _____

Signature _____, Secretary

Sample Annual Shareholder Meeting Minutes with Annotations

ANNUAL SHAREHOLDER MEETING MINUTES FOR MOTHER EARTH FARM, INC.

An annual shareholder meeting was held on February 11, 2015, at 2 p.m. at the Mother Earth Farm, Inc. office in Illini, Illinois,[1] for the purpose of electing directors of the corporation for next year's term, discussing the company's financial performance, addressing any amendments to the bylaws, and for any other relevant business matter that arose.[2]

[1] The place, time and date information needs to be in line with whatever is specified in the company's bylaws. For Mother Earth Farm Inc., the bylaws explicitly say that the meeting will be held on the second Tuesday of February at 2 p.m. Your bylaws don't necessarily have to be as precise. Most state statutes require that the annual meeting be held at a date, time and place set forth in the bylaws, or be determined in accordance with the bylaws. For example, the bylaws could simply specify a month and a place and require that the precise time be determined within 30 days of the meeting date. Whatever the case, be sure that you follow what your bylaws say and report the actual date, time, place and purpose of the actual meeting in your minutes.

[2] Most states require that director elections are held at the annual meeting. Any other matter that is discussed is up to you. It's helpful to state the purpose at the beginning of the minutes as it makes it easier to recall what was covered if you're searching for something in particular.

Mom Farmer acted as chairperson and Daughter Farmer acted as secretary of the meeting.[3]

[3] Mom is the president and the bylaws say that the president presides over shareholder meetings. Daughter is the secretary of the corporation, so she's the one that handles administrative aspects, including the minutes.

The secretary announced that all the attendees were given proper notification of the meeting's time, place and purpose as required by the bylaws, or that such notice had been waived. Copies of the written notice and any written waivers are attached to these minutes.[4]

[4] State statutes require that shareholders are told in advance the date, time and place of the annual meeting as well as the purpose, or what will be covered, so that they can plan and prepare. This invitation to the meeting–or "notice" in legal speak–must be in writing and must follow the timing protocol that is set forth in your bylaws. For example, if your bylaws say that you must notify shareholders of the annual meeting 30 days prior to the meeting date, be sure to do so. Your bylaws can also specify how such notice can be waived. For example, some bylaws say that if a shareholder shows up and didn't actually receive a written announcement about the meeting, the notice requirement is waived (unless they specifically came to raise issue about improper notice). This makes sense, as the point of requiring written notice is to be sure shareholders know about the meeting. If they show up, they obviously know about it. As for providing shareholders advanced notice about the purpose of the meeting, it's generally sufficient to attach an agenda or to simply provide some bullet points on topics to be covered along with the written notice announcing the meeting time and place. You may also want to include a catch-all statement like "any other relevant business matter that may arise." This allows other matters to be discussed if they spontaneously arise. So basically, this section in the minutes states the notice and waiver requirements in the bylaws were followed. It is also good practice to include copies of the written notice or waivers as they provide a safeguard if a shareholder later down the road contests that they weren't given proper written notice.

The secretary announced that an alphabetical list of the names and number of shares held by all shareholders was available at the meeting for any of the present parties to inspect.[5]

The secretary announced that the following shareholders, proxy holders and shares were present and constituted a quorum of the shareholders:[6]

Name	Number of Shares
Daughter Farmer	50
Mom Farmer	50

[5] Most state statutes require that an alphabetical list of the shareholders is available for inspection at the annual meeting. This is also required in the Mother Earth Farm bylaws. Including a statement about it in the minutes is good practice.

[6] This is where you list each shareholder and the number of shares they have. The bylaws

will specify what a quorum is, or how many shareholders need to be present for a vote to take place. The Mother Earth Farm, Inc. bylaws say that a quorum is a majority of the voting shares. Since mom and daughter both own 50 percent of the 100 shares of Mother Earth Farm, Inc., both need to be present to meet the quorum. If a proxy was used (i.e., someone standing in for either mom or daughter), be sure to include a sentence after this list that announces that a copy of the written proxy is attached to the meeting minutes.

The secretary announced that the following non-shareholder individuals were also present at the meeting:[7]

Name	Title
Joan Smith	Accountant

[7] This is where you list non-shareholders who were present at the meeting. This could include employees of the company who have something to report, or experts such as lawyers or accountants to advise on legal or financial matters.

The secretary announced that the minutes of the annual shareholder meeting held on February 12, 2014, were distributed at the meeting. The previous meeting's minutes were approved by all of the shareholders in attendance.[8]

[8] It is customary to approve the previous meeting's minutes as the first matter of business at a meeting. While it is not legally necessary, it's a good way to remind shareholders of the issues that came up the year before.

The president announced that the next item of business was the election of the board of directors for another one-year term. The shareholders nominated Mom and Daughter. Mom made a motion to vote on the nominations, and Daughter seconded the motion.[9] After a majority vote, the secretary declared that both Mom and Daughter were elected to serve on the board of directors for an additional year.[10]

[9] Making a "motion" and "seconding the motion" is a customary formality in corporate meetings. Basically, any official action or vote that is to be taken at a meeting requires at least two people to agree. The first "moves" or "makes a motion" for the vote, and the second person "seconds" the motion. Then the vote can take place. This helps assure that

only relevant and significant matters go to a vote. Here, it seems silly given there are only two shareholders. However, it's good business practice to follow these customary formalities.

[10] Since Mother Earth Farm, Inc. only has two shareholders who are also the only board members, officially voting on this matter each year may seem like a waste of time. However, it's important to follow the formality and to report it in the minutes since most states require director elections to be held at annual meetings.

The president announced that the next item of business was the financial performance of the company. The president presented the annual report, and a printed version of the report was attached to the end of the minutes.[11] Joan Smith, the accountant, reported that based on the findings in the annual report and her review of the company's financial statements, the company was doing well financially.

[11] If any reports are presented at the meeting, be sure to attach them to the minutes. Again, this serves to track what information was presented in case a dispute arises. Of note, most states require that a corporation prepares and files an annual report, which reports on the corporation's activities throughout the preceding year and provides a summary of the financial performance. Here, the accountant attended the annual meeting to report on the financial performance. This is not at all necessary. However, reviewing your financial performance annually with an accountant can be a helpful exercise. Doing this at an annual meeting ensures that all shareholders have the opportunity to directly hear the expert advice and any tips for financial improvement.

Mom then requested that the annual meeting be held in January instead of February. She presented an amendment to the bylaws to make this change and made a motion to vote on the matter. Daughter seconded the motion. After a majority vote of the shareholders in attendance, an amendment to the bylaws was adopted stating that annual meetings will now be held on the second Tuesday of January.[12]

[12] Electing the board of directors may be the only and final order of business, as it's really the only matter that is legally required to be handled at an annual meeting. However, consider the annual meeting as an opportunity to discuss and handle any new or unfinished business matters. One example is an amendment to the bylaws. The Mother Earth Farm, Inc. bylaws require unanimous consent for an amendment. The bylaws also require that a proposed amendment to the bylaws be announced before the meeting, or included in the official written notice. Be sure to follow your bylaws in such situations.

Here, both Mom and Daughter agree to changing the meeting time. Be sure to attach the amendment to the meetings and follow up by formally amending the bylaws accordingly and including a new copy of your amended bylaws in your corporate binder together with all your meeting minutes.

Since there was no further business to come before the meeting, on motion duly made by Mom and seconded by Daughter, the meeting was adjourned.[13]

Daughter Farmer, Secretary

[13] If there is no further business discussed, the meeting can be adjourned. Again, customarily, this official action requires two people to agree by making a motion and seconding the motion.

FARM COMMONS

SARE
Sustainable Agriculture Research & Education

Farmers' Guide to Business Structures: LLCs, Corporations, Partnerships and More

Chapter 6, Section 1: S Corporation Tax Status Fundamentals

www.sare.org/guide-to-business-structures

DISCLAIMER: This Guide does not provide legal advice or establish an attorney-client relationship between the reader and author. Always consult an attorney regarding your specific situation.

AT-A-GLANCE CHART: S CORPORATION FEDERAL TAX STATUS

General Concept	LLC with S Corp Tax Status	C Corporation with S Corp Tax Status
Name	"Farm Name, LLC"	"Farm Name, Inc."
Owners/investors are called	"Members"	"Shareholders"
Persons who make management decisions are called	"Managers" (if manager-managed), "Members" (if member-managed)	"Officers"
Creation document is called	"Articles of Organization"	"Articles of Incorporation"
Organizing document is called	"Operating Agreement"	"Bylaws"
An owner's investment in the company is called	"Capital Contribution"	"Equity Investment"
An ownership share is called	"Percentage Interest"	"Shareholder Equity" or "Shares"
A payment of the company's profits to the owners is called	"Distribution"	"Dividend"
Is there personal liability?	Limited to a member's capital contribution	Limited to a shareholder's investment

General Concept	S Corporation Specific
How many participants can you have?	Maximum 100 persons; all must be U.S. citizens and all must be human beings, estates, tax-exempt entities or certain qualified trusts
Annual meeting required?	Required
Different owner classes allowed?	Not allowed
EIN necessary?	Required
Taxation basics	Pass-through, but entity must file informational Form 1120S with the IRS, distribute Schedule K-1 to each owner and file all Schedule K-1s with the IRS

Introduction

An S corporation is a federal tax status that is recognized by the IRS; it is not a state-created entity such as a corporation or an LLC. Before becoming an S corporation (or, rather, electing S corporation tax status) you will first need to create an entity in your state. If you decide you want to elect S corporation tax status, the entity options for your farm operation are pretty much limited to either an LLC or a C corporation. Be sure to read Chapter 4 on LLCs and Chapter 5 on C corporations to help you determine which is the best option for your farm business. Once you've created your entity–by filing your articles of organization (LLC) or your articles of incorporation (C corporation) with your state's secretary of state office (or whichever state agency handles business creation documents)–you'll then need to consider whether electing S corporation tax status with the IRS is ideal for you.

> "An S corporation is a federal tax status that is recognized by the IRS. Before becoming an S corporation you will first need to create an entity in your state."

This chapter covers the characteristics, tax benefits and various requirements of the S corporation tax status. It also provides a basic overview of certain tax procedures S corporations need to follow. The purpose of this chapter is to provide farmers with a basic understanding of what it means to run a farm operation as an S corporation. S corporations are deeply rooted in tax issues, and therefore the financial implications will vary depending on the specific financial situations of the owners as well as the farm operation itself. While this Guide is not intended to provide tax advice, it will provide a brief overview of tax issues that go along with S corporations. Farm Commons strongly recommends that farmers see an accountant or tax attorney for guidance in deciding whether the S corporation tax designation is best for their farm operation before electing S corporation status.

S Corporation Origins

Congress created the S corporation in the late 1950s as a way to help small and family-owned businesses. The "S" actually stands for "small" business corporation. Before Congress created the S corporation, small business owners had only two choices when starting a business. They could create a traditional corporation (referred to here as a C corporation) or they could just accept the default structure of a sole proprietorship, if one owner, or general partnership, if multiple owners. It was really a decision on the lesser of two evils: double taxation or no liability protection.

While the C corporation provides a level of protection on business owners' personal assets, it is at the expense of what is known as "double taxation." Here's how it works. A C corporation first pays corporate tax on the business's taxable

income, should there be any at the end of the company's fiscal year. Then, if the company passes profit back to the owners, the shareholders must pay taxes on any earnings or profits they receive from the company. Granted, the individual owners are taxed at the dividend tax rate, which is currently less than the tax rate for ordinary income. But in the case of a small business where the owners depend on dividends for a portion of their household income, the total taxes paid on business income for the small business and owners can be astronomically high. On the other hand, while the partnership or sole proprietorship allows owners to avoid taxation at the business income level, the owners have to sacrifice protection of their personal assets for business liabilities. The S corporation was created to solve this quandary faced by small business owners.

Ultimately, the S corporation serves as an incentive for small business owners to form a business entity by stripping away the corporate tax burden. With the S corporation tax status, the owners' personal assets are protected from business liabilities, and they don't have to pay double taxes on the business's income. Instead, the entity's income is passed through to the owners, and the owners report the business income and pay the required taxes when filing their individual tax returns. So, federal tax is treated just like the sole proprietorship, general partnership and LLC. This explains why the S corporation has become so popular among small farm owners in particular.

"The S corporation serves as an incentive for small business owners to form a business entity by stripping away the corporate tax burden."

Growing popularity of the LLC with S corporation tax status combination

The IRS estimates that there were more than 4.6 million S corporation owners in the United States in 2014, which is over twice the number of C corporations. The number of LLCs has grown rapidly, rising from fewer than 120,000 in 1995 to more than one million today. The IRS clarified its rules for LLCs in the late 1990s, allowing LLCs to elect the C corporation or S corporation tax status or to simply be taxed as a sole proprietorship or general partnership. Ever since, the LLC has been gaining traction and is now one of the most popular entity choices for small businesses throughout the country given both its flexibility and liability protection. For a more detailed discussion on the LLC's flexibility and personal liability protection, read Chapter 4 on LLCs.

Basic Characteristics of the S Corporation

The S corporation protects personal assets from business liabilities

To get S corporation tax status, an entity must first be created at the state level as an LLC or C corporation. Given this, the S corporation comes with the same level of protection over personal assets that is provided by that business entity. To preserve the liability protection of personal assets, be sure to read Chapter 4 on LLCs and Chapter 5 on C corporations, or review the refresher overview of this issue in the box below.

In short, this personal liability protection is limited to the amount that each owner has invested in the company. In other words, once an owner transfers his or her investment in the farm operation to the business entity (i.e., a capital contribution if an LLC or an equity investment if a C corporation), the investment is the property of the entity. The owner is not entitled to get the investment back, and thus, she risks losing it. In effect, this investment amount reflects each owner's stake in the farm business. There are also certain caveats to the protection of personal assets that LLCs and C corporations offer. If the farm owners do not follow certain standards, the courts can go around the personal liability protection and allow creditors to access the individual owners' personal assets. There are two basic ways to prevent this. First, the farm business needs to be adequately capitalized so that the company can make due on its debts. Second, the owners must keep their personal affairs separate from business affairs by keeping separate bank accounts and not commingling funds.

In business law jargon, people often refer to the entity's protection of the owners' personal liability as a "shield" and the process of eliminating that protection if the owners don't run the business properly as "piercing the veil."

"Forming a business entity and electing S corporation tax status is not a substitute for insurance. It does nothing to change the landscape of a farm's potential liability."

Keep in mind, forming a business entity and electing S corporation tax status is not a substitute for insurance. It does nothing to change the landscape of a farm's potential liability. It only limits the assets available to satisfy that liability, should it materialize, to business assets. All the farm's assets are entirely available to anyone with a successful claim against a farm business entity. Good liability insurance provides the farm with a defense in court and a source of funds to pay out on a court claim if it is successful. Farm Commons strongly urges any farm business, no matter what business entity it adopts, to maintain adequate insurance coverage.

Refresher on protecting personal assets from business liabilities

Basically, there are two essential ways to protect business owners' personal assets: (1) sufficiently capitalize the farm operation, and (2) keep the farm operation's affairs separate from the owners' personal affairs. First, business

owners may lose their personal liability protection if the company is undercapitalized. As a basic rule of thumb, a company is adequately capitalized if it can make due on its debts, i.e., pay its monthly bills. Anything less would be undercapitalized. Courts are also able to access personal assets if the members fail to keep the business separate from their personal affairs. This includes commingling funds such as drawing on business assets to pay for personal expenses or not keeping separate business and individual bank accounts. The takeaway here is to develop policies and systems for keeping the farm business and individual affairs separate, which include at the minimum having separate bank accounts, credit cards and accounting systems.

Even if an entity is properly maintained, creditors often require that individual owners of a business entity personally guarantee obligations. Creditors know that if there's nothing left in the business entity there will be nothing left for them. What this means is that creditors may require a business owner to commit to loan payments as an individual, not just as a business owner (i.e., member of an LLC or shareholder of a corporation). As a result, personal assets will be on the line even though the business owner took on the obligation to benefit the business. Business owners have to negotiate whether and to what extent a personal guarantee is required with creditors on a case-by-case basis.

S corporations receive special tax benefits

Single layer of taxation

Farm operations often prefer the S corporation tax status because of its special tax benefits. As already mentioned, the primary tax benefit of the S corporation is the single layer of taxation, also referred to as pass-through taxation. Indeed, pass-through taxation is the default tax status of the LLC, sole proprietorship and general partnership. (A single-member LLC is taxed as a sole proprietorship and multi-member LLC is taxed as a general partnership, unless elected otherwise.) So this tax benefit is really only relevant to farm operations that are C corporations. Pass-through taxation allows the business's income to pass through to the owners without requiring the entity to first pay corporate taxes on business profits. The S corporation tax status allows a standard C corporation to be taxed this way. In effect, the owners can circumvent the double taxation dilemma of the C corporation. If an entity obtains S corporation tax status, the entity does not have

"The primary tax benefit of the S corporation is the single layer of taxation, also referred to as pass-through taxation."

to pay federal taxes on business income. Instead, each of the owners reports the business's income on his or her individual tax return and pays taxes on it.

> "The IRS handles self-employment taxes slightly differently for entities with the S corporation tax status."

State taxes are not addressed in this Guide

The S corporation tax status is only relevant for federal income taxes filed with the IRS. The farm entity will still need to abide by the state tax requirements. State taxes are separate and not addressed in this Guide.

Potential self-employment tax savings

The other special tax benefit that the S corporation provides relates to self-employment income. The IRS handles self-employment taxes slightly differently for entities with the S corporation tax status. Basically, in addition to a "reasonable" salary that the farm business pays the owners, the farm business can hand out business profits in the form of "distributions." Distributions are taxed at the lower dividend tax rate. In addition, distributions are free from self-employment taxes including Social Security and Medicare taxation, which can equate to about 15 percent savings in federal taxes. The takeaway here is that if a farm operation is an LLC or a C corporation and it is expected to earn significant revenues that are above and beyond a "reasonable salary" for the owner(s), the S corporation tax status may be a good option.

Distributions or dividends can of course only be made if there are sufficient profits in the farm operation. Otherwise, the entity will be considered undercapitalized.

You may be thinking, well, this is great, I can just keep my salary as low as possible so that the remainder is taxed at the lower dividend tax rate. Be careful! If you elect S corporation tax status for your business entity, keep in mind that the IRS does not look fondly on artificially low salaries and can reclassify dividends as salary. If this happens, the individual owner will end up having to pay back taxes and may risk an audit. So it's best to declare a "reasonable salary." So, what's a "reasonable" salary? The IRS will look at many different factors in making this determination. Anything above a reasonable salary could be reclassified and taxed at the higher employment income rate. The IRS will consider many factors, including the following:

> "If you elect S corporation tax status for your business entity, keep in mind that the IRS does not look fondly on artificially low salaries and can reclassify dividends as salary."

- training and experience of the individual
- duties and responsibilities of the individual
- time and effort devoted to the business by the individual
- dividend history of the business
- payments to non-shareholder employees

- timing and manner of paying bonuses to key people
- what comparable businesses pay for similar services
- compensation agreements
- the use of a formula to determine compensation

So what then is a "reasonable salary" for farmers or farm owners? It will depend on all the above factors and may, in fact, vary based on the region. A farmer with extensive experience who devotes great effort to the business may be less able to justify a low salary. If a farm business pays other employees well, and managers of similarly sized non-farm businesses receive ample salaries, the farm owner may have a hard time justifying a tiny salary as "reasonable." Current national statistics on farming itself can also help pinpoint a reasonable salary. According to the Bureau of Labor Statistics, in 2014, the average annual income for supervisors of farms and farmworkers was $47,540. If you own and run your own farm operation, which includes supervisory duties, the IRS may consider this as the baseline. Let's say an owner of a company with net annual income of $50,000 tried to claim that just $20,000 of that was a reasonable salary in hopes of getting a tax break on the remaining $30,000. You might have an uphill battle convincing the IRS that a farmer of similar skill and responsibilities could only reasonably expect $20,000.

"A farmer with extensive experience who devotes great effort to the business may be less able to justify a low salary."

How the S corporation tax status differs from the standard LLC and C corporation

The S corporation sounds a lot like the LLC. The LLC provides pass-through taxation and protects personal assets from business liabilities. So does the S corporation! So, what's so different about the standard LLC and an S corporation (keeping in mind that an S corporation is really an LLC or C corporation with S corporation tax status)? In short, the S corporation provides some potential tax benefits related to self-employment taxes. However, to get that benefit, the entity has to meet specific criteria and follow certain formalities, including holding annual meetings and dealing with federal tax paperwork every year. This is above and beyond what a traditional LLC requires.

So what's the difference between an S corporation and a C corporation? Well, the S corporation has an inflexible structure and requires certain formalities like the standard C corporation. However, unlike the C corporation, the S corporation provides the pass-through taxation to circumvent the double

taxation dilemma. The S corporation does not have to pay corporate taxes on business income. Instead, business income passes through to the individual owners who must report business income and pay their share of taxes on their individual tax returns. In addition, with an S corporation, business owners get to take advantage of the potential savings on self-employment taxes, which aren't available with a traditional C corporation.

Continue reading this chapter on S corporations for more details on the tax benefits, requirements and formalities that come with an S corporation. Then you can decide whether the benefits outweigh the costs for your farm operation.

BASIC COMPARISON OF THE BENEFITS OF A FARM'S BUSINESS STRUCTURE CHOICES

	Protection of Personal Assets	Pass-Through Taxation	Potential Self-Employment Tax Savings
Sole Proprietorship/General Partnership		✓	
LLC (with default filing as a sole proprietorship/general partnership)	✓	✓	
C Corporation	✓		
S Corporation	✓	✓	✓

Criteria and Formalities Required for S Corporation Tax Status

"To be eligible for S corporation tax status and to receive the special tax benefits, the farm business will need to meet four basic criteria."

