Using Multiple Business Entities for a Farm Operation

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Establishing a formal business entity such as a Limited Liability Company (LLC) or a Corporation is usually advantageous to a farming operation, but there can also be benefits to using several formal business entities in a farming operation rather than using just one entity. This bulletin explains how a multiple-entity approach can positively affect a farm's liability protection, facilitate bringing in the next farming generation, and address the needs of off-farm heirs. The bulletin also notes a few disadvantages and tax implications for using multiple formal business entities.

A multiple-entity plan

While there are unlimited combinations of how multiple-entity plans can be structured, a common approach for farming operations is to use three formal business entities: an operating entity, a machinery entity, and a land entity. Here is how each entity in a multiple-entity plan would function within the farming operation:

1. **Operating entity.** The operating entity pays the bills, sells the grain or livestock, and is essentially the "brain trust" of the farming operation. This entity is where most of the management occurs and where the money flows through. The assets held by this entity are typically crops, grain, or livestock and the operating bank account.

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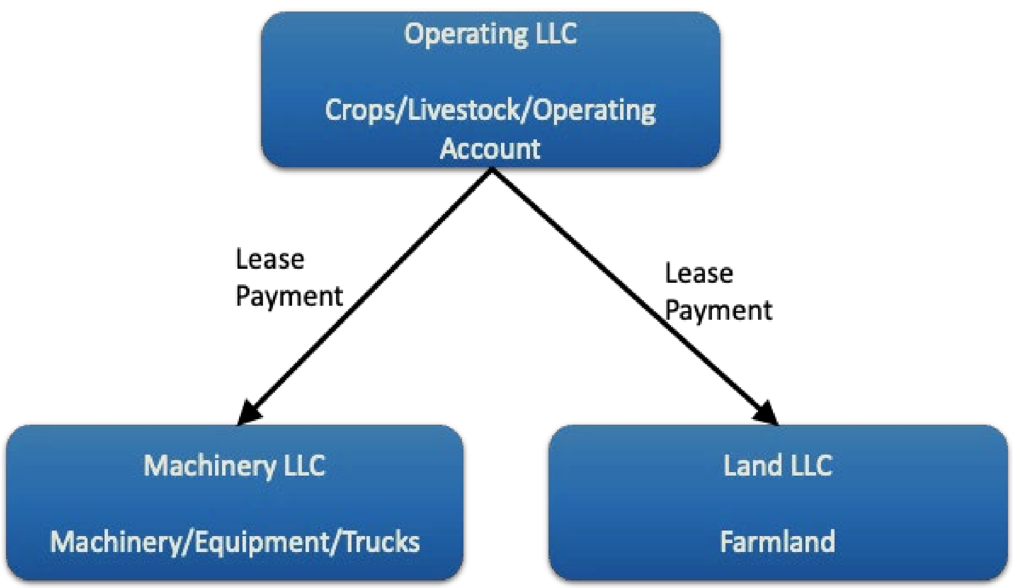
2. **Machinery entity.** A second entity can hold machinery, equipment and trucks. The operating entity leases this equipment and pays a lease payment to the machinery entity. This payment is important to keep the entities separate and distinct from each other and to pay debt and expenses of the machinery entity.

3. **Land entity.** The farmland is often held in a third, separate entity. The operating entity leases the land and pays rent to the land entity. Like the machinery entity, it is important for the operating entity to pay rent to the land entity to ensure the two entities are separate and distinct from each other. The land entity uses the lease payment to pay debt and expenses.

Diagram 1 illustrates the relationships among the three entities in a multiple-entity plan. For simplicity, we use LLCs as the formal business entities in the examples, but using other formal entities would have a similar effect. Most new farm businesses tend to organize as LLCs today, but Partnerships and Corporations are also used in some farming situations. For a detailed discussion of the characteristics of different types of entities, see the *Comparison of Business Entities Available to Ohio Farmers* law bulletin in this series.

Diagram 1. A multiple entity plan for a farm operation



Using a multiple-entity plan for liability protection

A multiple-entity plan can enhance the liability protection provided by LLCs and Corporations, which protect owners from the liabilities of the business. However, all of the assets within the business entity itself are at risk for the liability of the business. An LLC or Corporation only protects an owner's assets that are outside of the entity, not the assets in the entity. Using several entities to separate the assets can protect those assets from liability risk.