To be eligible for S corporation tax status and to receive the special tax benefits, the farm business will need to meet certain criteria and follow some formalities.

Four basic criteria must be met. If all four are not met, the farm business will not be eligible for S corporation tax status. First, the entity receiving the S corporation tax status has to have been filed in the United States. In other words, it can't be a foreign company. Second, all owners of the entity, whether members or shareholders, have to be U.S. citizens. So, if one of the farm business owners is from Canada and has not received citizenship, then the business cannot elect S corporation tax status. Third, the IRS does not allow another for-profit entity such as an LLC or corporation to be an owner of an S corporation. All owners must be living and breathing human beings, estates, tax-exempt entities or certain qualified

trusts. Finally, the farm operation must have 100 or fewer owners. So, a single member LLC can elect S corporation tax status, but if the farm operation has more than 100 members or shareholders, it cannot elect S corporation tax status.

The criteria: Is your farm business eligible for S corporation tax status?

If you answer yes to all of the four following questions, your farm entity is eligible for S corporation tax status:

1. Was your farm operation entity created in one of the 50 U.S. states?
2. Are all the owners U.S. citizens?
3. Are all of the owners human beings, estates, tax-exempt entities or certain qualified trusts?
4. Do you have 100 or fewer owners? (Family members count as just one shareholder for this purpose.)

The farm business will also need to abide by certain formalities to obtain and maintain the S corporation tax status. This includes holding annual meetings and taking minutes to evidence what happened in each meeting. Also, certain tax forms must be distributed to all of the business owners, and these forms must be filed alongside a thorough informational tax form with the IRS every year. While similar formalities and requirements are required for a C corporation, they are above and beyond what is required for a typical LLC. More details about these formalities and tax paperwork requirements will be discussed next. Be sure you meet all four criteria and carefully consider the required formalities before deciding to elect S corporation tax status.

> "The farm business will also need to hold annual meetings and prepare certain tax forms."

Electing S Corporation Tax Status

So if you've decided to pursue S corporation tax status, you'll likely be asking this next: What do you need to do to be recognized as an S corporation? It's really quite simple. First, if the farm business is an LLC, you'll need to fill out and file the IRS Form 8832, "Entity Classification Election." Here, you'll elect your preference to be taxed as a corporation. Don't stop there! Once you do this, you will be taxed as a C corporation and unless you follow the next step, you'll face the double taxation dilemma. If you're an LLC that's filed IRS Form 8832 or you are a C corporation that wants to receive the S corporation tax status, you will next need to fill out and file

with the IRS tax Form 2553, "Election by a Small Business Corporation." The form should be completed up to two months and 15 days after the beginning of the tax year the election is going to take effect, or at any time during the tax year preceding the tax year it is to take effect. This sounds complicated but the IRS provides examples of how the timing works in the instruction sheet for Form 2553. Ideally, you will file these forms within 12 months of forming your business entity. However, if you don't, you can still go through a process for a late classification.

How to elect S corporation tax status

If you have an LLC: First file IRS tax Form 8832 to elect your preference "to be classified as an association taxable as a corporation" and then file IRS tax Form 2553 to be classified as an S corporation.

If you have a C corporation: File IRS tax Form 2553 to be classified as an S corporation. These forms are available to download on the IRS website.

"Farm Commons highly recommends that farmers consult with a tax attorney or accountant ***before*** filing S corporation tax forms."

Farm Commons highly recommends that farmers consult with a tax attorney or accountant *before* filing these tax forms to be sure the S corporation tax status is the best option and the appropriate procedure is followed. Once the election is made, be sure to follow through by upholding best business practices, including following the required formalities and filing and distributing the required tax forms every year. Learn more in the next section.

Implementing Best Business Practices to Maintain S Corporation Tax Status

To continue to reap the benefits of the S corporation tax status and to maintain the liability protection provided by your selected business entity (i.e., LLC or corporation), the farm operation must follow through by upholding best business practices. For more detailed guidelines on this, be sure to read the LLC or C corporation chapters in this Guide. Basically, you must keep your business affairs separate from your personal affairs, abide by the provisions of your organizing document (the operating agreement if an LLC or bylaws if a corporation), file applicable annual maintenance fees with the state and maintain accurate accounting records. Here, we'll cover formalities that are specific to the S corporation. These include holding annual meetings and distributing and filing the required IRS tax forms.

Hold annual meetings

The IRS requires that an S corporation hold an annual meeting. You must have provisions setting forth the parameters for your annual meeting in your organizing document (the operating agreement if an LLC or bylaws if a corporation). The provision generally includes the month or season when the annual meeting is to happen. It also includes requirements for when and how you will notify the business owners about the place, time and other relevant details about the meeting, such as matters to be discussed. Once you set these parameters, you must follow them. You need to also take minutes to record what happens at the meetings. The minutes don't have to be elaborate, just enough to provide evidence of what happened and to help the participants recall what was discussed and decided, if needed.

See the *Sample Annual Members Meeting Minutes* (for LLCs) and the *Sample Annual Shareholder Meeting Minutes* (for C corporations) in the "Going Deeper" sections of the chapters on LLCs and C corporations.

Distribute and file S corporation tax forms: Form 1120S and Schedule K-1

Once you elect S corporation tax status, be sure the entity and each of its members fulfill annual tax obligations. This includes distributing tax forms, filing tax forms and, of course, making sure the individual owners pay taxes when due.

As an S corporation, you'll have to file the annual Form 1120S with the IRS. This is not a tax return, as the entity does not have to pay income taxes itself. Rather, this is an informational tax document used to report the business entity's profits, losses and any disbursements of profits given to its owners (dividends to shareholders if a corporation or distributions to members if an LLC). Again, the entity itself will not have to pay taxes, as the business's income passes through to the individual owners.

In addition, you will have to provide each of the owners with a Schedule K-1. The Schedule K-1 is similar to a W-2, the end-of-year wage statement that employees receive from their employers. The Schedule K-1 shows the self-employment income that each of the owners receives from the company. The entity must also submit a copy of Schedule K-1 to the IRS for each business owner. This allows the IRS to be sure that each owner is properly reporting any self-employment income he or she receives from the entity that has S corporation tax status.

"Once you elect S corporation tax status, be sure the entity and each of its members fulfill annual tax obligations."

Farm Commons recommends that you seek expert tax guidance before filing any of the required S corporation tax forms. Also of note, be sure to abide by all the state income tax requirements for your business entity (i.e., LLC or C corporation). The S corporation tax status is only relevant for federal income taxes filed with the IRS. This resource does not address state business tax issues.

Don't forget to file and pay your state income taxes!

Creating an S Corporation: Next Steps

By now you might be thinking that S corporations are great and that you want one for your farm operation. Or perhaps your friend has an S corporation or your accountant has recommended that you go that route. So now you might thinking, "Why aren't you telling me exactly how to form an S corporation?" Well, like we explained earlier in this chapter, unlike other entities, the S corporation is not actually formed at the state level. To become an S corporation, you first have to form an entity–a C corporation or an LLC–at the state level. Once this is done, that entity can become an S corporation by filing the necessary paperwork with the IRS, as outlined in the previous section. Forming an S corporation is basically electing S corporation federal tax status for your regular corporation or LLC. A lot of people don't think about it this way, so the S corporation is often referred to as a separate entity. For all federal tax purposes it is a separate entity, but you first need a corporation or LLC at the state level.

What's next then? Well, now that you have read this chapter on S corporations and have an understanding of the various benefits, eligibility criteria and requirements–and have spoken to your accountant to confirm that the S corporation is the best entity for you–your first step is to choose the best state-level entity for your farm operation. To help you through this process, review Chapter 4 on LLCs and Chapter 5 on C corporations.

Note that a B corporation can also elect the S corporation tax status, so that is another option for you if it's recognized in your state. You can learn more about B corporations in Chapter 7.

Once you've decided on the state-level entity, you'll then need to go through the process of setting that entity up in your state. The chapters in part 2 outline how this is done for each entity. In addition, the C corporation and LLC chapters each have a "Going Deeper" section that provides checklists and sample organizational agreements (bylaws for the C corporation and operating agreement for the LLC), as well as checklists that include a step-by-step process for setting up the entity at the state level and electing S corporation tax status with the IRS. If you go the C corporation route, be sure to pay particular attention to Article 6 of the *Mother Earth Farm, Inc. Bylaws*, which includes S-corporation-specific provisions. If you choose to form an LLC, be sure to pay particular attention to Articles 3.1, 6.1 and 7.6 of the *Extensive Operating Agreement for Sun Sisters Farm, LLC*, which all include S-corporation-specific provisions.

In sum, these are the steps that people mean when they say "forming an S corporation."

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SARE
Sustainable Agriculture Research & Education

Farmers' Guide to Business Structures:
LLCs, Corporations, Partnerships and More

Chapter 6, Section 2: Going Deeper Into S Corporation Tax Status

www.sare.org/guide-to-business-structures

DISCLAIMER: This Guide does not provide legal advice or establish an attorney-client relationship between the reader and author. Always consult an attorney regarding your specific situation.

Checklist: Creating a Farm Business with S Corporation Tax Status

Introduction

Many people refer to the S corporation as a separate entity and say, for example, "You should form an S corporation." In actuality, the S corporation is a federal tax status. You first have to form an eligible business entity at your state level—generally either an LLC or a C corporation—and then you elect the S corporation tax status with the IRS. This checklist guides farmers through this process of establishing the S corporation federal tax status for their farm operation.

This checklist is designed to be used with the other resources provided in this Guide. In particular, it may be helpful to review the previous section on S corporation tax status fundamentals first.

"This checklist guides farmers through the process of establishing the S corporation federal tax status for their farm operation."

Summary Checklist

- Verify that the S corporation tax status is right for your farm business and that you meet the criteria
- Decide on and form an eligible business entity at the state level
- Include provisions in the entity's organizing document related to the S corporation tax status
- File IRS tax forms to elect S corporation tax status
- Distribute and file S corporation tax forms, and file and pay state taxes
- Implement best practices for the entity you've chosen, including holding annual meetings

Checklist with Explanations

- Verify that the S corporation tax status is right for your farm business and that you meet the criteria

Read through the first section of this chapter to learn more about the tax advantages and requirements of having an S corporation. Now ask yourself: Would you benefit from the available tax advantages? Do you meet the eligibility criteria? Are you willing to follow through with the extra paperwork and formalities required in having the S corporation tax status? Farmers considering the S corporation tax status may also want to seek the advice of a tax attorney or an accountant prior to filing any forms with the IRS.

- Decide on and form an eligible business entity at the state level

Now that you have read the S corporations chapter and have an understanding of the various benefits, eligibility criteria and requirements—and have spoken to your accountant to confirm that the S corporation is the best entity for you—your next step is to choose the best state-level entity for your operation. Review the chapters on LLCs and C corporations (Chapters 4 and 5) to help you through this process.

Once you've decided on the state-level entity, you'll need to go through the process of setting it up. The chapters on each entity outline how to do this. In addition, the LLC and C corporation chapters each have a "Going Deeper" section that provides checklists and sample organizing agreements (bylaws for the C corporation and operating agreement for the LLC), as well as checklists that include a step-by-step process for setting up that entity at the state level.

If it is recognized in your state, a B corporation that elects S corporation tax status is another option for you. You can learn more about B corporations in Chapter 7.

Include provisions in the entity's organizing document related to the S corporation tax status

The entity's organizing document—bylaws for the C corporation or operating agreement for the LLC—should include S-corporation-related provisions. These provisions could either designate the S corporation tax status, or they could simply provide the framework for the members to elect and maintain the S corporation tax status—or revoke it—should they agree to do so.

If the organizing document designates the S corporation status, it should also restrict the transfer of stock or shares in a way that would disqualify the entity. For example, to have the S corporation tax status, all owners must be U.S. citizens, and a shareholder can't be another business entity. If an owner inadvertently transfers their stock to a Canadian, it would disqualify the entity. The organizing document should clearly restrict and invalidate such a transfer to prevent such disqualification. In addition, the organizing document should specify that the entity has only one class of stock or membership interests, which is a prerequisite for the S corporation tax status.

The following provides a sample of provisions related to S corporation tax status for C corporation bylaws. If you choose to form an LLC, take a look at the *Extensive Operating Agreement for Sun Sisters Farm, LLC* in Section 2 of Chapter 4. Pay particular attention to Articles 3.1, 6.1 and 7.6, which all include S-corporation-related provisions that provide the members the option to elect S corporation tax status.

Sample S corporation tax status provisions for C corporation bylaws

Article 6: Subchapter S Corporation Status

Section 1: Election

The Corporation shall be an "S corporation" as the term is defined in the Internal Revenue Code of 1986, as amended (the "Code"), and shall take all actions necessary to elect S corporation tax status and continue to keep the status in effect. The Corporation must not take any actions that would disqualify the Corporation as an S corporation as the term is defined in the Code.

Section 2: Restrictions on Transfer

No Shareholder may transfer, either directly or indirectly, any shares of the corporation to any person or entity if the holding of the Corporation's shares or stock by such a person or entity would disqualify the corporation as an S corporation as the term is defined in the Code. Any attempt to transfer an interest in the Corporation to such a person or entity shall be void and invalid.

Section 3: Subchapter S Stock

The Corporation may have no more than one class of stock, and within that class, the rights, designations and preferences of shares may differ only with respect to voting rights.

File IRS tax forms to elect S corporation tax status

Once you have your entity at the state level, you're ready to pursue the S corporation tax status with the IRS. Here's what you need to do:

- For an LLC: First, file IRS tax Form 8832 to elect your preference "to be classified as an association taxable as a corporation," and then file IRS tax Form 2553.
- For a C corporation: File IRS tax Form 2553.

These forms are all available to download on the IRS website.

Distribute and file S corporation tax forms and file and pay state taxes

You'll have to file the Form 1120S with the IRS each year. This is not a tax return, as

the entity does not have to pay income taxes itself. Rather, this is an informational tax document used to annually report the business entity's profits, losses and any disbursements of profits given to its owners (dividends to shareholders if a corporation or distributions to members if an LLC). The entity itself will not have to pay taxes, as the business's income passes through to the individual owners.

In addition, you will have to provide each of the owners with a Schedule K-1. The Schedule K-1 is similar to a W-2, the end-of the-year wage statement that employees receive from their employers. The Schedule K-1 shows the self-employment income that each of the owners receives from the company. The entity must also submit a copy of Schedule K-1 to the IRS for each business owner. This allows the IRS to be sure that each owner is properly reporting any self-employment income they receive.

Farm Commons recommends that you seek expert tax guidance before filing any of the required S corporation tax forms. Be sure to also abide by all the state income tax requirements for your business entity (LLC or C corporation). The S corporation tax status is only relevant for federal income taxes filed with the IRS.

Implement best practices for the entity you've chosen, including holding annual meetings

To continue to reap the benefits of the S corporation tax status and to maintain the liability protection provided by your selected business entity (LLC or corporation), the farm operation must follow through by upholding best business practices. For more detailed guidelines, be sure to read the "follow best business practices" section at the end of the LLC or C corporation chapters, depending on which entity you form at the state level. Basically, you must keep your business affairs separate from your personal affairs, abide by the provisions of your organizing document (bylaws if a corporation or operating agreement if an LLC), file applicable annual maintenance fees with the state and maintain accurate accounting records.

Notably, the IRS requires that an S corporation hold an annual meeting. You must set forth the parameters for your annual meeting in your organizing document. This generally includes designating the month or season when it is to happen. It should also include requirements for when and how the business owners will be notified about the place, time and other relevant details regarding the meeting, such as matters to be discussed. Once you set these parameters, you must follow them. Be sure to also take minutes to record what happens at the meetings.

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Farmers' Guide to Business Structures:
LLCs, Corporations, Partnerships and More

Chapter 7: B Corporation Fundamentals

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AT-A-GLANCE CHART: B CORPORATION

	General Concept	Terminology
B Corporation (if recognized by your state)	Name	Depends on state statute. In most states it is "Farm Name, Inc.," but in the state of Washington it has to be "Farm Name, SBC"– "SBC" stands for Social Benefit Corporation
	Owners/investors are called	"Shareholders"
	Persons who make management decisions are called	The "Board of Directors" is responsible for making key decisions; the "Officers" are responsible for the day-to-day management
	Creation document is called	"Articles of Incorporation"
	Organizing document is called	"Bylaws"
	An owner's investment in the company is called	"Equity Investment"
	An ownership share is called	"Shareholder Equity," or "Shares"
	A payment of the company's profits to the owners is called	"Dividend"
	Is there personal liability?	Limited to a shareholder's investment if corporate formalities are maintained
	How many participants can you have?	One or more people–can be other business entities or trusts, unless elect S corporation tax status
	Are different shareholder classes allowed?	Allowed, unless elect S corporation tax status
	Is an EIN necessary?	Required
	Who files the tax return?	Entity files an income tax return and pays corporate taxes; individuals also pay taxes on any dividends they receive from the corporation. Option to elect S corporation federal tax status
	Are there other key filings?	Most states require you to file an Annual Benefit Report
B Corporation with S Corporation Federal Tax Status	How many participants can you have?	Maximum 100 people; all must be U.S. citizens and none can be another business entity or trust
	Are different shareholder classes allowed?	Not allowed
	Who files the tax return?	Pass-through, but entity must file informational Form 1120S with the IRS, distribute Schedule K-1 to each owner and file all Schedule K-1s with the IRS

Introduction

The B corporation–or "benefit corporation"–is the newest entity form that has come onto the scene. It expressly allows owners of a company to establish a social or environmental purpose in addition to making profits. This is also known as the triple bottom line: people, planet, profits. The B corporation is not a nonprofit corporation or even a hybrid for-profit/nonprofit; it is a for-profit business entity that has a fundamental social or environmental purpose. The B corporation is now officially recognized by 32 states and the District of Columbia. This chapter will provide a brief overview of the B corporation. It also points to some resources to help you explore the B corporation option further if your farm operation shares the triple bottom line as a goal.

"The B corporation is a for-proft business entity that has a fundamental social or environmental purpose."

The following states currently recognize B corporations:

Arkansas, Arizona, California, Colorado, Connecticut, Delaware, Florida, Hawaii, Idaho, Illinois, Indiana, Louisiana, Maryland, Massachusetts, Minnesota, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Utah, Vermont, Virginia, Washington* and Washington, D.C.

*Note that the state of Washington has created the "social purpose corporation" instead of recognizing benefit corporations. For all intents and purposes, it has the same effect.

"Traditionally, all corporate decision-making is usually justified in terms of maximizing profts for the benefit of the owners or shareholders."

B Corporation Origins

Corporate law and culture are based on profits

Corporate law and culture in the United States are fundamentally motivated by profits and not really tailored to address the situation of a for-profit company that actually wants to pursue a social mission. While some corporations do in fact give back to society through donations or community programs, traditionally, all corporate decision-making is usually justified in terms of maximizing profits for the benefit of the owners or shareholders.

Let's say for example that the directors and officers of a farm operation decide to set a significant portion of land aside as a conservation easement instead of cultivating it for profit. If a shareholder of that company is not happy with their

return on investment and he sees that the directors are prioritizing environmental concerns above profits, they could raise issue with the directors responsible for such a decision. It's unlikely that a court would step in and say that the officers and directors were somehow wrong. This is because the courts generally defer to the judgment of directors under the "business judgment rule." In short, as long as the decision is reasonable and made with care, it will hold muster in the eyes of the court. The directors could certainly make a case for such a decision if it will result in tax credits for the company or good marketing based on the goodwill earned in the public eye. Nevertheless, directors and officers still feel pressured by the profit demand of the shareholders. After all, the shareholders vote for the directors, and a hostile takeover could ensue if they're not ultimately happy.

"Unlike the traditional C corporation, a "B" or benefit corporation is a legal structure that requires the company's management to make an overall positive impact on society and the environment."

B Lab created the B corporation to highlight a social purpose

The point is that many people do not agree with having to go through the exercise of justifying all decisions based on profits to meet the demands of shareholders. While most business owners realize that it's important for a company to make profits, many are increasingly recognizing that it's just as important to give back to society and not decisively exploit people and the environment. Let's say that Farmer John wants to set up a chicken farm. In addition to making a profit, Farmer John wants to make sure that his business (1) is environmentally sustainable, (2) treats the chickens with the highest animal husbandry standards, and (3) gives 50 percent of its profits back to the local community. Farmer John could very well do this under the traditional C corporation or LLC entity. However, if he were to ever sell his business, he would have no way of guaranteeing that his social-purpose motive would be carried on by the new owners.

In an attempt to alleviate the traditional corporate law constraints on entrepreneurs who care about social and environmental causes, B Lab, a Pennsylvania nonprofit corporation, created the benefit corporation. Unlike the traditional corporation, a "B" or benefit corporation is a legal structure that requires the company's management to make an overall positive impact on society and the environment. It permits management to take into consideration social and environmental factors when making decisions as much as or more so than making a profit.

At first the benefit corporation was a product of B Lab and was not officially recognized by state corporation statutes. So, B Lab functioned as a third-party

certifier. A company that wanted to be recognized by the public as a benefit corporation would file an application with B Lab. B Lab would have the company answer an extensive list of questions to ensure that the company is truly following its stated general benefit goal. It also required the company to change some of its formation and organizing documents to include provisions declaring the social purpose. If the company did all of this, including paying a small fee, it would officially be recognized by B Lab as a certified B corporation.

States began recognizing B corporations in mass

Meanwhile, B Lab created model laws and worked diligently with state legislatures across the country to advocate for legislation that would expressly recognize the benefit corporation. They have done an amazing job. The first state to adopt the benefit corporation was Maryland on April 13, 2010. Now, in just five years, 32 states plus the District of Columbia have passed statutes allowing for the creation of benefit corporations in their state or district.

"As of 2015, 32 states plus the District of Columbia have passed statutes allowing for the creation of B corporations in their state or district."

Basic Characteristics of a B Corporation

The B corporation shares the same governance structure as the C corporation–shareholders, directors and officers. It also protects the personal assets of the owners from the business's liabilities as long as the corporate formalities are upheld, just as with the C corporation and the LLC business entities. In addition, the B corporation structure embodies three main pillars that govern the company: purpose, accountability and transparency.

"The B corporation protects the owners' personal assets from the business's liabilities just like LLCs and C corporations."

Declare a social purpose

While traditional corporations have the single duty to maximize profit, benefit corporations have the increased purpose of considering society and the environment in addition to seeking a profit. A farm operation that decides to form a B corporation must declare their commitment to creating "general" public benefit. In most state B corporation statutes, this general purpose is defined as "to pursue the creation of a material, positive impact on society and the environment, taken as a whole, as assessed against a third-party standard, from the business and operations of a benefit corporation." A farm operation could also declare a "specific" social benefit, such as "The corporation is organized for the purpose of furthering sustainable food systems."

Establish accountability with the board of directors

To ensure that the company is being held accountable for pursing its declared social purpose, the B corporation form expressly requires directors to consider society and the environment when making decisions. In addition, the B corporation state statutes provide shareholders with a right to sue the directors should the shareholders determine that the directors are deliberately making decisions that are directly counter to the stated social purpose. These "private right of action" provisions are much like the accountability elements of traditional corporations; however, they include the consideration of society and the environment in addition to profit.

"B corporations can't simply say they're going to serve a social purpose. They have to show and tell the public how they are actually doing it."

Maintain transparency with the public

In addition, B corporations can't simply say they're going to serve a social purpose. They have to show and tell the public how they are actually doing it. This is primarily done through an annual benefit report that explains how the corporation pursued a general or specific social benefit and includes an assessment of its efforts measured against a third-party standard. It's up to the company to choose the third-party standards, and the standards will vary depending on the industry and the social goals. For example, in the sustainable farming community, two third-party standards that have been used by B corporations include the Food Alliance certification and the Sustainable Farm certification. In addition, B Lab has a tool called the "B Impact Assessment" where companies can measure their success and progress toward certain social goals.

The exact requirements of the annual benefit report vary from state to state. Most states require the annual benefit report to be issued to shareholders and to be made available on the B corporation's public website. In addition, many states require the B corporation to file the annual report with the state. Overall, this transparency element prevents the B corporation from becoming a vehicle for what's known as "greenwashing," or simply vowing a commitment to environmental stewardship through marketing and advertising while going about the business of making a profit with little regard for the corporation's environmental impact.

Forming a B Corporation at the State Level

If your farm operation is located in the District of Columbia or one of the many

states that recognized the B corporation, you have the option to form one officially. This process is very similar to forming a C corporation. It follows the same governance structure: directors, officers and shareholders. It also requires the same formation and governing documents: articles of incorporation and the bylaws. Be sure to review the chapter on C corporations (Chapter 5) for more details on forming and upholding a corporation, as this chapter only covers aspects that are unique to the B corporation.

"The process of forming a B corporation at the state level is very similar to forming a C corporation."

Note that one of the drawbacks of a B corporation is that some fear that the stated social purpose will make it challenging for the entity to raise funds from outside investors like venture capitalists and angel investors who want to maximize the return on their investment. Others point out that more and more investors are intrigued by a triple bottom line goal, and some are particularly attracted to the B corporation structure because of the social gains. If your farm operation anticipates a need to obtain financing from outside private investors, be sure to thoroughly investigate the implications of forming a B corporation.

Create and file the articles of incorporation that include a social purpose

You'll need to file articles of incorporation with your state just as you would for a C corporation. The only difference is that you'll need to be sure you're using the B corporation form, if there is one provided by your state's business registration office. Otherwise, you'll need to create your own document and include the specific B corporation language. A quick internet search for "benefit corporation and [your state]" should get you the information you need to get started. B Lab also has a helpful state-by-state resource on its website called "How to Become a Benefit Corporation." The link is provided in the resources section at the end of this chapter.

Basically, to achieve B corporation status at the state level, the articles of incorporation must declare the B corporation status. For example, at the top it could say: "Articles of Incorporation for Local Fruit Farm, Inc., A Benefit Corporation."

"The articles of incorporation must declare a general social benefit purpose."

In addition, the articles must declare a general social benefit purpose. This is usually specified in the statute. The language that must be included for the general purpose is typically something like: "to pursue the creation of a material, positive impact on society and the environment, taken as a whole, as assessed against a

"The articles may also designate a specific purpose such as: "The corporation is organized for the purpose of furthering sustainable food systems."

third-party standard, from the business and operations of a benefit corporation." If the company decides to designate a specific purpose as well, it must be included in the articles of incorporation. An example of a specific purpose is: "The corporation is organized for the purpose of furthering sustainable food systems." Or it could be even more specific such as Farmer John's stated purpose above: "to operate the business in a way that ensures that it (1) is environmentally sustainable, (2) treats the chickens with the highest animal husbandry standards, and (3) gives 50 percent of its profits back to the local community."

What if your farm business is already a C corporation?

If your business is already a C corporation and you would like it to become a B corporation, most states will allow you to change it by simply amending your articles of incorporation and bylaws by including the required language to declare a social purpose. Be sure to follow the voting process for amending these documents as specified in the original document. Also, you'll need to file your amended articles with the secretary of state office.

Include the B corporation purpose and provisions in your bylaws

"The bylaws must include your declared social purpose and could include safeguards to protect the social purpose."

The bylaws, which is the organizing document of the B corporation, must also include your declared social purpose. In addition, the bylaws should include a provision that specifies the requirements for preparing the annual benefit report, as specified by the state B corporation statute. This will serve as a helpful reminder to the board of directors and the shareholders of this legal requirement. Finally, the bylaws could include a provision that firmly protects the social purpose. If, for example, the bylaws require only a majority vote of the shareholders or the directors to amend the bylaws or articles, the social purpose is at risk if a shareholder or group of shareholders that is opposed to the social purpose somehow obtains more than 51 percent interest in the company. They could simply vote to amend or even erase the social purpose. By including a provision that requires a consensus or supermajority (i.e., two-thirds majority vote) to amend or end the social purpose, the founding owners' social purpose motive is better protected. Some state B corporation statutes actually set the minimum threshold to a supermajority. If this is the case, you would not necessarily need to include a separate provision in the bylaws, as the state law would govern. However, including it would serve as a reminder to the directors and the shareholders of

what is required for an amendment.

Electing federal tax status

Being a benefit corporation does not affect the tax status of a company. A company can still elect to be taxed as a C corporation or an S corporation. Be sure to review these chapters of the Guide before deciding what tax status is best for your farm operation should you decide to form a B corporation.

Implementing Best Business Practices for Your B Corporation

Prepare an annual benefit report and file it with the state, if required

To abide by the transparency provisions, all B corporations are required to create an annual benefit report. The report must be given to the shareholders and made available to the public by posting it on the company's website. Many states also require the B corporation to file the annual benefit report with the state, and some require a small fee (around $45).

States vary in what is required to be included in the annual benefit report. Typically, the report is a narrative description that must include (1) the short- and long-term goals of the corporation with respect to its social purpose(s), (2), the significant actions taken in the past year to achieve these goals, (3) future actions the corporation expects to take to achieve the goals, and (4) an assessment of the company's social and environmental performance measured against a third-party standard. According to the Model B Corporation Legislation, which many states have adopted, the third-party standard must be comprehensive, independent, credible and transparent.

There are more than a dozen third-party standards that have been used by B corporations to meet the requirements of their annual benefit reports. As previously mentioned, third-party standards that are particularly relevant for farm operations include Food Alliance certification and Sustainable Farm certification. Food Alliance certification is governed by Food Alliance and it provides comprehensive third-party certification for social and environmental responsibility in agriculture and the food industry. Sustainable Farm certification is governed by Sustainable Agriculture Network, which promotes efficient and productive agriculture, biodiversity conservation and sustainable community development by creating social and environmental standards.

> "All B corporations are required to create an annual benefit report that must be given to shareholders and made available to the public by posting it on the company's website."

Obtain required licenses and permits

Just as for any business entity, certain registrations, licenses and permits may be required. Most cities and many counties require all businesses to register and get a business license or a tax registration certificate, which may also require the business to pay a minimum tax. States may also require the farm business to get a seller's license before selling anything to the public, and the local planning board may require the farm business to have a zoning permit depending on the location of the farmland. All these forms are pretty straightforward.

> "The B corporation will have to uphold all corporate formalities to maintain the entity's intregrity."

Follow through with all other requirements as if you were a C corporation

The above points are unique just to B corporations. Keep in mind that a B corporation will have to uphold all corporate formalities to maintain the entity's integrity and to protect the shareholders' personal assets from the business's liabilities. This includes holding annual meetings and taking minutes, keeping separate bank accounts, filing annual fees, preparing and filing annual tax forms, obtaining required licenses and so on. Be sure to also read Chapter 5 on C corporations in conjunction with this chapter if you decide to form a B corporation to ensure that you are abiding by all that is required.

For more detailed information on upholding corporate formalities, read Chapter 5 on C corporations in conjunction with this chapter.

Becoming a Certified B Corporation

Becoming a "Certified B Corporation" is different than becoming a B corporation at the state level. B Lab, the nonprofit organization that created the benefit corporation model, handles the Certified B Corporation certification process. This is akin to third-party organic certifiers like Oregon Tilth, CCOF, Midwest Organic Services Association, etc. However, it is a bit different. Unlike organic certifiers, which require just the baseline of what the USDA organic standards require, the B corporation certification often goes above and beyond what the state benefit corporation statutes require. It provides yet another level of accountability and transparency. It also provides companies with a level of marketing, as the Certified B Corporation stamp has become somewhat of an icon over the years. Companies like Patagonia, Kickstarter and Method Products are all Certified B corporations.

> "B Lab, the nonprofit organization that created the benefit corporation, handles the Certified B Corporation certification process. "

Becoming a Certified B Corporation is relatively simple if your company is already abiding by a social and environmental mission. First, you have to complete the B Impact Assessment and earn a minimum score of 80 out of 200 points. The B Impact Assessment has three main sections. The environmental section evaluates

a company's products, operations (materials, energy use, facilities, emissions) and supply chain. The community impact section evaluates the social impact of the company's products; the fair labor and local focus of its supply chain; employee, supplier and ownership diversity; volunteerism; and charitable giving. The worker section examines a company's relationship with its workforce, including the company's compensation, benefits, training programs, ownership, management/worker communication, job flexibility, corporate culture, and health and safety.

Next, you have to meet the legal requirement by forming an appropriate entity in your state. The best way for companies to meet the legal requirement is to use the benefit corporation legal entity if it is available in your state. B Lab prefers this corporation structure because its formality lends itself better to the accountability and transparency mechanisms that are required. If the B corporation entity is not yet available in your state, or if for whatever reason you decide not to form one, the next best option is to form an LLC. The flexible LLC structure allows owners to adopt a social purpose and to include the purpose as well as the distinct decision-making, accountability and transparency principles in the operating agreement without being counter to the state LLC statute. At first, many of the original benefit corporations certified by B Lab were formed as LLCs.

"If the B corporation entity is not yet available in your state, or if for whatever reason you decide not to form one, the next best option is to form an LLC."

The third and final step of becoming a Certified B Corporation is to sign and submit the B Corporation Declaration of Interdependence and Term Sheet with B Lab along with the required annual fee. The fee is based on your company's annual sales. See the B Lab website for fee information.

More resources on forming a B corporation

B Lab's homepage: www.bcorporation.net

What are B Corps: www.bcorporation.net/what-are-b-corps

How to become a benefit corporation (B Lab):
http://benefitcorp.net/businesses/how-become-benefit-corporation

How to become a benefit corporation (Drinker Biddle & Reath):
http://benefitcorp.net/sites/default/files/documents/How_to_become_a_benefit_corporation.pdf

How do I pick a third-party standard?:
http://benefitcorp.net/businesses/how-do-i-pick-third-party-standard

FARM COMMONS

SARE
Sustainable Agriculture Research & Education

Farmers' Guide to Business Structures:
LLCs, Corporations, Partnerships and More

Chapter 8: Nonprofit Fundamentals

www.sare.org/guide-to-business-structures

DISCLAIMER: This Guide does not provide legal advice or establish an attorney-client relationship between the reader and author. Always consult an attorney regarding your specific situation.

AT-A-GLANCE CHART: NONPROFITS

General Concept	Nonprofit Specific Terminology
Name	"Farm Organization, Inc." for incorporated nonprofits
Owners/investors are called	None! A nonprofit has no owners
Persons who make management decisions are called	The "Board of Directors" is responsible for management of the nonprofit
Creation document is called	"Articles of Incorporation"
Organizing document is called	"Bylaws"
An owner's investment is called	None–no owners
An ownership share is called	None–no owners
State and IRS interaction	A nonprofit is first formed at the state level as an incorporated nonstock/nonprofit entity. To earn tax-exempt status, the nonprofit must then apply to the IRS for recognition under the 501(c) code. If the organization also wishes to accept tax-deductible donations, it must be recognized as a 501(c)(3), specifically. Generally, the state will also recognize tax-exempt status after the IRS does.
How many participants can you have?	State law requires two to three people. IRS rules require a minimum of three people to serve on the board of directors
Is there personal liability?	No, if the nonprofit is incorporated. Yes, if the nonprofit is unincorporated.
Are annual meetings required?	Yes, most state nonprofit statutes require that the organization hold at least an annual meeting
Who files the tax return?	All nonprofits must file an annual tax return with the IRS or risk revocation of their status. The informational returns are known as the 990 series and the specific form depends on the organization's size.

Introduction

It's an old joke among farmers: "I should really form a nonprofit organization because I certainly don't make any profit!" Although that might be true, the decision to form a nonprofit organization is a bit more complex than assessing whether the business generates a profit. This chapter will explore in detail what nonprofits are, how they are formed and the structures behind them.

State and IRS Classifications

Like all of the other business entities addressed in this Guide, the steps in forming a nonprofit organization are managed at both the state and the IRS level. The IRS classification of an entity as a tax-exempt charity that is eligible to receive tax-deductible donations is what most people mean when they use the phrase nonprofit organization. While this step is important, it is different than forming the entity itself. Forming the entity occurs at the state level and is the first subject we will explore. At the state level, an organization can utilize either the unincorporated or incorporated option.

"The steps in forming a nonprofit organization are managed at both the state and the IRS level. At the state level, an organization can utilize either the unincorporated or incorporated option."

Forming a Nonprofit at the State Level

Key characteristic of the nonprofit: no individual ownership

All 50 states have statutes that define how a nonprofit corporation is formed. Some states use the phrase "nonstock corporation" rather than nonprofit corporation. This phrase is perhaps the more accurate one as it illustrates the real distinction between a nonprofit and a for-profit entity at the state level. It's not about profit, as a nonprofit can generate a profit. But, what a nonprofit cannot do is create stock. A nonprofit organization cannot be owned by anyone. It cannot be sold and its assets cannot be used for the benefit of one or a group of private individuals.

"A nonprofit organization cannot be owned by anyone. It cannot be sold and its assets cannot be used for the benefit of one or a group of private individuals."

Many farmers would like a business that they can eventually sell to a new farmer or transition to the next generation. The business may also be the farmer's retirement fund. After a lifetime of building a brand, a market and equity in the business, farmers often need to cash in on some of that equity for retirement. A farmer who chooses to form a nonprofit entity may work as an employee and then receive a retirement package at the end of their career. But, the farmer gives up a significant amount of control as the nonprofit's board of directors sets compensation and retirement packages or otherwise maintains control over the

farmer's compensation. A nonprofit organization must be controlled by a board of directors that is charged with upholding certain legal duties to the public as a whole. As part of those legal duties, boards may be limited in how they compensate farmers or finance a retirement.

> "A nonprofit organization must be controlled by a board of directors that is charged with upholding certain legal duties to the public as a whole."

Incorporated nonprofit organization

The majority of nonprofit organizations choose to form an incorporated entity. Two main factors drive this decision. First, many organization participants want their personal assets to be insulated from the organization's liabilities. As an example, a group of neighbors may gather every Saturday to tend an orchard in their neighborhood. The group may organize events such as apple tastings or classes in pruning and planting apple trees. Say one of the group members gives a child a pruning lesson and the child cuts himself in the process. The child's parents could sue group members in their personal capacity because the orchard organization may not legally exist as an entity to be sued. Suing the individuals who participate within it may be the only option the child's parents, or their insurance company, have to recover for damages incurred.

Second, the majority of nonprofit organizations intend to seek IRS tax-exempt status as a nonprofit. Although an unincorporated entity may still apply for nonprofit status with the IRS, the organization will need to draft many of the same documents required to form a nonprofit corporation. At that point, it seems logical to file the paperwork at the state level so participants may receive personal liability protection as well.

Incorporated nonprofit: The formation process

Forming a nonstock or nonprofit corporation is generally quite simple. The organization will prepare and file articles of incorporation, along with bylaws that outline the entity's operating rules and board of directors, for example. Broadly speaking, a nonprofit organization is governed by a board of directors. The board is elected or appointed according to the organization's bylaws. The board must then elect or appoint officers from among its members. State law may dictate specific procedures for election or appointment of officers as well as the number and type of officers or directors. Bylaws may need to be filed with the state to demonstrate that the organization is complying with state rules. In addition, nonprofit corporations may choose to be membership organizations or not. Membership organizations often have additional rules in state laws for how members may

participate in the organization governance. Of course, the state-level formation process is usually accompanied by a fee or two. On the plus side, the fees for forming a nonstock or nonprofit corporation are generally low compared to a for-profit entity.

Is membership right for your organization?

Choosing to become a membership organization is a serious decision. If the organization elects to be classified as a nonprofit corporation with members, members have specific legal rights to elect the board of directors and make other decisions for the organization. The members can exert a lot of power over the board. This can certainly be a good thing for cultivating shared responsibility for the organization's mission. Yet, if the organization isn't prepared to explore and satisfy the laws for membership, it may be easier to create shared responsibility in other ways. A non-member organization can still have supporters, sponsors and volunteers who have significant responsibility for the organization.

Incorporation grants personal asset protection for participants

The directors, officers and members of the board of directors of a nonstock or nonprofit corporation receive personal liability protection from organizational responsibilities, provided the organization has followed its legal obligations. Of course, officers and directors can still be sued by individuals asserting that legal obligations were not followed and thus personal protection doesn't attach to directors and officers. Many nonstock or nonprofit corporations will carry what is called directors and officers insurance so they can afford to defend themselves and their directors or officers from any claims or lawsuits that may be filed.

"Many nonprofits will carry what is called directors and officers insurance so they can afford to defend themselves and their directors or officers from any lawsuits or claims that may be filed."

Unincorporated nonprofit association

Individuals familiar with the sole proprietorship and a general partnership understand that sometimes a person doesn't have to actually file any paperwork to form a business entity. Simply acting in a certain manner is enough to qualify as a business. This is possible when forming a nonprofit organization as well. When a group of people get together to undertake an activity for mutual or public benefit that is not meant to generate a profit, they may be forming an unincorporated nonprofit organization (UNA). UNAs are very diverse and may focus on educational, scientific, sports, community, health or other interests. A UNA may

be comprised of as few as two people, although some states require three people to participate before the group will be deemed a UNA.

A group of individuals might form a farm-related UNA for many purposes. Let's return to our community orchard example. The group may charge for apple tastings or classes and use the revenue to purchase additional apple trees. The group is acting together to achieve a common mutual purpose and isn't intending to engage in business or make a profit. Given this, they may have formed a UNA.

Forming a UNA is simple. The group doesn't have to do anything except act together for a common mutual or public purpose. Organization and governance is quite simple–state laws requiring UNAs to take specific actions are uncommon. That isn't to say no laws apply to UNAs. To the contrary, organizations that solicit for donations must register with the state, and organizations that take in money are responsible for tax filings, which would apply to UNAs as much as to any organization.

> "The personal assets of the people participating in the unincorporated nonprofit association may be accessed to satisfy the liabilities that the organization as a whole might incur."

The UNA: Simplicity has trade-offs

Unincorporated nonprofit associations carry the same trade-offs as general partnerships. Members find it easy to form an unincorporated association as there is no need to file paperwork or have a board of directors. On the other hand, the personal assets of the people participating in the UNA may be accessed to satisfy liabilities that the organization as a whole might incur. Because the UNA does not need to draft any bylaws or assign responsibility to specific individuals as incorporated nonprofits must, it can be difficult to efficiently manage the organization's obligations. For example, responsibility to comply with the laws described above regarding donations and taxes might fall through the cracks in an overly simplified UNA.

Obtaining Nonprofit Tax Status with the IRS

Preparing the tax-exempt application

Forming a nonstock or a nonprofit corporation at the state level is quite easy and is the first step in forming a nonprofit organization. But, it is generally not the last step. As explained earlier, most people who form a nonstock or nonprofit corporation actually have an additional goal in mind. They would like the organization's income to be tax exempt and would like the opportunity to receive tax-deductible donations. This is a separate matter and generally handled first at the federal IRS level.