The Machinery LLC and the Land LLC. By placing machinery in a separate LLC and land in another LLC, the high liability exposure of farm machinery is separated from the land. Keeping the land separate and distinct from farm machinery and trucks using multiple entities is an effective liability management strategy. This strategy will work even if the same people own both entities. Under the law, each LLC is a separate person, distinct from its owners.

The Operating LLC and the Land LLC. The liability exposure of the Operating LLC is also prevented from reaching the Land LLC because the two entities are separate and distinct. The Land LLC has no responsibility for the Operating LLC--it is merely a landowner leasing land to the Operating LLC. So, by having separate entities for the farm operations and the land, the land is well protected from the liability exposure of the farm operations.

The Operating LLC and the Machinery LLC. There is less reliable liability separation between the Operating LLC and the Machinery LLC. This limited separation between the two entities is the result of an owner or employee of the Operating LLC likely operating the machinery. Most liability incidents involving machinery are due to operator error. In the event of operator error, the liability reaches back to the Operating LLC. For this reason, in most situations there should not be much confidence placed in the liability separation between the Machinery LLC and Operating LLC. The best liability management tool for this situation is good and adequate liability insurance. See the *Using Liability Limiting Entities to Manage Liability Exposure for Ohio Farms* bulletin in this series for a more detailed discussion on this issue.

Liability insurance remains important. While multiple entities can provide good liability protection for farm assets, especially land, they are no substitute for liability insurance. Using business entities for liability protection should always be the back-up liability management plan. The primary liability protection strategy should always be liability insurance. It is a good idea to regularly review all farm assets and activities with the farm's insurance agent to ensure adequate coverage in the insurance policy.

Using a multiple entity plan to bring in the next farming generation

A challenge many farm families face is how to bring the next generation of farmers into the farming operation. In addition to the challenges of management, delegation of responsibility, and communication, the intensive capital nature of farming presents a unique challenge to many farm families. That is, how can the farm bring a 25-year-old with few assets into a multi-million dollar farming operation? The next generation farmer may not have the resources to buy into the farming operation. Also, the current generation may not be comfortable making a gift of hundreds of thousands of dollars or more to the next generation to bring them into the farming operation. Using multiple entities can help reduce the challenges of this situation.

Example 1. Let's start with a typical farming operation that has all its assets under common ownership, either as individuals or an entity. Mom and Dad are the owners of the farming operation. The assets in the farming operation are grain and crops valued at $500,000, machinery valued at $1 million and land valued at $2 million for a combined value of $3.5 million. The goal is to bring Daughter into the farming operation as a 10% owner. Either Daughter must pay $350,000 to buy a 10% share of the operation or Mom and Dad must gift her $350,000. Mom and Dad are reluctant to give Daughter part ownership of the machinery and land in the event Daughter ends up not staying on the farm.

To overcome this difficult situation, the same multiple-entity plan discussed above can be used. Instead of one farming operation holding all the assets, the grain is held in an Operating LLC, the machinery in a Machinery LLC, and the land in a Land LLC. Now, Mom and Dad can bring Daughter into the Operating LLC as a 10% owner for only $50,000. Daughter may have $50,000 available for a buy-in or, more likely, Mom and Dad are more comfortable making a $50,000 gift. Also, it may be possible to get the Operating LLC to a near $0 value by distributing out the grain to Mom and Dad before Daughter enters the operation.

Daughter has now become an owner in the Operating LLC and can help with management decisions for the farming operation. Mom and Dad have retained full ownership and control over the machinery and land. Perhaps after a few years, when Mom and Dad are more confident Daughter intends to stay on the farm, Daughter begins to buy into or is gifted ownership in the Machinery LLC. Or perhaps Daughter eventually buys her own machinery for the farming operation. The same can be done with the Land LLC.

A multiple-entity strategy can allow the next generation farmer to enter the farming operation without the burden of accounting for the value of all farm assets. It also allows the current generation to maintain ownership and control of the more valuable farm assets while the next generation transitions into the farming operation.

Note: This above strategy may not be advisable if the farm operation is held in a Corporation. Withdrawing assets from a Corporation can trigger tax liability. Be sure to consult with legal or tax advisors.

Using a multiple entity plan to address off-farm heirs

Another challenge for many farm families is addressing off-farm heirs in a farm succession plan. The challenge arises because the majority of a farmer's wealth is usually in the farm assets. It is not unusual for 80 to 90% of a farmer's wealth to be in farm assets. The farming heir needs the farming assets to continue a viable farming operation. However, if the farming heir receives all the farm assets, there may not be sufficient assets for the non-farm heirs to inherit.

Example 2. Continuing from Example 1, Mom and Dad own $3.5 million in farm assets and $500,000 in non-farm assets. Daughter would like to continue the farming operation while Son is not interested in farming. Mom and Dad's goal is to transfer a viable farming operation to Daughter while providing an equitable inheritance to Son. Also, they feel Daughter has earned assets through "sweat equity" by staying on the farm and helping the farm and Mom and Dad's wealth grow.

If Daughter receives all of the farm assets and Son receives only the non-farm assets, there is a $3 million disparity between inheritances. For some farm families, this disparity may be an acceptable outcome but for those families where this disparity is a problem, a multiple-entity business structure can help. Let's assume Mom and Dad have multiple entities like those discussed previously. Mom and Dad can decide that upon their deaths, Daughter will receive their entire interest in the Operating LLC ($500,000) and Machinery LLC ($1 million) so that Daughter has full control of the operating assets and the day-to-day decisions for the farming operation.

To make a more balanced inheritance, Mom and Dad can give Daughter and Son equal shares in the Land LLC ($1 million each). To protect Daughter's ability to continue the farming operation, they name Daughter as the successor manager to the Land LLC and limit ownership transfers to only family members. Son will be a 50% owner in the Land LLC and will receive 50% of the rental income paid by the Operating LLC but will not be able to interfere with Daughter's farming operation.

In this plan, Daughter will receive $2.5 million of farm assets. Son will receive $1 million worth of ownership in the Land LLC and $500,000 of non-farm assets. Now, the disparity of inheritance is reduced to $1 million, which is acceptable to Mom and Dad.

This strategy protects Daughter's farming operation in several ways. First, Daughter is the sole owner of the operating assets that are critical for the farming operation. She will have full control over the day-to-day decisions of the farming operation. While Son owns 50% of the Land LLC, Daughter is the manager and will make decisions as to management of the land. The LLC is set up to prevent ownership from being transferred outside of the family so Daughter will not have to deal with non-family members.

Using multiple entities can provide an effective farm succession plan. The multiple entity strategy can allow non-farm heirs to inherit farm assets without interfering with the farming operation. The strategy can also be carried through to future generations to keep the farm operating in the family for many years. It should be recognized that this plan constrains the off-farm heir's control over farm assets. Off-farm heirs expecting to cash out and receive a large sum of money from farm assets may be disappointed because they cannot do so.

Disadvantages of multiple entity plans

There are two primary disadvantages of a multiple entity plan. The first is the cost. Each entity has an initial establishment cost. These costs include registration with the Ohio Secretary of State and legal fees for drafting documents. Establishing a new entity can cost several thousand dollars.

The second disadvantage is the time and money required to operate the LLCs. Each LLC must keep its own accounting records and file a tax return. Lease payments between the entities must be monitored and paid at least once per year. When changing to multiple entities, farm vendors must be notified of the change in business structures. For example, the grain elevator must receive the new entity information with instructions to sell all grain in the name of the new operating entity. The additional management required to operate multiple entities is not overwhelming but it does take extra time, especially the first year or two of the new business structures.

Tax implications of multiple entity plans

Any changes to the business structure or addition of new entities will have tax implications. Before implementing changes to the farm business structure, the farm's tax advisor should be consulted for input. As everyone knows, taxation rules are complicated and have many nuances and exceptions. The legal analysis of a new business structure should be accompanied by a tax analysis, and the tax analysis should receive significant deference.

Seek legal counsel

Changes to the farm business structure or adding new entities should occur in consultation with legal counsel. Each farm family and each farming operation is unique, and a business plan should be designed specifically for an individual family farming operation. An attorney experienced in farm business matters can provide invaluable assistance in designing and implementing a plan appropriate for a specific family farming operation.

The *Structuring Your Farm Business* bulletin series is a project of the **OSU Agricultural & Resource Law Program**, Find other law bulletins in this series and all our resources on OSU's Farm Office website, a one-stop shop for agricultural law and farm management information.

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