A nonprofit entity that wants to be recognized as federally tax exempt or to receive federal tax-deductible donations must apply for these classifications with the IRS. Technically, these are two different procedures. Organizations that fall under the 501(c) section of the tax code are considered tax exempt. This means that if the organization brings in revenue and generates a profit above and beyond its expenses, those monies are not taxed. The ability to accept tax-deductible donations is reserved for organizations that qualify under the 501(c)(3) section of the tax code. These organizations are considered charities. The tax code has several other classifications (such as 501(c)(5) for farm advocacy organizations), which are tax exempt but may not accept tax-deductible donations. Many farms and farm-related entities want both tax-exempt status and the ability to accept tax-deductible donations, so this resource focuses on the obligations of 501(c)(3) organizations.

"A nonprofit entity that wants to be recognized as federally tax exempt or to receive federal tax-deductible donations must apply for these classifications with the IRS."

To form a 501(c)(3), the entity completes and submits IRS Form 1023, "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code" or its shorter version, IRS Form 1023-EZ. The application is designed to illustrate to the IRS whether the organization meets the obligations contained within the federal tax code for a 501(c)(3) organization. For example, the application contains questions meant to show whether the entity is formed as a nonstock or nonprofit corporation at the state level (or that it has equivalent paperwork in place); the organization is formed for specific purposes; the bylaws contain specific clauses such as those relating to conflicts of interest; and other details. Of course, the IRS isn't merely curious–it's checking to see if the entity passes the test. Before dedicating the effort to completing a potentially lengthy IRS Form 1023, an organization should verify that it will pass a few additional tests to become a 501(c)(3) organization. The rest of this chapter explores those tests.

What is your nonprofit's purpose?

A nonprofit organization must be exclusively dedicated to one or more qualifying purposes before it will receive 501(c)(3) status. These purposes include religious, charitable, scientific, public safety testing, literary, educational, national or amateur sports competition, or the prevention of cruelty to children or animals.

"Farms seeking 501(c)(3) tax-exempt status are most likely to qualify for either an educational or a charitable purpose."

Farms seeking 501(c)(3) status organizations are most likely to qualify for either an educational or a charitable purpose. Beginning with educational purposes, farms operated as part of a school program may find easy opportunity here. Fortunately for everyone else, an educational purpose doesn't require a formal

school environment. Organizations can satisfy an educational purpose when they are dedicated to producing educational materials and doing broader outreach on educational subjects. For example, one tax-exempt farm uses ecological techniques to repair land depleted from years of monoculture farming. Because the farm is exclusively dedicated to demonstrating techniques and advancing awareness of the scientific principles behind the farm, the IRS found that it satisfied an educational purpose. The IRS also pointed out that this farm is open to the public, publishes articles widely on its results and does not make a substantial profit.

Some farms may earn 501(c)(3) status under a charitable purpose. The IRS' definition of a charitable purpose is broad. To summarize the elements most potentially relevant to farming, charity includes combating poverty, alleviating discrimination and stimulating economic development in economically depressed communities. Farms dedicated to providing job training and skills development in regions that suffer from a lack of opportunity might qualify as charitable. There also may be opportunity to use farming to alleviate discrimination or to ease neighborhood relations.

"A tax-exmpt farm must be organized exclusively for an exempt purpose."

Is your farm exclusively dedicated to a qualifying purpose?

A tax-exempt farm must be organized exclusively for an exempt purpose. The exclusivity of the qualifying purpose is an important note. If teaching and outreach are a side benefit of raising or selling crops and livestock, the educational purpose isn't exclusive. A tax-exempt farm can make a profit, as long as the profit generation is in accordance with the purpose. For example, the farm above was allowed to make a profit so long as the generation of profit was for the purpose of educating the public that ecologically sound farming techniques can be profitable.

Some farmers might be disappointed to learn that adopting or promoting sustainable and environmentally friendly practices is not itself charitable or educational. Sustainable farms do improve the environment and offer many benefits to communities. When the food produced by these farms is marketed and consumed within communities, there is a potential to improve community health. People can learn more about their environment, neighbors and food production by buying from sustainable local farms. But, even if the farm loses money by adopting sustainable, environmentally friendly practices and selling locally, that doesn't mean it qualifies for 501(c)(3) status. The IRS code and the cases that interpret it have set out very specific definitions for "charitable" and "educational" purposes, so farmers must be careful to see if they meet these definitions.

Two more tests to go!

If the farm is organized for a qualifying purpose, the organization should then ask if it passes the commerciality test and the public support test. These will also be required to qualify as a 501(c)(3) organization.

Pop quiz! 501(c)(3) organizations must answer "yes" to the following questions to receive the tax classification:

1. Is the organization formed exclusively for a qualifying purpose as follows: religious, charitable, scientific, public safety testing, literary, educational, national or amateur sports competition, or the prevention of cruelty to children or animals?
2. Is the organization not overly commercial in nature in that it does not unduly compete with for-profit businesses?
3. Is the organization publically supported as demonstrated by its sources of revenue?

The commerciality test protects for-profit enterprises

Before getting into details on the commerciality test let's talk about a scenario that's playing out in communities across the United States. Nonprofit organizations are successfully establishing farms that meet charitable, poverty alleviation or educational purposes. For example, young people are learning how to grow food and build a sustainable business enterprises in their communities. Displaced workers are receiving job training skills by learning how to farm and how to sell those products at farmers' markets. Church groups, schools and neighborhood organizations are all creating vibrant solutions to real needs within their communities through farming experience and knowledge.

As positive as they are, these programs don't always work to everyone's benefit. A farm organized as a 501(c)(3) may have a competitive advantage in the marketplace because it can accept tax-deductible donations and because it does not have to pay taxes on the profit it generates. This may influence the farm to sell its products at a lower cost compared to a for-profit business, expand sooner or capture market share earlier in the season. Understandably, this can create tension in communities where for-profit farms feel they are being undermined by well-meaning organizations.

"A farm organized as a 501(c)(3) may have a competitive advantage in the marketplace because it can accept tax-deductible donations and because it does not have to pay taxes on the profit it generates."

No 501(c)(3) status for overly commercial organizations

The IRS has anticipated this scenario and the commerciality test is meant to prevent the benefits offered to tax-exempt organizations from becoming a threat to regular businesses. Under the commerciality test, an organization will not qualify for 501(c)(3) status if its operations are overly commercial in nature. This can happen when an organization directly competes with for-profit businesses. Assessing when an organization crosses the line into becoming "overly commercial" can be difficult. The IRS will apply several general factors to the specific situation. Generally speaking, a farm that does not advertise its products or does not make sales to the general public is less likely to be too commercial. Farms that have a low sales volume and depend primarily on charitable contributions for their revenue are likewise less likely to be too commercial. Of course, it can be difficult to satisfy these criteria if the farm exists to provide job or entrepreneurial training skills. Organizations in such a position may need to carefully scrutinize their programs and the IRS' guidance material on this subject to avoid failing this test.

"Under the commerciality test, an organization will not qualify for 501(c)(3) status if its operations are overly commercial in nature."

The public support test separates foundations from public entities

A 501(c)(3) organization must also pass the public support test. This test is designed to separate private foundations from public entities. Most organizations would like to be public entities since they enjoy fewer restrictions and greater tax benefits. Generally, this test focuses on identifying where the organization gets its money—if revenue is largely from the public as a whole, the organization meets the test. However, the details are a bit more complex.

Organizations can pass the public support test in two ways. Both tests are measured over a five-year period. First, if an organization receives a substantial part (more than one-third) of its total income from government grants, grants from other charities, donations from the public, membership fees and mission-related revenue, it passes part of the first test. However, if more than 2 percent of the organization's total support comes from a single individual, that portion should be excluded from the one-third calculation. If an organization fails this test, it may try for the "facts and circumstances" test, which it has two ways to pass. First, the organization's percentage of income from public sources may be as low as 10 percent if other circumstances such as the makeup of the board of directors, its programming and its accessibility to the public all demonstrate that it is a public entity. The second way to pass the facts and circumstances test is different: Two

"To meet the public support test, the farm must receive more than one-third of its support in contributions from the general public or from sales directly related to its tax-exempt purpose."

elements must be met. The organization must receive more than one-third of its support in contributions from the general public or from sales directly related to its tax-exempt purpose. Then, the organization must also receive no more than one-third of its support from investment income and sales from purposes unrelated to its tax-exempt purpose.

This is confusing, so let's explore a few basic situations where the various public support tests will NOT be passed. Let's say a farm generates all its revenue from the sale of tickets to a haunted Halloween barn tour. Another farm might have a single benefactor that donates 95 percent of the organization's revenue each year. A third farm might receive the bulk of its income from leasing property or facilities to unrelated entities–perhaps it owns several duplexes that are leased on the regular rental market. These farms would likely fail the public support test because their income doesn't come from a spectrum of the public at large. Instead, it comes from unrelated sales, a single benefactor and investment or real estate ventures. These tests can be difficult and complex, especially for organizations that don't yet know where their support will come from. Farms going down this path should seek information from the IRS and from organizations that support nonprofit entities.

Tax exemption can be a relatively expensive and long process

The process to receive 501(c)(3) status can be expensive and long. The fee for the IRS Form 1023-EZ is $400 for qualifying entities. For those that must complete the IRS Form 1023, entities with anticipated annual gross revenue over $10,000 averaged across four years pay a fee of $850. The IRS Form 1023 fee for entities with lower gross receipts is $400. Application processing times can be as quick as six months, but if the IRS has additional questions, it can take a year or longer to get an answer. The process is complete when the IRS issues a determination letter to the entity, which is the organization's proof of status. Earlier, this Guide suggested that organizations fully explore their qualifications for 501(c)(3) status before completing the application. Not only will this save time, it will save money.

Never heard of the Form 1023-EZ? Learn if you qualify to use this shorter form at irs.gov.

Implementing Best Business Practices for Your Nonprofit

Like all other business entities, the nonprofit will have to uphold certain formalities and best practices to maintain the entity's integrity. This includes keeping the nonprofit's financial affairs separate from the those of the nonprofit's directors and officers, such as maintaining separate bank accounts and accounting systems. The board of directors and officers must also abide by the bylaws, as

these are the ground rules for how the entity is to operate. This includes complying with a strict conflict of interest policy to ensure that directors and officers do not have a critical say in a matter that would benefit or harm their personal financial situation. In addition, annual maintenance obligations deserve close attention. A nonprofit organization will need to complete annual paperwork at both the state and federal levels. The state may require annual fees to maintain the nonstock or nonprofit corporation, as well as annual fundraising registrations and tax filings, which also take time to prepare and often involve fees. At the IRS level, an organization must complete an annual tax return, even if no tax is owed. Depending on the organization's size, the form may be the IRS Form 990-N, 990-EZ, or 990. Failure to file annual tax returns with the IRS can result in revocation of tax-exempt status. If this happens to an organization, it may need to resubmit IRS Form 1023 all over again to reapply.

"Failure to file annual tax returns with the IRS can result in revocation of your tax-exempt status."

Find more guidance on forming nonprofit organizations

The Internal Revenue Service website (www.IRS.gov/charities-non-profits) is the most authoritative source of information. Don't forget to review it.

The National Council of Nonprofits (www.councilofnonprofits.org) has a brief guide that addresses legal and non-legal considerations. Also, they can direct you to your state council of nonprofits organization, which can be a valuable resource for state-specific formation and tax information.

How to Form a Nonprofit Corporation (Nolo Publishing): This reliable publisher of legal information has some great, easy-to-read resources on the legal aspects of forming a nonprofit. Check your local library for copies. The Nolo website has some state-specific information as well.

FARM COMMONS

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Farmers' Guide to Business Structures:
LLCs, Corporations, Partnerships and More

Chapter 9: Cooperative Fundamentals

www.sare.org/guide-to-business-structures

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AT-A-GLANCE CHART: COOPERATIVES

General Concept	Cooperative Terminology
Name	"Farm Name Cooperative" (or abbreviations "co-op" or "CP")
Owners/investors are called	"Members"
Persons who make management decisions are called	The "Board of Directors" is responsible for making key decisions; the "Officers" (optional) are responsible for the day-to-day management
Creation document is called	"Articles of Incorporation"
Organizing document is called	"Bylaws"
An owner's investment in the company is called	"Member Investment"
An ownership share is called	"Membership"
A payment of the company's profits to the owners is called	"Patronage Dividend" or "Patronage Refund"
Is there personal liability?	Limited to each member's investment so long as best business practices are upheld
How many participants can you have?	At least two people, can be other business entities
Are different ownership classes allowed?	Allowed
Is an EIN required?	Required
Who files the federal tax return?	It depends on the type of earnings. For all earnings a cooperative makes from transacting business with and for its members (i.e. patrons), the income passes through to the individual members for tax purposes. The members report this income as a patronage refund on their individual tax return and pay taxes at the dividend tax rate. For earnings that the cooperative makes from transacting business with and for non-members, the cooperative must report earnings on its own tax return, Form 1120-C, which are taxed at the corporate tax rate.

Introduction

Cooperatives are for-profit businesses that are governed on the principle of one member, one vote. Each member gets an equal vote, regardless of the ownership percentage breakdown in the business. Most cooperatives start when a group of people come together with a shared need. They devise a strategy or solution, and then pool their resources to implement it. The cooperative is organized to serve its members, for example by offering discounts or leveraging special services. Profits are distributed based on each member's participation or usage rate in the cooperative rather than percentage of ownership. This makes it very different from a C corporation, where both voting and profit distribution to shareholders for the most part must be based on ownership percentage. This chapter highlights the various types and central characteristics of the cooperative entity and presents basic legal considerations involved in creating and maintaining one.

> "The cooperative is organized to serve its members. Profits of the business are distributed based on each member's participation or usage rate in the cooperative."

Cooperative Origins and Types

Cooperatives have been around for hundreds of years; their origin is rooted in agricultural ventures. The first cooperatives were created in Europe in the 17th century when farmers pooled their resources together to more efficiently grow food. The first documented consumer cooperative was a retail store in England in the mid-1700s that sold butter, oatmeal, sugar, flour and candles to its members at a discount. Here in the United States, the cooperative model has a long history, including the Grange, which also has its roots in farming.

The types of cooperatives vary based on the particular resources, services or products they provide and who the members are. An agricultural cooperative, also known as a farmers' co-op, is a cooperative where farmers pool their activities or production resources together. For example, a family farm may be too small to afford expensive farm equipment or machinery that they only use rarely. A group of local farmers may decide to get together to form a farm equipment cooperative that purchases the necessary equipment for all the members to share. Each member invests some money to pay for the equipment, and in return they get the privilege to use all the equipment owned by the cooperative.

Another type of cooperative would be a service cooperative, such as a distribution and marketing cooperative. A farm doesn't always have the means or the time to deliver its produce to the market, or to advertise or market its products to the general public. So, the distribution and marketing cooperative could act as an

integrator, collecting the output from farmer members and then coordinating the distribution and marketing of the farmers' products. The cooperative could even manufacture some value-added products. Such a cooperative would include both farmer members (producers) and worker members (i.e., distributors, marketers, manufacturers). Again, the cooperative would divvy up any profits at year's end and distribute them to the members based on their inputs to the cooperative.

A cooperative could also be made up partly or entirely of consumer members. An example of this is the local food co-op. Such cooperatives typically offer their members or patrons a discount on the products they sell. At year's end, the food co-op directors could decide to refund or distribute any profits made to the members based on their usage or purchases at the local food co-op.

These are just some examples of how the cooperative model works in reality, particularly in the context of sustainable food and farming. The possibilities are endless, really. Overall, cooperatives provide a vehicle to help farmers and other community members leverage a solution to their individual needs by joining forces. For example, institutional buyers may be more willing to purchase from and even provide better terms to local farmers that are part of a larger cooperative than if they are each out on their own. This can help the farmers involved reach a broader market, which can result in increased profits for all farmers involved, as well as make more local produce available in the local marketplace.

"Because cooperatives are governed on the principle of one member, one vote, democracy is a defining characteristic of cooperatives."

Basic Characteristics of the Cooperative

Cooperatives embody democratic and community values

Because cooperatives are governed on the principle of one member, one vote, democracy is a defining characteristic of cooperatives. No member-owner can dominate the decision-making process, no matter how much money that member invests. The cooperative's fundamental purpose is to meet the needs of its members. The democratic structure helps ensure that *all* of the members' needs are being met, not just a select few with the most power or money. In addition, by their nature, cooperatives promote community values such as sharing and collaboration. Cooperatives are formed by a group of people who come together because they share a need and want to work together to resolve it. The democratic- and community-oriented values inherent in the cooperative structure are often appealing to many farmers who want to work within their local community to not only grow a viable business, but to also contribute to a healthier local food system.

Obtaining investor funding may be a challenge

However, because of the one person, one vote principle, cooperatives may struggle to obtain financing through traditional investors. This is because investors typically prefer it when their investment translates into decision-making power—the more they invest, the more control they have. While the one member, one vote principle of cooperatives may be appealing to small farmers and local community members, bigger investors may choose to invest their money in an LLC or C corporation where they can literally buy more power. Farm operations that anticipate needing significant financing from investors should consider this potential challenge before forming a cooperative.

On the other hand, a variety of government-sponsored grant programs are available specifically for certain types of farm-related cooperatives. For example, the USDA Office of Rural Development offers grants for new and existing rural development cooperatives. So in certain situations, cooperatives may present more funding opportunities for farm operations that adopt a cooperative model.

Cooperatives protect member-owners' personal assets from the business's liabilities

Like LLCs and C corporations, a cooperative is considered a limited liability business entity. What this means is that the personal assets of the members are protected from the business's liabilities, to an extent. Let's say, for example, a farmer-distributor cooperative is made up of about 20 farmer-members who grow local produce and two worker-members who help distribute and market the local produce to institutional buyers in the local community. The cooperative decides to take out a loan to purchase a refrigerated truck so the worker-members can collect and distribute the produce. If the cooperative defaults on this loan, the creditor can only come after the business's assets, and not the personal assets of each of the members. This includes any capital or equipment that is officially owned by or has been invested in the cooperative. It's unlikely that a farmer-member would have invested their farmland into such a cooperative, so that farmland would be protected, as it is not an asset of the cooperative. Without the protection of the cooperative entity, a court may determine that the farmers and the workers were operating as a general partnership. If this happens, then each of the farmers' and workers' personal assets could potentially be at risk, which could in fact include the farmers' land.

> "Like LLCs and C corporations, the members of a cooperative are protected from the business's liabilities."

However, the limited liability protection offered by the cooperative entity is

not absolute. Just as for an LLC and a C corporation, to maintain the status and protection granted by a cooperative, the cooperative must observe corporate formalities, avoid mixing personal assets with company assets, provide adequate funding for the business to operate and follow other standards. This means that the cooperative must have a bank account, credit cards and accounting system that is separate from the members' personal accounts. Also, the business must generally have enough money in its accounts to make due on its debts. If the business starts recklessly spending money and incurring a lot of debt, a court could determine that the entity is undercapitalized and go around it to access the personal assets of the members. The takeaway is that if you go to the trouble of forming a cooperative, or any business entity, be sure to follow through and uphold best business practices by taking steps to treat the cooperative as a separate entity and being careful not to let the entity take on too much debt.

Cooperatives do not substitute for insurance or reduce the likelihood of liabilities

Forming a cooperative, or any business entity, is not a substitute for insurance. Some farmers mistakenly believe creating a business entity of some kind reduces the likelihood of liability. Creating a cooperative does nothing to change the landscape of a farm's potential liability; it only limits the assets available to satisfy that liability, should it materialize, to business assets. All the farm business's assets are entirely available to anyone with a successful claim against the cooperative. Good liability insurance provides the farm business with a defense in court and a source of funds to pay out on a court claim if it is successful. Farm Commons strongly urges any farm business, no matter what business entity it adopts, to maintain adequate insurance coverage.

> "Forming a cooperative, or any business entity, is not a substitute for insurance."

Forming a Cooperative

Come up with a shared need and strategy

Forming a cooperative is slightly different than forming any other business entity. Typically, to start up, a group of initial members who share a common need, often referred to as the "charter members," meet up to strategize on how they can work together to address or resolve that need. For example, a group of farmers may come together to strategize on how best to distribute their produce into institutions or restaurants in the local community. They explore how they can work together so that they all succeed. The initial group comes up with a business plan, which

The group of initial members who meet up because they share a common need are referred to as the **charter members**.

may include an assessment of how feasible the strategy of working together is as well as an analysis of the costs and benefits of doing so. The group could simply work together to implement their strategy in a cooperative way without officially forming a cooperative entity. However, to receive the added benefits and protections of a business entity, the group may decide that it's in their best interest to file the necessary paperwork in their state to officially form a cooperative entity.

"The first step of officially forming a cooperative is to draft and file the articles of incorporation."

File articles of incorporation

The first step of officially forming a cooperative is to draft and file the articles of incorporation. Once the articles of incorporation are filed with and approved by the state's business entities agency, most commonly the state's secretary of state office, the cooperative will officially be recognized and receive all the benefits and privileges of the cooperative business entity. The articles typically require basic information, like the location and purpose of the cooperative, as well as a list of the names and contact information of the charter members. An internet search of "forming a cooperative in [your state]" will most likely get you the information you need. The filing of the articles may also be accompanied by a required fee–usually around $45. Annual fees may also be required. These are all considerations a farm operation should evaluate before deciding what business entity to create, as the registration and annual fees can vary based on both the state and the entity.

"The bylaws list membership requirements, duties, responsibilities and other operational procedures that allow your cooperative to run smoothly."

Prepare bylaws

Most state cooperative statutes do not actually require a cooperative to create bylaws. However, if no bylaws are in place, then the cooperative must abide by its state's default statutes, which may or may not be in the best interest of the farm operation. It's often best to take control of the matter and create your own rules. Basically, the bylaws list membership requirements, duties, responsibilities and other operational procedures that allow your cooperative to run smoothly. While the voting must be based on one member, one vote, other significant issues still need to be addressed.

Some key issues to consider and include in the bylaws of your cooperative

The following highlights some issues to consider when drafting bylaws for a cooperative:

- **Membership**: Do you want to have different classes of members with different rights and duties? For example, a distribution cooperative may

want to set out separate roles and responsibilities for farmer-members and worker-members. The membership section should also include specific rules for suspending or terminating membership if a member wants to leave, or if a member is not cooperating. Can the other members force the person out? This section should include guidelines for returning member investments if they leave. Membership shares are often non-transferrable, which means that a member cannot simply transfer their membership to someone else.

- **Finances**: How are the profits and losses of the cooperative business apportioned to the members for tax purposes? When and how are the profits distributed or paid out to the members? The distribution of profits in a cooperative is typically called a patronage refund. Once a year, a formal accounting determines the cooperative's revenues and expenses. Revenue remaining (net margin) is then distributed to members in proportion to patronage or usage of the cooperative. The bylaws should set out what the standard way is of measuring patronage. Also, some bylaws require or allow members to elect to leave a portion of the refund in the cooperative each year. This helps keep the business well capitalized and on solid financial grounds. The portion of the member's patronage refund that is retained is allocated to the member's equity account and paid out at a later date. The bylaws are the place to set the ground rules for distributing or retaining patronage refunds.
- **Board officers**: Some state cooperative statutes require the board of directors to also have officers, such as a president/chair, secretary and treasurer. Check with your state's requirements. The bylaws should outline the duties of each officer and specify how the officers are designated. Are they elected by the members or chosen by the board of directors? Also, how long do their terms last?
- **Administration**: This section includes issues regarding voting and meetings, as well as designating any committees and advisory councils, and similar matters. In particular, while voting must be based on one person, one vote, you still need to decide whether a majority or consensus vote will govern some or all of the big decisions that are made. Big decisions include adding new members, terminating memberships, amending the bylaws, taking on significant debt, electing the board of directors, ending the business, starting a new line of business, etc.

The distribution of profits in a cooperative is typically called a **patronage refund**.

"The bylaws are the place to set the ground rules for distributing or retaining patronage refunds."

Requiring a consensus ensures that everyone is in agreement, so reaching agreement could be challenging. Yet, majority consensus may reflect too little agreement for significant issues. Another option would be to require a supermajority consensus, such as two-thirds or three-quarters, for all or some issues. This section should also discuss the details of the annual meeting, which is required for cooperatives in most states. When and where do meetings take place? When and how are members informed of the details of the meeting (i.e., time, place, purpose, etc.)?

- **Dissolution**: What's the process if the cooperative goes out of business? What happens if the members or board of directors decide to close the business voluntarily? How will any remaining assets be divided?
- **Dispute resolution**: What happens if a dispute arises among the members or between the members and the board of directors? Does everyone just go to court right away? Often, bylaws include an alternative dispute provision that requires the matter to be resolved out of court, such as through a mediator or arbitration board. This is smart, as going to court is inherently expensive.

These are just a few of the important issues to consider when drafting the bylaws. These types of issues can be very specific to the type of farm operation, so the bylaws offer the opportunity to best accommodate your members' needs, even if bylaws are not required in your state. Also remember that the provisions must be in line with your state's cooperative statute. If there's a conflict, the state statute will govern. For this reason, Farm Commons recommends consulting with an attorney who is familiar with the cooperative statute in your state to help with drafting or finalizing the bylaws.

"The provisions in your bylaws must be in line with your state's cooperative statute. If there's a conflict, the state statute will govern."

Create a membership application and agreement

One option is to create both a membership application to recruit new members and a separate membership agreement that members sign once they've been approved. However, a well-crafted application could serve both roles. The membership application component asks questions that help vet new members to be sure they share in the cooperative's mission. It should basically seek out why they want to join, what skills or assets they have to offer and so on. The membership agreement component serves as a legal document to verify the membership and the individual's commitment to certain obligations. As

such, the agreement section should specify rules, roles and responsibilities that members must abide by, as well as outline the rights and privileges that come with membership. For example, the membership agreement should specify that the members must comply with relevant tax laws upon becoming members. It should also specify any investment or fee obligations. Does membership require just a one-time investment or fee, or are annual fees required to maintain membership each year? A copy of the bylaws should be included with the application/agreement so that each member acknowledges and understands how the cooperative is run. Each member should sign the agreement, and the agreements from all members should be kept in a safe place.

> "The membership agreement should specify the rules, roles and responsibilities that members must abide by, as well as outline the rights and privileges that come with membership."

Conduct a charter member meeting and elect directors

During this meeting, charter members should vote to adopt the bylaws. The board of directors should be elected and officers should be designated, in accordance with the bylaws. Be sure to take minutes at this and all official meetings to document what happened. The cooperative is now officially formed.

Implementing Best Business Practices for Your Cooperative

File federal taxes

For-profit cooperative corporations receive some special treatment for federal taxation. Although the cooperative entity is generally taxed as a normal C corporation, it can reduce its tax exposure by issuing what are known as "patronage dividends" (also referred to as "patronage refunds") to patrons or members of the cooperative. A patronage dividend is basically a refund to the cooperative's members who purchase goods or services from the cooperative. It is calculated based upon the amount that each patron spends or uses the cooperative in a given tax year. When filing its federal tax returns, a cooperative may deduct the amount of the patronage dividends it issues from its gross income. In effect, this income passes through to the individual members, who must report and pay taxes for it on their individual tax return at the dividend rate. The cooperative itself pays no taxes on these earnings. However, any earnings that the cooperative makes by selling goods or services to non-members must be reported on the cooperative's income tax return. These earnings will be taxed at the corporate rate.

Patronage dividends have to abide by very specific requirements. These are

"The IRS requires that patronage refunds be directly associated with the usage or value of business done for that particular patron or member."

set forth in the IRS' Subchapter T Cooperatives tax code. The IRS requires that patronage refunds be directly associated with the usage or value of business done for that particular patron or member. Identifying income that can be distributed as a patronage dividend and calculating those dividends in a manner that qualifies for the federal tax deduction can be very, very complex. Be sure to seek the assistance of a tax attorney or accountant who is familiar with the cooperative tax code when determining how to go about calculating the amount that each member of the cooperative receives each year.

Note too that in general, a cooperative is not required to issue patronage dividends to all its members. It can define classes of members that receive more or less than one another, or nothing at all. For example, these classes can be based on purchasing a "membership," certain types of members like farmer-members and worker-members, or other criteria. However, this can again complicate matters for tax purposes, so be sure to consult expert advise before designating such classes.

Let's presume, for the moment, that the issuance of patronage dividends is done correctly. The members who receive patronage dividends from the cooperative must report that income and pay taxes on it through their individual tax return. The cooperative will need to issue a Form 1099-PATR, "Taxable Distributions Received From Cooperatives," to each member who receives at least $10 in patronage dividends, and to file all the Form 1099-PATRs with the IRS. If the farm operation earns income from selling products or services to non-members, or for whatever reason does not properly follow the protocol for issuing patronage dividends, it must prepare and file Form 1120-C with the IRS and pay taxes on all earnings not reported as patronage dividends. Other forms may be required depending on the farm operation. Don't forget that the cooperative will need to abide by state tax obligations, which vary from state to state. The best place to seek guidance is through your tax attorney or accountant, or to contact your state's department of revenue.

Again, determining how to fulfill the cooperative's tax obligations can be very complex. This section does not serve in any way as tax advice and only outlines the issues and complex nature of cooperative tax law. Farm Commons strongly advises that any farm operation that becomes a cooperative seeks the assistance of a tax attorney or other tax professional when making these decisions.

Are you a consumer cooperative or farmer cooperative?

If so, you may be exempt or eligible for special federal tax treatment.

Consumer cooperative

If the entity qualifies as a consumer cooperative that mainly provides retail sales of goods or services that are generally for personal, living or family use, the members may be exempt from filing federal taxes. If so, the cooperative would need to file Form 3491, "Consumer Cooperative Exemption Application." If the IRS determines that the exemption applies, the cooperative would not need to issue Form 1099-PATR, and the members would have no federal tax obligations for any patronage refunds they receive. State taxes may or may not still apply.

Farmer cooperatives

Farmer cooperatives qualifying under section 521 of the tax code may receive certain special tax deductions. This special tax treatment came about in the 1920s because of the severe economic pressure and hardship that many farmers faced, and it has stayed around ever since. Farmer cooperatives used to be entirely exempt from federal taxes, but the full exemption was repealed in the 1950s. Now they simply receive certain special tax benefits. Basically, farmer cooperatives can deduct dividends paid on capital stock, which are special earnings. They can also deduct distributions of non-patronage income (i.e., income they earn by selling their products or services to non-members) that are given to patrons on a patronage basis. To qualify as a section 521 farmer cooperative, the entity must meet a long laundry list of eligibility requirements regarding how the cooperative is organized and how it operates. For example, the primary activity must be to market the products of members and other producers and/or purchase supplies and other equipment for members and other people; the value of products marketed for members must exceed that of products marketed for non-members; the value of supplies and equipment sold to members must exceed that of such products sold to non-members; substantially all of the cooperative (at least 85 percent) must be owned by producers who have used the cooperative's services during the past tax year; and so on. This is not an exhaustive list. Indeed, this is yet another very complex area of the tax code. It's best to speak to your tax attorney or accountant to clarify the financial implications and to assess whether your cooperative may be eligible. If so, the cooperative will need to officially apply, which is done by filling out and filing IRS Form 1028. The procedures to apply are set forth in Revenue Procedure 84-46.

"Determining how to fulfill a cooperative's tax obligations can be very complex."

Again, preparing and filing tax paperwork can be tricky for a cooperative. It's best to work with an accountant or tax attorney who is familiar with the strict guidelines for cooperatives.

Hold an annual meeting

Most state cooperative statutes require cooperatives to hold an annual meeting. This is the time to review the program and business of the cooperative for the past year, to elect officers and to plan the next year's activities. The annual meeting should be open to all members and other interested people. Be sure to follow the protocol set forth in your bylaws for sending out the meeting invitation or notice to all members, conducting the meeting and holding votes. The annual meeting agenda will include matters like reading the minutes, presenting annual reports of the business operations, hearing reports of officers and any committees, electing directors, discussing unfinished business and raising new business or issues. Minutes must be taken at the annual meeting and at all other official meetings to officially document what happened, including who was present and what decisions were made. The minutes do not have to be elaborate. They simply have to provide enough detail to show what happened in case an issue or dispute arises.

"Most state cooperative statutes require cooperatives to hold an annual meeting."

What if I don't want to hold an annual meeting?

Good question. Most states require all cooperatives to hold annual meetings. However, many states do not require LLCs to hold annual meetings. The LLC provides a very flexible structure that folks can use to create a business entity with cooperative principles. The operating agreement can be drafted such that some decisions are made on the basis of ownership and others by democratic voting of members. Forming an LLC provides an alternative option to the cooperative as it can achieve the same principles of democratic voting and community cooperation. Be sure to consult with an attorney who's familiar with both cooperative and LLC law in your state to help guide you through the process of creating a cooperative-oriented operating agreement. Also, the chapter on LLCs (Chapter 4) offers detailed information about forming an LLC, including sample operating agreements and checklists to help guide you through the process of creating an LLC and preparing an operating agreement.

Follow through with all other requirements to maintain the business entity's integrity

Like all other formal business entities, the cooperative will have to uphold certain formalities and best practices to maintain the entity's integrity and protect the members' personal assets from the business's liabilities. These include keeping the business's financial affairs separate from the members' financial affairs, including maintaining separate bank accounts, credit cards and accounting systems. The cooperative must not recklessly spend money and incur a lot of debt, otherwise courts could determine that the entity is undercapitalized and go around it and access the members' personal assets to cover the business's liabilities. The cooperative members must also abide by the bylaws, as these are the ground rules for how the entity is to operate, and must file annual fees, obtain required licenses and so on. Cooperatives are considered a form of a corporation, and they share many similarities in the formalities required for C corporations. The "Implementing Best Business Practices" section in the C corporation chapter (Chapter 5) provides a thorough breakdown of what is required to maintain a corporation's integrity, which aside from the tax obligations is for all intents and purposes the same for cooperatives. Refer to that section if your farm operation decides to form a cooperative.

"Like all other formal business entities, the cooperative will have to uphold certain formalities and best practices to maintain the cooperative entity's integrity."

See the "Implementing Best Business Practices" section in the C corporation chapter (Chapter 5) for more guidance on how to maintain the integrity of a cooperative.

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Farmers' Guide to Business Structures: LLCs, Corporations, Partnerships and More

Part 3: Special Considerations

Chapter 10. Anti-Corporate Farming Laws
- Section 1: Fundamentals of Anti-Corporate Farming Laws
- Section 2: Flowcharts of State-Specific Anti-Corporate Farming Laws

Chapter 11. To Diversify or Not to Diversify

Chapter 12. Joining Forces with Other Farmers

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Chapter 10, Section 1: Fundamentals of Anti-Corporate Farming Laws

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Prohibitions on Farmland Ownership and Leasing

Several Midwestern states limit the ability of corporations and LLCs to control farms and farmland. The statutes laying out these rules are commonly referred to as "anti-corporate farming" laws. Although they vary, these laws generally prohibit limited liability companies and corporations from owning or leasing farmland. Iowa, Kansas, Minnesota, Missouri, North Dakota, Oklahoma, South Dakota and Wisconsin all have anti-corporate farming laws on the books.

"Several Midwestern states have statutes—or "anti-corporate" farming" laws—that limit the ability of corporations and LLCs to control farms and farmland."

Despite the breadth of these laws, many farm business entities will not be directly affected. Farm LLCs and corporations usually do not actually own farmland, so prohibitions on farmland ownership are not a problem. Instead, an individual shareholder or member maintains title to farmland itself; ownership is not transferred to the entity. Farmers often do this for liability insulation. Because the farm business's assets are still available to satisfy farm business liabilities, maintaining the land in private, individual ownership protects it from business liabilities. In these cases, the individual shareholder or member leases the farmland to the business entity.

Where state law also prohibits LLCs and corporations from leasing farmland, of course, farmers might still run into problems. In these cases, farmers often rely on exceptions for small and family-owned farm businesses. Every state with an anti-corporate farming law allows entities with just a few related shareholders or members to own or lease farmland.

Innovative and less traditional farm business entities may face potential complications with anti-corporate farming laws. The affordability of farmland is a barrier for many beginning farmers. To deal with this problem, communities are creating innovative opportunities for groups of people to contribute money to an emerging farm business operation in exchange for a later return on their investment. In other areas, farmers are organizing LLCs, corporations and cooperatives to collectively purchase and manage farmland as a group. Both of these examples can lead to inadvertent violations of anti-corporate farming laws, as this chapter will illustrate.

Why Do these Laws Exist?

Most anti-corporate farming laws were passed between the 1930s and the 1970s with a goal of protecting and preserving smaller family-based farms as the ideal

ownership structure. Tightly knit farm operations are perceived as more closely connected to the land and thus more inclined to faithfully guard farmland resources. When these laws were passed, the vast majority of farms were organized as sole proprietorships or general partnerships. Farm corporations were rare and limited liability companies did not exist in many states when these laws were passed. Corporations were viewed suspiciously as distant, anonymous and not responsible to the communities in which they operated, and are still viewed that way by many. The road hasn't been a smooth one for anti-corporate farming laws. Constitutional challenges and modification by legislatures have weakened or eliminated state laws or individual provisions. Even farm advocates feel these laws have not fulfilled their original objective and are just a trap for the unwary. Some rural communities feel these laws limit solutions to the complex but endemic problem of the loss of small, family farms from the countryside. Regardless of their practical effect, these laws are still a relevant consideration for beginning farm businesses in the Midwest.

"Anti-corporate farming laws are still the rule in Iowa, Kansas, Minnesota, Missouri, North Dakota, Oklahoma, South Dakota and Wisconsin."

Look Before You Leap

Anti-corporate farming laws are still the rule in Iowa, Kansas, Minnesota, Missouri, North Dakota, Oklahoma, South Dakota and Wisconsin. In the next section, we present state-by-state flowcharts that can help you navigate your state's anti-corporate farming laws. Farmers in these states who are considering forming a corporation or LLC should first consult these flowcharts. But before we get there, please keep these important notes in mind.

If you are in one of these Midwestern states, be sure to consult our flowcharts in the next section before forming a corporation or LLC.

These flowcharts:

- **Are designed to help farmers identify if there are issues they must explore further**
- **Do not provide definitive answers about how anti-corporate farming laws affect a specific operation**
- **Do not thoroughly explain each state's laws**
- **Do not explore all possible exceptions or explain all obligations for any enterprise**

This chapter and the accompanying flowcharts are designed to be read in connection with this Guide as a whole. Unlike previous chapters, this chapter does not go into detail about what a shareholder or member is or what the phrase "percentage interest" means, to highlight just two examples. Farmers should read

"The flowcharts are designed to assist farmers in identifying whether they may be eligible for an exemption from ownership or leasing of farmland."

this Guide as a whole before delving into this section. Anti-corporate farming laws are always subject to legislative change and evolving interpretations by the courts. Remember, these flowcharts are only designed to assist farmers in identifying whether they may be eligible for an exemption from ownership or leasing of farmland. All farmers will need to seek more information from an attorney to fully understand their obligations.

Next Steps

Farmers in Iowa, Kansas, Minnesota, Missouri, North Dakota, Oklahoma, South Dakota and Wisconsin should check the flowcharts on the following pages if they are considering forming an LLC or a corporation.

Anti-corporate farming laws may change over time. Check with an attorney in your state for updated information. If you live in a state that does not have an anti-corporate farming law at the time this book was printed, it is unlikely such a law has been created. However, it's best to check with an attorney to confirm.

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Farmers' Guide to Business Structures:
LLCs, Corporations, Partnerships and More

Chapter 10, Section 2: Flowcharts of State-Specific Anti-Corporate Farming Laws

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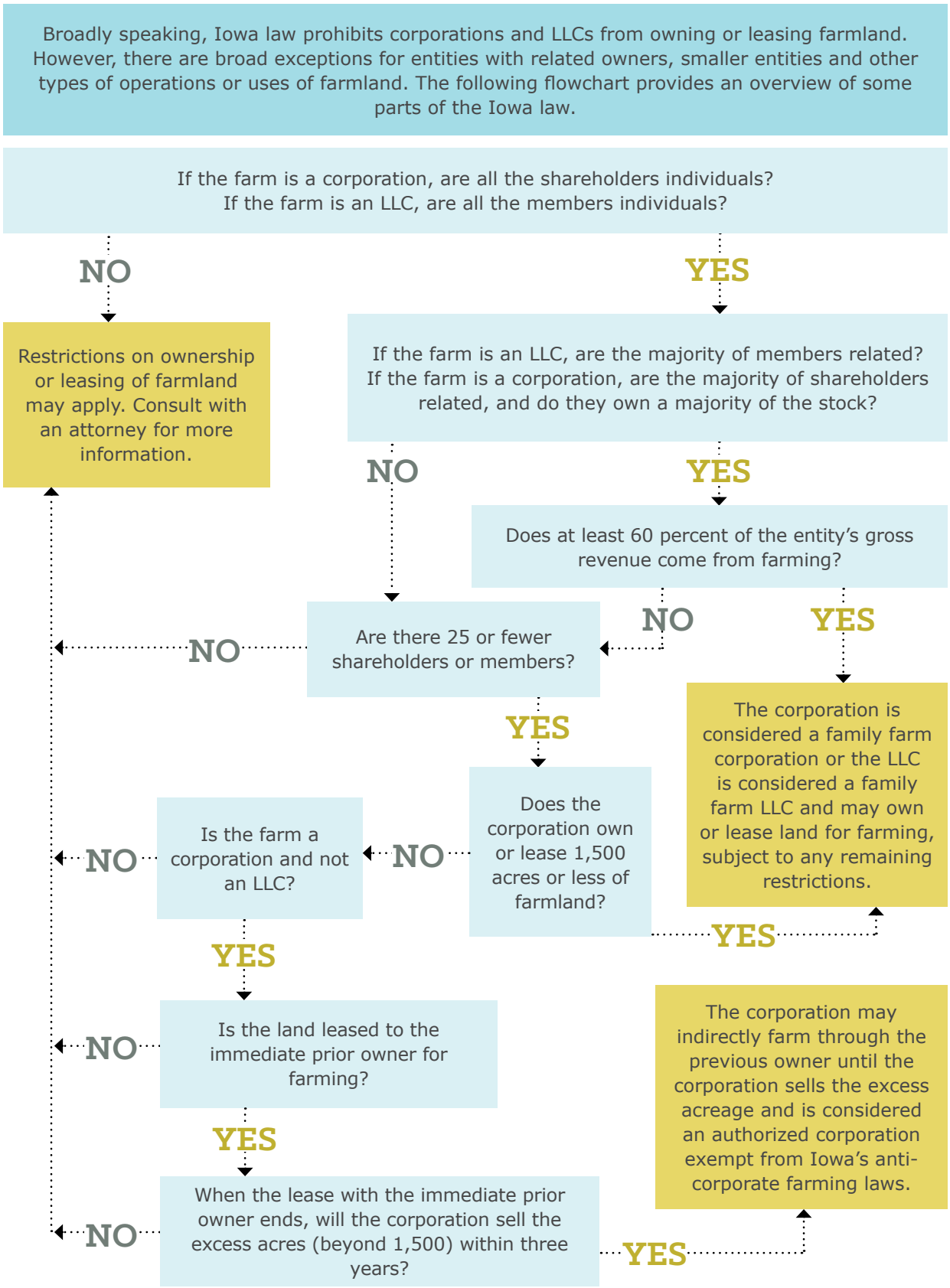
Iowa Anti-Corporate Farming Flowchart

Broadly speaking, Iowa law prohibits corporations and LLCs from owning or leasing farmland. However, there are broad exceptions for entities with related owners, smaller entities and other types of operations or uses of farmland. The following flowchart provides an overview of some parts of the Iowa law.



Kansas Anti-Corporate Farming Flowchart

Kansas broadly prohibits corporations and LLCs from owning or leasing agricultural land in the state. However, there are exceptions for small entities, family-owned entities and those engaged in farming, among other exceptions. The following flowchart provides an overview of some parts of Kansas law.

Four types of entities are allowed to engage in owning or leasing agricultural land: 1) a family farm corporation, 2) an authorized farm corporation, 3) a limited liability agricultural company, and 4) a family farm limited liability agricultural company.

A family farm corporation is one that meets all of the following criteria:
1. The majority of the voting stock is held by people related to each other.
2. The majority of the stockholders are people related to each other.
3. All stockholders are natural people or trustees for a trust benefiting a natural person.
4. At least one stockholder is a person residing on the farm or actively engaged in the labor or management of the farming operation.

A family farm limited liability agricultural company is one that meets all of the following criteria:
1. The majority of the members are people related to each other.
2. The members are natural people or trustees for a trust benefiting a natural person.
3. At least one member is a person residing on the farm or actively engaged in the labor or management of the farming operation.

An authorized farm corporation is one that meets the following criteria:
1. There are 15 or fewer stockholders, AND
2. The stockholders are all natural people, one of whom resides on the farm or is actively engaged in labor or management of the farm, OR
3. The stockholders include only natural people, family farm corporations (defined above) or family farm limited liability agricultural companies (defined above).

A limited liability agricultural company is one that meets the following criteria:
1. There are 10 or fewer members, AND
2. The members are all natural people, one of whom resides on the farm or is actively engaged in labor or management of the farm, OR
3. The stockholders include only natural people, family farm corporations (defined above) or family farm limited liability agricultural companies (defined above).

Does the entity meet the definition of one of the following: a family farm corporation, an authorized farm corporation, a limited liability agricultural company or a family farm limited liability agricultural company?

NO

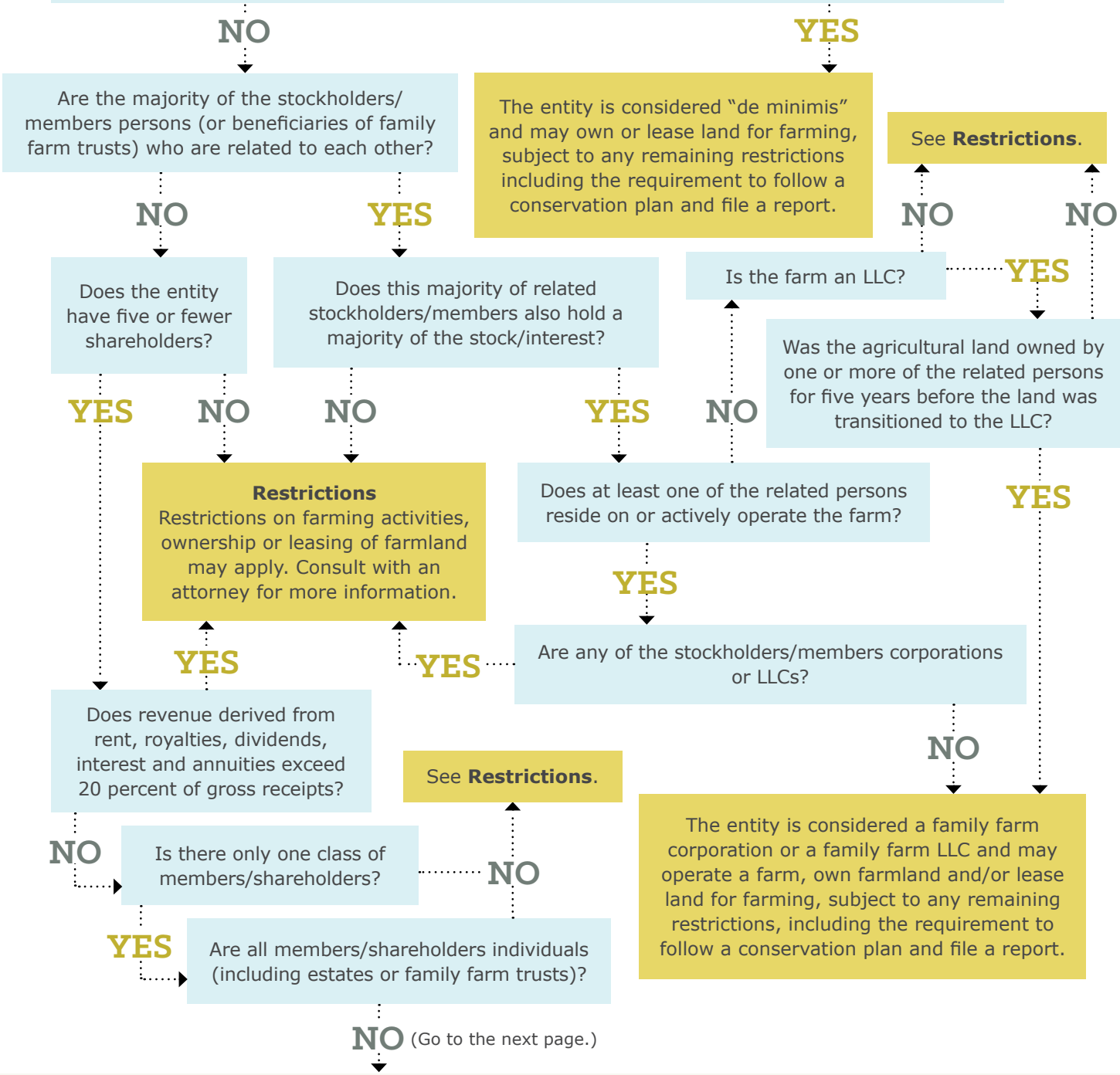
Restrictions on ownership or leasing of farmland may apply. Consult with an attorney for more information.

YES

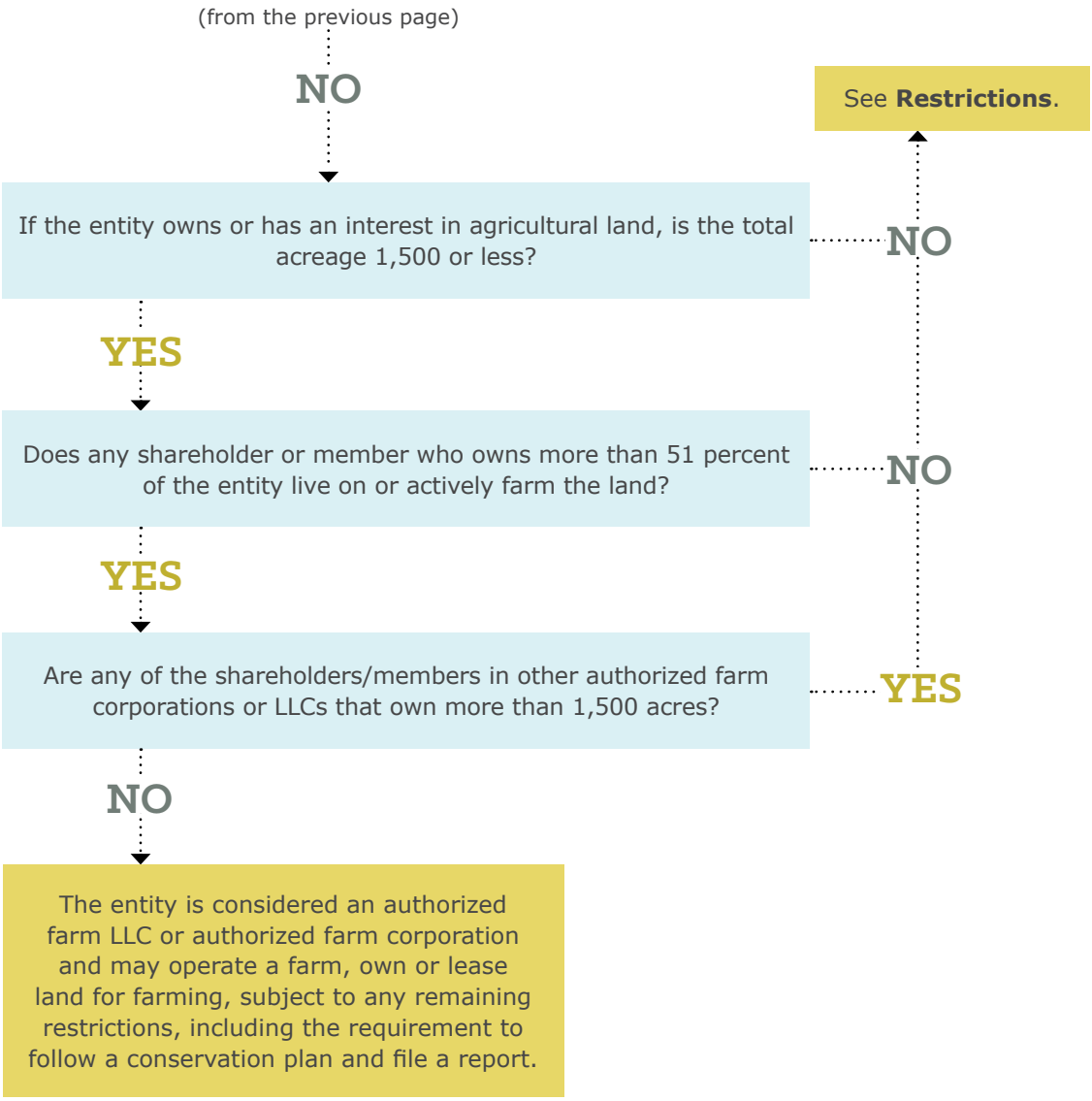
The entity may own or lease land for farming, subject to any remaining restrictions.

Minnesota Anti-Corporate Farming Flowchart

Minnesota generally prohibits corporations and LLCs from engaging in farming and from owning or leasing farmland. Minnesota law exempts several types of entities and operations from this restriction, including nonprofit organizations, some types of livestock operations, small entities, family owned entities and those with owners engaged in farming, among other exceptions. The following is an overview of some parts of the Minnesota law.



Minnesota Anti-Corporate Farming Flowchart Cont.



Missouri Anti-Corporate Farming Flowchart

Generally speaking, Missouri law prohibits corporations from engaging in farming or owning farmland. Family owned and operated corporations are exempt, among other types of entities. It is unclear if Missouri law applies to LLCs. Farmers considering forming an LLC should read the flowchart below as if they were forming a corporation. If the anti-corporate farming law might apply to the operation, a person forming an LLC should also seek counsel.

Two types of entities are allowed to engage in farming or own farmland: 1) authorized farm corporations and 2) family farm corporations.

An authorized farm corporation is one that meets all of the following criteria:
1. All shareholders are people, estates or trusts.
2. At least two-thirds of the corporation's total net income is from farming.

A family farm corporation is one that meets all of the following criteria:
1. At least one-half of the voting stock is held by members of a family.
2. At least one-half of the stockholders are members of a family.
3. At least one stockholder is residing on or actively farming the operation.
4. If there are any stockholders that are also corporations, the stockholder corporation meets criteria 1-3.

Does the corporation meet either the definition of an authorized farm corporation or a family farm corporation?

NO

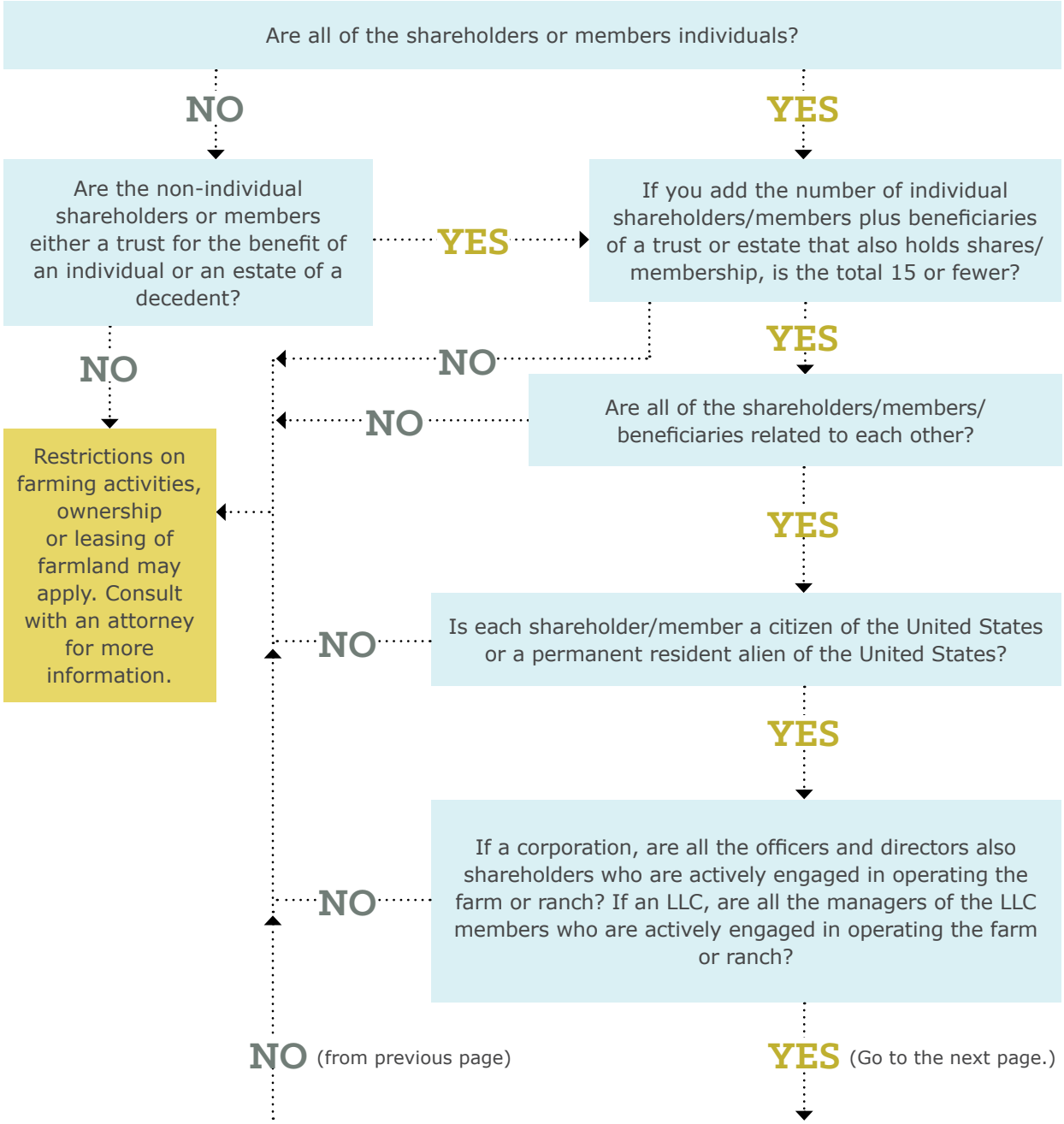
Restrictions on farming activities or ownership of farmland may apply. Consult with an attorney for more information.

YES

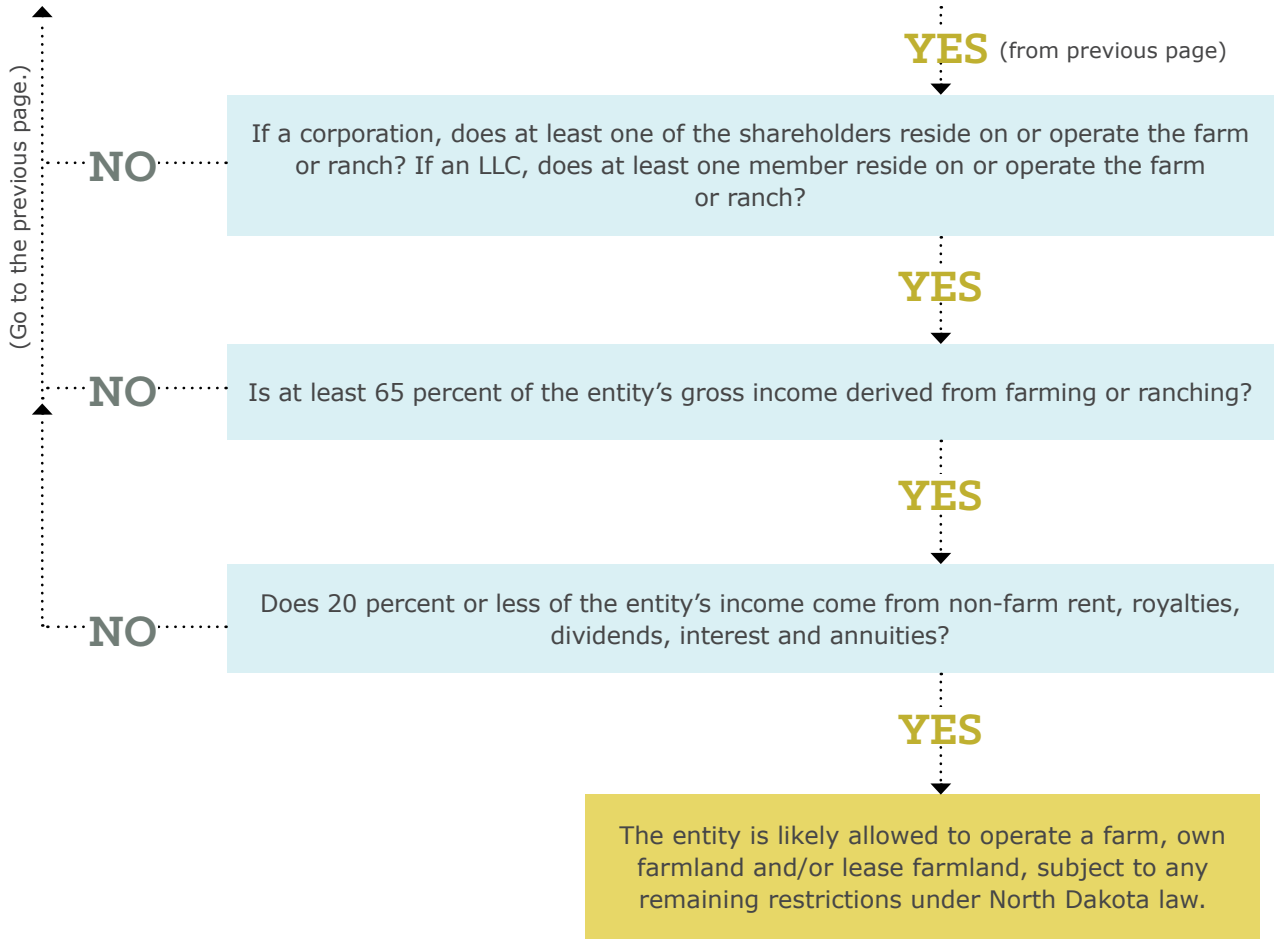
The corporation may engage in farming or own farmland, subject to additional restrictions such as reporting requirements.

North Dakota Anti-Corporate Farming Flowchart

North Dakota law prohibits corporations and LLCs from owning or leasing land for farming or ranching, and from engaging in the business of farming or ranching. However, there are exceptions for small, family based entities, among others. The flowchart below is an overview of certain exemptions for corporations and LLCs.

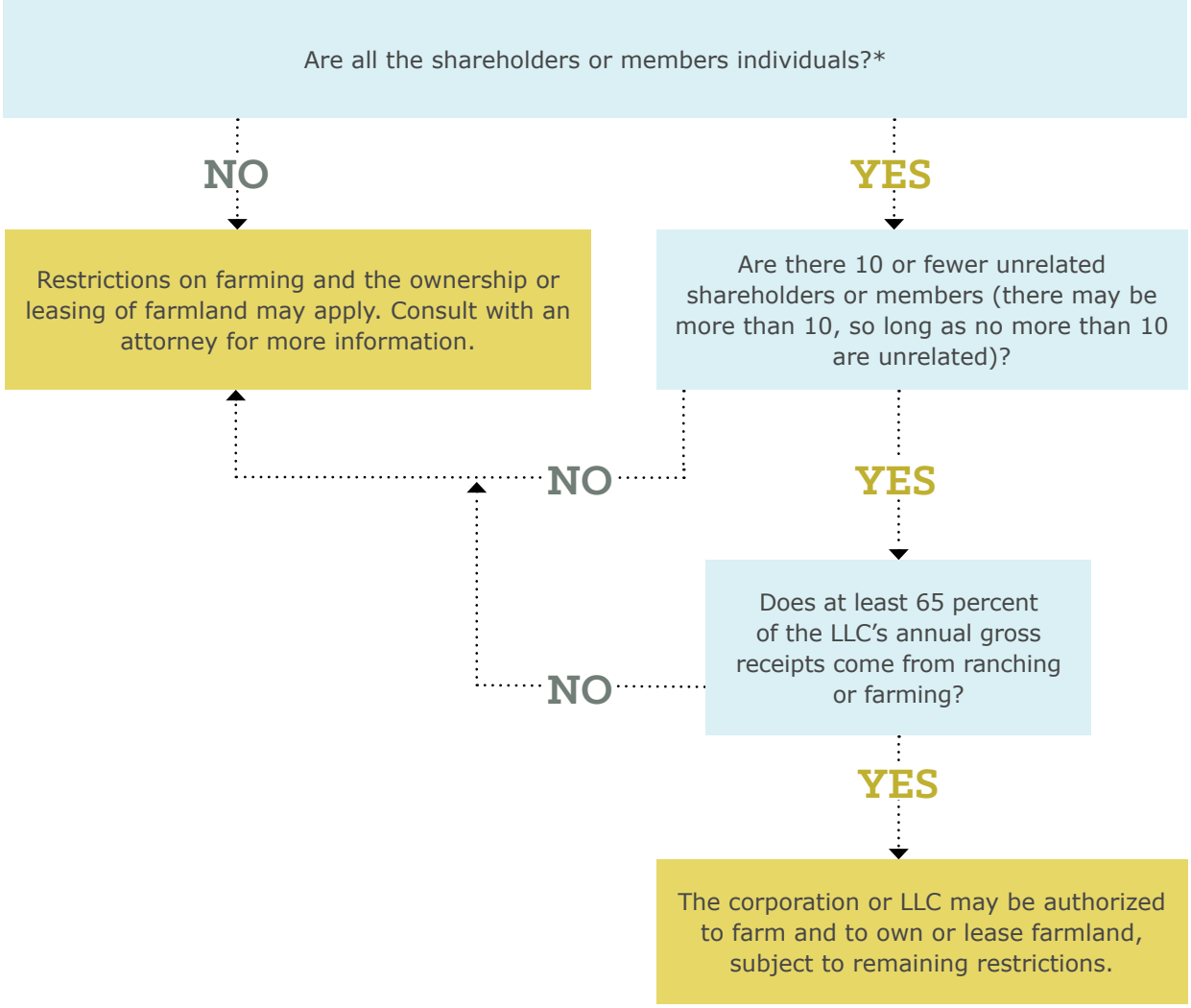


North Dakota Anti-Corporate Farming Flowchart, cont.



Oklahoma Anti-Corporate Farming Flowchart

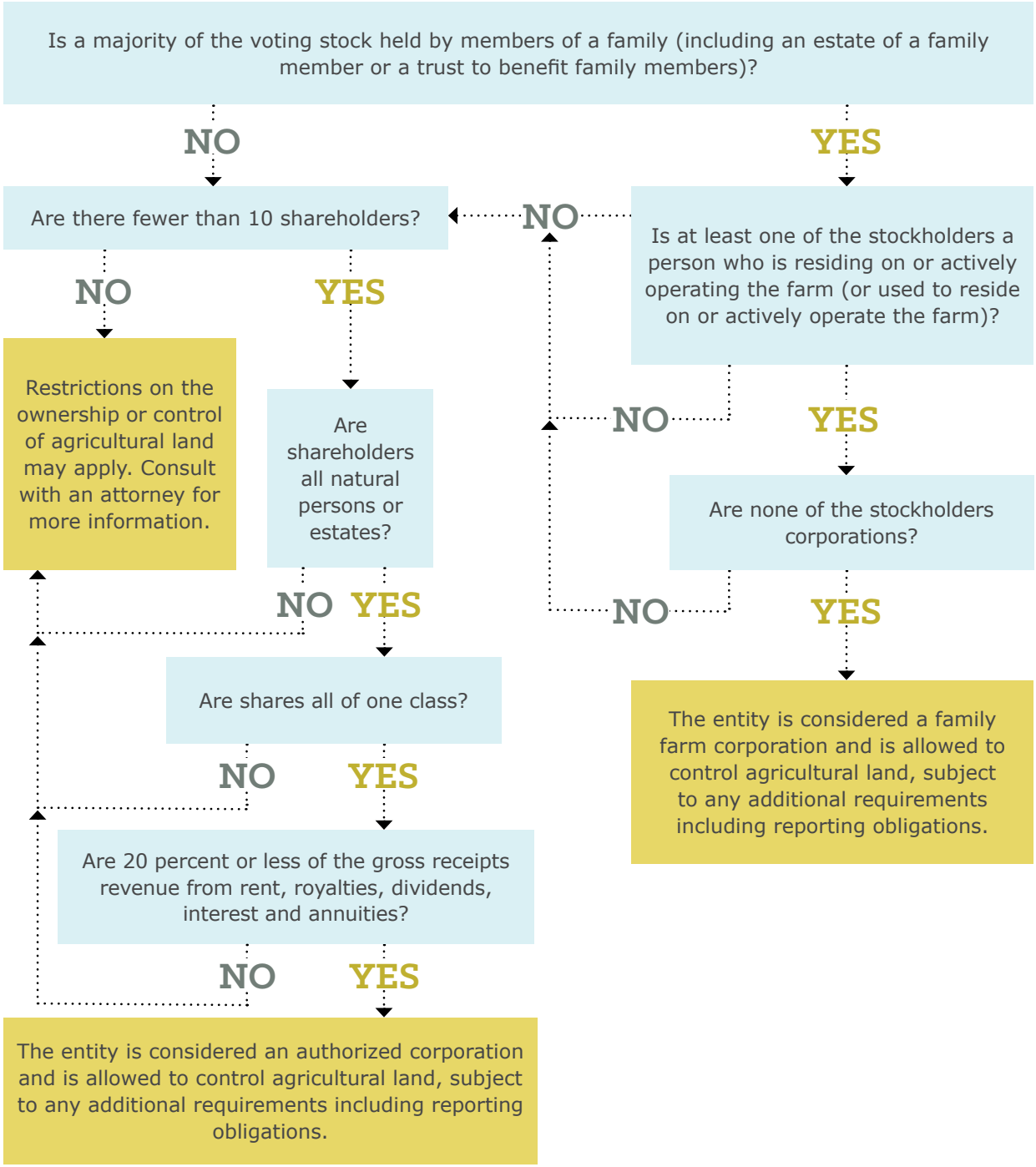
Oklahoma law generally prohibits corporations and other entities from engaging in farming or ranching, and from owning or leasing farmland. Oklahoma law has exceptions for small and family owned corporations and LLCs, among other exemptions. The flowchart below explores some aspects of these exceptions.



*It may be possible to have shareholders/members that are trusts, estates, corporations and/or LLCs. These entities must also meet the "10 or fewer" and "at least 65 percent" rules and thus be authorized themselves to farm and lease farmland.

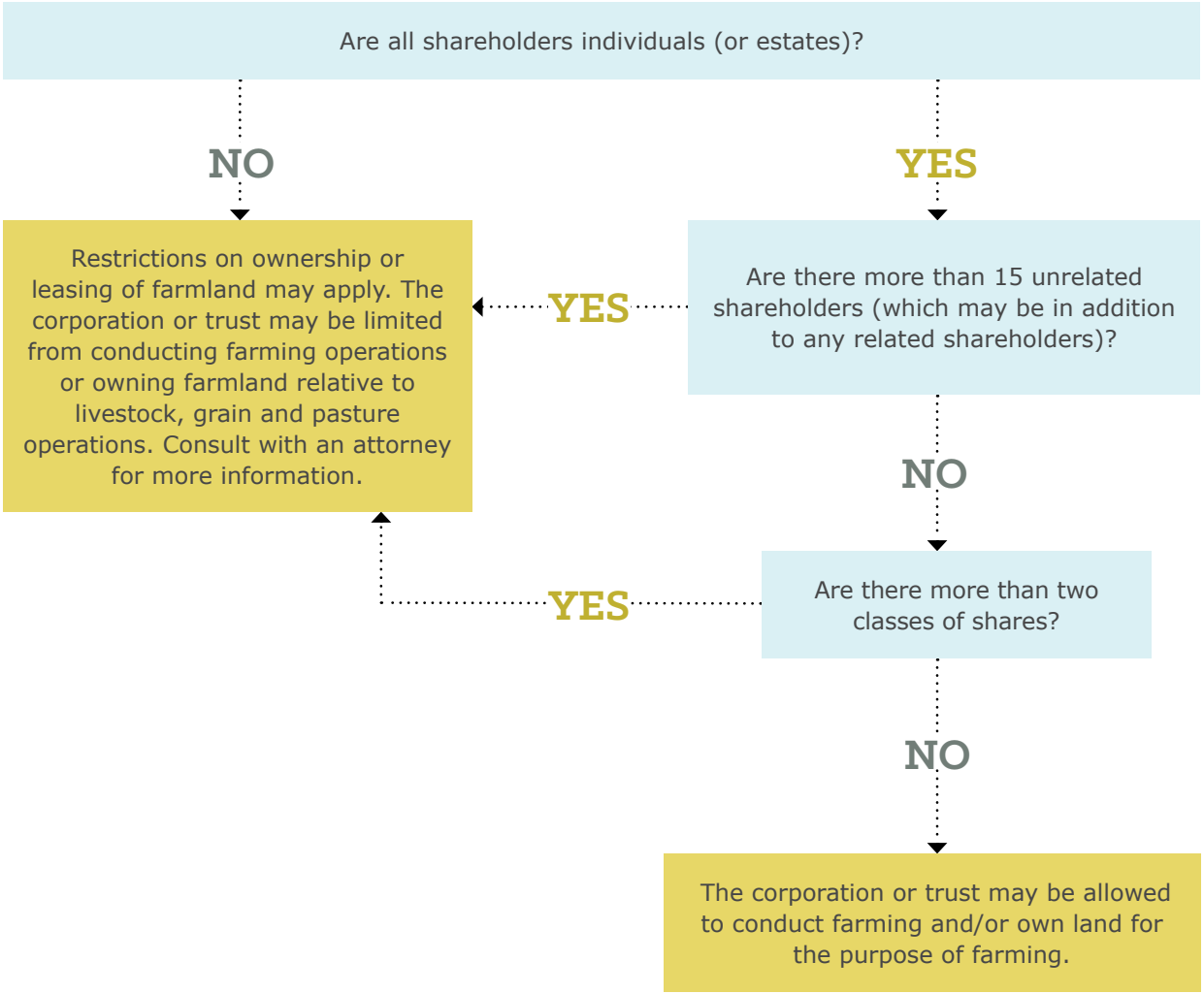
South Dakota Anti-Corporate Farming Flowchart

The South Dakota law prohibits corporations and LLCs from controlling agricultural land by owning or leasing it. The law provides exceptions for corporations that are small, engaged in farming and family operated. The flowchart below explores some aspects of these exceptions to South Dakota's law. It is unclear if South Dakota law applies to LLCs. Farmers considering forming an LLC should read the flowchart below as if they were forming a corporation. If the anti-corporate farming law might apply to the operation, a person forming an LLC should also seek counsel.



Wisconsin Anti-Corporate Farming Flowchart

Wisconsin law prohibits corporations and trusts from carrying on farming or owning land for farming, generally speaking. The law applies to livestock and row crop operations, primarily. It is unclear if Wisconsin law applies to LLCs. Farmers considering forming an LLC should read the flowchart below as if they were forming a corporation. If the anti-corporate farming law might apply to the operation, a person forming an LLC should also seek counsel.



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Sustainable Agriculture Research & Education

Farmers' Guide to Business Structures: LLCs, Corporations, Partnerships and More

Chapter 11: To Diversify or Not to Diversify

Issues to Consider with Value-Added Products

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DISCLAIMER: This Guide does not provide legal advice or establish an attorney-client relationship between the reader and author. Always consult an attorney regarding your specific situation.

Introduction

The most successful sustainable farm businesses often have several aspects to the farm operation. With multiple revenue and marketing avenues, the farm is better able to withstand disruption in one area of the business. Diversification can create opportunities to expand the business for incoming family members or partners. It can also create deeper engagement with existing customers by giving them new ways to engage with the farm business. Of course, profitability is always an excellent reason to diversify. For farms otherwise dependent on raw agricultural product sales, value-added products and diversification can tap into more profitable revenue streams.

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Farm diversification comes in all shapes and sizes. An herb farm may decide to dry its product and create a line of teas or culinary products. A berry farm may expand into processing jams or frozen fruits. As customers seek new ways to connect with the source of their food, many farms are hosting educational classes, tours and other farm events. Farmers with a wealth of experience are making their knowledge available to other farmers and organizations through consulting. Each of these are unique and important diversification opportunities.

Each of these diversification opportunities presents interesting legal questions for the farm business entity. One primary question many farmers face is whether to keep the new operation within the existing farm business entity or start a new entity. For example, Berry Farm, LLC may decide to create Berry Farm Jams, LLC. The production and marketing of strawberries occurs under the farm-related LLC, while the production and marketing of jams occurs under the jam-related LLC. As an alternative, Berry Farm, LLC might decide to create a subsidiary entirely owned by the farm with the name Berry Farm Jams, LLC. Or, all of this may be too much trouble and Berry Farm, LLC may simply choose to make jam within the existing farm entity.

What is the right choice for Berry Farm, LLC? As with so many legal questions, there isn't a single correct answer. A farm considering diversification needs to analyze several different factors and come to a conclusion based on the unique characteristics of their existing farm and planned diversification. This chapter discusses the various factors farmers should consider, although it's not an exhaustive list. This chapter is designed to be read along with other sections in this Guide that provide much more detail on the characteristics of several available business entities.

Farms considering adding value to their raw agricultural products have a lot of legal issues to consider aside from the choice of a business entity. Zoning rules, insurance and labeling laws all come into play. Learn about managing these new obligations by reading the Farm Commons guide, *Adding Value to Farm Products: The Legal Issues*, available at the Farm Commons website.

Key Factors to Consider When Deciding Whether to Create an Additional Entity

The time and monetary cost

The primary drawbacks of creating a separate entity are the potentially high costs in time and money.

"The cost of establishing and maintaining a separate entity is the first factor to consider."

The cost of establishing and maintaining a separate entity is the first factor to consider. Nearly every state charges a fee for creating an entity and for annual maintenance. The new enterprise might need separate insurance policies, tax licenses and other government or administrative permits like zoning or use permits. At the end of the year, each entity requires its own tax filings and perhaps its own fee for the preparation of those taxes. The initial and ongoing costs can add up quickly and are enough to give a farmer pause before creating another entity.

If you are trying to track down the application fee and annual fees for establishing a business entity, start with your state's business entities registration office, which is likely the secretary of state. They usually handle the creation of business entities. Answers should be available by phone or at the agency's website.

As farmers will understand from reading earlier chapters of this Guide, filing the legal paperwork to create an entity isn't enough to earn the protections it offers. An LLC, S corporation, C corporation or cooperative is only legally resilient if the business owner follows best business practices: separate bank accounts, maintenance of separate books and separate formation documents such as bylaws or operating agreements. If a farmer creates a separate enterprise to house a jam processing operation, for example, the farmer needs a new bank account, separate bookkeeping and new bylaws or an operating agreement specific to the jam entity. Bookkeeping, accounting and legal fees can essentially double with the creation of a second entity.

Create a plan to implement best business practices for the LLC, S corporation and C corporation by reading through our chapters on these entities in this Guide.

The cost and administrative burden of starting a second business entity might be the only drawback for the diversified farm business, but that doesn't mean that it is insignificant. To really understand its role in the decision-making process we need to weigh this drawback against the benefits gained from creating a separate entity.

Going through the processes of establishing a separate enterprise can be a benefit itself! Maintaining a separate bank account, books and governing documents such as an operating agreement or bylaws may help the farmer manage the diversified enterprise over the long term. Separate books and tax filings can make it easier to understand the enterprise's financial situation. Having to write an entirely new operating agreement or bylaws may motivate the owner and any business partners to think through the contingencies of the diversified enterprise itself. On the other hand, nobody wants to do paperwork just for the sake of it. If the farmer and any business partners aren't learning anything new through the process of drafting a new governing document or creating new operating procedures, perhaps it isn't worth the time. In short, don't assume that writing a new organizing document is a negative thing for your farm. Going through the process may lead to a more resilient business over time.

"It's not essential to form a separate entity. The original farm entity could create a separate class of members or shareholders relative to the diversified entity only."

Learn how a group of neighboring farmers benefited from the process of drafting an operating agreement for their new cooperative marketing LLC at the Farm Commons website. Watch the short video profiling the experience of Pasture Perfect Poultry on the "About" page.

Different owners or investors

If the diversified venture has different owners or investors, there may be a benefit to forming a separate entity.

For most farm businesses, it's not essential to form a separate entity just because new stakeholders join the business for the diversified enterprise. The original farm entity could create a separate class of members or shareholders relative to the diversified enterprise only. The separate class or share type could have different contribution, distribution, and procedural rules that apply only to those folks. The existing bylaws

or operating agreement could be revised to accommodate new shareholders or members. However, the process can inadvertently open up a proverbial can of worms and lead to a long, drawn-out revision process with many stakeholders.

Creating a new entity is often the fastest, easiest way to create a new framework for different owners or investors. A separate entity gets to start fresh and avoid discussion or compromise with existing stakeholders. New owners and investors may have such different needs that they want to create a new operating agreement or bylaws entirely.

If the farm entity files taxes as an S corporation, a new entity may be the only option if a new owner's needs are quite different than current owners' needs. S corporations are only allowed one class of shares. S corporations offer less flexibility to accommodate various types of investors.

A "class" of shares refers to the rights and obligations of a specific type of shareholder.

To summarize, if the existing business is an LLC, C corporation or cooperative, the organizational documents could be adapted to accommodate different classes of ownership/investment. If the existing farm business files taxes as an S corporation, the new owners/investors must receive the same return on their investment as existing owners/investors. Or, they must create a separate business entity.

Valuable assets or large investments

If the new diversified venture will bring in valuable assets or significant investment, there may be a lot of benefit to creating a separate entity.

"If one enterprise has assets that are particularly valuable, it may be wise to isolate those assets to a separate entity."

As farmers know from reading this Guide, a business entity protects personal assets from business liabilities. The business's assets are still available to satisfy business liabilities. If one enterprise has assets that are particularly valuable, it may be wise to isolate those assets to a separate entity. For example, let's say that a vegetable farm is thinking of installing a commercial kitchen to produce peeled and chopped root vegetables. The processed vegetables will fetch a higher price and allow the farmer to expand into new markets. But, the commercial kitchen will require tens of thousands of dollars of equipment. If the farmer operated the processing kitchen within the farm business, the commercial kitchen assets would be available to satisfy liabilities that extend from the farm operation. In addition, a person with a legal claim against the processing operation could take the assets of the farm. For this reason, many business owners prefer to create separate entities to house businesses with assets of significant value. If the diversified operations are placed in separate entities, each of the entities and the owners are insulated from the business liabilities of the other.

At first blush, this factor seems very persuasive. Farmers might be thinking, "My farm assets are valuable, and I want to insulate my land and equipment from risk, so this is a major benefit." While this logic is sound, we don't need to take it too far. Any farmer's first line of defense against liability is insurance. Businesses carry insurance so that they don't lose their assets if they become legally liable. The insulation provided by a separate business entity generally only comes into play if the insurance policy is nonexistent or insufficient. More robust insurance coverage can create a stronger first line of defense. Then, after that step has been taken, farmers can consider whether a separate entity is worth the increased costs to create a secondary line of defense.

"Businesses carry insurance so that they don't lose their assets if they become legally liable."

Farmers are understandably concerned about losing their land to a legal liability. To help manage this risk, farmers generally prefer to keep their land under personal ownership. They don't transfer title to the land to the business entity. The reasons are both personal and practical. Legitimately, land often is a personal asset passed down from family member to family member. Unlike a potato planter or commercial processing equipment, people own land for personal use. In a farm business where the land is used for the farming enterprise, the landowner personally leases the land to the business enterprise. If the farm is sued, the insurance policy will kick in as a first line of defense. If the insurance policy doesn't cover the loss or is insufficient, the creditor might look to business assets next. Then the second line of defense, our entity, kicks in because the creditor can't reach the land–it's a personal asset.

Any time a farmer adds a new aspect to the farm operation, he or she should check into the farm's insurance situation. Especially with activities like processing, education and agri-tourism, the usual farm liability policy probably won't provide coverage. Getting good insurance coverage is essential to protecting the diversified venture's assets. Whether the existing policy provides coverage, what new policy might be needed, and how much coverage may cost all depend on very specific factors. Farm Commons has a resource to help farmers get a start in understanding their insurance options. Read Farm Commons' guide, *Managing the Sustainable Farm's Risks with Insurance: Navigating Common Options* at our website.

To summarize, farms looking at a farm operation and a diversified venture with disparate or distinct asset values might more strongly consider creating a second business entity to insulate assets from potential liability. But, insurance and careful allocation of business and personal assets also help manage risks even if a separate entity is not established.

Uniquely risky ventures

If the new diversified venture is particularly risky, creating a separate business entity can be very beneficial.

> "If the new venture will expose the farm to much greater risk than it has experienced in the past, it may be wise to isolate that risk within a separate entity."

If the new venture will expose the farm to much greater risk than it has experienced in the past, it may be wise to isolate that risk within a separate entity. The processing kitchen is a great example here, as well. Processing food can introduce new vectors for contamination and increase the chance of a food safety incident. One of the benefits of diversifying a business is that it opens up new buyers and markets, but that too can expand risk. The same caveats we described above about insurance being the first line of defense still apply, but creating a second entity is a good second line of defense here.

As a contrast, let's say a farmer is launching a new consulting venture. The risks inherent to advising other farmers about their businesses are quite low. There aren't that many ways to injure people or property while sitting at a desk dispensing advice! Doing consulting under the umbrella of the existing farm business likely doesn't significantly increase total risk exposure. The farmer would still want to talk to his or her insurance agent to make sure the consulting activities are covered, but creating an entirely separate entity may not be an efficient choice.

Different employment law obligations

Farms that benefit from more lenient farm employment laws may have more to gain from forming a separate entity for diversified ventures.

Here's some background on the situation. In some states, farms are not obligated to follow the same employment laws as non-farm businesses. Farms up to a certain size may not need to pay the same minimum wage, provide the same workers' compensation coverage or pay into unemployment insurance like a non-farm business. However, these exceptions only apply to farm activities. The distinction is a subtle but important one: It's not the farm business that gets the exception from employment laws–it's the farm activity. If the farm engages in non-farm activities (such as processing, education and agri-tourism), those activities may need to follow non-farm rules.

Not sure how to move forward exploring your farm's employment law obligations? Read Farm Commons' guide, *Farm Employment Law: Know the Basics and Make Them Work For Your Farm*, available at our website.

If the farm business is benefiting from more relaxed farm employment laws, it may want to protect those benefits by creating a separate entity for the diversified venture. By creating a separate entity, farm and non-farm labor are kept separate. This may benefit the farm by allowing it to preserve the less strict employment laws for the farm labor. Essentially, the employee is working for two different companies at that point–two companies that follow different wage and benefit rules. If the two enterprises were mixed, the exemptions for the farm labor might be lost completely (generally if the non-farm labor comprises half or more of the employee's time).

"If the farm business is benefiting from more relaxed farm employment laws, it may want to protect those benefits by creating a separate entity for the diversified venture."

Different states and the federal government handle farm and non-farm obligations quite differently. This resource will not explain those differences–it's just meant to point out that they exist and that diversification can change the farm's employment law obligations. Whether or not a specific farmer benefits from creating two entities depends on the state it's located within and its existing employment law obligations.

Different succession or transfer plans

If the farm and the diversified enterprise will be transferred to two different individuals or in two different ways, there may be more benefit to creating a separate entity.

Transfer of the business is one of the top reasons farms form business entities in the first place. By creating units of ownership such as shares or percentages of interest, the farm has a handy unit with which to transfer ownership as a whole (rather than transferring individual assets). Also, creating the operating agreement or bylaws can guide the succession process by laying out how decision-making and authority transfer along with ownership.

Because the process of creating and defining the entity is often part and parcel of the business succession, it usually makes sense to create separate entities if the owners prefer that the separate enterprises and assets are passed on to different individuals. So, if a farm owner is already planning to transfer a new diversified venture to a different person than the farm as a whole, that's a good reason to create a separate entity right away. Then when the time comes to transfer it, a

"The ultimate benefit and costs of creating a separate entity for succession planning purposes depend on the farm's timing, location and expenses."

foundation is already in place. Naturally, if the envisioned transfer is many years down the line, creating a separate entity could be a bit premature if annual costs for registration, taxes and accounting will pile up. The ultimate benefits and costs of creating a separate entity for succession planning purposes depend on the farm's timing, location and expenses.

How can creating an entity help a farmer transfer the business? Watch a short video on Highland Valley Farm and how they created an S corporation to transfer the business to the next generation. It's at the Farm Commons website on our "About" page.

Conclusion

Creating a separate entity for a new venture may be the right choice for many farm businesses. But, each situation is different and farms should make a careful decision by analyzing the above factors, among others. Farm Commons always recommends meeting with an attorney and an accountant before making significant choices like these.

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Chapter 12: Joining Forces with Other Farmers

Issues to Consider When Working Together

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Introduction

Farmers have always known the power of working together, and today's sustainable farm businesses are no different. Many farmers are exploring a wide range of options for working with other farm businesses in meeting shared objectives. Multiple farms might combine product for a single community-supported agriculture (CSA) program. Other farms might reach a broader base of buyers by cooperatively marketing their products. Some farms are interested in sharing the burdens of distribution by forming a company that delivers to multiple buyers. Still other farmers are forming collective enterprises to purchase equipment, manage labor resources and help educate the next generation farmers.

> "Although their objectives for working together may differ, any farm business that joins with another for common purpose faces a range of legal considerations."

Although their objectives for working together may differ, any farm business that joins with another for common purpose faces a range of legal considerations. These are not necessarily barriers to cooperative efforts; they simply require conscious attention and decision-making.

The goal of this chapter is to help farmers identify some potential legal issues that emerge when farm businesses work together. Our emphasis is on concerns relative to choosing and organizing a business entity. Although plenty of other legal concerns exist, we encourage farmers to check out Farm Commons' employment and insurance law guides to get a feel for those issues. Here, we identify and discuss unique concerns with "accidental partnerships," joining a business as an individual or an entity, and the importance of thorough organization documents.

Here, we identify and discuss unique concerns with "accidental partnerships," joining a business as an individual or entity, and the importance of thorough organization documents.

Key Factors to Consider When a Farm Operation Works with Other Farms

Farmers can accidentally form a partnership, leaving all partners exposed to elevated risks

Whether helping each other bale hay, sort livestock or deliver product, farmers work together all the time. We know that these acts of kindness are part of being a good neighbor and are essential for a less isolated and more enjoyable rural life. The law honors neighborly relations, and helping out another farmer does not necessarily mean that the two of you are at greater risk.

Yet, a couple of farmers who work together consistently to achieve a shared purpose may cross the line into forming a business together at some point. This is where our legal concerns arise. This distinction between simply helping each

other out and forming a business enterprise matters. Businesses and individuals have different legal obligations; we need to know when a business exists and when it doesn't. For example, we know from the sole proprietorships and general partnerships chapter of this Guide (Chapter 3) that partners in a legal "general partnership" are mutually responsible for each other's obligations and liabilities. To know if the individuals have that shared responsibility (as opposed to individual responsibility for their individual actions only), we need to know if the individuals have formed a general partnership.

"Partners in a legal 'general partnership' are mutually responsible for each other's obligations and liabilities."

The answer to whether folks have formed a general partnership should be pretty easy, right? Did they sign documents to form one? Did they say they formed one? If only it were that simple! Because no formal action is required to form a general partnership, we don't have any clear indicating factor when one has been formed. It's all about whether the people involved are acting or representing themselves as if they are a business. Any time we have to evaluate behavior or representations, it can get pretty murky. What does it mean to "act" like you've formed a separate business with another farmer?

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For better or worse, our legal system is all about drawing lines in the sand and forcing gray areas into black and white boxes. Whether two or more farmers have formed a separate business is precisely one of those gray areas that lawmakers and courts have tried to define as black and white. Generally speaking, people have formed a partnership when they 1) act like co-owners of a business and 2) intend to carry on the business for a profit (as opposed to intending to create a nonprofit). More specifically, the question is settled according to the laws of each state and the courtrooms that define state law. Still, we can generalize across all states. Each state relies on some version of the four main factors below.

Below, we explain each factor and use an example to help illustrate how a court might apply the factor to a farm business. Imagine for a moment that we have two hypothetical farmers joining together to market a CSA option. The first farmer, let's call her Sally, raises poultry for meat and eggs. Our second hypothetical farmer is George; he grows vegetables. Sally and George offer a single CSA share that combines vegetables, eggs and chicken in one convenient plan. George and Sally haven't done anything distinct such as signing a partnership agreement. Both operate their own farms and haven't given much thought to whether their business is a partnership or two independent businesses assisting each other.

Factor: If individuals share profits from a common enterprise, a court is more likely to find that they have formed a partnership

Before we get further into this factor, let's outline a few basics. We are using the accounting definition of profit: business revenues minus business expenses. Profit goes beyond simply gaining a benefit. If one farmer helps another bring in the hay, the hay producer has benefited because they have more hay to sell, sooner. That's not the same as sharing in profit, though. The concerns of the individuals need to be economic, to an extent.

> "If folks create a business plan together that calls for generating mutual profit, it looks like they're intending to form a shared business."

Profit must also be mutual. Let's use our example of Sally and George to illustrate this. Sally and George might distribute a single sign-up form that requires CSA members to send in two checks, one to Sally for the eggs and chicken, and one to George for the vegetables. In this situation, it looks like Sally and George may not generate a mutual profit. Each will keep their own books where they post individual revenues, deduct individual expenses and earn a profit according to largely individual effort. This situation looks a lot less like a partnership.

By contrast, Sally and George might allow CSA members to write a single check, perhaps one written out to a farm name that is different from their own individual farm names. Sally and George might deposit this check into a separate bank account from which they both draw to cover their expenses in producing chicken, eggs and veggies for the CSA. At the end of year, Sally and George might split any profit that remains. This, of course, looks a lot more like sharing profits from the common enterprise! There's still plenty of room to find that Sally and George have not formed a general partnership with this arrangement, but they are certainly closer than if they had taken separate checks.

Factor: If people intend, or appear to intend, to carry on a business together, a court is more likely to find they have formed a partnership

This factor is especially amorphous! What does it mean to "appear to intend" to do something? Although we can't define it, we can spot a few illustrations of an intention. If folks create a business plan together that calls for generating a mutual profit, it looks like they're intending to form a shared business. If they contribute investments to the business (or plan to do so), speak of each other as partners in their business and both enter into commitments on behalf of the enterprise, it looks like they intend to have a business. Not doing these things (like not entering into any commitments and not making any investments) doesn't mean a business hasn't been formed, but having done them can serve as evidence.

Going back to our example of Sally and George, let's say that Sally and George discuss marketing efforts for their CSA. They agree that Sally will attend a CSA open house, distribute brochures and take payments. While she's at the open house, Sally will also pick up some boxes from another farmer and pay for them with money George put into their shared bank account. In the meantime, George is meeting with a banker to talk about getting a modest loan for a distribution vehicle. Sally and George have agreed that George may sign a loan for up to $10,000 and that loan payments will be taken from the shared bank account. Each of these actions are signs that they think they are participating in business together. Both are acting on behalf of the other's interests—one in the sale of product and the other for a loan payment. Both are indicating an intention to pool money, with the future goal of generating profit from their mutual efforts.

Keep in mind that whether an enterprise actually makes a profit, or even if the business plan has a reasonable chance of making a profit, isn't relevant. People can and do form failing, profitless general partnerships all the time! It's the plan and intention to work towards the profit together that reveals a general partnership.

Factor: If people share common ownership of property, a court is more likely to find they have formed a partnership

The common ownership of property is a pretty strong indication that two people have formed a partnership. For example, if Sally and George purchased the truck with shared funds, it's more likely they have formed a partnership. Not having any common ownership of property doesn't mean that a partnership hasn't been formed, however. Many businesses don't utilize property at all. Sally and George might form a marketing venture wherein they call restaurants on behalf of each other's farm business and sell their product together. This wouldn't require anything more than a phone. The court would look to other more relevant factors than common ownership of property to determine if Sally and George's marketing venture is a partnership.

Factor: If people share control of the enterprise, a court is more likely to find they have created a partnership

In a legal sense, sharing control of an enterprise generally means a shared ability to influence significant decisions on behalf of the business. Entering into debt, making accounting and tax decisions, acquiring property and taking on investors

"If people share common ownership of property or share control of the enterprise, a court is more likely to find they have created a partnership."

or members are all significant decisions. When individuals have an opportunity to present their perspective and control the outcome of the significant decisions, they are more likely to have a partnership. This doesn't mean each partner has to have the authority to make unilateral decisions or even an equal say in the decision. Each partner might get voting power over entering into debt, acquiring property, etc, in proportion to their stake in the business—that still qualifies as sharing control. In contrast, if one person has no say over a matter at all, they have an employee/manager relationship rather than a partnership relationship.

Why does it matter if you've formed a "partnership," without fully realizing it?

Above, we outlined four different factors that a court will consider in determining if a partnership exists. But, have we fully explored what it means to have accidentally formed a partnership? If individuals don't realize that they have formed a general partnership then they likely haven't taken good risk management steps to accommodate their increased risk. Next, we will explore the increased risks and the management strategies farmers might adopt.

> "If you don't realize you have a partnership, you may not be managing the risk of joint and several liability, and you might not have drafted a partnership agreement."

If you don't realize you have a partnership you may not be managing the risk of joint and several liability

Earlier in this chapter we briefly discussed that if you have a general partnership, you can be held personally responsible for liabilities that your partner incurs. (We go into much more detail about how this "joint and several" liability works in Chapter 3 on general partnerships.) If you know that you may be potentially responsible for the decisions of your partner, you might act differently. For example, you might choose to keep your businesses separate and avoid a partnership. Or, you might be more diligent about following up on matters and allocating responsibility clearly. Perhaps you will take a closer look at your insurance policy and make sure that you have coverage for whatever might happen within the general partnership. The bottom line is that if you don't know your current risks, you can't manage them.

For more on joint and several liability, see Chapter 3 on the fundamentals of sole proprietorships and general partnerships.

If you don't realize you have a partnership, you might not have drafted a partnership agreement

A partnership agreement is a document that individuals create to outline their mutual obligations and business operation procedures. Our chapter on LLC operating agreements (Chapter 4) goes into full detail about the content of these

types of agreements. We will summarize by saying that a partnership agreement is essential to identifying how decisions are made and how partners enter and exit the enterprise, and to outlining partners' legal obligations to each other. When individuals haven't acknowledged that they have a partnership, they probably haven't thought about these decisions, let alone put them on paper.

Not having a partnership agreement gives individuals less control over their enterprise. If something goes wrong and a court is forced to make a decision about legal responsibilities, the court will rely on state law rather than the decision of both parties. The state law may or may not be best for the business.

If you don't realize you have a partnership, you might not have insurance for your increased risks

Insurance is any business's first line of defense against liabilities. It's even more important than forming a business entity. The entity generally provides liability protection over personal assets, not business assets. The bottom line is, business assets are not protected if an enterprise doesn't have insurance. When farmers start working with others, they may assume the other farmer's insurance policy will cover them. These kinds of assumptions can come with terrible consequences if they are false. Any time a farm begins a new venture, the farmer should check with his or her insurance agent about coverage. Don't immediately assume a new venture will cause rates to go up—the partnership might be covered under existing policies. Or, you might simply need to add the partnership as an "additional insured" to the policy. The best solution may depend on whether a separate partnership has been formed or not, so determining where you stand is an important first step.

"Any time a farm begins a new venture, the farmer should check with his or her insurance agent about coverage. You might simply need to add the partnership as an 'additional insured.'"

If you don't realize you have a partnership, you haven't considered creating a different business entity such as an LLC

Given the opportunity, most farmers don't choose to remain as a general partnership. The cost of creating a separate entity such as an LLC or a corporation is low compared to the benefits—primarily, insulation for personal assets from business liabilities. Perhaps the biggest drawback to not knowing that you have a partnership is not realizing that it is time to form a more optimal business entity. Farmers have a lot to gain from a conscious choice about which business entity to operate under.

Fundamentally, there's nothing inherently wrong with having a general

partnership and not realizing it. Problems occur if the increased risks to which the partnership is exposed materialize. Farmers can manage those risks. It's all about making a conscious choice of whether and how to manage that risk. Choosing to draft a partnership agreement or forming an LLC or corporation could be the right choice, but there is no single correct answer; it's all about the farmers' situation and preferences.

Farmers should decide if they are participating in the co-venture as an individual or as a business

"For farmers considering joining forces with other farmers, the question of whether to participate as an individual or business entity arises."

If you have read through this Guide already, you know that LLC members and corporation shareholders aren't necessarily individual people. Other businesses can be members of an LLC or shareholders in the corporation as well. For farmers considering joining forces with other farmers, the question of whether to participate as an individual or business entity arises. Like so many legal questions, there's no single correct answer. We have to assess several factors against the individual situation of those involved. To help illustrate the factors involved in making this decision, we will go back to our example of Sally and George and their cooperative CSA adventure.

If the new entity is an S corporation, the farmer must participate as an individual

The first factor is relatively straightforward. If the new collaborative venture is already organized as a corporation, options may be limited. As discussed in the C corporations chapter (Chapter 5), a corporation can either file taxes as a C corporation or as an S corporation. If the new venture isn't planning on taking on outside investment or doing a public offering, it probably plans to file taxes as an S corporation. If an entity files taxes as an S corporation, all shareholders must be individuals. Other LLCs and corporations may not be shareholders in an S corporation. If the entity is already organized as an LLC and has already chosen to file taxes as an S corporation, the same applies.

Let's return to our example of Sally Smith and George Merry, two farmers who are creating a co-owned venture to distribute Sally's poultry and George's vegetables as a single CSA share. Sally currently raises her chickens and her eggs under her existing business, Sally's Farm, LLC. In her eagerness, Sally has already filed the paperwork to form the corporation Happy Peach Farm, Inc., the business under which she and George will market their CSA. Sally and George agree that Happy Peach Farm should file taxes as an S corporation; they want to avoid the double

taxation of a C corporation. In this case, Sally can only join Happy Peach Farm, Inc. as Sally Smith. If she receives stock in Happy Peach Farm, Inc. in her capacity as a member of Sally's Farm, LLC, Happy Peach Farm will lose its eligibility to be taxed as an S corporation. Sally can't necessarily convert Happy Peach Farm, Inc. to an LLC, either. Depending on the business's assets and accounting, doing that can have tax consequences. The best choice may be for Sally to join in her individual capacity as Sally Smith.

The farm or farmer should join the new venture in whichever capacity they will act in

Should a farm choose to join a multi-farm venture as the farm or as the farmer? Sometimes, this question can be answered with common sense alone. The farmer should ask him or herself in which capacity he or she will actually be participating in the business. Will the farmer be making decisions in the multi-farm venture on behalf of him or herself personally or on behalf of his or her existing farm business? Participation is on behalf of the existing farm business if it takes into account the farm's overall business plan, growth strategy, financial situation, investor or partner preferences, or other business-specific factors. Participation is on behalf of a farmer personally if it considers personal objectives such as retirement plans, personal income, other actual or planned business ventures, purely personal objectives and other factors that aren't related to the farm operation.

The question of personal or business capacity might seem pedantic, but it has real-world implications. As a participant in a multi-farm venture, you will have legal obligations to the venture. These obligations might be spelled out in an operating agreement or they might be traditional legal obligations that apply regardless. These obligations might require you to avoid competing with the multi-farm venture, to disclose certain information or to refrain from voting on certain matters when you have a conflict of interest. The member of an LLC or the officer/director of a corporation needs to be sure he or she understands these legal obligations and can fulfill them.

"As a participant in a multi-farm venture, you will have legal obligations that might require you to avoid competing with the multi-farm venture, to disclose certain information, or to refrain from voting on certain matters."

Anti-corporate farming laws may affect the farmer's decision to join as an individual or as an LLC/corporation

If the new multi-farm venture will operate a farm, own farmland or lease farmland, and is located in Iowa, Kansas, Minnesota, Missouri, North Dakota,

Oklahoma, South Dakota or Wisconsin, all potential members should look closely at the state's anti-corporate farming laws. These laws restrict the ability of LLCs and corporations to control farmland or participate in farming under certain conditions. Many of these laws only allow LLCs or corporations where all members/shareholders are individual persons (and not other LLCs or corporations) from farming or controlling farmland.

Anti-corporate farming laws aren't designed to trip up well-meaning collaborative farm ventures, but they can have that effect, especially if people aren't aware these laws exist. The laws often have wide exceptions, so most businesses will still be able to conduct their operations. They just have to make sure they organize the business in certain ways or avoid titling farmland in the name of the business. Read our anti-corporate farming chapter (Chapter 10) for more information.

"Farmers may encounter other factors that affect their decision to join a multi-farm venture as an individual or as a business. Certainly, tax factors may play a role."

Joining as a business may make it easier to transfer ownership

If the member of an LLC or shareholder of a corporation is a business entity rather than a person, control of that membership follows the business rather than person. Farmers getting ready to transfer a business might find this convenient. For example, let's say farmer Sally plans to retire in two years. She has a farm successor lined up and they are going through the process of transferring ownership and managerial authority. Sally's successor is excited about the CSA opportunity and plans to continue working with George. If Sally joins Happy Peach Farm, Inc. as the member of her LLC, membership in Happy Peach Farm will transfer neatly to her successor along with ownership of Sally's Farm, LLC.

Farmers may encounter other factors that affect their decision to join a multi-farm venture as an individual or as a business. Certainly, tax factors may play a role. Farmers should check with their accountant or tax preparer to understand any broader implications for the business's financial situation. An attorney, insurance agent and other professionals can also be helpful in the decision.

Pay close attention to developing strong business organization documents

Farmers reading this Guide thoroughly will fully understand the role of strong business organization documents already! If you haven't yet, please give a close read to our section on LLC operating agreements as you consider drafting a partnership agreement, bylaws or operating agreement (Chapter 4, Section 2). These documents are essential to setting up a strong working relationship between

all partners in the business. Read the section on LLC operating agreements and review our sample document to pick up plenty of tips for preventing problems before they start.

Next Steps

Multi-farm ventures are the key to sustainable growth for many farm businesses. Production, marketing, labor and distribution ventures can all be made more efficient and more enjoyable when you join forces with others. These ventures can make the farm more resilient by opening up new markets and boosting profitability, but they can also make the farm more vulnerable. If farmers aren't careful about forming business partnerships, they can create more risk than they intend. Also, if a farmer doesn't carefully consider the nature of his or her participation, or the detailed ground rules in the organizing document, problems can emerge down the road. By the time that happens, it might be too late to effectively resolve legal problems that could have been prevented.

"If a farmer doesn't carefully consider the nature of his or her participation in a multi-farm venture, problems can emerge down the road."

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REPONDS

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FARMERS' GUIDE TO BUSINESS STRUCTURES

LLCs, CORPORATIONS, PARTNERSHIPS AND MORE

Establishing and maintaining the right business structure for your farm operation may not sound like exciting work, but it is important. Forming a business structure can help manage risk by protecting the owners' assets from the business' liabilities; promote good business practices through accounting and decision-making protocols; raise funds from outside investors; and ease the ownership transition process. For most farmers and ranchers, choosing a structure is straightforward. Complexity arises when drafting organizing documents to support your structure of choice, or, determining how it will operate. *Farmers' Guide to Business Structures* will support you throughout this process, from outlining the options and how to choose one, to in-depth chapters on the characteristics and requirements of each. To help you on your way, this Guide includes sample operating agreements, bylaws and other documents for C corporations and limited liability companies (LLCs). This Guide is meant to assist you but does not offer legal or financial advice for your situation. To succeed in this process, work with an attorney, accountant and others with expertise in this subject area.

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